# Alabama at the Crossroads: An Economic Guide to a Fiscally Sustainable Future

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## ABSTRACT

Alabama has been traveling down a fiscally unsustainable road. The burden of unchecked fiscal irresponsibility will ultimately fall on taxpayers, making Alabama an unattractive location for residency or business. This path has led Alabama to a crossroads, one where the choice is to continue down the same unsustainable path or to take the alternative road of fiscal and economic reform. Through reform, Alabama can set itself on the road to economic freedom and prosperity, thereby making the state an attractive location for entrepreneurship, investment, and job creation. This study analyzes the road Alabama has been traveling and the crossroads it has brought Alabama to today, nd offers reforms that would put the state on an alternative path toward prosperity-enhancing economic freedom and limited government. Those changes include budget, tax, public-sector pension, constitutional, and regulatory reforms.

*JEL* codes: D7, H7, R5

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Like many states throughout the nation, Alabama currently stands at a crossroads. The road Alabama has been traveling down has increasingly embraced a larger role for state government in relation to the private sector and in a fiscally unsustainable manner. Growing fiscal problems have been left for the next legislative session, the next election, or even the next generation to address. This paper argues that reforms can be made now to avert Alabama's looming financial crisis by curtailing growth in the size of government and by adopting reforms that help foster economic growth.

Taking the path of reform is not easy, even at a crossroads where the options are clear. Special interest groups and the tendency to maintain the status quo often make initiating reform difficult. Yet reform is necessary if Alabama residents are to pass along a fiscally sustainable and vibrant state to the next generation.

This study examines Alabama's history over the past few decades, detailing the road the state has been traveling down and the fiscal implications of continuing down the same path. To properly understand where this road has taken Alabama, it is necessary to see where the state stands today by comparing Alabama to both its regional state neighbors and the rest of the nation. We examine major issues facing Alabama that affect its fiscal sustainability and economic vibrancy, including state budget reform, public-sector pension reform, privatization, and regulatory reform. Our study offers reforms that could place Alabama on an alternative road of fiscal sustainability, limited government, and economic prosperity.

## THE STATE OF ALABAMA'S ECONOMY

How does Alabama compare to other states in economic prosperity? Alabama is 45th in *Business Insider*'s ranking of state economies.[1] The ranking incorporates several important metrics of economic growth and performance, including GDP growth, unemployment, average wages, and home and auto sales. Not only does Alabama rank poorly compared to the rest of the nation, it also ranks poorly in comparison to its regional neighbors, as shown in table 1. Breaking down some of the components included in the index, Alabama generally falls behind its neighbors with regard to GDP growth and per capita personal income. For example, Alabama's per capita personal income is $2,800 below the average of the rest of the states in our regional comparison.

**TABLE 1. REGIONAL COMPARISON OF ECONOMIC PROSPERITY**

| | Alabama | Florida | Georgia | Mississippi | Tennessee | Texas | Louisiana |
|---|---|---|---|---|---|---|---|
| *Business Insider* state economy rankings[a] | 45th | 6th | 12th | 38th | 18th | 3rd | 29th |
| Change in real GDP by state, 2014[b] | 0.7% | 2.7% | 2.3% | −1.2% | 1.7% | 5.2% | 1.9% |
| State unemployment, October 2015[c] | 5.9% | 5.1% | 5.7% | 5.9% | 5.6% | 4.4% | 6.2% |
| State per capita personal income/state ranking, 2014[d] | $37,512/ 44th | $42,737/ 28th | $38,980/ 40th | $34,431/ 50th | $40,457/ 36th | $45,996/ 22nd | $42,030/ 30th |
| *Forbes* "Best States for Business"[e] | 45th | 20th | 11th | 49th | 20th | 6th | 40th |

Sources: (a) Andy Kiersz and Elena Holodny, "Here's How All 50 State Economies Are Doing, Ranked from Slowest to Fastest," *Business Insider*, August 4, 2014, http://www.businessinsider.com/state-economic-growth-rankings-2014-8; (b) Bureau of Economic Analysis, "Broad Growth across States in 2014," June 10, 2015, http://www.bea.gov/news releases/regional/gdp_state/gsp_newsrelease.htm; (c) Bureau of Labor Statistics, "Local Area Unemployment Statistics: Unemployment Rates for States," January 26, 2016, http://www.bls.gov/web/laus/laumstrk.htm; (d) Bureau of Economic Analysis, "State BEARFACTS," September 30, 2015, http://bea.gov/regional/bearfacts/statebf.cfm; (e) "Best States for Business: 2015 Ranking," *Forbes*, accessed February 24, 2016, http://www.forbes.com/best-states-for-business/list/.

Economic performance metrics like those are important for two primary reasons. First, businesses and residents may look to these metrics in deciding where to locate because they want to be in areas where the economy is thriving, not stagnating or declining. Given Alabama's comparative economic performance, it is not surprising that the state is ranked 45th by *Forbes*, with only

1. Andy Kiersz and Elena Holodny, "Here's How All 50 State Economies Are Doing, Ranked from Slowest to Fastest," *Business Insider*, August 4, 2014, http://read.bi/1lswzyZ.

Mississippi ranking lower in our regional comparison.[2] With Georgia ranked 11th and Tennessee 20th, it is not hard to see why businesses often prefer to locate elsewhere.

The second reason economic performance measures are important is that subpar economic performance in comparison to other states can indicate one or more serious underlying problems. One major factor that influences national and state economic growth and prosperity, along with GDP growth and per capita income, is economic freedom. To that end, a Fraser Institute report ranks states according to economic freedom, measuring such factors as the size of state government, taxation, and regulation.[3] The 2014 study finds that states with the most economic freedom have per capita GDP that is 14 percent higher than the least free states, which amounts to an astonishing $6,800 in additional income per person. According to a separate study, a one-unit increase in economic freedom can boost employment growth in a state by up to 4 percent.[4] For Alabama, a 4 percent increase in employment growth would amount to approximately 80,000 new jobs per year.[5] In addition to leading to economic prosperity, economic freedom shows a strong association with overall life satisfaction, another factor that business owners and residents examine when deciding where to locate.[6]

Predictably from its economic performance, Alabama does not rank highly in economic freedom, especially in comparison to its neighbors. Overall, Alabama ranks 27th in economic freedom in the United States. While Mississippi fares worse in economic freedom, Alabama's other regional neighbors enjoy substantially more economic freedom, putting them in a better position for economic, job, and wage growth (see table 2). The Mercatus Center at George Mason University's *Freedom in the 50 States* index ranks Alabama higher, at 18th, for economic and personal freedom.[7] For fiscal health, Alabama ranks fairly well on a relative basis compared to surrounding states. However, nearly all states,

2. "Best States for Business: 2015 Ranking," *Forbes*, accessed February 24, 2016, http://www.forbes.com/best-states-for-business/list/.
3. Dean Stansel, José Torra, and Fred McMahon, "Economic Freedom of North America 2014" (Fraser Institute, Vancouver, British Columbia, 2014).
4. Thomas A. Garrett and Russell M. Rhine, "Economic Freedom and Employment Growth in U.S. States," *Federal Reserve Bank of St. Louis Review* 93, no. 1 (2011): 1–18.
5. Daniel J. Smith, "Economic Freedom Key to State's Growth," *Montgomery Advertiser*, December 31, 2014, http://on.mgmadv.com/1B62dgd.
6. Hans Pitlik, Dulce M. Redin, and Martin Rode, "Economic Freedom, Individual Perceptions of Life Control, and Life Satisfaction" (Economic Freedom of the World Early Release, Fraser Institute, Vancouver, British Columbia, 2015).
7. William P. Ruger and Jason Sorens, *Freedom in the 50 States: An Index of Personal and Economic Freedom* (Arlington, VA: Mercatus Center at George Mason University, 2014).

including Alabama, face disconcerting long-term fiscal uncertainties and shortfalls.[8] Importantly, Alabama is currently in a position to undertake the necessary reforms before underlying problems worsen.

**TABLE 2. REGIONAL COMPARISON OF ALABAMA BY ECONOMIC FREEDOM AND SIZE OF GOVERNMENT**

| | Alabama | Florida | Georgia | Mississippi | Tennessee | Texas | Louisiana |
|---|---|---|---|---|---|---|---|
| Economic freedom ranking, 2014[a] | 27th | 21st | 10th | 48th | 9th | 1st | 5th |
| "Freedom in the 50 States" ranking, 2013[b] | 18th | 23rd | 9th | 41st | 3rd | 14th | 37th |
| Fiscal health ranking, 2015[c] | 13th | 5th | 26th | 33rd | 8th | 19th | 35th |
| Overspending since 1999[d] | 21% | 27% | 16% | 31% | 20% | 20% | 23% |
| State and local debt per capita, 2015[e] | $6,127 | $7,651 | $5,656 | $4,891 | $5,764 | $10,473 | $7,834 |
| Government employees per 100 private-sector workers, 2012[f] | 20.3 | 14.3 | 17.2 | 25.1 | 16 | 16.9 | 19.6 |
| Public employee compensation premium, 2014[g] | 11% to 20% | 6% to 10% | −5% to 5% | −5% to 5% | −5% to 5% | 6% to 10% | 11% to 20% |

Sources: (a) Dean Stansel, José Torra, and Fred McMahon, "Economic Freedom of North America 2014" (Fraser Institute, Vancouver, British Columbia, 2014); (b) William P. Ruger and Jason Sorens, *Freedom in the 50 States: An Index of Personal and Economic Freedom* (Arlington, VA: Mercatus Center at George Mason University, 2014); (c) Eileen Norcross, "Ranking the States by Fiscal Condition" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2015); (d) Patrick Gleason and Nathaniel Rome, "Runaway Spending: A Bipartisan Problem," Americans for Tax Reform blog, June 26, 2015, https://www.atr.org/runaway-spending-bipartisan-problem; (e) Jared Walczazk and Liz Malm, "Where Does Your State Stand on State and Local Debt Per Capita?," *Tax Policy Blog* (Tax Foundation), September 10, 2015, http://taxfoundation.org/blog/where-does-your-state-stand-state-local-debt-capita; (f) John R. Hill, "The Hidden Costs of Alabama's State and Local Workforce" (White Paper, Alabama Policy Institute, Birmingham, June 2014); (g) Andrew G. Biggs and Jason Richwine, "Overpaid or Underpaid? A State-by-State Ranking of Public-Employee Compensation" (Economic Policy Working Paper 2014-04, American Enterprise Institute for Public Policy Research, April 2014).

One problem Alabama faces is coming to terms with the growth in state spending that has occurred over time, although Alabama does not stand alone in this regard. An Americans for Tax Reform study found that government spending, even after adjustments for population growth and inflation, has increased drastically since 1999 in Alabama (by 21 percent) and among its

8. Eileen Norcross, "Ranking the States by Fiscal Condition" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2015).

regional neighbors.[9] While Alabama's state and local debt per capita of $6,127 puts it in the middle of our regional comparison, Georgia, Mississippi, and Tennessee have significantly less debt per resident.

Another factor in Alabama's low economic freedom ranking is its high levels of both public-sector employment and public-sector employee compensation. Alabama is one of only two states facing both problems, increasing both the size and the cost of state government for taxpayers.[10] For instance, Alabama has 20 government employees for every 100 private-sector workers.[11] Only nine other states have a higher ratio of government employees per private-sector worker, so most states are providing government services with substantially fewer employees. Mississippi is the only nearby state with more public employees per private-sector worker (table 2).

In addition, an American Enterprise Institute study found that Alabama's state employees are paid 11 percent to 20 percent more than their private-sector counterparts.[12] Compared with other states, this places Alabama in the "large premium" category, with only California, Illinois, and New York paying state employees more than a 20 percent premium. Neighboring states Florida, Georgia, Mississippi, Tennessee, and Texas all have public-sector compensation more in line with their private-sector counterparts (table 2). Both the size of public employment and the high level of public-sector employee compensation in Alabama are drags on the private-sector economy, undermining economic freedom.

"Both the size of public employment and the high level of public-sector employee compensation in Alabama are drags on the private-sector economy, undermining economic freedom."

9. Patrick Gleason and Nathaniel Rome, "Runaway Spending: A Bipartisan Problem," Americans for Tax Reform blog, June 26, 2015, https://www.atr.org/runaway-spending-bipartisan-problem.
10. Daniel J. Smith, "High Public Employment Hurts State's Economy," *Montgomery Advertiser*, September 10, 2014, http://on.mgmadv.com/1rXmLFs.
11. Cameron Smith, "How 'Bare-Bones' Is Alabama's State and Local Government Workforce?," *AL.com*, June 25, 2014, http://s.al.com/Mi0gUiV.
12. Andrew G. Biggs and Jason Richwine, "Overpaid or Underpaid? A State-by-State Ranking of Public Employee Compensation" (Working Paper 2014-04, American Enterprise Institute, April 2014).

In the remainder of our study, we examine policy areas that are contributing to overspending and the increased size of government in Alabama, as well as other policy factors that reduce economic freedom and thus economic performance in the state.

## ALABAMA'S STATE BUDGET

Like many states, Alabama is constitutionally obligated to pass a balanced budget annually. Importantly, this constraint is relatively binding, stipulating that where deficiencies in the budget emerge, the state must make cuts to spending to rebalance the budget. Also of significance is that Alabama is one of only three states that maintains more than one budget, with the two largest being the General Fund (GF) and the Education Trust Fund (ETF). This split emerged in 1927 and continues today.[13]

As it stands, these separate budgets have caused contentions at times and are one of the reasons for Alabama's current fiscal problems, including a short-term $200 million budget shortfall that emerged entering the 2015 legislative session and an even larger projected long-term budget shortfall.[14] The short-term budget shortfall led to a serious political impasse, in which Governor Robert Bentley and many legislators argued that the only way to solve the budget gap was through tax increases. However, many state legislators forcefully opposed tax increases, resulting in two special legislative sessions meant to reach a compromise. Although these sessions did result in the budget gap being filled, this was accomplished through temporary measures including transferring revenue from the ETF, increasing the cigarette tax, and making some cuts to public agency budgets.

Several characteristics of Alabama's budgeting process helped frame these episodes. First, while the GF faced the above-mentioned shortfall, the ETF had a surplus of some $200 million to $300 million. For most states that maintain a consolidated budget, a surplus in one area would offset any shortfall in another, effectively balancing the budget. However, given the strict rules governing Alabama's various and distinct budgets, the ETF surplus could not easily be transferred to the GF. Table 3 provides a breakdown of fiscal year (FY) 2014 expenditures for the GF and ETF by major component.

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13. Alabama Policy Institute, "State Budget Consolidation," Guide to the Issues, accessed August 29, 2015, http://www.alabamapolicy.org/wp-content/uploads/GTI-State-Budget-Consolidation.pdf.
14. Charles J. Dean, "Gov. Bentley on a Deeper Budget Hole: We Don't Have Enough Money to Cover What We Owe," *AL.com*, November 19, 2014, http://s.al.com/W7OtNYT.

TABLE 3. TOTAL APPROPRIATIONS OF ALABAMA'S GENERAL FUND AND EDUCATION TRUST FUND BY MAJOR CATEGORY, FY 2014

| | Unearmarked appropriations | Earmarked appropriations |
|---|---|---|
| Alabama's general fund | | |
| Legislative | $38,523,387 | $2,445,331 |
| Judicial | $114,080,800 | $88,791,233 |
| Executive | $1,786,444,631 | $12,374,527,434 |
| Other appropriations | $90,207,989 | $29,146,348 |
| Transfers | $25,214,455 | 0 |
| Nonstate agencies | $196,978 | 0 |
| Total appropriations | $1,811,856,064 | $12,494,910,346 |
| Alabama's education trust fund | | |
| State agencies and institutions | $4,649,628,557 | $3,112,179,447 |
| Colleges, universities, and schools | $1,070,993,538 | $5,333,913,858 |
| Separate appropriations acts | $9,975,500 | 0 |
| Conditional appropriations released | $36,000,000 | 0 |
| Total appropriations | $6,067,116,151 | $8,446,093,305 |

Sources: Alabama Department of Finance, Executive Budget Office, "State of Alabama General Fund Fiscal Year 2014 Appropriations," accessed December 13, 2015, available at http://budget.alabama.gov/pages/appropgf.aspx; Alabama Department of Finance, Executive Budget Office, "State of Alabama Education Trust Fund Appropriations as of September 30, 2014," accessed December 13, 2015, available at http://budget.alabama.gov/pages/appropetf.aspx.

Alabama's executive branch receives the largest appropriations of both earmarked and unearmarked funds, while the ETF's largest expenditures are for state agencies and institutions (largely K–12 education) and postsecondary education. Additionally, as shown in table 3, each fund has specifically earmarked revenue sources. Some funds even have revenues earmarked for particular items in their budgets. Therefore, it is important to analyze the specific components of each budget, how the makeup and funding of these components have changed over time, the impact these changes have had on the long-term fiscal health of the state, and what can be done to solve budgeting problems in the long run.

The state's GF is responsible for covering ordinary expenses of the three branches of state government and other governmental functions, debt service on some specific general obligation bond issues, and capital outlays. Various public programs are funded through the GF, with the largest outlays being for Medicaid and criminal justice and corrections.[15] More than 40 different taxes fund GF expenditures. The largest sources include the insurance company

15. Alabama Department of Finance, Executive Budget Office, "State General Fund—Brief Description," accessed August 29, 2015, budget.alabama.gov/pages/gfdesc.aspx.

“Although the Alabama state government suffers from a lack of transparency in general, it is especially problematic and concerning with respect to the state budget.”

premium tax, the oil and gas lease and production tax, the cigarette tax, and the ad valorem tax, as well as taxes collected by the state’s Alcoholic Beverage Control Board.[16]

The ETF is the largest operating fund in the state of Alabama. Its outlays cover maintenance and development of public education in Alabama and debt service on capital outlays. Particular programs that are supported by the ETF include K–12 education, public libraries, scholarship programs, various regulatory agencies related to education, and two- and four-year colleges and universities.[17] Importantly, funding for the ETF is drawn from 10 separate revenue sources, the largest being individual and corporate income taxes, sales taxes, utility taxes, and use taxes.

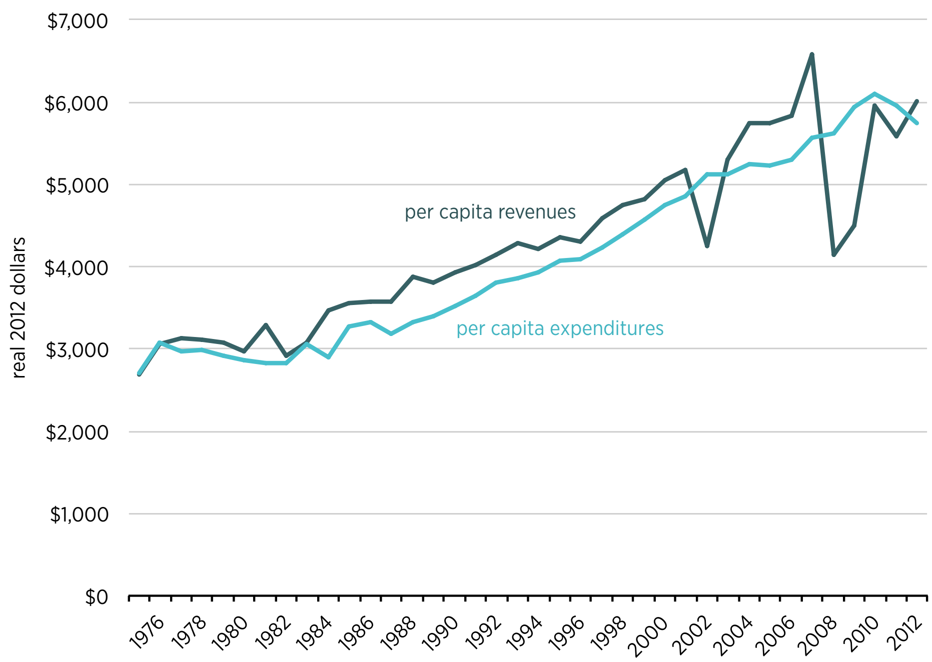
The ETF receives roughly 52 percent of state appropriations (i.e., money set aside for a specific purpose), whereas the GF receives roughly 16 percent. Again, the bulk of the appropriations made in the GF are Medicaid obligations and corrections spending, consuming 35 percent and 22 percent, respectively, of total GF appropriations. Overwhelmingly, the GF budget shortfall can be attributed to disproportionate spending in these two areas; thus, those two areas of expenditures should be reformed to rein in spending and minimize shortfalls in the future.

Although a comprehensive overview of Alabama’s fiscal position would be desirable, such an overview would be extremely difficult, if not impossible, to undertake. Although the Alabama state government suffers from a lack of transparency in general, it is especially problematic and concerning with respect to the state budget. Still, it is possible to evaluate some trends in Alabama’s budget and fiscal position, although admittedly in a less than systematic way.

Figures 1 and 2 show the general trend in Alabama’s revenue and expenditure structures for the state government and local governments, respectively, from 1975 to 2012. There has been a clear upward trend in both revenues

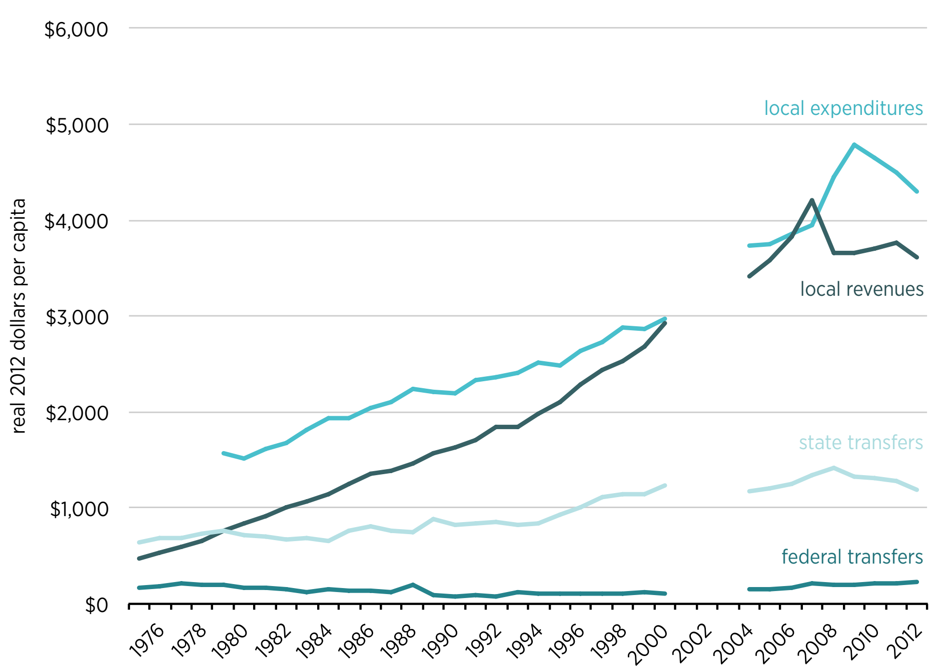
16. Ibid.
17. Ibid.

FIGURE 1. ALABAMA'S PER CAPITA STATE REVENUES AND EXPENDITURES, 1975–2012




Source: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/.

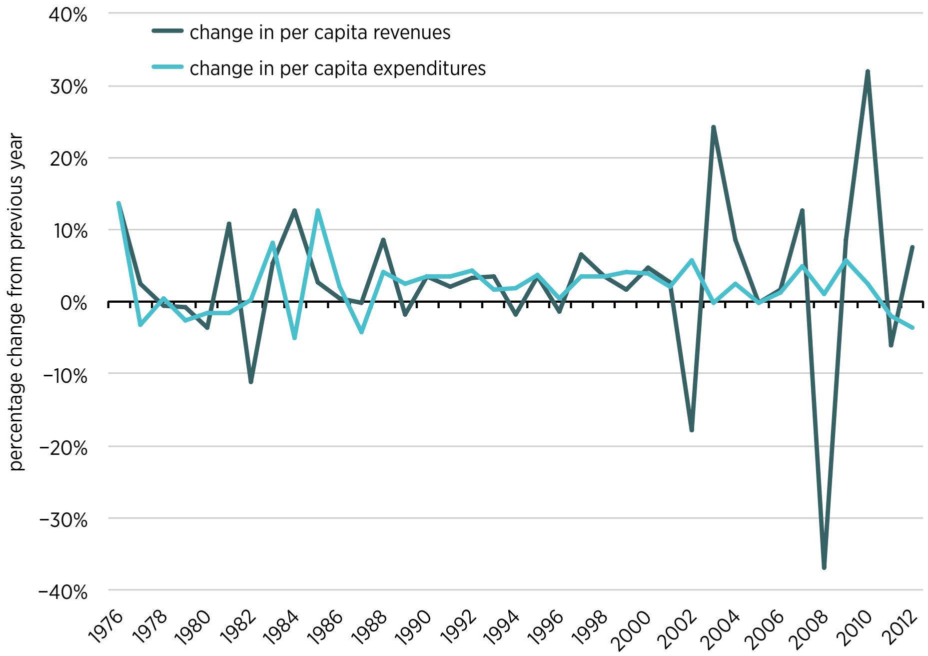
FIGURE 2. ALABAMA'S PER CAPITA LOCAL REVENUES, EXPENDITURES, AND INTERGOVERNMENTAL TRANSFERS, 1975–2012




Note: Data for 1976–2000, 2004–2012.

Source: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/.

FIGURE 3. PERCENTAGE CHANGE IN ALABAMA'S PER CAPITA REVENUES AND EXPENDITURES, 1976–2012




Source: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/.

and expenditures. Importantly, per capita revenues have become much more volatile than expenditures, especially beginning shortly after 2000—largely revolving around business cycle fluctuations.

Figure 3 provides a snapshot over the same range for the percentage change in both revenues and expenditures for the state. This snapshot more clearly reveals that, while revenues have seen significant swings around the business cycle, per capita state expenditures have almost never declined, even during economic downturns. Even Alabama, a relatively fiscally conservative state, has experienced a steady growth in public expenditures. What is driving this growth? Given the lack of transparency, it is difficult to analyze the complete picture, but we can evaluate some major components of the state's budget that drive these overall trends.

As noted, unlike the vast majority of states, Alabama does not have a consolidated budget, but rather one that is split. Each receives its revenues from a number of separate sources, with most revenues earmarked for specific purposes. In fact, nearly 85 percent of all revenue in Alabama is earmarked for a particular purpose, which is by far the largest percentage of earmarking of any state.[18] Alabama's figure of 85 percent contrasts with a state average of 24 percent nationwide.[19]

Alabama's high percentage of earmarked revenues certainly contributes to budget shortfalls in the state when they emerge, as they did during the 2015 legislative session—shortfalls that could be avoided with budget reform. However, it is important to understand that such budget changes would provide only short-term, temporary relief. Truly meaningful and sustainable solutions to Alabama's long-term budget problems will require more comprehensive spending reforms. Such reforms would include a general downsizing of the state government, an overhaul of how the state applies Medicaid funding, a reduction in the cost of incarceration, and meaningful and long-lasting changes to K–12 education delivery and funding.

In the near future, the state could help alleviate its short-term fiscal problems by consolidating its budgets into one general budget and by reducing its reliance on earmarked tax revenues for specific projects. The typical justification for earmarks is that particular revenue sources are dedicated to funding particular expenditures, generally meant to best approximate a use tax. For example, earmarking gasoline taxes for road construction and maintenance would, presumably, tax the people who directly use roads.

However, revenue sources are not always matched to associated earmarked expenditures. Theoretically, there should be no actual effect on the overall size and scope of state expenditures, regardless of whether funds are actually earmarked for a specific purpose.[20] Thus, even if these earmarks did operate effectively as use taxes in general, the theory indicates that earmarked revenues are no better than undedicated revenues at reducing spending. The fungibility of revenues suggests that simply spending a dedicated dollar on a particular project will only free up what would have been a dollar from the general budget to be used instead for other purposes. The overall effect may be to make the size of government grow, even if faced with potential voter backlash. This effect is especially true if voters are typically averse to broad-based tax increases, which an earmarked tax (e.g., state lottery, cigarette tax) can avoid.

To better understand this process, consider the following example. If $1,000 of GF revenue goes toward highway construction, the state government could impose a $500 gasoline tax and dedicate the revenues to highway

18. George R. Crowley and Adam J. Hoffer, "The Effects of Dedicating Tax Revenues" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, June 14, 2012).
19. Ibid.
20. James M. Buchanan, "The Economics of Earmarked Taxes," *Journal of Political Economy* 71, no. 5 (1963): 457–69.

spending. Here it would seem that highway spending should increase to $1,500. However, these revenues can also be used as substitutes, meaning $500 of GF revenues could be freed for another purpose, thus leaving no change in highway funding but ultimately increasing total public expenditures.

Empirical estimates of the extent to which dedicated revenues actually lead to an increase in the overall size of government suggest that for each additional dollar raised as earmarked revenue, there is no discernible increase (and many times an actual decrease) in dedicated expenditures on a particular program, and total GF expenditures rise. Thus, dedicated earmarks tend to be ineffective at increasing the expenditures of their targeted programs but do generally increase expenditures on other programs.[21] The most likely explanation for this result is that government officials use earmarks primarily to mask both government growth and tax increases.

Such a scenario is likely occurring in Alabama, as earmarked revenues are derived from taxes that impact only a minority of the population (e.g., cigarette taxes), meaning that it is relatively easier to enact tax increases on certain activities. Rather than constrain government spending, the overall effect of earmarked revenues is to actually increase government expenditures. This would appear to be the case in Alabama, where dedicated revenues in the ETF increased by more than 52 percent between 1997 and 2014 (from an inflation-adjusted $4 billion in 1997 to $8.5 billion in 2014) and by an astounding 807 percent in the GF between 1997 and 2014 (inflation-adjusted $1.4 billion in 1997 to $12.5 billion in 2014).

A consolidated budget for Alabama could also solve several problems caused by earmarked revenues comprising such a large share of the overall budget. As noted, while a roughly $200 million shortfall existed in the GF in the 2015 legislative session, there was simultaneously a $200 million surplus in the state's ETF. A consolidated budget would have immediately closed this gap. Additionally, Alabama's GF faces a chronic problem due to the nature of the taxes that go toward financing that budget. Most of the GF's revenue sources have not increased over time relative to the ETF's primary revenue sources (personal income tax and general sales tax). A combined budget would make it possible to pool revenues to close potential gaps, avoid legislative gridlock, and better meet unexpected fiscal needs on a year-to-year basis.

It is important to note, however, that neither ending dedicated revenues nor consolidating the separate budgets would solve Alabama's long-term fiscal problems. Serious structural changes are needed to do so. As indicated in figure 1, the state's expenditures have grown significantly over the past several decades.

21. Crowley and Hoffer, "Effects of Dedicating Tax Revenues," 30.

Figures 4 and 5 provide a breakdown of the state's major expenditure areas for both the ETF and the GF between 1997 and 2014 to more closely assess how resources have been spent and what has changed over time.

The two most significant ETF expenditures have been K–12 education and higher education. These two expenditure areas have accounted for roughly 80 percent of all ETF expenditures over time, with expenditures for higher education accounting for the largest portion of the budget. (Later, we provide a detailed discussion of reforming education in Alabama.) Figures 6 and 7 provide the breakdown of Alabama's GF budget for the same years.

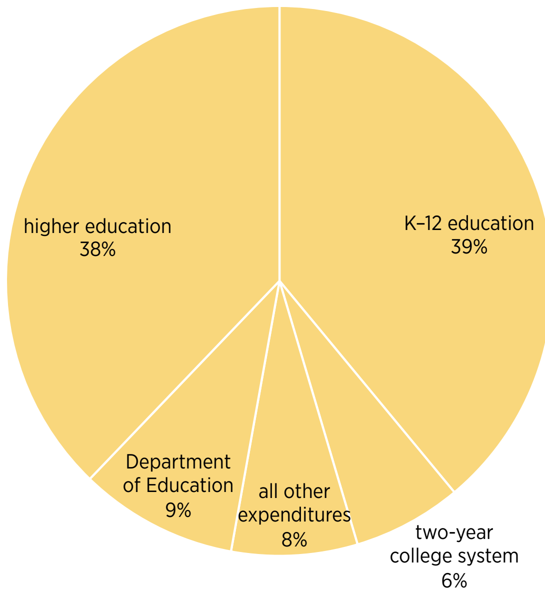
By far the largest expenditure from the state's GF is for Medicaid, which has grown from roughly 37 percent of total GF expenditures in 1997 to roughly 42 percent in 2014. That translates into an 82 percent increase in GF expenditures between 1997 and 2014 (from approximately $3.3 billion in 1997 to approximately $6.0 billion in 2014). Without reform, Medicaid expenditures will continue to burden the state's budget and fiscal health. Further, total state funding for Medicaid from all sources, not including intergovernmental transfers, is roughly $1.89 billion, versus the generally reported sum of $600 million directly from the GF. This point is underappreciated, but it should reinforce the need for reform.

One innovative way that these expenditures could be reined in, and thus help the state return to long-term fiscal sustainability, would be through the adoption of federal block grants. Currently, the federal government reimburses roughly 60 percent of a state's Medicaid costs, which provides incentives to spend while discouraging cost-saving measures. A federal program of block grants to the states would instead give Alabama a fixed sum of money annually for its Medicaid expenditures.

Consider the Temporary Assistance for Needy Families program, which began in 1997 and replaced the Aid to Families with Dependent Children program. This federal program provides block grants to states to provide cash assistance to indigent families with dependent children,

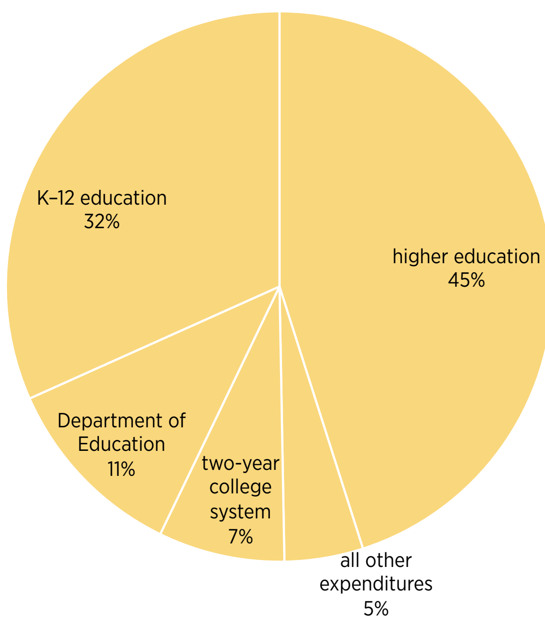
"Neither ending dedicated revenues nor consolidating the separate budgets would solve Alabama's long-term fiscal problems. Serious structural changes are needed to do so."

FIGURE 4. ALABAMA'S TOP FIVE EDUCATION TRUST FUND EXPENDITURES, 1997



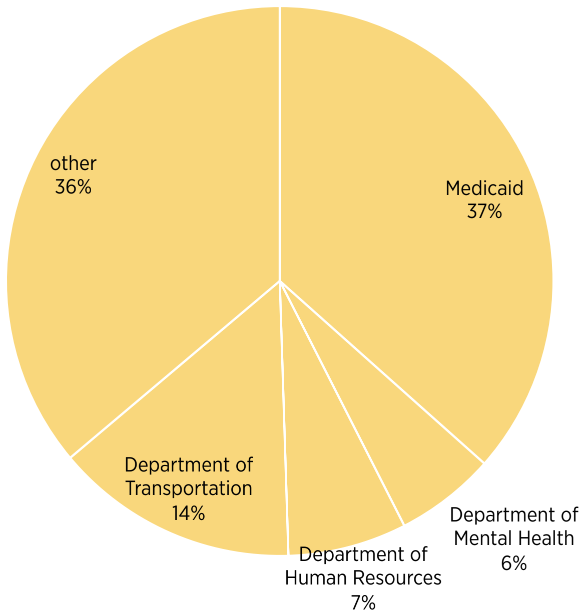

Source: Alabama Department of Finance, Executive Budget Office, "State of Alabama Education Trust Fund Fiscal Year 1996–1997 Appropriations," accessed December 13, 2015, available at http://budget.alabama.gov/pages/appropetf.aspx.

FIGURE 5. ALABAMA'S TOP FIVE EDUCATION TRUST FUND EXPENDITURES, 2014



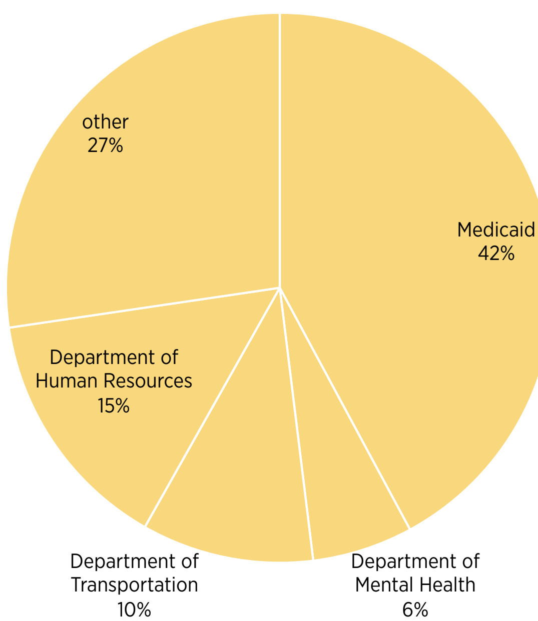

Source: Alabama Department of Finance, Executive Budget Office, "State of Alabama Education Trust Fund Fiscal Year 2014 Appropriations as of September 30, 2014," accessed December 13, 2015, available at http://budget.alabama.gov/pages/appropetf.aspx.

FIGURE 6. ALABAMA'S TOP FIVE GENERAL FUND EXPENDITURES, 1997




Source: Alabama Department of Finance, Executive Budget Office, "State of Alabama General Fund Fiscal Year 1996–1997 Appropriations," accessed August 29, 2015, available at http://budget.alabama.gov/pages/appropgf.aspx.

FIGURE 7. ALABAMA'S TOP FIVE GENERAL FUND EXPENDITURES, 2014




Source: Alabama Department of Finance, Executive Budget Office, "State of Alabama General Fund Fiscal Year 2014 Appropriations as of September 30, 2014," accessed August 29, 2015, available at http://budget.alabama.gov/pages/appropgf.aspx.

with limited federal oversight. States receive block grants by meeting a set of federal goals, with funding levels frozen at 1996 levels.

A similar program of block grants to the states could be established to help fund Medicaid, with a set of broad goals meant to promote healthy outcomes (compared to the current system, which simply promotes spending). Importantly, federal funding could be based on a state's actual poverty rate, which should promote better administration and oversight of the state's program.[22]

Block grants for Medicaid have been tried in Indiana and Rhode Island. Rhode Island saved roughly $55 million between 2009 and 2012, in addition to realizing greater flexibility for Medicaid recipients and the medical profession alike.[23] Block grants would provide an important incentive for Alabama to control its increasing Medicaid costs, thereby helping to reduce spending on the largest single item in the state's budget. The issue of Medicaid is also tied to the total amount of federal money that Alabama receives, which has seen a sizable increase since the early 1990s. These intergovernmental grants are equal to roughly 30 percent of total state expenditures (see figure 8).

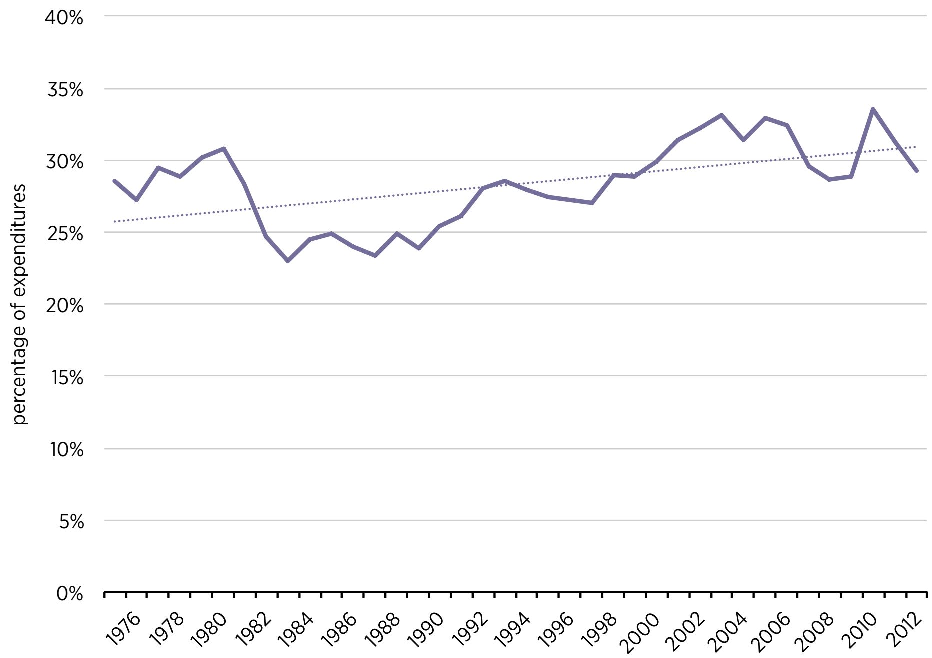
Although this ratio of federal transfers to state expenditures has remained relatively constant over the past 40 years, with such a sizable percentage of the state's budget effectively being paid through federal aid, Alabama has had additional opportunities to increase the public benefits it provides to citizens without simultaneously requiring those same citizens to pay for them. This ultimately masks the true size of the state government. It also makes it relatively more difficult for the state to meet its obligations if and when these resources are no longer available. The problem can be especially acute during periods of recession, when federal aid can be more difficult to come by. Therefore, it would be beneficial for Alabama to transition away from such a large dependence on federal aid and thereby to truly account for the actual size of the state's government.

An important bright spot is Alabama's relatively low debt burden, as shown in figure 9. There has been a significant decline in the state's debt-to-GDP ratio over time. This is a very important trend that Alabama should continue to follow. A relatively low debt burden provides the state with more room to meet unforeseen needs through debt financing without significantly hindering economic growth in the process.

This trend can generally be attributed to a relatively strict debt limit imposed by the state's constitution, which prohibits Alabama from issuing any

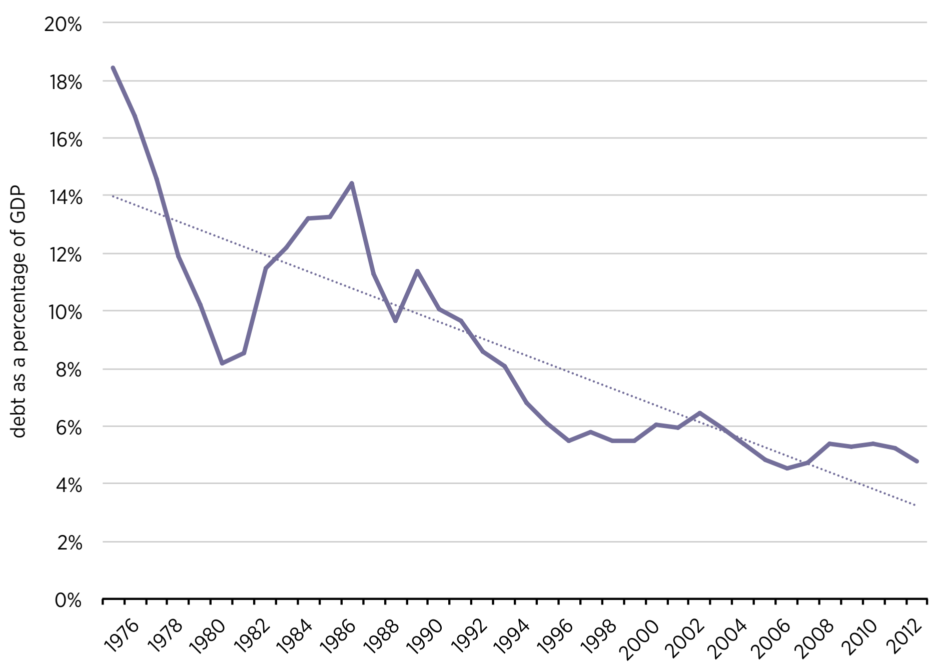
22. For an overview of these issues, see Paul Howard, "How Block Grants Can Make Medicaid Work" (Issue 2012 No. 24, Manhattan Institute for Policy Research, September 2012).
23. Scott Beaulier, "Medicaid in Alabama: Innovative Reforms for the Future" (Alabama Policy Institute, Birmingham, AL, 2012).

FIGURE 8. INTERGOVERNMENTAL GRANTS AS A PERCENTAGE OF STATE EXPENDITURES, 1975–2012




Source: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/.

FIGURE 9. ALABAMA'S DEBT-TO-GDP RATIO, 1975–2012




Source: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/.

debt, except by amendment to its constitution. Such a constraint forces each debt issue to be presented as a ballot measure to the state's voters, who then have an opportunity to veto any proposed issue. The state's supreme court has largely upheld these restrictions, allowing only very short-term debt (to meet operating expenses in the same fiscal year) to be issued without voter approval. This restriction, along with a number of other constitutional restrictions to be discussed later, should remain and should be reinforced.

The remainder of this study is dedicated to finding additional solutions, both short term and long term, aimed at returning Alabama to fiscal sustainability and toward a path to prosperity.

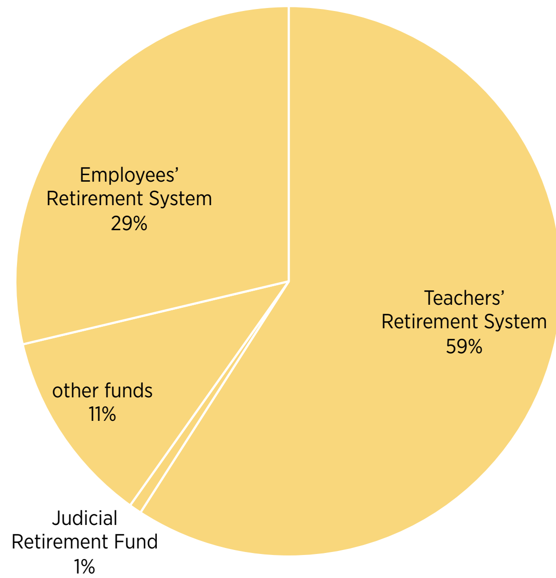
## THE RETIREMENT SYSTEMS OF ALABAMA

The Retirement Systems of Alabama (RSA) is a public-sector pension system that provides a defined benefit retirement plan to state and local employees. The RSA operates three main retirement plans: the Teachers' Retirement System (TRS), the Employees' Retirement System (ERS), and the Judicial Retirement Fund (JRF). While the TRS and ERS make up the majority of assets in the RSA (see figure 10), the RSA also oversees a variety of smaller state and local funds (see table 4).

Established in 1939, the TRS is a cost-sharing multiple-employer retirement plan that provides benefits to employees of public educational institutions, including K–12, two-year community colleges, four-year universities, and state education agencies. The ERS, which provides benefits to state police and employees and to any city, county, town, or quasi-public organization that opts in, was established in 1945 as a multiemployer public employee retirement plan. The JRF, which was established in 1973, is a cost-sharing multiemployer plan for qualified judicial positions. As of September 30, 2014, the TRS had more than 128,000 active and 83,900 retired members, the ERS had more than 80,000 active and 43,000 retired members, and the JRF had more than 330 active and 370 retired members. At the same time, there were 13 universities, 27 postsecondary institutions, 138 K–12 school systems, and 31 state and miscellaneous agencies participating in the TRS; 292 cities, 65 counties, 1 state agency, and 513 other public entities participating in the ERS; and 67 counties and 1 state agency participating in the JRF.[24]

24. Data are from Retirement Systems of Alabama, *Component Units of the State of Alabama Comprehensive Annual Financial Report for the Fiscal Year Ended September 30, 2014*, 23. In the RSA's *2014 Annual Report*, slightly different figures are given: for the TRS, 14 universities, 27 postsecondary institutions, 138 K–12 school systems, and 30 state and miscellaneous agencies; for the ERS, 128 state agencies, 65 counties, 292 cities, and 499 other public entities. Retirement Systems of Alabama, *2014 Annual Report*.

FIGURE 10. THE TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND AS PERCENTAGES OF THE ASSETS MANAGED BY THE RETIREMENT SYSTEMS OF ALABAMA




Source: Retirement Systems of Alabama, *2014 Annual Report*.

TABLE 4. FUNDS UNDER THE MANAGEMENT OF THE RETIREMENT SYSTEMS OF ALABAMA

| Fund | Total Funds Managed in 2014 ($, thousands) |
|---|---|
| Teachers' Retirement System | 22,285,470 |
| Employees' Retirement System | 10,809,605 |
| PEIRAF—Deferred Compensation Plan (RSA-1) | 1,782,728 |
| Alabama Retired Education Employees' Health Care Trust | 1,184,901 |
| Judicial Retirement Fund | 275,700 |
| Alabama Trust Fund | 269,150 |
| Alabama Treasury Fund | 250,163 |
| Alabama State Employees' Retired Health Care Trust Fund | 156,192 |
| County Municipal Trust Fund | 132,837 |
| Public Education Employees' Health Insurance Fund | 126,444 |
| Local Government Health Insurance Fund | 121,816 |
| Public Education Employees' Retirement Account Fund | 84,412 |
| Alabama State Employees' Health Insurance Fund | 75,406 |
| Alabama Underground & Aboveground Storage Tank Trust Fund | 33,291 |
| Alabama Senior Services Trust Fund | 33,001 |
| Division of Wildlife and Freshwater Fisheries | 20,451 |
| State Docks Pension Plans | 16,218 |
| Alabama Cultural Resources Preservation Trust Fund | 12,225 |
| Clerks' & Registers' Supernumerary Fund | 11,599 |
| Charlotte Thorn Trust Fund | 9,026 |
| Alabama Marine Resources Endowment Trust Fund | 1,412 |
| Alabama Firefighters Annuity & Benefit Fund | 65 |

Note: PEIRAF = Public Employees Individual Retirement Account Fund.

Source: Retirement Systems of Alabama, *2014 Annual Report*.

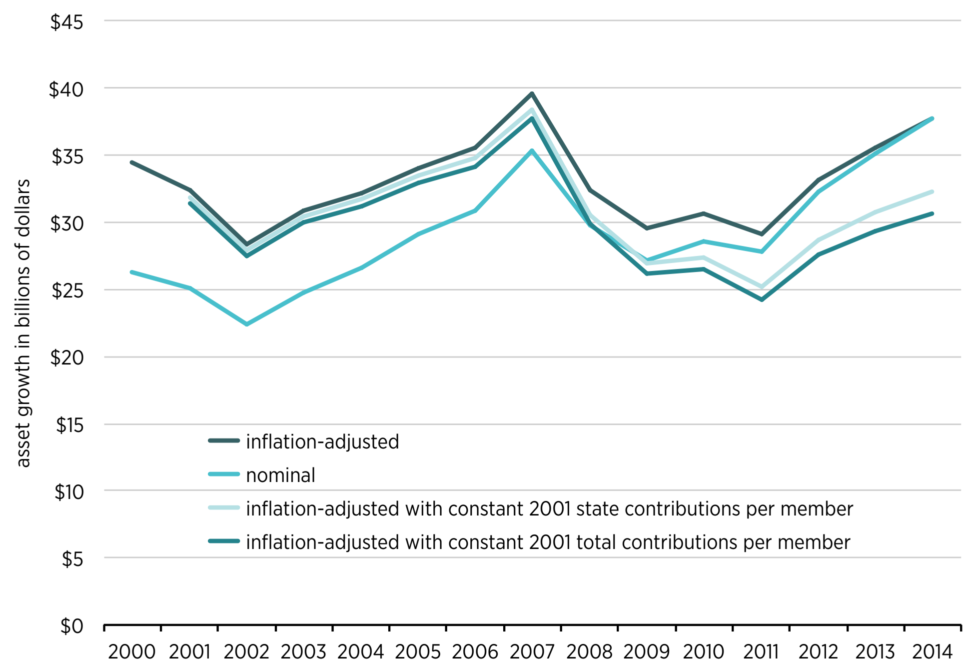
Given the fact that most economists believe that without pension reform states face austerity budgets, federal bailouts, default, or a mix of these options, it would be prudent for employees, retirees, legislators, and taxpayers to carefully monitor the funding health of the RSA system.[25] Although some states (e.g., Michigan, North Carolina, and Utah) have taken proactive steps to address underfunding problems with their pension plans, many states around the nation continue to face severe funding gaps.[26] To fully assess the funding health of the RSA, it is essential to get a comprehensive picture of how it is structured and where it stands today.

At the end of FY 2014 (September 30), total reported assets under management in all funds reported in the RSA (table 4) came to $37.69 billion, which represents an increase in total assets under management of 43.15 percent since 2000. After adjusting for inflation, however, this represents growth in total assets under management of only 9.44 percent since 2000 (see figure 11).[27] Thus, examining asset growth since 2000 without adjusting for inflation overstates the increase in total assets under management by more than 450 percent. Even this figure includes the growth in employee and employer contributions, in addition to the growth in total assets under management due to the accumulation of investment returns.

Backing out accumulated state contributions to the RSA since 2000 (but keeping the investment returns from these contributions) and leaving in employee contributions show that total assets under management (adjusted for inflation) have *decreased* by 27.5 percent. If state contributions per active member had remained constant at the 2001 level,[28] the increase in total assets under management would have fallen to just 1.16 percent. Finally, if both state

25. "U.S. State Budgets," *IGM Forum* (Initiative on Global Markets, University of Chicago Booth School of Business), October 1, 2012, http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_87dlrlXQvZkFB1r.
26. Pew Charitable Trusts, "The State Pensions Funding Gap: Challenges Persist," July 2015; US Senate Committee on Finance, "State and Local Government Defined Benefit Pension Plans: The Pension Debt Crisis that Threatens America," January 2012; Dan Liljenquist, "Keeping the Promise: State Solutions for Government Pension Reform" (American Legislative Exchange Council, Arlington, VA, August 2013).
27. We adjust for inflation by using the personal consumption expenditure chain-type price index from the Bureau of Economic Analysis from October 1 to best match the year-end report dates of September 30. Personal consumption expenditures are used by the Congressional Budget Office for most inflation measures. The only exception we make here is that the actuarial value of assets and liabilities in 2003 was reported in the RSA's 2009 comprehensive annual financial report as of June 30, not September 30. We use the personal consumption expenditures chain-type price index for July 1 for these data (only a slight modification from October 1).
28. The 2001 level was used because total active membership in the RSA was not given in the RSA's 2000 comprehensive annual financial report.

FIGURE 11. RETIREMENT SYSTEMS OF ALABAMA ASSET GROWTH, 2000–2014



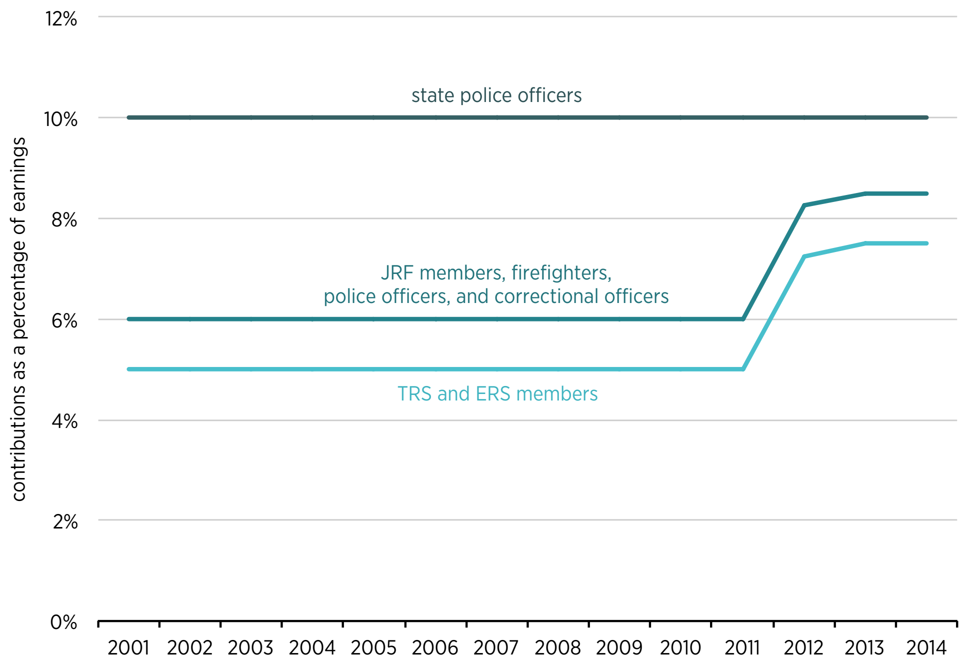

Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/.

and employee contributions per active member had been maintained at the 2001 level, the growth in total assets under management since 2001 would have fallen to a *negative* 2.51 percent. This demonstrates that the increase in inflation-adjusted total assets under management is driven by increasing state and employee contributions to the system, not by investment returns.

Additionally, RSA members who leave their jobs, and thus leave the retirement system, forfeit their employer contributions. Rather than returning these contributions to the employer or even to the state, they remain in the RSA as an increase in assets.[29] Although data are not publicly available to back out the contributions of withdrawn members from total assets under management,[30] with more than 159,490 members having left the RSA since 2001,[31] it is clear that, in addition to the above adjustments, backing out the state contributions

29. Conversation with RSA Deputy Director Donald Yancey, October 5, 2015.
30. A written request to the RSA for these data, per the Alabama Public Records Law, was submitted by the authors on November 9, 2015. As of February 2016, the RSA has not acknowledged or responded to the request.
31. The number of members who withdrew in 2000 is not given in the RSA's 2000 comprehensive annual financial report.

FIGURE 12. ALABAMA'S PUBLIC EMPLOYEE CONTRIBUTION RATES—TIER 1 TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND, 2001–2013




Note: TRS = Teachers' Retirement System, ERS = Employees' Retirement System, JRF = Judicial Retirement Fund. State police contribution rates were not provided in the Retirement Systems of Alabama's 2005–2009 comprehensive annual financial reports. It was unclear whether the state police contribution rate decreased over this period to the same level as other ERS police contribution rates, as reported in the Retirement Systems of Alabama comprehensive annual financial reports for this period (6 percent), or whether the rate remained 10 percent over this period (and was accidentally excluded from the comprehensive annual financial reports). Given that no separate rate was reported for state police over this period, we assume the rate remained 10 percent from 2005 to 2009. This assumption affects only this graph and none of the remaining calculations or figures in this section.

Source: Comprehensive annual financial reports of the Retirement Systems of Alabama, available at http://www.rsa-al.gov/index.php/about-rsa/publications/.

of withdrawn employees would substantially decrease the RSA's growth in total assets under management.

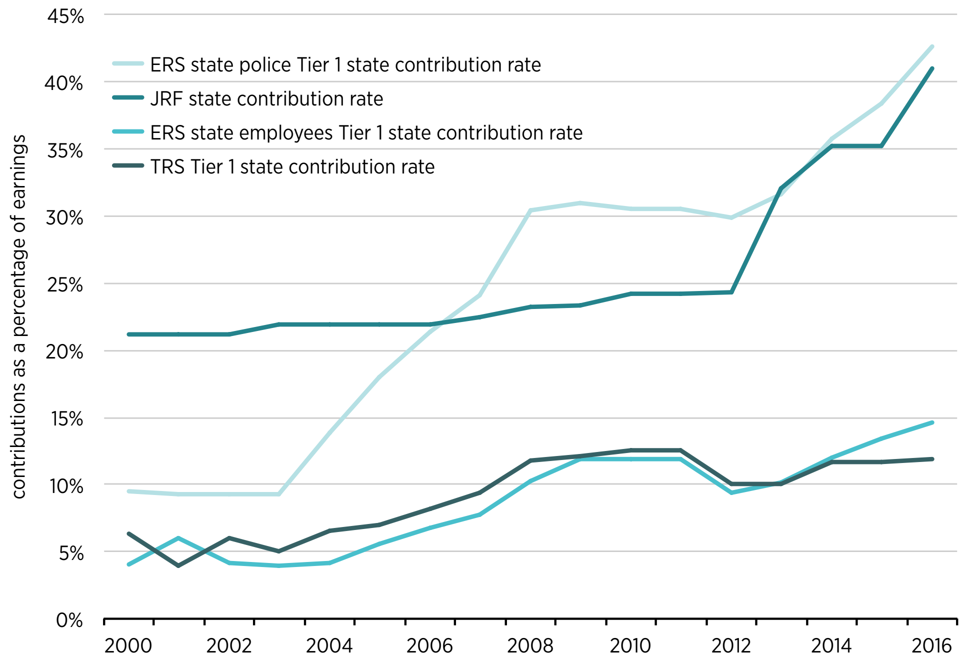
Of course, neither state nor employee contributions remained constant over this time period. TRS, ERS, and JRF members each make mandatory employee contributions to the RSA. Historically, members of the TRS and ERS have contributed 5 percent of earnings, and state police have traditionally paid a rate of 10 percent. JRF members and firefighters, police officers, and correctional officers have traditionally paid 6 percent. After October 1, 2011, TRS and ERS members saw their employee contribution rates increased to 7.25 percent, and JRF members, police officers, and correctional officers saw their rates jump to 8.25 percent (see figure 12).

With the enactment of legislative reforms passed in 2012, TRS and ERS memberships were split into two tiers (Tier 1 and Tier 2), which increased the employee contribution rate for employees hired before January 1, 2013, and decreased the employee contribution rate for employees hired after January 1, 2013. Tier 1 members of the TRS and ERS saw another increase in their contribution rate to 7.5 percent. Contribution rates for JRF members and Tier 1 firefighters, police officers, and correctional officers were raised to 8.5 percent. (The contribution rate for state police remained at 10 percent.) Everyone hired on or after January 1, 2013, is considered a Tier 2 member. Tier 2 members of the TRS and ERS (except state police and certified law enforcement personnel, correctional officers, and firefighters) pay a rate of 6 percent; Tier 2 state police contribute 10 percent; and Tier 2 certified law enforcement personnel, correctional officers, and firefighters pay 7 percent. The way to interpret these changes is that Tier 1 members contribute more relative to Tier 2 members but expect to receive larger disbursements at retirement.[32] Ultimately, both reduced benefits and increased contributions lower the return on contributions from the RSA for both Tier 1 and Tier 2 members.[33]

In addition to employee contributions, the RSA receives employer contributions from the state. These contributions ultimately come from Alabama taxpayers. State contributions to the TRS, ERS, and JRF have increased drastically since 2000 (see figure 13). For Tier 1 TRS members, state contributions have increased from 6.38 percent of employee pay in 2000 to 11.94 percent for 2016, an increase of more than 87 percent (the state will pay 10.84 percent for Tier 2 TRS members).[34] ERS members have seen their state contribution rate balloon from 4.08 percent in 2000 to 14.57 percent in 2016, a 257 percent increase (the state will pay 14.09 percent in 2016 for Tier 2 ERS members). State police in the ERS receive a different state contribution rate than other ERS members. Their state contribution rate has increased from 9.45 percent in 2000 to 42.61 percent in 2016, a 351 percent increase (the state will pay 38.98 percent for Tier 2 state

32. For more detail on the background and current status of each pension system, see the Retirement Systems of Alabama's website at http://www.rsa-al.gov/. The above information was taken from Retirement Systems of Alabama, *Component Units of the State of Alabama Comprehensive Annual Financial Report for the Fiscal Year Ended September 30, 2014*.
33. Stephen C. Miller, "5 Retirement Systems of Alabama (RSA) Myths and the Truth They Don't Want You to Know," *Yellowhammer News*, August 24, 2015, http://yellowhammernews.com/politics-2/5-retirement-systems-of-alabama-rsa-myths-and-the-truth-they-dont-want-you-to-know-opinion/.
34. Data for 2000–2007 are from comprehensive annual financial reports of the state of Alabama, available at http://comptroller.alabama.gov/pages/cafr.aspx. Data for 2007–2014 are from comprehensive annual financial reports of the Retirement Systems of Alabama, available at http://www.rsa-al.gov/index.php/about-rsa/publications/. Data for 2015 and 2016 are from a letter from RSA Accounting to TRS Participating Units, June 29, 2015, http://www.rsa-al.gov/uploads/files/TRSRateChangeLetter_16.pdf.

FIGURE 13. ALABAMA'S TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND STATE CONTRIBUTION RATES, 2000–2016




Note: TRS = Teachers' Retirement System, ERS = Employees' Retirement System, JRF = Judicial Retirement Fund.

Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/.

police in the ERS).[35] JRF members have traditionally enjoyed much higher state contribution rates for their pension accounts; however, even their state contribution rates have increased recently, from 21 percent in 2000 to 40.98 percent in 2016, which is a 93 percent increase.[36]

The majority of state contributions does not now go toward the pensions of current contributing members but instead is used to fund previously accrued liabilities. For instance, for Tier 1 TRS members in 2016, 82 percent of the state contribution will go toward covering unfunded actuarial accrued

35. Data for 2000–2007 are from comprehensive annual financial reports of the state of Alabama. Data for 2007–2014 are from comprehensive annual financial reports of the Retirement Systems of Alabama. Data for 2015 and 2016 are from Cavanaugh Macdonald Consulting LLC, "Report on the Actuarial Valuation of the Employee's Retirement System of Alabama as of September 30, 2013," http://www.rsa-al.gov/uploads/files/ERS-Val-2013-9-30.pdf.
36. Data for 2000–2007 are from comprehensive annual financial reports of the state of Alabama. Data for 2007–2014 are from comprehensive annual financial reports of the Retirement Systems of Alabama. Data for 2015 and 2016 are from Cavanaugh Macdonald Consulting LLC, "Alabama Judicial Retirement Fund Report of the Actuary on the Annual Valuation Prepared as of September 30, 2013," http://www.rsa-al.gov/uploads/files/JRF-Val-2013-9-30.pdf.

liabilities.[37] For Tier 1 ERS employees, 85 percent of their state contribution covers unfunded actuarial accrued liabilities.[38] For Tier 1 ERS state police, 76 percent of their state contribution will go to cover unfunded actuarial accrued liabilities.[39] Beginning in 2016, JRF members will see 64.2 percent of their state contribution go toward covering unfunded actuarial accrued liabilities.[40]

It is helpful to examine the trend of employee and state contributions per active members in the TRS (see figure 14), the ERS (see figure 15), and the JRF (see figure 16). In the TRS, employee and state contributions per active member were, at one point, nearly identical. They have since diverged, owing to the fact that the RSA needed to amortize unfunded liabilities when returns on past contributions fell short of the assumed investment rate of return. Thus, state contributions have steadily grown faster than the individual contributions that employees make. As of September 30, 2014, state contributions exceed employee contributions per active member by more than $2,000, which is up from a difference of only $524 in 2001 after adjusting for inflation (a 290 percent increase). Thus, the TRS is increasingly relying on taxpayer contributions to shore up the pension liabilities of TRS members.

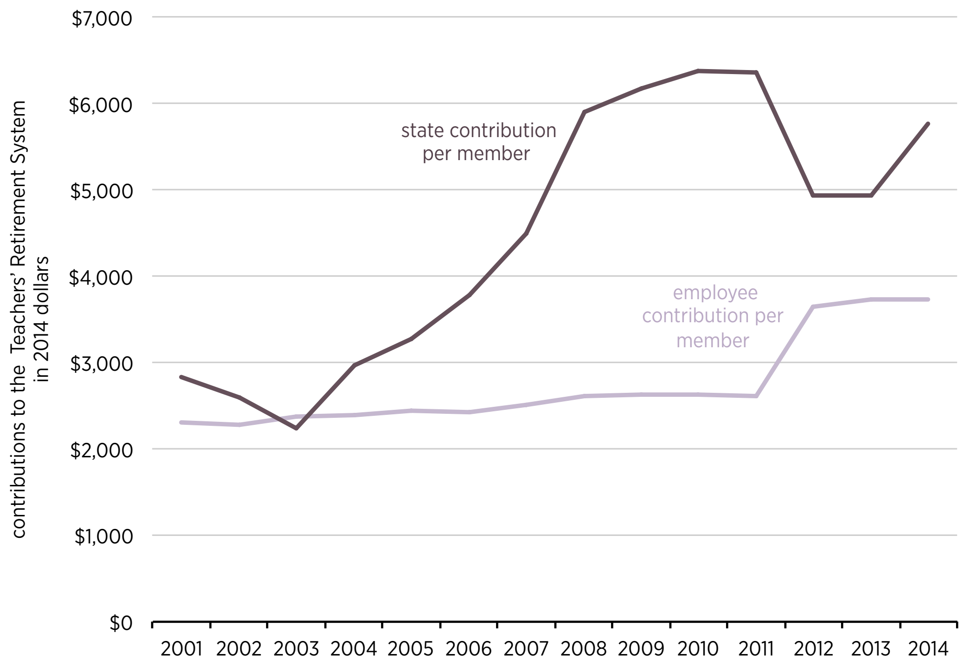
A similar pattern is seen with the ERS. In 2001–2004, employee and state contributions per active member were nearly identical. In 2001, employee contributions were $144 more than state contributions. State contributions now exceed employee contributions by more than $2,090 per active member.

Unlike with TRS and ERS members, JRF members have traditionally received much larger state contributions per person relative to their employee contributions. For instance, in 2001, the state contribution per active member (adjusted for inflation) was more than $21,400 greater than employees' contributions to the pension system. However, even in the JRF, the gap between these contribution rates has grown, indicating an even more substantial increase in reliance on taxpayer funds. In 2014, state contributions per active member were more than $35,900 greater than the contributions made by employees (a 67.8 percent increase).

It is also helpful to look at total state contributions to the TRS, ERS, and JRF over time (see figure 17). Although total state contributions to these pension

37. Data are from Cavanaugh Macdonald Consulting LLC, "Teachers' Retirement System of Alabama Report of the Actuary on the Annual Valuation Prepared as of September 30, 2014," http://www.rsa-al.gov/uploads/files/TRS-Val-2014-9-30.pdf.
38. Data are from Cavanaugh Macdonald Consulting LLC, "Report on the Actuarial Valuation of the Employees' Retirement System of Alabama Prepared as of September 30, 2013."
39. Ibid.
40. Data are from Cavanaugh Macdonald Consulting LLC, "Alabama Judicial Retirement Fund Report of the Actuary on the Annual Valuation Prepared as of September 30, 2013."

**FIGURE 14. ALABAMA'S TEACHERS' RETIREMENT SYSTEM CONTRIBUTIONS PER ACTIVE MEMBER, 2001–2014**

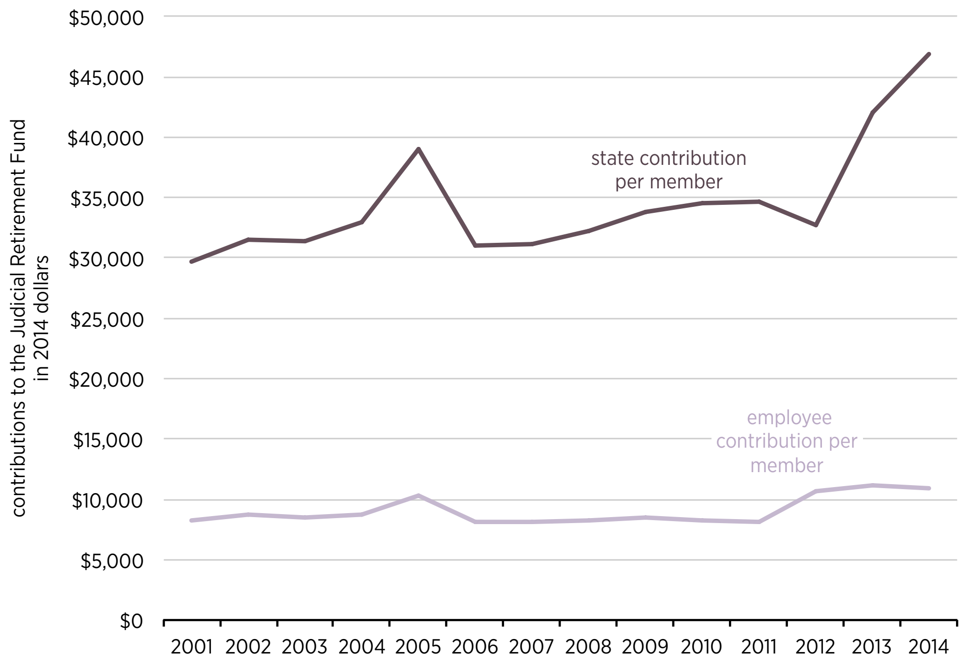



Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

**FIGURE 15. ALABAMA EMPLOYEES' RETIREMENT SYSTEM CONTRIBUTIONS PER ACTIVE MEMBER, 2001–2014**

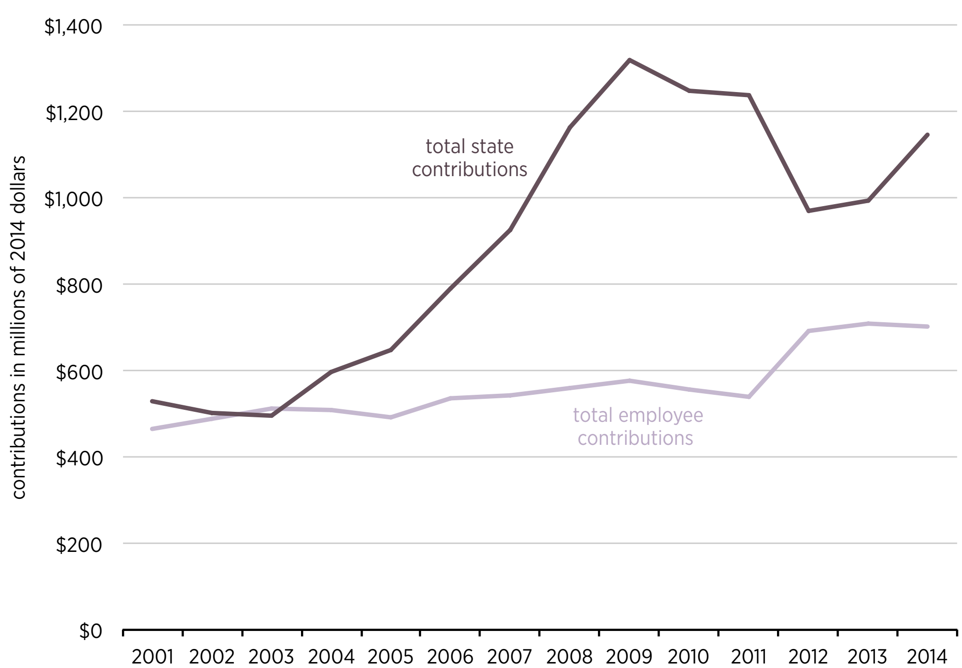

Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

**FIGURE 16. ALABAMA JUDICIAL RETIREMENT FUND CONTRIBUTIONS PER ACTIVE MEMBER, 2001–2014**



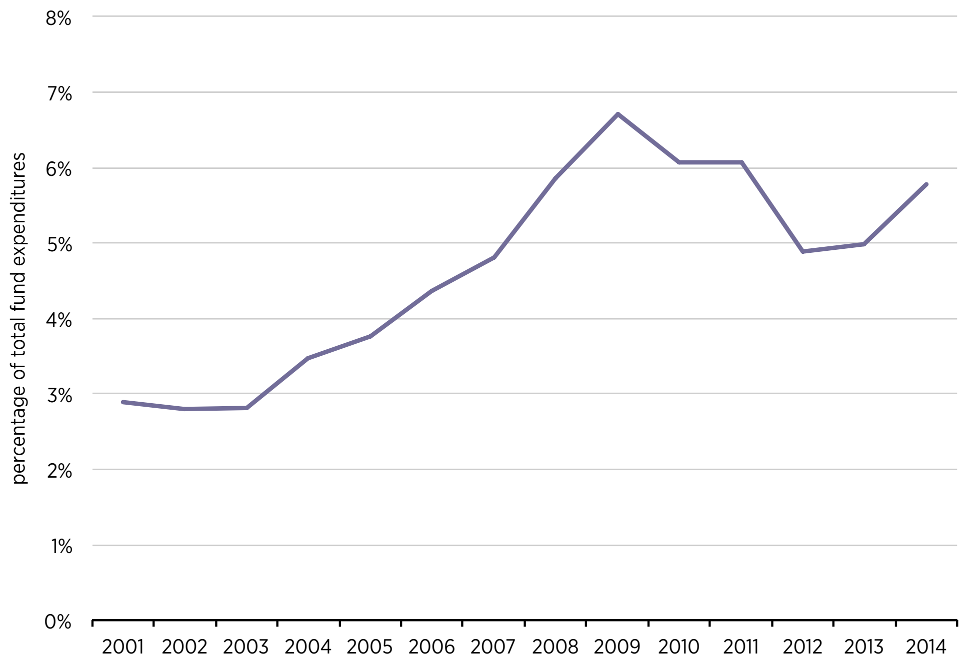

Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

**FIGURE 17. ALABAMA TOTAL STATE (EMPLOYER) AND EMPLOYEE CONTRIBUTIONS TO THE TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND, 2001–2014**




Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

FIGURE 18. ALABAMA PENSION CONTRIBUTIONS AS A PERCENTAGE OF TOTAL STATE FUND EXPENDITURES, 2001–2014




Sources: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/; comprehensive annual financial reports of the state of Alabama, available at http://comptroller.alabama.gov/pages/cafr.aspx.

funds have increased more than 117 percent since 2001, employee contributions have increased just over 51 percent. The total difference between the contributions made by employees and the contributions made by the state has increased a staggering 603 percent. In 2014, state contributions exceeded employee contributions by $442 million.

Over time, state contributions to the pension system have thus taken a larger absolute amount of state resources—resources that are then unavailable for other state programs. Figure 18 shows state pension contributions as a percentage of total state fund expenditures since 2001, where it currently stands, as of September 30, 2014, at 5.78 percent. That is more than twice the percentage of the total state fund expenditures that pension contributions took up in 2001. With total state fund expenditures approaching $20 billion per year, this percentage represents a relatively large amount ($1.146 billion in 2014).

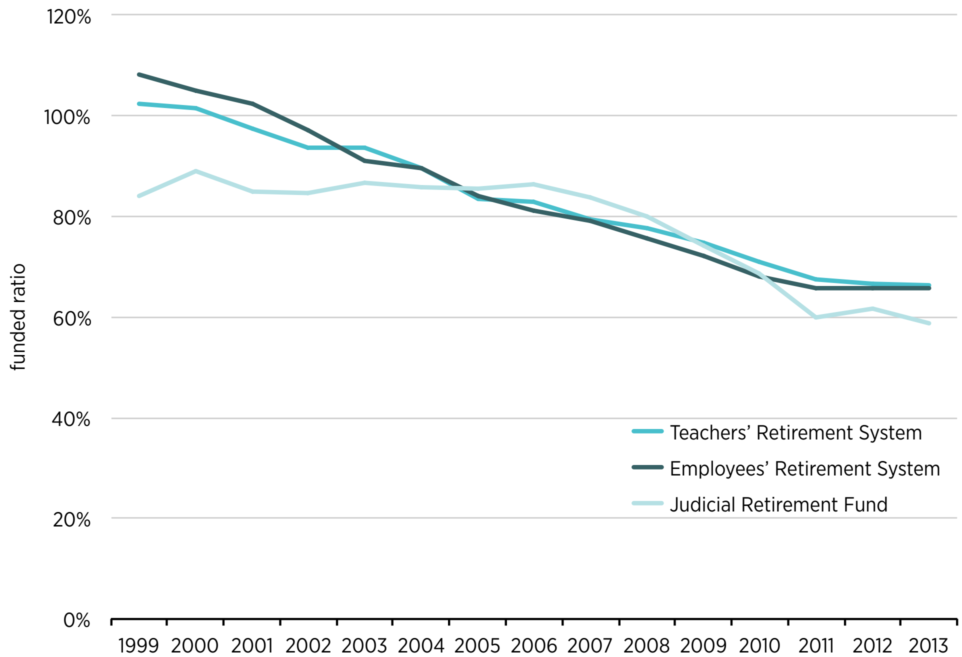
Well-managed pension plans remain solvent if they are fully funded. A funding ratio of 100 percent ensures that total assets in the system meet total expected liabilities. While the RSA argues that an 80 percent funded ratio is "perfectly fine for a public fund,"[41] the American Academy of Actuaries argues that a funded ratio of 80 percent not only is inappropriate for a public pension system but also has become a "mythical standard."[42] The academy further argues that every public pension system should aim to have a funded ratio of 100 percent.[43] In every annual edition of the state of Alabama's comprehensive annual financial report from 2000 to 2005, the "Pension Trust Funds" section dealing with the RSA states that "analysis of this percentage [the funded ratio] over time indicates whether the respective system is becoming financially stronger or weaker. Generally, the greater this percentage, the stronger the retirement system."[44] This wording was inexplicably dropped beginning with the 2006 report.

Thus, examination of the changes in the funded ratios of the TRS, ERS, and JRF provides a good indicator of the direction of the funding health of these pension plans and whether the RSA's financial position is improving or weakening. According to the RSA's own statements, the funded ratios for the TRS, ERS, and JRF have fallen substantially since 2003 (see figure 19).[45] The TRS went from a funded ratio of 102.5 percent in 1999 to 66.2 percent in 2013. The ERS had a funded ratio of 108.2 percent in 1999, which dropped to 65.7 percent in 2013. Finally, the JRF fell from 84.2 percent in 1999 to 58.7 percent in 2013.

In comparison to other states, a recent Pew Charitable Trusts study on state pension funding gaps found that the decline in Alabama's funded ratio moved the state from 20th place in its funded ratio to 30th place in a decade, despite making 100 percent of the annual required contribution.[46] A comparison of assets and liabilities for the TRS, ERS, and JRF is helpful as well. Figure 20 shows the inflation-adjusted change in TRS assets and liabilities since 2003. While assets were only $1.5 billion less than liabilities in 2003, the gap between assets and liabilities steadily grew to more than $10 billion in 2013. In

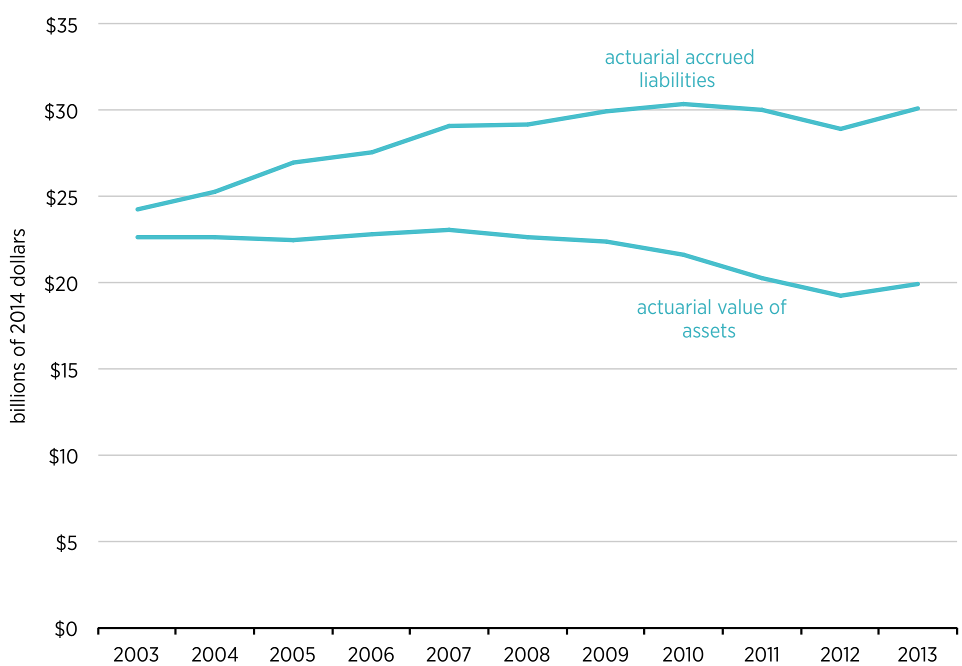
41. David G. Bronner, "Follow the Money," *Advisor* (Retirement Systems of Alabama), July 2014.
42. American Academy of Actuaries, "The 80% Pension Funding Standard Myth," Issue Brief, July 2012.
43. Ibid.
44. Comprehensive annual financial reports of the state of Alabama.
45. Actuarial assets and liabilities data dating back to only 2003 were found in publicly available documents of the RSA. The funded ratio was reported in the state of Alabama's publicly available comprehensive annual financial reports going back to 1999. The 2004 report gives the funded ratio for the ERS in 2003 as 93.0 percent. State of Alabama, *Comprehensive Annual Financial Report for the Fiscal Year Ended September 30, 2004*. The figure in the Retirement Systems of Alabama's 2009 comprehensive annual financial report is 91.1 percent, which is used here. Retirement Systems of Alabama, *Component Units of the State of Alabama Comprehensive Annual Financial Report for the Fiscal Year Ended September 30, 2009*.
46. Pew Charitable Trusts, "State Pensions Funding Gap."

**FIGURE 19. ALABAMA TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND FUNDED RATIOS, 1999–2013**



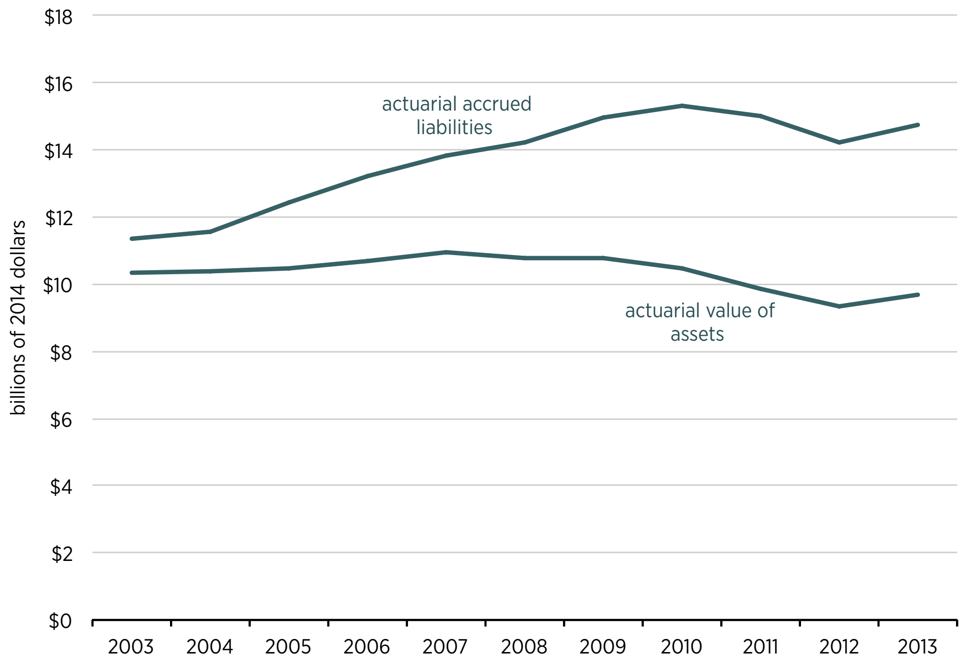

Sources: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/; comprehensive annual financial reports of the state of Alabama, available at http://comptroller.alabama.gov/pages/cafr.aspx.

**FIGURE 20. ALABAMA TEACHERS' RETIREMENT SYSTEM ASSETS AND LIABILITIES, 2003–2013**




Sources: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/; comprehensive annual financial reports of the state of Alabama, available at http://comptroller.alabama.gov/pages/cafr.aspx. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

FIGURE 21. ALABAMA EMPLOYEES' RETIREMENT SYSTEM ASSETS AND LIABILITIES, 2003–2013




Sources: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/; comprehensive annual financial reports of the state of Alabama, available at http://comptroller.alabama.gov/pages/cafr.aspx. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

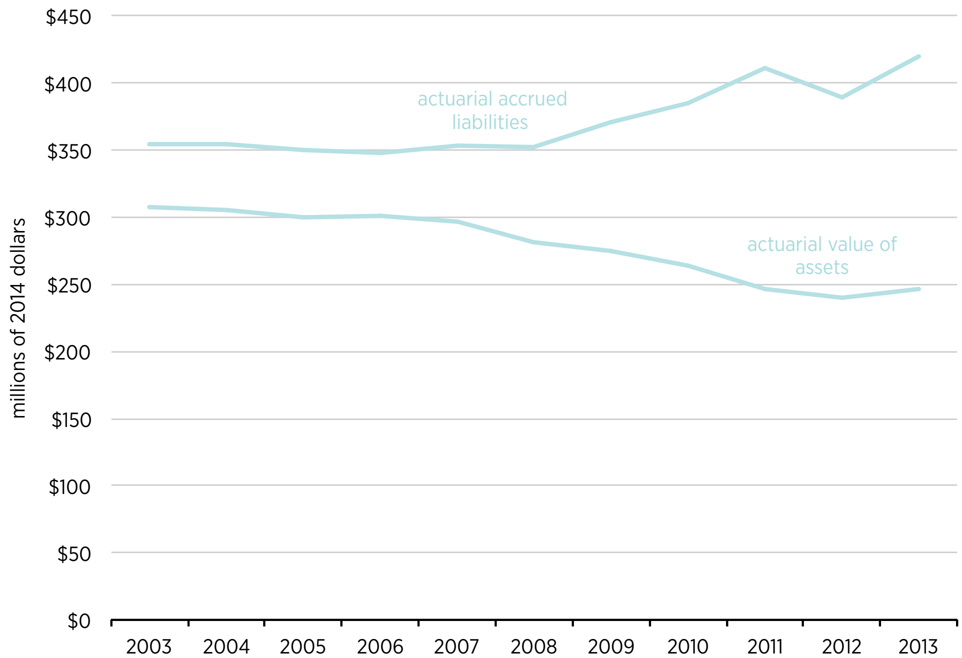
fact, the actuarial value of the TRS's assets has fallen by 12.2 percent since 2003, while liabilities have increased by 24.2 percent.

Similarly, the ERS had assets of only $1 billion less than liabilities in 2003, but the gap between liabilities and assets increased to $5 billion by 2013 (see figure 21). The actuarial value of the ERS's assets has fallen by more than 6.4 percent since 2003, while liabilities have increased by 29.8 percent.

JRF's unfunded liabilities grew from $47.4 million in 2003 to more than $173 million in 2013 (see figure 22). The actuarial value of the JRF's assets fell by 19.7 percent since 2003, while liabilities grew by 18.4 percent.

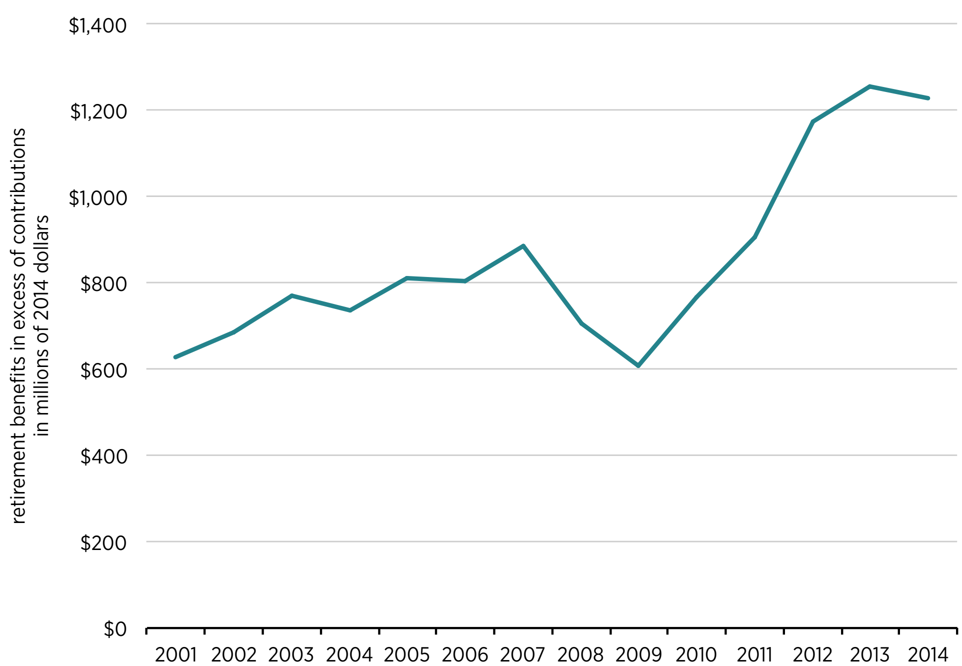
As the RSA shifts to a pay-as-you-go system with substantial unfunded liabilities, any difference between the total amount of contributions to the RSA, ERS, and JRF and the amount of benefits being paid out becomes a concern. Figure 23 shows the annual benefits, including retirement benefits, returns of contributions, and death benefits, in excess of annual employee and

FIGURE 22. ALABAMA JUDICIAL RETIREMENT FUND ASSETS AND LIABILITIES, 2003–2013



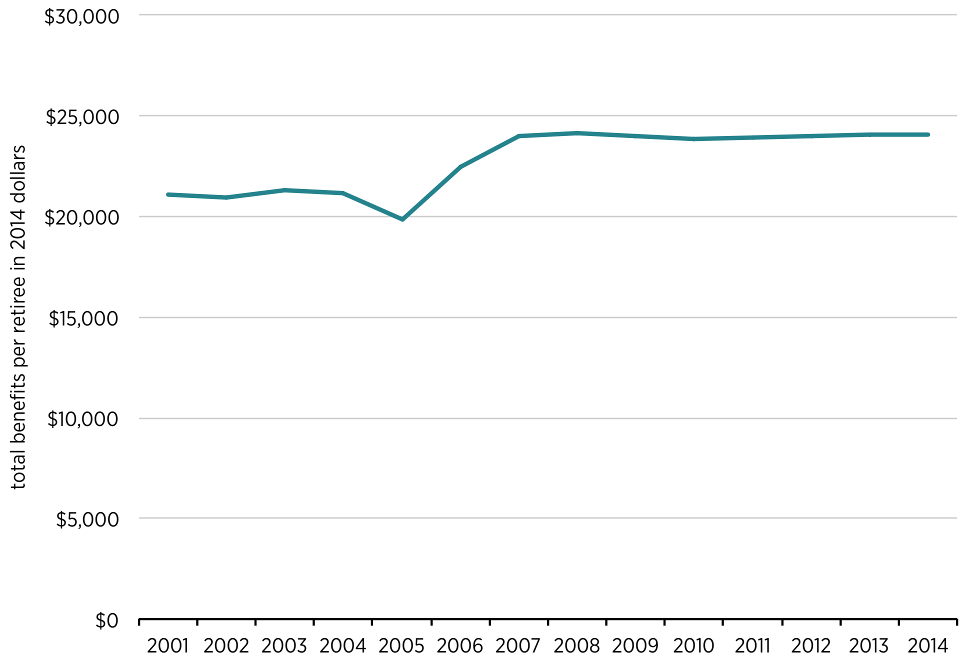

Sources: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/; comprehensive annual financial reports of the state of Alabama, available at http://comptroller.alabama.gov/pages/cafr.aspx. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

FIGURE 23. ALABAMA ANNUAL RETIREMENT BENEFITS IN EXCESS OF ANNUAL CONTRIBUTIONS, 2001–2014




Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

FIGURE 24. ALABAMA TOTAL TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND BENEFITS PER RETIREE, 2001–2014




Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/. Data were adjusted for inflation to 2014 dollars using the personal consumption expenditures chain-type price index from October 1 to best match the Retirement Systems of Alabama's annual report date of September 30 (see https://research.stlouisfed.org/fred2/series/PCEPI).

state contributions (adjusted for inflation).[47] The gap between total annual benefits and total employee and state contributions has grown by 95.5 percent since 2001. In 2014, total benefits paid out exceeded total contributions by almost $1.23 billion.

This trend has occurred even though total TRS, ERS, and JRF retirement benefits, return of contributions, and death benefits per retiree remained relatively constant from 2007 to 2014 (see figure 24).

Even more concerning, the declining funded ratios reported here, which were taken directly from the RSA's annual reports, fail to properly depict the true size of the RSA's unfunded liabilities because of the use of flawed accounting practices.[48] The RSA assumes an 8 percent rate of return on investments

47. The RSA's annual reports only describe the return of contributions and death benefits together.
48. Eileen Norcross, "Pension Reform in Alabama: A Case for Economic Accounting," in *Improving Lives in Alabama: A Vision for Economic Freedom and Prosperity*, ed. Daniel Sutter (Troy, AL: Manuel H. Johnson Center for Political Economy, n.d.).

and then uses that rate to discount its liabilities. This method is a flawed way to evaluate the liabilities of defined benefit pension plans because any such plan is a contractual obligation to pay a defined sum to an employee once the employee has met the plan's basic requirements, regardless of the amount paid in by the employee.[49] It is a guaranteed liability that must be paid regardless of whether the plan's investments actually return the assumed 8 percent and, as such, should be discounted at a low rate of return that reflects the lack of certainty (the risk-appropriate rate). While the Governmental Accounting Standards Board permits public pensions to discount their liabilities in this manner, rules governing US corporations and most public pensions in other countries recognize the risk associated with this accounting practice and forbid its use.[50] Thus, state public-sector pensions in this country have a strong incentive to discount liabilities at a much higher rate than an appropriate risk-free rate to make the actuarial value of their pension liabilities appear much smaller than it is.[51]

Thus, it is important to examine the financial soundness of the RSA's use of a risk-appropriate rate of return to discount the actuarial value of its liabilities, rather than the 8 percent discount rate used in the RSA's annual reports. However, to examine only the effects of this change in assumptions, we maintain the RSA's assumed 8 percent rate of return for its assets for this analysis. It should be noted that public-sector pensions have been adjusting their assumed rates of return on their assets below 8 percent on the recommendation of actuaries and pension specialists precisely because an 8 percent rate of return on assets is seen by many investment experts as unrealistically optimistic.[52] Therefore, our calculation of the RSA's unfunded ratio using a risk-free rate of return to discount liabilities should be viewed as overstating the percentage of liabilities covered by assets, since, realistically, the actuarial value of RSA assets may be overstated.

49. Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210; Andrew G. Biggs and Kent A. Smetters, "Understanding the Argument for Market Valuation of Public Pension Liabilities" (American Enterprise Institute, May 2013); Andrew G. Biggs, "The State of Public Pension Funding: Are Government Employee Plans Back on Track?" (Economic Perspectives, American Enterprise Institute, Washington, DC, September 2015); Ronald J. Ryan and Frank J. Fabozzi, "Rethinking Pension Liabilities and Asset Allocation: A Pension Crisis Looms," *Journal of Portfolio Management*, Summer 2002.
50. Biggs, "State of Public Pension Funding."
51. Biggs and Smetters, "Understanding the Argument for Market Valuation"; Biggs, "State of Public Pension Funding"; Ryan and Fabozzi, "Rethinking Pension Liabilities."
52. Timothy W. Martin, "Public Pension Funds Roll Back Return Targets," *Wall Street Journal*, September 4, 2015, http://www.wsj.com/articles/taxpayers-more-pension-burdens-headed-your-way-1441388090; Andrew Biggs, "Public Pensions Lower Return Assumptions, but Taking More Risk," *Forbes*, September 8, 2015, http://onforb.es/1XHZOmX.

To robustly estimate the market valuation of RSA liabilities, we examine four measures of risk-appropriate discount rates: a 10-year Treasury bond, a notional 15-year Treasury bond, the Treasury's 10-year High Quality Market (HQM) corporate bond yield (the measurement of the corporate bond yield mandated by the Pension Protection Act of 2006), and the 15-year Citigroup Pension Discount Curve. We use the 2.64 percent yield on a 10-year Treasury bond, the 3.025 percent yield on a notional 15-year Treasury bond, the 3.97 percent HQM corporate bond yield, and the 4.72 percent yield from the 15-year Citigroup Pension Discount Curve on, or as close as possible to, September 30, 2014, to match the date of the RSA's 2014 comprehensive annual financial report on the actuarial value of RSA assets and liabilities (see table 5). Using the more appropriate risk-adjusted rates of return to discount its liabilities, the TRS's funded ratio drops to between 27.1 percent and 41.7 percent, the ERS's funded ratio drops to between 26.9 percent and 41.4 percent, and the JRF's funded ratio drops to between 24 percent and 37 percent.

**TABLE 5. MARKET VALUATION OF ALABAMA TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND LIABILITIES**

| | TRS | ERS | JRF | Total TRS, ERS, and JRF accrued unfunded liability | Unfunded liabilities as a % of 2014 tax revenue | Years required to fund unfunded liabilities (constant 2014 tax revenue) |
|---|---|---|---|---|---|---|
| RSA 2014 CAFR (8%) | | | | | | |
| Actuarial value of assets | 19,629,816,000 | 9,546,459,000 | 243,316,000 | | | |
| Actuarial accrued liabilities | 29,665,843,000 | 14,536,600,000 | 414,200,000 | 15,197,052,000 | 165.7% | 1.66 |
| Funded ratio | 66.17% | 65.67% | 58.74% | | | |
| 10-year Treasury bond (2.64%) | | | | | | |
| Accrued liability | 72,518,129,341 | 35,534,707,002 | 1,012,511,567 | 79,645,756,911 | 868.6% | 8.69 |
| Funded ratio | 27.07% | 26.87% | 24.03% | | | |
| 15-year Treasury bond (3.025%) | | | | | | |
| Accrued liability | 60,182,978,618 | 29,490,343,051 | 840,285,905 | 61,094,016,575 | 666.3% | 6.66 |
| Funded ratio | 32.62% | 32.37% | 28.96% | | | |
| 10-year Treasury HQM corporate bond (3.97%) | | | | | | |
| Accrued liability | 63,757,691,877 | 31,241,993,148 | 890,196,715 | 66,470,290,740 | 724.9% | 7.25 |
| Funded ratio | 30.79% | 30.56% | 27.33% | | | |
| 15-year Citigroup Pension Discount Curve (4.72%) | | | | | | |
| Accrued liability | 47,088,215,402 | 23,073,760,352 | 657,454,394 | 41,399,839,147 | 451.5% | 4.52 |
| Funded ratio | 41.69% | 41.37% | 37.01% | | | |

Note: TRS = Teachers' Retirement System, ERS = Employees' Retirement System, JRF = Judicial Retirement Fund, RSA = Retirement Systems of Alabama, CAFR = comprehensive annual financial report, HQM = High Quality Market.

Source: Retirement Systems of Alabama, *Component Units of the State of Alabama Comprehensive Annual Financial Report for the Fiscal Year Ended September 30, 2014*.

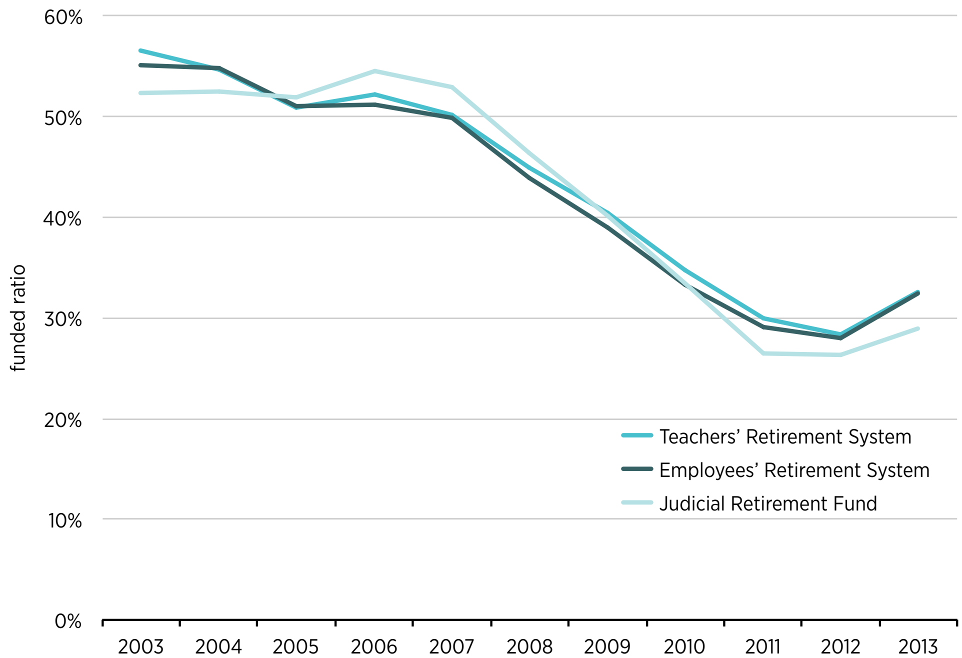
Regardless of the assumed discount rate, it is clear that reform is necessary. Using the more appropriate risk-free rate to discount liabilities helps gauge the fiscal impact that unfunded liabilities pose to Alabama. For example, according to the RSA's own assessment in its 2014 comprehensive annual financial report, unfunded liabilities were 165.7 percent of Alabama's 2014 state tax revenue. The amount increases to between 451.5 percent and 868.6 percent with a more appropriate discount rate. Thus, while the RSA's current assessment means it will take 1.66 years of total state tax revenues to bridge the gap between pension assets and liabilities—still a substantial number—the number could be between 4.52 and 8.69 years if more appropriate assumptions are used. Figure 25 provides the annual funded ratios for the TRS, ERS, and JRF, discounting liabilities with the appropriate notional 15-year Treasury bond for each year.

Rather than undertaking fundamental reform, some public-sector pension plans around the nation that face situations similar to the RSA's have resorted to making riskier investments to maintain an illusion of funding health.[53] While riskier investments might earn a higher rate of return, they expose the pension plan, including its members and taxpayers, to a much higher level of risk. The RSA has followed this course by shifting its portfolio from relatively safer investments to higher-risk equity investments.[54]

For example, the allocation of the TRS's portfolio has changed drastically since 2001 (see figure 26). The total percentage of the portfolio invested in equities increased from 43.5 percent in 2001 to 66.82 percent in 2014, and domestic fixed-income investments decreased from 44.61 percent in 2001 to 21.37 percent in 2014. The ERS and JRF portfolios saw similar trends. The total percentage of equities in the ERS portfolio increased from 47 percent in 2001 to more than 65 percent in 2014, and the percentage of total domestic fixed-income investments decreased from 43 percent in 2001 to nearly 21 percent in 2014.[55] The total percentage of equities in the JRF portfolio increased from 48.6 percent to 70.5 percent, and the percentage of fixed-

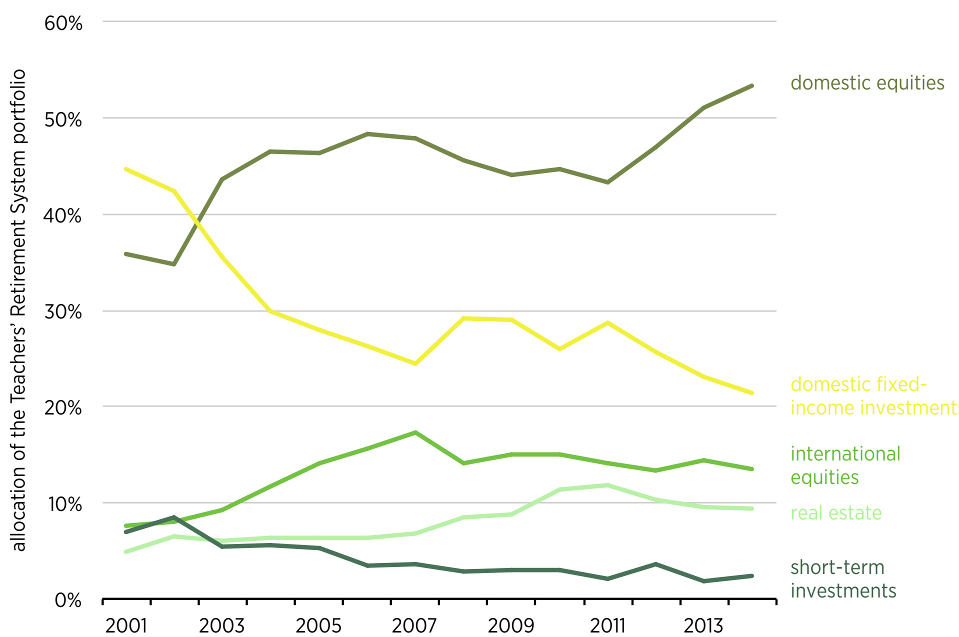
53. George Pennacchi and Mahdi Rastad, "Portfolio Allocation for Public Pension Funds" (NBER Working Paper No. 16456, National Bureau of Economic Research, Cambridge, MA, October 2010); Pew Charitable Trusts and Laura and John Arnold Foundation, "State Public Pension Investment Shift over Past 30 Years," June 2014; Daniel Bradley, Christos Pantzalis, and Xiaojing Yuan, "The Influence of Political Bias in State Pension Funds," *Journal of Financial Economics* 119, no. 1 (2016): 69–91; Biggs, "State of Public Pension Funding"; Biggs, "Public Pensions Lower Return Assumptions"; Novy-Marx and Rauh, "Liabilities and Risks of State-Sponsored Pension Plans."
54. Norcross, "Pension Reform in Alabama"; Daniel J. Smith, "RSA Is a Poor Steward of Our Retirement Resources," *AL.com*, July 29, 2015, http://s.al.com/cigvTxR.
55. Data are from the Retirement Systems of Alabama, annual reports.

**FIGURE 25. ANNUAL FUNDED RATIO FOR ALABAMA TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND DISCOUNTING LIABILITIES WITH NOTIONAL 15-YEAR TREASURY BONDS, 2003–2013**



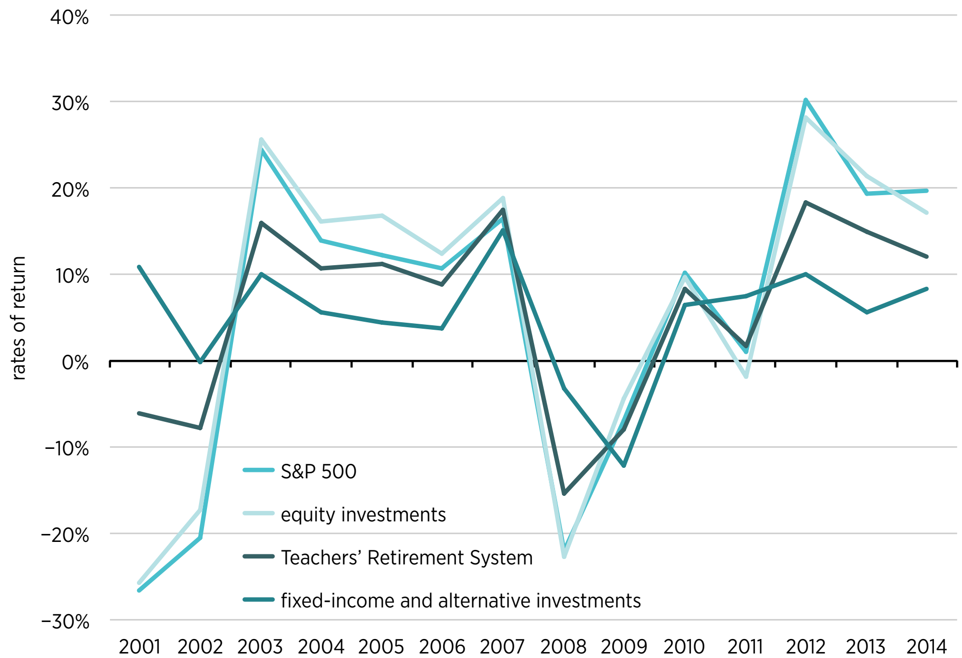

Note: TRS = Teachers' Retirement System; ERS = Employees' Retirement System; JRF = Judicial Retirement Fund.
Sources: Data for 2000–2007 are from the comprehensive annual financial reports of the state of Alabama, available at http://comptroller.alabama.gov/pages/cafr.aspx; data for 2007–2013 are from the comprehensive annual financial reports of the Retirement Systems of Alabama, available at http://www.rsa-al.gov/index.php/about-rsa/publications/.

**FIGURE 26. ALLOCATION OF ALABAMA TEACHERS' RETIREMENT SYSTEM INVESTMENT PORTFOLIO, 2001–2014**




Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/.

FIGURE 27. ALABAMA TEACHERS' RETIREMENT SYSTEM RATES OF RETURN, 2001–2014




Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/.

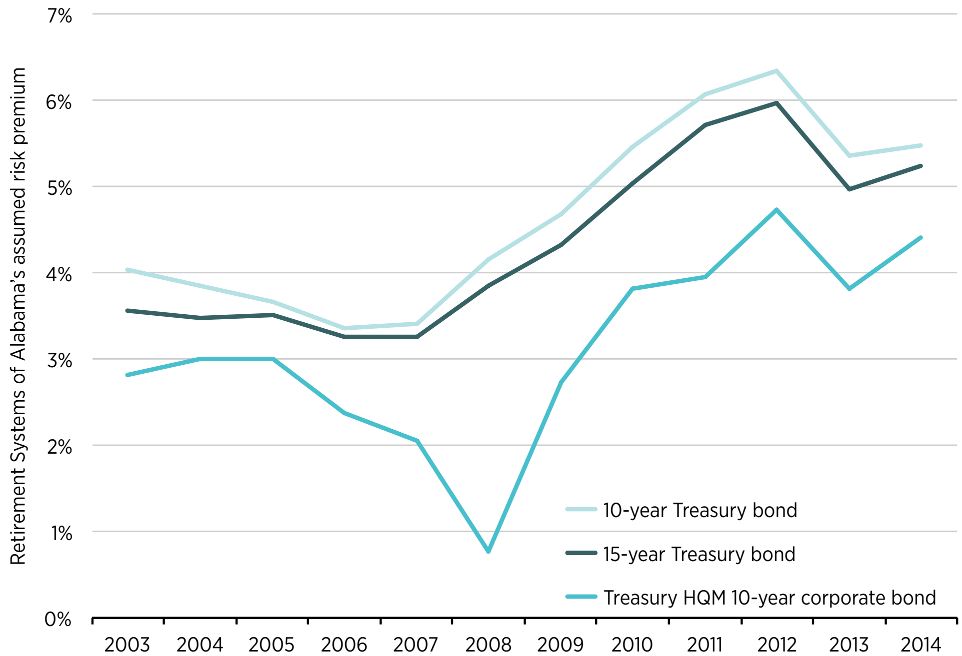
income investments decreased from just below 45 percent to more than 22 percent.[56]

Looking at the returns of the TRS portfolio over the same period, it is clear that the RSA shifted more of its portfolio into investments that more closely mimic the equity volatility of the S&P 500 (see figure 27). The ERS and JRF show similar trends.

Another way to measure the increased investment risk incurred by the RSA is to take the portfolio's annual assumed rate of return (8 percent) and subtract the risk-free rate of return for each year using the yield from a risk-free investment. This will produce the assumed risk premium, a common measure of the level of risk exposure. For instance, in 2014, the RSA assumed a return on assets of 8 percent. With a 2.75 percent notional 15-year Treasury bond yield on September 30, 2014, the assumed risk premium by the RSA was 5.25 percent (8 percent less 2.75 percent). We can compare this risk premium annually to see how the RSA's assumed level of risk exposure has changed over time.

56. Ibid.

FIGURE 28. MEASURES OF THE RETIREMENT SYSTEMS OF ALABAMA'S ASSUMED RISK PREMIUM, 2003–2014




Sources: 10-year Treasury and 15-year notional Treasury bond rates are available from the Department of the Treasury's Resource Center, "Daily Treasury Yield Curve Rates," https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield. High Quality Market (HQM) corporate bond rates are available from the Department of the Treasury's Resource Center, "Corporate Bond Yield Curve Papers and Data," https://www.treasury.gov/resource-center/economic-policy/corp-bond-yield/Pages/Corp-Yield-Bond-Curve-Papers.aspx.

Figure 28 shows that the RSA's assumed risk premium has increased over time. For robustness, we calculated the RSA's assumed risk premium using three separate risk-free assets: a 10-year Treasury bond, a notional 15-year Treasury bond, and the Treasury's 10-year HQM corporate bond yield.[57] We took the yields reported closest to September 30 of each year to best match the RSA's year-end reports. The RSA's assumed risk premium increased by 35.6 percent since 2003 using the 10-year Treasury bond, 47.3 percent using a notional 15-year Treasury bond, and by 56.9 percent using the HQM corporate bond yield. If the RSA had maintained a constant risk premium since 2003, the assumed rate of return should have been, more conservatively, between 6.32 percent and 6.56 percent in 2014.

57. James A. Girola, "The Corporate Bond Yield Curve for the Pension Protection Act," presentation, US Department of the Treasury, October 11, 2007.

Investor Andy Kessler argues that pension funds' expected rate of return is the "biggest lie in global finance."[58] While an assumed rate of return of 8 percent would have been justified in the past, a more realistic and conservative assumption now should be about 3 percent, according to Kessler. Although the RSA has continued to assume an 8 percent rate of return, its rate of return for 2014/15 was 1.04 percent for the TRS, 1.05 percent for the ERS, and −.54 percent for the JRF.[59] The RSA's 10-year returns for the TRS, ERS, and JRF portfolios were 5.41 percent, 5.16 percent, and 6.10 percent respectively.[60] Kessler says that assuming an improbably high rate of return is ultimately going to cost taxpayers, a prediction shared by the *Economist*.[61]

Ironically, one argument against transitioning to a defined contribution private pension plan for public-sector employees is that defined contribution plans expose retirees to more risk. Increasingly, the RSA's portfolio is reflecting a higher degree of risk, a risk that retirees and taxpayers must bear despite their own personal preferences.

Another potential reason why the RSA is shifting to a riskier investment strategy is the lower returns seen from its foray into investing in private placements, particularly investments meant to encourage economic development in Alabama. Reportedly, these types of investments make up more than 10 percent of the RSA's investment portfolio, although detailed information is not transparently provided by the RSA.[62] These investments typically include large equity or debt stakes in companies, which tend to be relatively risky, such as those with Signal International and US Airways that led to massive losses for RSA members and Alabama taxpayers.[63] Large, controlling-interest equity or debt stakes in a single company are traditionally taken by venture capitalists, not public-sector pension plans, because of the financial risk to plan members and taxpayers. Furthermore, if private investors are not willing to fund such projects, these investments by pension plans tend to be very risky relative to their rate of return.

As mentioned, many of these investments are undertaken with the goal of fostering economic development. While the RSA has been quite open about

58. Andy Kessler, "The Pension Rate-of-Return Fantasy," *Wall Street Journal*, April 9, 2013, http://on.wsj.com/12H7h7Q.
59. Data are from Marc Green, "2015 Investment Performance," *Advisor* (Retirement Systems of Alabama), December 2015.
60. Ibid.
61. "Many Unhappy Returns," *Economist*, September 12, 2015, http://econ.st/1QqLSsq.
62. David G. Bronner, "Johnson Center a Poor Steward of Facts Where RSA Concerned," *AL.com*, July 31, 2015, http://s.al.com/4eVv5HV.
63. Smith, "RSA Is a Poor Steward."

the fact that these investments perform substantially worse than others in its portfolio, the RSA argues that greater investment in Alabama will lead to economic development, which will increase employment growth and eventually increased tax revenues for the state.[64] However, the track record of public pension investments in promoting economic development is lackluster at best.[65] While finance professors Jeffrey Brown, Joshua Pollet, and Scott Weisbenner find that in-state investments can earn above-average returns, such returns are often made through political connections.[66] Another study argues that political bias often leads to risky investments that end up costing taxpayers and retirees.[67] Such a policy has led to investments in golf courses, luxury hotels, office buildings, and print media.[68] Recent litigation regarding these investments made its way to the Alabama Supreme Court, which ruled that such investment decisions are well within the authority granted to the RSA.[69] However, if state legislators view economic development incentives as a worthwhile goal to pursue, they should fund such incentives out of general funds rather than through the state's pension system.[70]

Several additional problems are associated with attempting to achieve economic development with public-sector pension funds. First, a significant body of academic literature finds that economic development investments are often used to prop up and subsidize failing businesses and other projects that would not otherwise exist.[71] Such investments significantly lower the return to retirees and unnecessarily put taxpayers at risk. Additionally, there is evidence that the decision about where to invest can—and often does—become political rather than economic, meaning generally lower

64. Samuel Addy and Ahmad Ijaz, "2009–2011 Economic Impacts of RSA on Alabama" (University of Alabama, Tuscaloosa, May 2012); M. Keivan Deravi, "The Economics of Retirement Systems of Alabama's Investments on the State Economy and the RSA," presentation, Auburn University, accessed February 24, 2016, http://www.rsa-al.gov/uploads/files/Deravi_PowerPoint_5-2012.pdf.
65. Yael V. Hochberg and Joshua D. Rauh, "Local Overweighting and Underperformance: Evidence from Limited Partner Private Equity Investments" (NBER Working Paper No. 17122, National Bureau of Economic Research, Cambridge, MA, June 2011).
66. Jeffrey R. Brown, Joshua M. Pollet, and Scott J. Weisbenner, "The In-State Equity Bias of State Pension Plans" (NBER Working Paper No. 21020, National Bureau of Economic Research, Cambridge, MA, March 2015).
67. Bradley, Pantzalis, and Yuan, "Influence of Political Bias in State Pension Funds."
68. David G. Bronner, "Danger, Danger: RSA Is Investing in Alabama!," *AL.com*, December 19, 2013, http://s.al.com/uXYhRfk.
69. *Ex parte* Bronner (Ala. December 31, 2014).
70. In the section "Economic Incentive Programs" (page 49), we argue that economic incentive programs do not have a track record of fostering economic growth and job creation.
71. Carl Davis, "Tax Incentives: Costly for States, Drag on the Nation," Institute for Taxation and Economic Policy, August 12, 2013.

“Ultimately . . . it is through competitive fiscal and tax policy that the state could create an environment conducive to economic growth and development, not one-off investments . . . in targeted industries or specific economic sectors.”

returns on investment relative to what could otherwise be obtained.[72] Such decisions tend to undermine the market economy and also promote cronyism.[73]

Finally, investing public-sector pension funds in the state amounts to a high-risk investment strategy in itself because, if Alabama’s economy declines, the RSA’s returns will likely decline as well.[74] RSA investments that are made specifically to promote economic development in Alabama make the RSA’s investment portfolio less diversified and thus riskier—but riskier in a way that does not trade off more risk for a greater return, because financial markets do not reward unsystematic, diversifiable risk. Particularly concerning for a public-sector pension plan that engages in in-state economic development projects, as the RSA does, is the fact that tax revenues are also likely to decline when the economy declines. Thus, taxpayers are often on the hook for shoring up the public-sector pension plan precisely when the state’s economy and tax revenues are in decline.

In-state economic development is, therefore, an investment strategy that should be abandoned by the RSA. Pursuing economic development would be better served through fiscal policy dictated by the state legislature. If state leaders view economic incentive programs as worthwhile goals, the programs should be funded out of general revenues, rather than appropriating the state’s pension system to pursue subsidiary goals that undermine the RSA’s primary goal of managing state employees’ retirement investments. This is especially true when the subsidiary goals increase the risk for RSA members and taxpayers.

72. Christopher Coyne and Lotta Moberg, “The Political Economy of State-Provided Targeted Benefits” (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, May 2014); Davis, “Tax Incentives.”
73. Coyne and Moberg, “Political Economy of State-Provided Targeted Benefits”; Daniel J. Smith and Daniel S. Sutter, “Gauging the Perception of Cronyism in the United States” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, October 2012).
74. Norcross, “Pension Reform in Alabama.”

Ultimately, as argued elsewhere in this study, it is through competitive fiscal and tax policy that the state could create an environment conducive to economic growth and development, not one-off investments with pension system funds in targeted industries or specific economic sectors. If this in-state investment policy were abandoned, it would allow the RSA to maximize returns for both current members and retirees and would help increase the likelihood of improving the funding health of the entire system, thereby reducing the strain of the public-sector pension system on taxpayers.

To ensure the fiscal sustainability of Alabama's public-sector pension plans, several additional changes should be considered. The state should immediately transition new hires—and current employees who elect to do so—from the current defined benefit retirement system to a defined contribution retirement system. Additionally, such private retirement accounts could be serviced by competing private financial companies. Fiscal sustainability is ensured under a defined contribution system, as it does not put taxpayers in the position of being the guarantors of benefits to pensioners. Rather, a defined contribution retirement plan (like those used in much of the private sector) would require the employer to provide only a specified contribution to the fund, often with a contribution match by the employee. The annual payout at retirement would then depend on market returns earned over the life of the plan.

Private financial companies have developed extremely reliable investment methods to provide the level of return and risk that retirees are comfortable with and that allow them to adjust their investment distributions as they get closer to retirement so as to protect their investments from market volatility. Importantly, private retirement accounts would give state employees ownership of their retirement accounts, enabling them to tailor their investments to their own personal preferences.

Private retirement accounts would also better serve RSA members who do not work for the state long enough to become vested. The current vesting period is 10 years for TRS and ERS members.[75] Members who leave before becoming vested receive only their employee contributions. Employer contributions, rather than going to exiting employees, the state, or even the employer (such as the university that paid the contributions), remain in the RSA. TRS, ERS, and JRF members of at least three years receive a graduated percentage return of 4 percent annual interest. The rest of the returns earned on even the employees' contributions are maintained in the asset portfolio of the RSA

75. JRF members are automatically vested. *Judicial Retirement Fund Member Handbook*, http://www.rsa-al.gov/uploads/files/JRF_Member_Handbook_bookmarked_2014.pdf.

(see table 6). While the RSA persists in assuming an 8 percent rate of return on investments, it guarantees members who withdraw only a fraction of that return. The Bureau of Labor Statistics reports that median state and local employees will stay at their current job only 7.4 and 7.9 years, respectively.[76] Given that Vanguard reports that the majority of its employer plans provide immediate vesting, the RSA does not offer an attractive, portable option for recruiting state employees.[77]

**TABLE 6. PERCENTAGE OF INTEREST REFUNDED TO WITHDRAWN RETIREMENT SYSTEMS OF ALABAMA MEMBERS**

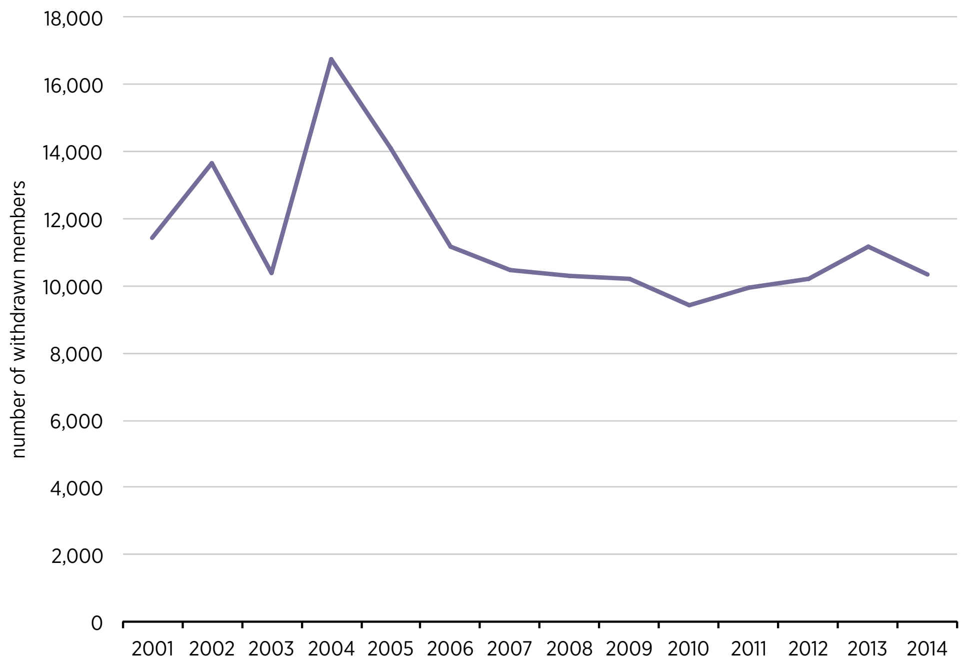
| Years of membership | % of interest refunded |
|---|---|
| less than 3 | 0 |
| 3–16 | 50 |
| 16–21 | 60 |
| 21–26 | 70 |
| 26 or more | 80 |

Sources: "Table of Refunds" in *Teachers' Retirement System Member Handbook: Tier 1*, 9, http://www.rsa-al.gov/uploads/files/TRS_Member_Handbook_T1_bookmarked.pdf; "Table of Refunds" in *Employees' Retirement System Member Handbook: Tier 1*, 9, http://www.rsa-al.gov/uploads/files/ERS_Member_Handbook_T1_bookmarked.pdf; "Table of Refunds" in *Judicial Retirement Fund Member Handbook*, 7, http://www.rsa-al.gov/uploads/files/JRF_Member_Handbook_bookmarked_2014.pdf.

More than 159,400 members have withdrawn from the RSA system since 2001 (see figure 29). This number represents a small, but certainly not insignificant, portion of the RSA membership who would benefit from a portable retirement account. Those members potentially include the spouses of Alabama graduate students teaching in K–12 classrooms, the spouses of military service members, and untenured faculty members who increasingly must take offers from universities in other states to build up their academic portfolios to receive tenure. It should be noted that, in addition to these employees being offered only a small return on their own contributions and being forced to forfeit their employer-side contributions, these state employees are more likely to have lower salaries than employees with longer-term positions. The lack of portable retirement options restricts the state's ability to recruit and retain quality public-sector

76. Bureau of Labor Statistics, "Employee Tenure Summary," Economic News Release, September 18, 2014, http://www.bls.gov/news.release/tenure.nr0.htm.
77. Vanguard, "How America Saves 2015: A Report on Vanguard 2014 Defined Contribution Plan Data," June 2015.

FIGURE 29. NUMBER OF ALABAMA TEACHERS' RETIREMENT SYSTEM, EMPLOYEES' RETIREMENT SYSTEM, AND JUDICIAL RETIREMENT FUND WITHDRAWN MEMBERS, 2001–2014




Source: Retirement Systems of Alabama, annual reports, available at http://www.rsa-al.gov/index.php/about-rsa/publications/annual-report/.

employees.[78] This lack might be one reason a recent study by Maria Donovan Fitzpatrick finds that, on the margin, state employees prefer monetary compensation to future compensation in the form of a public-sector pension.[79]

Michigan and Utah have taken proactive steps to shore up their unfunded pension liabilities by opening alternative retirement options to state employees. In Michigan, state employees can enroll in defined contribution plans that are serviced by competing financial companies. This choice increases the range of retirement options available to state employees, enabling them to tailor their retirement plans to their own needs and risk tolerance. Under this system, Michigan has saved taxpayers an estimated $2 billion to $4 billion since 1997.[80]

78. Interview with Robert M. Costrell, Michael Podgursky, and Christian E. Weller, "Fixing Teacher Pensions: Is It Enough to Adjust Existing Plans?," *Education Next*, Fall 2011, 60–69; Robert M. Costrell and Michael Podgursky, "Reforming K–12 Educator Pensions: A Labor Market Perspective" (Policy Brief, TIAA-CREF Institute, February 2011).
79. Maria Donovan Fitzpatrick, "How Much Are Public Teachers Willing to Pay for Their Retirement Benefits?," *American Economic Journal: Economic Policy* 7, no. 4 (2015): 165–88.
80. Richard C. Dreyfuss, "Estimated Savings from Michigan's 1997 State Employees Pension Plan Reform" (Policy Brief, Mackinac Center for Public Policy, Midland, MI, June 2011).

While reforms have saved Michigan taxpayers substantially, Michigan has continued to incur unfunded liabilities for members in the legacy plan, despite closing it to new members. It is important to note that the underfunding problems would have been far worse if reforms had not been made.[81] In addition, the reforms were made only for the state employee pension plan and not the largest pension plan in the system—the Michigan Public School Employees' Retirement System, which remains significantly underfunded. Utah's pension reform preserved the pension system for then-current employees and offers new employees the option of enrolling in a defined benefit retirement plan with capped state contributions or a defined contribution retirement plan.[82]

With public-sector pension reform, transition reform costs are often overstated because of a misunderstanding of the Governmental Accounting Standards Board's accelerated amortization schedule rules for closing a defined benefit pension plan to new employees.[83] Cavanaugh Macdonald Consulting (the RSA's actuary), in its capacity as the consulting actuary for the Kansas Public Employees Retirement System, made this clear, stating that the board's Summary of Statement No. 25[84] is "strictly related to account for pension benefits, and does not represent a requirement to fund the plan under the standard." Although the board's rules set requirements for how a transition is accounted for, the board does not set the actual funding policy. State legislators do that.[85]

Another step Alabama should take to ensure the long-term fiscal sustainability of the state's pension system is to adopt and maintain more accurate accounting methods for evaluating investment returns and the funding health of the RSA. More transparency regarding the pension system would help. For 2015, the State Integrity Investigation project gives Alabama a letter grade of C+ for state pension fund management owing to the extent and effectiveness of its transparency laws.[86] There is a stark difference between investment reports from private companies, such as TIAA-CREF, and those coming from the RSA.

81. Mackinac Center for Public Policy, "Michigan's Pension Underfunding Problem," accessed February 24, 2016, https://www.mackinac.org/20884.
82. "The Utah Pension Model," *Wall Street Journal*, January 19, 2011, http://on.wsj.com/1ziRTAy.
83. Robert M. Costrell, "'GASB Won't Let Me'—A False Objection to Public Pension Reform" (Policy Perspective, Laura and John Arnold Foundation, Houston, TX, May 2012); Andrew G. Biggs, "Transition Costs and Public Employee Pension Reform" (American Enterprise Institute, Washington, DC, March 24, 2015).
84. Governmental Accounting Standards Board, "Summary of Statement No. 25," November 1994, http://www.gasb.org/st/summary/gstsm25.html.
85. Costrell, "'GASB Won't Let Me.'"
86. Virginia Martin, "Alabama Gets a D+ Grade in 2015 State Integrity Investigation," Center for Public Integrity blog, November 9, 2015, http://www.publicintegrity.org/2015/11/09/18322/alabama-gets-d-grade-2015-state-integrity-investigation.

In addition, little information is provided to the public on the performance of the RSA's private placement portfolio year to year or on the types of investments undertaken. Even when it comes to information requests, the RSA has not been transparent. For this study, we sent the RSA an initial information request on September 8, 2015, primarily for information mentioned in the RSA's annual reports and comprehensive annual financial reports as being available to the public on request. We followed this by a formal Alabama Public Records Law request on November 9, 2015. As of March 2016, we have not received a response from the RSA. (See appendix A for a copy of the second request.)

## ECONOMIC INCENTIVE PROGRAMS

Economic incentive programs are designed to recruit particular businesses to a state through the use of tax breaks, subsidies, and other types of selectively offered incentives. Included are programs aimed at in-state companies to encourage homegrown expansion. The goal of such programs is to encourage economic, job, and wage growth. However, by selectively applying such programs, state and local politicians are effectively picking economic winners and losers, essentially playing the role of venture capitalist at taxpayer expense for bad investments. Rather than welcoming all businesses—outside and inside the state—to set up or expand with low, equal taxes across the board, such programs allow politicians to handpick the recipients of their handouts. Economic incentive programs tend to leave politically unconnected companies at a competitive disadvantage.

Unfortunately, economic incentive programs have a poor track record nationwide. In a review of state and local incentive programs, business professor Richard Florida finds that "there is virtually no association between economic development incentives and any measure of economic performance."[87] A 10-year study on the Michigan Economic Growth Authority program in Michigan finds that $3 billion in state and local incentives did not increase income or employment. Each job that was created cost taxpayers $123,000; 75 percent of the jobs lasted only one year, and the remaining 25 percent disappeared after only two years.[88] Furthermore, these jobs paid lower wages than existing jobs.[89]

87. Richard Florida, "The Uselessness of Economic Development Incentives," *CityLab*, December 7, 2012, http://www.citylab.com/work/2012/12/uselessness-economic-development-incentives/4081/.
88. Michael D. LaFaive and Michael J. Hicks, "MEGA: 10 Years with Little to Show," Mackinac Center for Public Policy, May 2, 2005, https://www.mackinac.org/7084.
89. Michael D. LaFaive and Michael J. Hicks, "MEGA: A Retrospective Assessment" (Report, Mackinac Center for Public Policy, Midland, MI, April 2005).

The Anderson Economic Group finds that, at best, some programs have small positive effects with little impact on employment or tax revenues.[90]

A study of Ohio's economic incentive programs finds that promised jobs often failed to materialize and that the incentives had very little (perhaps even a negative) effect on growth.[91] Economists Chris Coyne and Lotta Moberg find that targeted benefits, such as economic incentive programs, in general fail to achieve their goals, tend to increase cronyism, and provide privileges to politically connected businesses.[92]

Subsequently, we review Alabama's tax incentives, film subsidies, and broadband development programs and argue that these programs should be sharply curtailed or, even better, abandoned in favor of programs that create a relatively low regulatory and low tax environment for the state. Such an environment will increase entrepreneurship and competitiveness with other states and will create a level playing field for all firms.

## Tax Incentives

Alabama has a history of providing select tax incentives and other subsidies to help bring in outside corporations (especially those involved in manufacturing, such as the automotive industry) so as to increase employment opportunities and economic growth throughout the state. This push was largely driven by the decision to court Mercedes-Benz in 1993 with a number of tax rebates and other incentives meant to lure the company to the state. The total incentives provided to Mercedes-Benz amounted to $253 million, costing taxpayers $170,000 per job created.[93] The state has since been involved in a number of additional high-profile deals meant to court other industries.

Overall, Alabama provides a plethora of tax incentives, subsidies, job training efforts, and other rebates for select firms that decide to locate in the state. To date, major programs include the Income Tax Capital Credit, along with property and sales tax abatements. Established in 1995, the Income Tax Capital Credit provides a credit of up to 5 percent of total capital costs of a qualified project. The Tax Incentive Reform Act of 1992 grants local authorities the

90. Patrick L. Anderson, Theodore R. Bolema, and Alex L. Rosaen, "Effectiveness of Michigan's Key Business Tax Incentives" (Anderson Economic Group, East Lansing, MI, March 4, 2010).
91. Todd M. Gabe and David S. Kraybill, "The Effect of State Economic Development Incentives on Employment Growth of Establishments," *Journal of Regional Science* 42, no. 4 (2002): 703–30.
92. Coyne and Moberg, "Political Economy of State-Provided Targeted Benefits."
93. George R. Crowley, "Tax Incentives, Job Creation, and the Unseen: Is Alabama Giving Away the Store to Attract New Industry?," in *Improving Lives in Alabama: A Vision for Economic Freedom and Prosperity*, ed. Daniel Sutter (Troy, AL: Manuel H. Johnson Center for Political Economy, n.d.).

ability to abate state sales and use taxes, noneducational county and city sales and use taxes, noneducational property taxes for up to 10 years, and mortgage and recording taxes for select projects. Additional assortments of smaller tax incentives for businesses along with various incentives are geared toward specific industries, such as the film industry.[94]

Although the intent of those programs is to increase both direct and indirect employment opportunities and thereby also economic growth, development, and tax revenues, such programs have failed to deliver in Alabama or elsewhere. The economic literature regarding industry tax incentives, as well as Alabama's record, shows that these programs provide little, if any, net benefit to the state's economy and end up hurting economic growth and development.[95] Further, given the lack of transparency that exists at both the state and local levels in Alabama, it is almost impossible to verify that the terms of agreements the state has made with corporations are being carried out. In fact, Alabama is one of only five states with no reporting on its tax incentive programs.[96]

Additional evidence comes from Good Jobs First, a policy resource center in Washington, DC. Its studies show that of the major tax incentive programs offered by Alabama, only information on the state's Industrial Development Training program is publicly and readily available. In 2014, Good Jobs First ranked Alabama 44th in

"Given the lack of transparency that exists at both the state and local levels in Alabama, it is almost impossible to verify that the terms of agreements the state has made with corporations are being carried out."

94. For details about these projects, see Alabama Department of Revenue, "Tax Incentives," accessed February 24, 2016, www.revenue.alabama.gov/taxincentives/; "Incentives for Film Production," Alabama Film Office, accessed February 29, 2016, http://alabamafilm.org/2010/filmmakers incentives2.shtml.

95. Crowley, "Tax Incentives, Job Creation, and the Unseen"; Florida, "Uselessness of Economic Development Incentives"; Gabe and Kraybill, "Effect of State Economic Development Incentives"; Alan Peters and Peter Fischer, "The Failures of Economic Development Incentives," *Journal of the American Planning Association* 70, no. 1 (2004): 27–37; Davis, "Tax Incentives."

96. Will Freeland, Ben Wilterdink, and Jonathan Williams, "The Unseen Costs of Tax Cronyism: Favoritism and Foregone Growth" (State Factor, American Legislative Exchange Council, Arlington, VA, July 2014).

terms of disclosure when it comes to economic development subsidies, stating in its report that Alabama, along with Hawaii, has "very poor disclosure." The evidence seems to suggest that transparency is a major weakness in these programs.[97]

The intent of offering tax incentive programs is to provide a competitive environment relative to that of other states and regions, especially in the face of stiff competition from other states that also offer incentives. It is argued that such programs will increase economic growth and development, thereby increasing the tax base and, with it, tax revenues. These programs are also aimed at providing numerous direct and indirect (and, it is hoped, relatively high-paying) employment opportunities throughout the state. Additionally, it is generally believed that without tax incentives, corporations will be lured to other states and regions with more attractive incentive packages.

Such economic incentive programs also have secondary effects and unintended consequences. The costs are generally unaccounted for, but they can impose a substantial burden on a state's economy. The track record of these programs suggests that the costs often outweigh the benefits. Thus, pursuing these policies in Alabama is more likely to hurt the economy than help it.

Where these select incentives are offered, all firms and businesses that do not receive similar preferential treatment are left at a competitive disadvantage relative to the firms that are able to secure incentives from the state. This situation is especially harmful to direct competitors that are already operating in a state. It leads to a significant amount of rent-seeking and other wasteful uses of resources. In addition to lobbying to secure incentive packages for themselves, businesses often lobby to block incentives for their competitors. These effects have been clearly observed both in the economics literature and in the state of Alabama.[98]

For instance, in 1995, Trico Steel (which is now owned by Nucor) was able to secure roughly $85 million in tax incentives from the state to locate in Alabama. This agreement left incumbent Gulf States Steel (a direct rival of Trico Steel) at a significant competitive disadvantage. As a result, Gulf States Steel attempted to block the incentives package through legal action. Although the lawsuit was eventually dropped, this example does show the potentially harmful effects that tax incentives can have on competition and on firms not receiving the tax incentives. A similar issue came up in the late

97. Philip Mattera et al., *Show Us the Subsidies: An Evaluation of State Government Online Disclosure of Economic Development Subsidies* (Washington, DC: Good Jobs First, January 2014).
98. David Brunori, "Principles of Tax Policy and Targeted Tax Incentives," *State and Local Government Review* 29, no. 1 (1997): 50–61; Crowley, "Tax Incentives, Job Creation, and the Unseen."

1990s, when eight relatively small insurance companies sued the state of Alabama over the tax credits being issued. The small companies argued that the incentives disproportionately benefited the larger companies that were able to take advantage of them. Although the suit ultimately failed, it did reach the state supreme court.[99]

Further, the evidence clearly indicates that in many instances any gains in employment are offset by employment losses in unsubsidized sectors of the economy, such as unsubsidized direct competitors. Every dollar of economic incentives necessarily comes from individuals and businesses paying taxes, which prevents them from spending or investing their money as they see fit. While economic incentive programs may create jobs, they necessarily come at the cost of jobs that would have been created elsewhere in the economy. However, such programs are directed by political actors who do not act as residual claimants and who are demonstrably less likely to make prudent investments than private-sector investors. In the long run, state economic incentive programs promote rent-seeking, temporary jobs, and a biased environment favoring businesses that are good at currying political favor.

Additionally, it would appear that, in the absence of these tax incentives, many of the jobs would have been created anyway. Dagney Faulk, director of research at the Center for Business and Economic Research at Ball State University in Muncie, Indiana, examines various employment tax credits provided to businesses by the state of Georgia. Faulk's research, which is largely corroborated by studies of other states' incentive programs, finds that roughly 73 percent to almost 77 percent of the additional jobs are ones that would have been created without the tax credits. Thus, Georgia paid more than $3 million to help create jobs that would have been created without incentives.[100]

Therefore, it is important to properly assess the success or failure of economic incentive programs in Alabama. To do so, we need to see if the number and size of economic incentive packages offered in Alabama have any impact on entrepreneurial and business formation activity. Table 7 provides an annual breakdown of the tax incentives the state provided from 1993 through 2003. Figures 30 and 31 show rates of entrepreneurship between 1996 and 2014 and net firm formation between 1993 and 2013, respectively.

99. Brunori, "Principles of Tax Policy."
100. Dagney Faulk, "Do State Economic Development Incentives Create Jobs? An Analysis of State Employment Tax Credits," *National Tax Journal* 55 (2002): 263–80.

TABLE 7. KNOWN ALABAMA STATE AND LOCAL TAX INCENTIVES BY YEAR AND AMOUNT

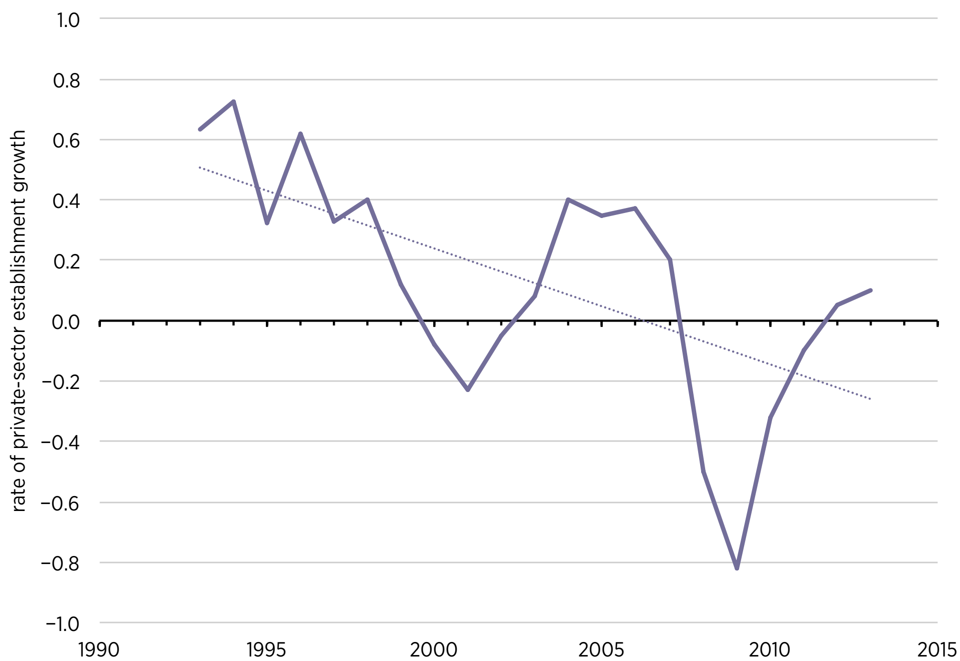
| Year | Amount (real 2014$) | Year | Amount (real 2014$) |
|---|---|---|---|
| 1993 | $389,918,118 | 2004 | 0 |
| 1994 | 0 | 2005 | 0 |
| 1995 | $132,037,795 | 2006 | 0 |
| 1996 | 0 | 2007 | $1,227,538,213 |
| 1997 | $221,248,598 | 2008 | $8,402,028 |
| 1998 | 0 | 2009 | $125,976,579 |
| 1999 | $224,515,534 | 2010 | $19,602,910 |
| 2000 | $164,010,481 | 2011 | $17,313,712 |
| 2001 | 0 | 2012 | $181,996,316 |
| 2002 | $118,039,017 | 2013 | $456,921,658 |
| 2003 | 0 | 2014 | $271,000,000 |

Source: Good Jobs First, "Subsidy Tracker 3.0," accessed December 13, 2015, http://www.goodjobsfirst.org/subsidy-tracker.

FIGURE 30. RATES OF ENTREPRENEURSHIP IN ALABAMA, 1996–2014


Source: Ewing Marion Kauffman Foundation, "State Rankings," *The Kauffman Index* website, accessed February 24, 2016, http://www.kauffman.org/microsites/kauffman-index/rankings/state.

FIGURE 31. NET FIRM ESTABLISHMENT RATE IN ALABAMA BY YEAR, 1993–2013




Source: Bureau of Labor Statistics, "Business Employment Dynamics," accessed December 13, 2015, http://www.bls.gov/bdm/bdmstate.htm.

The information on tax incentives offered by year (since 1993) is from Good Jobs First,[101] which attempted to record and compile all known instances where state and local governments throughout the country offered some form of public assistance to attract businesses to their regions. The data for the state of Alabama are incomplete, and much of this stems from the fact that there is almost no accountability or oversight of the process through which tax incentives are offered by the state. Once economic incentives are secured, there is also no public assessment of the programs to evaluate their success or failure. If anything, the data compiled by Good Jobs First underestimate the number and size of economic incentive packages in Alabama.

The rates of entrepreneurship in Alabama essentially stagnated and remained constant between 1996 and 2014, trending at about 22 new entrepreneurial start-ups per 100,000 citizens per year (see figure 30). We can augment this data with the net firm establishment rate in Alabama between 1993 and 2013 (the most recent year for which data are available; see figure 31).

101. Good Jobs First website, accessed August 29, 2015, http://www.goodjobsfirst.org/.

“Every dollar provided to a given corporation in a tax incentive package is one less dollar that can be spent elsewhere for the provision of legitimate government goods and services.”

This finding shows a clear downward trend in net firm formation for all firm sizes in Alabama. Although the Great Recession took its toll on new firm formation, there has been little in the way of rebound over the past several years. Also, throughout the 1990s there was a clear downward trend in firm formation.

As Table 7 indicates, tax incentives provided since 1993 have totaled roughly $3.5 billion, with a clear upward trend in the total amount of economic incentive packages awarded beginning in 2007 with the megadeal to German multinational conglomerate ThyssenKrupp. This deal is especially significant considering the other generous tax incentives that the state and various local governments offered to businesses over this period. The stated intent of the programs was to attract largely manufacturing firms from outside the state and thereby promote job creation and economic growth in Alabama. Although these programs succeeded in enticing some manufacturers, such as Hyundai, Kia, and Mercedes-Benz, the evidence suggests that such policies tend to crowd out private investment and leave existing or even would-be firms and entrepreneurs at a competitive disadvantage. Thus, the overall outcome suggests that economic incentive programs fail to encourage entrepreneurial formation, economic growth, or development. The trends shown in figures 30 and 31 provide at least a correlation and some corroborating evidence of this effect.

Every dollar provided to a given corporation in a tax incentive package is one less dollar that can be spent elsewhere for the provision of legitimate government goods and services. Ultimately, every dollar offered in subsidies or in the form of a reduced property tax assessment is one dollar less for infrastructure, schools, or any other public service. This result has become a major issue in recent years, especially given the budget shortfalls in Alabama and other states, including Kansas, which reduced funding for K–12 education by $104 million in 2012 to provide a tax incentive package to AMC Entertainment. In fact, the Alabama Education Association brought a lawsuit against the governor of Alabama in 2012 to make the argument that tax incentives lead to a direct drain on resources available for K–12 education in the state.[102] Although the lawsuit was dismissed in circuit court, this action shows that providing large and very generous subsidies to attract outside business does have at least the potential to reduce resources available for other functions of government.

These issues are very real for the state of Alabama given the size and scope of many of the packages and the budget difficulties the state continues to face. Ultimately, the cost of such programs falls on taxpayers in the form of higher taxes or cuts to traditional government services. The starkest example involves ThyssenKrupp Steel, which located in Mobile County in 2007. At the time, the estimated investment on ThyssenKrupp's part was $4 billion, which led to fierce competition over tax incentives between Alabama and Louisiana.

To secure ThyssenKrupp's agreement to locate to Mobile County, the state of Alabama (along with various local governments) provided tax abatements valued at $350 million, cash grants of $314 million, nontax incentives valued at $145 million, and $48 million in construction and employee training reimbursements. In 2011, the tax abatements were increased to $600 million, which brought the total value of the incentive package to roughly $1 billion. In return, ThyssenKrupp promised 2,000 plant jobs, which was estimated to create an additional 4,300 indirect jobs.

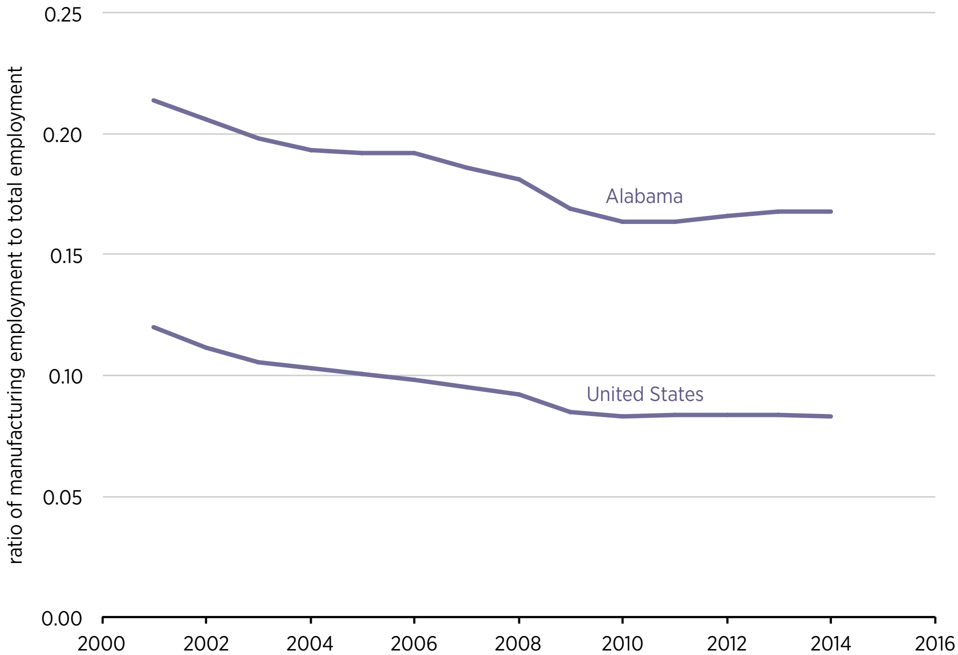
It is estimated that, on the basis of the 1,800 employees ThyssenKrupp had in 2011 and an average manufacturing wage in Mobile County of $58,000, the entire tax package meant a total cost of $555,555 per direct job created.[103] Even at full capacity (with 2,700 employees), this package would amount to $370,000 per employee. Adding in the estimated 4,300 indirect jobs results in a per-job cost of $142,857, significantly higher than the average manufacturing wage.[104]

The stated purpose of economic incentive programs is not just to induce job creation but also to attract high-paying jobs to the state. The phrase "high-paying jobs" often means manufacturing jobs. Thus, it would also be important to evaluate trends in manufacturing employment in Alabama and across the country over time.

Figure 32 clearly indicates that manufacturing employment in Alabama has generally followed similar trends nationwide, with a clear downward trend overall. Given that most of the incentives that have been provided have

102. Cliff Sims. "Court Sides with Gov. Bentley in Lawsuit Brought by Former AEA President," *Yellowhammer News*, March 15, 2012, http://yellowhammernews.com/blog/court-sides-with-gov-bentley-in-lawsuit-brought-by-former-aea-president/.
103. Crowley, "Tax Incentives, Job Creation, and the Unseen."
104. Ibid.

FIGURE 32. RATIO OF MANUFACTURING EMPLOYMENT TO TOTAL EMPLOYMENT IN ALABAMA, 2001–2014




Source: Bureau of Labor Statistics, "State and Metro Area Employment, Hours, & Earnings," accessed December 13, 2015, http://www.bls.gov/sae/data.htm.

gone to manufacturing firms, the long-term sustainability of economic incentive programs and the jobs they create is in question. Although productivity in manufacturing has been on the rise, the main argument generally put forth for economic incentives is the need to increase employment, especially high-paying employment. If the goal of tax incentives is to increase employment opportunities, the evidence in figure 32 suggests that such programs should target industries that are actually providing employment opportunities, which does not seem to be the case for manufacturing.

A major problem that Alabama must grapple with when it comes to economic incentive programs is the state's lack of transparency and accountability. Pew Charitable Trusts attempts to tackle this issue by analyzing the accountability and oversight measures that exist in each state to measure the return a given state receives from its incentive packages. Pew finds that more than half of all states have no steps in place to measure or monitor the effectiveness of their programs. Pew also analyzes the effectiveness of states' oversight and evaluations of tax incentive programs on the basis of how well they informed policy choices, included analyses of all major tax incentives, measured economic impact, and drew clear conclusions from the findings.[105]

Pew finds that Alabama provides no oversight or assessment of state and local tax incentives. In fact, Alabama is one of only two states that do not provide any documentation on their incentive packages and one of only 17 states that do not evaluate tax incentives for their effectiveness. In effect, the incentive packages largely emerge from a black box with no accountability, oversight, or monitoring once granted. Overall, this finding suggests that it is impossible, given the transparency issues in the state, to effectively determine whether there is *any* benefit associated with Alabama's tax incentives. Nor is there a process for evaluating tax incentive programs annually so as to review and recommend reforms.

This absence of oversight suggests that there are many potential avenues for reforming the current selective tax incentive structure that exists in Alabama. A first-best solution would be to simply end the programs that exist. As discussed, economic incentive programs tend to attract firms in declining industries (e.g., manufacturing), which may be detrimental to a state's economy in the long run. Economic incentive programs also tend to be very costly, and they tend to limit funding for other public expenditures. Finally, economic incentive programs generally create an environment ripe for rent-seeking by fostering a situation in which the government selects winners and losers.

A better option would be to reform Alabama's tax code in a manner that would maintain current low tax rates while closing loopholes. Many of the incentive packages agreed to include provisions that require the state to guarantee that a firm receives all available tax credits offered by law, which suggests that the tax code has become overly complex and difficult to navigate.[106] Removing these barriers will provide a more competitive and fair tax environment in the state.

A second-best option for Alabama would be to stop providing selective tax incentives to particular firms and instead provide blanket incentives to any firm that meets specific qualifications. Such a policy is less economically distortionary, because it does not alter incentives to the extent that selective benefits do, and it may also make Alabama a relatively competitive state compared to other states and regions.[107]

105. Pew Center on the States, "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth" (Pew Charitable Trusts, Washington, DC, April 2012).
106. Crowley, "Tax Incentives, Job Creation, and the Unseen."
107. Ibid.

Finally, if neither of these possibilities is politically feasible, the state should at least increase the transparency and accountability associated with all deals and incentive packages it hands out. This increase would include careful economic impact analyses by independent third-party analysts to estimate the effect that any proposed incentive package would have. Further, there should be careful annual monitoring to ensure that all prespecified goals are being met and that the benefits of packages are continuously meeting or exceeding their costs. In the event that the goals are not met, all incentive packages should include sunset and clawback clauses that provide an opportunity for the state to recoup the cost of the packages if a specific firm fails to achieve its promised goals. Incentive programs could also be sharply limited in the total dollar amount granted and could have a built-in goal of attaining a specific unemployment rate that, once reached, automatically suspends further programs.

## Film Project Incentives

Although much smaller pthan the economic incentive programs in the state, film project incentives in Alabama have been growing. In 2009, the legislature authorized the Alabama Film Office to grant up to $5 million in film subsidies per year, which quickly ballooned to $25 million.[108] Yet only half of the film projects approved through the program in 2014 were conducted in Alabama.[109] This growing investment in film project subsidies is a concern for Alabamians, especially given the lackluster performance of such programs nationwide. In fact, while Alabama is expanding its investment in these programs, many states are defunding or eliminating theirs because they recognize that the programs are a net drain on taxpayers and the economy.[110] Michigan

108. Casey Toner, "Alabama Officials and Lawmakers Eye Changes to Film Program to Tone Down State Funded 'Star Power,'" *AL.com*, August 13, 2014, http://s.al.com/OL4zuE; Associated Press, "Film Incentives Increasing in Alabama," *ABC 11 Newscenter*, July 19, 2015, http://www.wtok.com/home/headlines/Film-Incentives-Increasing-in-Alabama-317429811.html; "Summary of Alabama Film Incentives," Alabama Film Office, accessed February 24, 2016, http://www.alabamafilm.org/downloads/Summary_of_Film_Incentives2.pdf.
109. Casey Toner, "How Much Did Alabama Film Incentives Benefit In-State Productions?," *AL.com*, August 27, 2014, http://s.al.com/IafA96U; Cliff Sims, "Movie Boom: 25 Films and 10 Reality TV Shows Have Been Shot in Alabama since 2011," *Yellowhammer News*, January 5, 2015, http://yellowhammernews.com/business-2/movie-boom-25-films-10-reality-tv-shows-shot-alabama-since-2011/.
110. Jarrett Skorup, "Five Reasons Government Subsidies for Films Are a Bad Idea," *Michigan Capitol Confidential* (Mackinac Center for Public Policy), March 27, 2013, http://www.michigancapitolconfidential.com/18456.

recently ended its film project incentive programs, which cost taxpayers, in some cases, $186,519 per job created.[111]

In a national study of state film project incentive programs, William Luther, an assistant professor of economics at Kenyon College in Gambier, Ohio, finds that these costly programs do not deliver the economic benefits promised.[112] Instead, they often create temporary positions for in-state residents with little opportunity for mobility while paying top dollar to out-of-state A-list actors.[113] The Center on Budget and Policy Priorities, a research and policy institute in Washington, DC, comes to similar gloomy conclusions.[114] In a review of state-specific film project incentive programs, the center finds that estimates of the revenue gained per dollar spent on these programs range from 28 cents to a mere 7 cents—a low return by any measure. Alabama should thus immediately end its film subsidy program.

## Broadband Development

In 2015, Governor Bentley commissioned a 19-person advisory board to explore state and local broadband development in Alabama.[115] While supporting broadband development is an increasingly popular economic incentive plan at the state and local levels, the performance of subsidies, tax breaks, and other types of government grants in promoting economic growth has been lackluster. An analysis by the Mackinac Center for Public Policy finds that Michigan's Broadband Development Authority cost state taxpayers nearly $15 million, prompting a previous supporter of the system, then–Senate Majority Leader Ken Sikkema, to label it as "one of the biggest flops in state government."[116] Alabama has the opportunity to avoid the same fate.

A primer on broadband development published by the Cato Institute concludes that tax credits or subsidies for broadband development tend to undermine competition in this technology to the benefit of incumbent industries and

111. Paul Egan, "Snyder Signs Bill Ending Incentives for Film Industry," *Detroit Free Press*, July 10, 2015, http://on.freep.com/1MkPxWl.
112. William Luther, "Movie Production Incentives: Blockbuster Support for Lackluster Policy" (Special Report No. 173, Tax Foundation, Washington, DC, January 2010).
113. Robert Tannewald, "State Film Subsidies: Not Much Bang for Too Many Bucks" (Center on Budget and Policy Priorities, Washington, DC, December 2010).
114. Ibid.
115. Lee Roop, "Governor Creates Broadband Office to Spread High-Speed Internet in Alabama," *AL.com*, July 17, 2015, http://s.al.com/KtQACSM.
116. Michael D. LaFaive and James M. Hohman, "Broadband Development Authority" (Report, Mackinac Center for Public Policy, Midland, MI, 2009).

at the expense of consumers.[117] Furthermore, the study finds that, across America, broadband programs are not necessary for relatively low income and rural households to have Internet access. In a thorough investigation of the effect of state and local broadband development projects, George Mason University economics MA alumnus Brian Deignan finds that, while government-supported broadband programs have increased business formation by 3 percent, worker income actually decreased by 1.3 percent. In addition, such programs increased local government employment by 6 percent, a further burden to taxpayers that inhibits private-sector job growth.[118]

The focus of government-supported broadband development programs on Internet availability appears to be wrongheaded, especially in rural areas with elderly populations. Rather than lacking access to the Internet, elderly people and those in rural areas may lack an understanding of the usability and relevance of the Internet to their lives.[119] Expanding Internet access to areas of Alabama where people do not know how to use computers or the Internet, or have no perceived need for broadband service, is unlikely to have any economic effect. For example, many local businesses in Troy, Alabama, do not have a web presence, despite having broad access to the Internet and an in-town college population of potential customers who are presumably tech savvy.

Considering the limited economic benefits of government broadband development programs compared with the costs of reducing competition and innovation, state and local governments should instead allow private-market competition to spur innovative technologies that will expand Internet access. A better move would be to analyze and reform any unnecessary fees and regulatory barriers that impede development of broadband service at the state and local levels.[120]

On the basis of the national evidence, Alabama should not dedicate resources to broadband development. Instead, the state should remove any remaining regulations that prevent broadband service from being expanded by private providers.

117. Wayne A. Leighton, "Broadband Deployment and the Digital Divide: A Primer" (Policy Analysis No. 410, Cato Institute, Washington, DC, August 2001).
118. Brian Deignan, "Community Broadband, Community Benefits? An Economic Analysis of Local Government Broadband Initiatives" (Mercatus Graduate Policy Essay No. 17, Mercatus Center at George Mason University, Arlington, VA, 2014).
119. Roslyn Layton and Michael Horney, "Innovation, Investment, and Competition in Broadband and the Impact on America's Digital Economy" (Mercatus Working Paper No. 14-22, Mercatus Center at George Mason University, Arlington, VA, August 2014).
120. Ibid.

## PRIVATIZATION

Alabama is facing both short- and long-term budget problems. Recent experience suggests, however, that Alabamians, in general, do not support increased taxes as a way to solve the state's budgetary woes. Importantly, the willingness to bear taxes plays a significant role in conveying to public authorities citizens' assessment of the proper size and role of government.[121] Thus, state leaders ought to pursue ways to cut the size of government by addressing spending rather than by seeking additional sources of revenue to fund the fiscal trajectory. Even modest savings on particular services can add up over time.

While state leaders were hard pressed to find ways to address even the short-term budget gap in 2015 without raising additional taxes, the long-term budget problem could impede long-term economic growth.[122] Privatization can offer a way to procure modest savings in the short term that can add up to substantial long-term savings by reducing the size of government. Privatization is the process of turning over publicly provided services—services that can, and arguably should, be provided by the private sector—to for-profit companies through competitive bidding. Privatization is an alternative to direct government provision and helps steer government resources to core governmental services, rather than to services generally provided by the private sector.

Many of the services the state of Alabama provides are not proper functions of a limited government, meaning that state resources are being unnecessarily drained from the core functions of government. Because Alabama is one of only two states struggling with both

"Privatization can offer a way to procure modest savings in the short term that can add up to substantial long-term savings by reducing the size of government."

121. Richard E. Wagner, *Deficits, Debt, and Democracy: Wrestling with Tragedy on the Fiscal Commons* (Cheltenham, UK: Edward Elgar, 2012); Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, "Privatization in the United States," *Rand Journal of Economics* 28, no. 3 (1997): 447–71.

122. Daniel J. Smith, "If Alabama Leaders Want to Raise Revenue, They Should Cut Taxes," *Yellowhammer News*, March 9, 2015, http://yellowhammernews.com/business-2/if-alabama-leaders-want-to-raise-revenue-they-should-cut-taxes-opinion/.

disproportionately large public-sector employment and above-average public-sector compensation, a drain is created on government resources and on Alabama's economy (because the public sector is ultimately supported by the private sector).[123]

Privatization offers many benefits to cash-strapped governments, including higher-quality service, lower costs, and the freeing up of government officials' time to focus on achieving their core missions rather than the provision of auxiliary services. In fact, contracting is so beneficial that it is common practice in the private sector for companies to contract for auxiliary services from a host of other companies. Contracted services in the private sector range from consulting, advertising, and logistics to accounting and payroll services, lawn maintenance, and janitorial services.

A competitive bidding process provides service providers with incentives to innovate and strive for cost efficiencies. Unfortunately, these incentives are difficult, if not impossible, to replicate when a service is provided by a government agency. However, state and local governments can privatize many services and functions by carefully contracting for their provision, by monitoring performance, and by reopening a contract for bids if there is noncompliance. As economist Paul Rubin argues,

> When a competitive open market exists, this usually offers the most powerful method of controlling costs. If a product is made internally, then the firm must spend substantial managerial resources monitoring costs and efficiencies. In the market, on the other hand, simple shopping or seeking bids can easily and cheaply control costs. The best way to control costs is through the market.[124]

Privatization can cut the cost of government services substantially. In fact, in summarizing the empirical evidence on privatization, Andrei Shleifer, a professor of economics at Harvard University, concludes that when it comes to government provision of goods and services, "the conditions under which government ownership is superior . . . are very limited."[125] Private companies that specialize

123. Smith, "High Public Employment Hurts State's Economy"; Biggs and Richwine, "Overpaid or Underpaid?"; Smith, "How 'Bare-Bones' Is Alabama's State and Local Government Workforce?"
124. Paul H. Rubin, *Managing Business Transactions: Controlling the Cost of Coordinating, Communicating, and Decision Making* (New York: Free Press, 1990), 4.
125. Andrei Shleifer, "State versus Private Ownership," *Journal of Economic Perspectives* 12, no. 4 (1998): 133–50.

in the provision of a specific good or service can generate cost efficiencies from their expertise and scale. A common example of a form of privatization is the purchase of cars for state motor pools from private-sector companies, such as Ford and GM. It would obviously be costly and inefficient for state governments to operate their own automobile companies. Similar logic can apply to lawn maintenance, accounting services, tax collections, liquor stores, and an array of auxiliary services currently undertaken by the state of Alabama.

Privatization has a strong record of success at the federal, state, and local levels.[126] In fact, economists Manuel H. Johnson and James Bennett argue that evidence on the benefits of privatization "is both overwhelming and irrefutable."[127] In Alabama, privatization could be used in many different areas to cut government expenditures and increase the quality of service. In the remainder of this section, we examine a few possible areas where privatization in Alabama would reduce the burden of state government on taxpayers.

## Privatization of Auxiliary School Functions

The privatization of auxiliary school functions, from major services such as transportation, food, and maintenance all the way to specific services such as physical therapy, lawn-mowing, and coaching, is saving school districts across the United States millions of dollars.[128] These savings are funneled back to classrooms to ensure that more of the dollars earmarked for education are actually making their way into classrooms.

For instance, 13.2 percent of traditional public school districts contract for food management services, 17.7 percent contract for maintenance and operation services, and 30 percent contract for transportation services.[129] In some states, such as Michigan, privatization has become an increasingly common way for school districts to improve service quality and increase savings. Contracting in Michigan school districts, for at least one of the three major services—transportation, food, and maintenance and operations—increased from 31 percent in 2001 to 65.5 percent in 2013, resulting in millions in reported savings.[130] In 2013,

126. Ibid.; Eytan Sheshinkski and Luis F. López-Calva, "Privatization and Its Benefits: Theory and Evidence," *CESifo Economic Studies* 49, no. 3 (2003): 429–59.
127. James T. Bennett and Manuel H. Johnson, *Better Government at Half the Price: Private Production of Public Services* (Ottawa, IL: Caroline House, 1981).
128. Daniel J. Smith and Robin P. K. Aguiar-Hicks, "School Service Privatization in Alabama," in *Improving Lives in Alabama: A Vision for Economic Freedom and Prosperity*, ed. Daniel Sutter (Troy, AL: Manuel H. Johnson Center for Political Economy, n.d.).
129. Ibid.
130. Ibid.

92 percent of Michigan school districts reported being satisfied with their contracting experience.[131] A study by the Mackinac Center for Public Policy and the Georgia Public Policy Foundation of school contracting found that in 2015 more than 33 percent of Georgia public school districts contracted outside companies for one of the three major services.[132] Mackinac conducted similar surveys in Texas and Pennsylvania, finding that nearly 23 percent of Texas school districts contracted one of the three major services and that more than 75 percent of Pennsylvania school districts did so.[133]

Yet school service privatization is underused in Alabama's K–12 schools, meaning that funds earmarked for education are unnecessarily not making their way to classrooms. A recent report finds that less than one-fifth of Alabama's K–12 school districts contract out for at least one of the three major services (food, maintenance, and transportation).[134] Given that Alabama school districts collectively spend $1.4 billion—20 percent of the education budget—on these three services, millions of dollars in funding is needlessly being kept from classrooms. In Indiana, a study on contracting by school districts found that those that contracted for transportation services saved an average of 12 percent,[135] which would amount to annual savings of $40 million in Alabama.

Alabama school districts should be encouraged to bid out auxiliary school services to private companies, especially before receiving any additional per-pupil funding from the state. Contracting with private companies would save school districts money that could be repurposed to education and to improving the quality of educational services. It would also free school administrators to focus on what they are best at doing—educating youth—rather than managing dietary guidelines and transportation schedules.

131. Ibid.
132. Michael D. LaFaive and Kelly McCutchen, "Mackinac Center Survey Finds One-Third of Ga. School Districts Contract Out Services," Mackinac Center for Public Policy blog, August 28, 2015, http://www.mackinac.org/21667.
133. Michael D. LaFaive, "Survey: Pennsylvania Is School Contracting Leader," Mackinac Center for Public Policy blog, September 1, 2015, http://www.mackinac.org/21673; Michael D. LaFaive and James Quintero, "New Survey Says Texas Schools behind Contracting Curve," Mackinac Center for Public Policy blog, September 2, 2015, http://www.mackinac.org/21680.
134. Smith and Aguiar-Hicks, "School Service Privatization in Alabama."
135. Robert A. McGuire and T. Norman Vann Cott, "Public versus Private Economic Activity: A New Look at School Bus Transportation," *Public Choice* 43, no. 1 (1984): 25–43.

## Alcoholic Beverage Control Liquor Store Privatization

The Alabama Alcoholic Beverage Control (ABC) Board operates 176 liquor stores (with nearly 600 employees) that compete with private liquor stores.[136] Under the arrangement, private liquor stores, bars, and restaurants are required to purchase all their liquor from the state's ABC stores. There is a 10 percent discount for purchases by the case, but many bars and restaurants, and even small liquor stores, are forced to make single-bottle purchases at full price, giving ABC stores a competitive pricing edge.[137] Also, ABC stores in Alabama are prohibited from owning land for their stores, so ABC stores are leased from private owners, who form a unique group of entrenched interests (in addition to ABC employees) that benefit from maintaining the current arrangement.

A frequent argument against privatization is that it will lead to increased alcohol consumption and negative social outcomes, such as increased underage drinking and drunk driving. A study by M. Keivan Deravi, professor of economics at Auburn University–Montgomery, and Barbara Buchanan, research specialist at the same university, commissioned by the Alabama Alcoholic Beverage Control Board, argues that privatization of ABC stores would lead to increased prices *and* increased consumption of alcohol, in addition to other undesirable social outcomes.[138]

Because most states across the nation do not operate their own liquor stores, a significant body of evidence is available to measure these claims empirically.[139] However, each state has a unique mixture of alcohol control laws, of which government ownership of liquor stores is only one component. Therefore, it is necessary to look at each state's complete regime of alcohol controls to identify any relationship with negative social outcomes. In a systematic study covering every state over multiple years, Michael LaFaive, director of the Morey Fiscal Policy Initiative at the Mackinac Center for Public Policy, and Antony Davies, an associate professor of economics at Duquesne University, examine each state's alcohol laws and classify each as a heavy-control, moderate-control, light-control, or licensed state according to specified definitions, with

136. Cameron Smith, "Last Call for Alabama's State-Run Liquor Operations," *AL.com*, March 29, 2015, http://s.al.com/E66gcOT.
137. Elizabeth Beshears, "Alabama Lawmaker Wants to Get the State Out of the Retail Liquor Business," *Yellowhammer News*, March 16, 2015, http://yellowhammernews.com/politics-2/alabama-lawmaker-wants-to-get-the-state-out-of-the-retail-liquor-business/.
138. M. Keivan Deravi and Barbara Buchanan, "Fiscal and Social Ramifications of Privatization of Spirit Retail Market in Alabama," prepared for Alabama Alcoholic Beverage Control Board, 2014.
139. Nick Banaszak, "State Lawmakers Explore Ending Monopoly on Liquor Sales," *WHNT News 19*, September 30, 2012, http://whnt.com/2012/09/30/state-lawmakers-explore-ending-monopoly-on-liquor-sales/.

“Privatizing the audits of state agents would save Alabama $13 million annually. It would also likely improve the quality of auditing services, including the timeliness of audits.”

licensed states being the least restrictive—and most popular—alcohol control regime.[140] LaFaive and Davies compare the states in each classification to social outcomes, such as alcohol-related driving fatalities and alcohol consumption. They find no relationship between the degree of alcohol control and these outcomes. A compilation of their data shows no relationship between state liquor control and negative social outcomes such as binge drinking, underage drinking, or alcohol-related deaths.[141]

In a separate study with Antony Davies, John Pulito, a senior business systems analyst for CBRE, finds that “privatization is associated neither with increased alcohol consumption nor increased traffic fatalities involving impaired drivers.”[142] Pulito and Davies’s findings are further supported by George Mason University economics professor Donald Boudreaux and Regulatory Economics Group senior consultant Julia Williams in their examination of the relationship between alcohol control measures and alcohol-related problems.[143] Boudreaux and Williams conclude that “control states suffer just as many alcohol-related problems as do license states.”

Regarding prices, the study commissioned by Alabama’s Alcoholic Beverage Control Board provides no evidence to support the claim that privatization of the state’s liquor stores would increase prices (a claim that violates basic economic principles) other than a link to a newspaper article regarding an increase in prices after the state of Washington privatized its liquor stores. However,

140. Michael D. LaFaive and Anthony Davies, “Alcohol Control Reform and Public Health and Safety” (Policy Brief, Mackinac Center for Public Policy, Midland, MI, May 2012).
141. Mackinac Center for Public Policy, “Alcohol Control and Social Outcomes,” accessed February 24, 2016, https://www.mackinac.org/depts/fpi/alcoholcontrol.aspx.
142. John Pulito and Antony Davies, “Government-Run Liquor Stores: The Social Impact of Privatization” (Policy Brief, Commonwealth Foundation, Harrisburg, PA, October 2009).
143. Donald J. Boudreaux and Julia Williams, “Impaired Judgment: The Failure of Control States to Reduce Alcohol-Related Problems” (Policy Report No. 14, Virginia Institute for Public Policy, Gainesville, VA, July 2010).

according to the article, the actual cause of the rise in alcohol prices was the increase in taxes that the state imposed after privatization.[144] Michael LaFaive compares the price of liquor and beer in states actively involved in liquor distribution with states that allow private competition. Not surprisingly, he finds that liquor prices are 3 percent higher and beer prices 7.8 percent higher in states that control alcohol.[145]

Based on that evidence, there is simply no compelling argument for continued state operation of liquor stores in Alabama. Though special interest groups benefit from the current arrangement, state policy should be made on the basis of what is best for long-term growth and economic prosperity for all Alabamians, not for special interest groups. Alabama should privatize its ABC liquor stores to help ensure a fiscally sustainable future for the state.

## Accounting and Auditing Privatization

State auditor Jim Zeigler estimates that privatizing the audits of state agents would save Alabama $13 million annually.[146] It would also likely improve the quality of auditing services, including the timeliness of audits. Currently, state audits cost twice as much as comparable audits conducted in the private sector. Delays under the current system prevent the audits from being useful to government agencies. Similar savings and quality improvements are available for state and local accounting and tax collection services. Similarly, Ziegler argues that each state agency should competitively contract with a private accounting firm for accounting services.[147] Exploring options for privatizing such services as accounting and auditing could potentially save Alabama millions annually.

## Golf Courses, Parks, Rest Stops, Visitor Centers, and Driver's License Offices

The state of Alabama (as well as numerous local governments) owns and operates numerous golf courses, parks, rest stops, and visitor centers that could—

144. Ángel González, "In Aftermath of Liquor Privatization, Spirits Everywhere, Not Cheap," *Seattle Times*, June 30, 2014, http://www.seattletimes.com/business/in-aftermath-of-liquor-privatization-spirits-everywhere-not-cheap/.
145. Michael D. LaFaive, "State Alcohol Control Law Expensive, Unfair, Ineffective" (Viewpoint on Public Issues, Mackinac Center for Public Policy, Midland, MI, January 2012).
146. Drew Galloway, "Alabama State Auditor Releases Plan to Avoid State Park Shutdown," *WHNT News 19*, April 21, 2015, http://go.whnt.com/1G42hMk.
147. Angel Coker, "Jim Zeigler: Alabama Should Privatize State Audits," *Tuscaloosa News*, April 21, 2015, http://www.tuscaloosanews.com/article/20150421/NEWS/150429889.

and should—be operated by the private sector. There is simply no public-goods argument for ownership and operation of golf courses at the state or local level.[148] Golf courses should be sold to the private sector. Justifications that are based on claims that golf courses create an economic effect depend on unrealistic and faulty assumptions.[149] Golf is a private good that should be provided only by the private sector.[150]

Additionally, the operation of park, rest stop, and state visitor center services could be contracted to private providers or even sold directly to private companies.[151] Both California and Georgia recently privatized state parks to improve efficiency, joining other states such as Arizona, Colorado, Nevada, New Mexico, Oregon, and Washington.[152] Alabama operates all 22 of the state's parks, and state leaders have threatened to close 15 because of recent fiscal shortfalls.[153] Privatization would alleviate the tax burden of state-run parks for taxpayers, including taxpayers who may never use many of the parks.

The announced closure in 2015 of 31 driver's license offices in Alabama for budgetary reasons sparked significant controversy, especially because the closures were predominantly in rural, poor, and minority counties. While it may, in fact, be difficult to justify operating driver's license offices in locations where there is little need for them (especially if other options exist nearby), an alternative would be to privatize driver's license offices altogether. If a true market demand exists for a driver's license office in a county and people are

148. Michael D. LaFaive, "Slicing Municipal Golf from Government Balance Sheets," Mackinac Center for Public Policy, December 2, 2004, https://www.mackinac.org/6900.
149. Daniel J. Smith, "Let's Bust the Myth That Raising Taxes Will Stimulate Alabama's Economy," *Yellowhammer News*, June 19, 2015, http://yellowhammernews.com/politics-2/lets-bust-the-myth-that-raising-taxes-will-stimulate-alabamas-economy-opinion/.
150. Raymond J. Keating, "Fore: Watch Out for Government Golf!," Foundation for Economic Freedom blog, August 1, 1997, http://fee.org/freeman/detail/fore-watch-out-for-government-golf.
151. James M. Hohman, "Give MDOT a Potty Break: Privatize State Rest Areas," *Michigan Privatization Report* (Mackinac Center for Public Policy), April 26, 2004; Ronald D. Utt, "Privatizing Rest Stops Allows States to Serve Motorists and Increase Revenues," WebMemo #2724, Heritage Foundation, December 8, 2009, http://www.heritage.org/research/reports/2009/12/privatizing-rest-stops-allows-states-to-serve-motorists-and-increase-revenues.
152. Tim Omarzu, "Georgia Privatizing Five State Parks with Upscale Lodges and Golf Courses," *Times Free Press*, May 2, 2013, http://www.timesfreepress.com/news/local/story/2013/may/02/georgia-privatizing-five-state-parks-upscale-lodge/106931/; Leonard Gilroy, "Public-Private Partnerships Could Save State Parks," *Orange County Register* (Reason Foundation), May 31, 2013, http://reason.org/news/show/state-parks-privatization-californi; Leonard Gilroy, Harris Kenny, and Julian Morris, "Parks 2.0: Operating State Parks through Public-Private Partnerships," in *Conservation & the Environment: Conservative Values, New Solutions*, ed. P. Lynn Scarlett (N.p.: Conservation Leadership Council, January 2013).
153. Megan Miller, "State Financial Troubles Leading to Closing of 15 State Parks," *WIAT*, April 15, 2015, http://wiat.com/2015/04/15/state-financial-troubles-leading-to-closing-of-15-state-parks/.

willing to pay for it, a private business could successfully provide the service. Many states (including Arizona, Louisiana, and Ohio) have privatized driver's license offices, driver testing, and titling services, helping to ensure service in rural areas without draining state resources.[154]

## EDUCATION REFORM

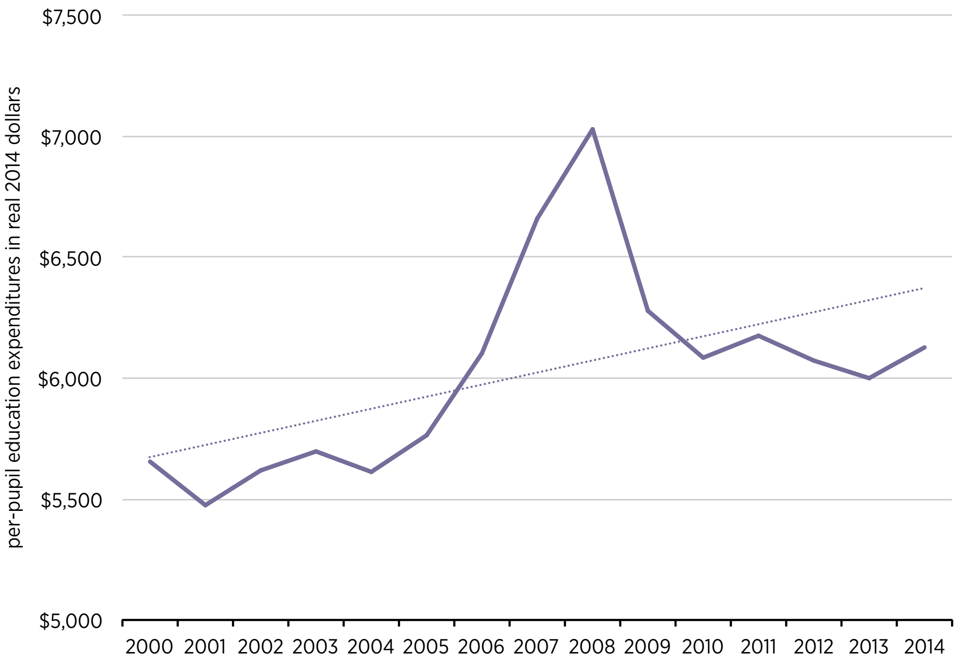
Like many states, Alabama has a school system that is inadequately preparing the state's youth for college or for 21st-century jobs. The symptoms of failing schools in Alabama include low student achievement levels and an ill-prepared workforce, both at an ever-increasing cost to taxpayers. Far too many Alabama high school graduates are not prepared for college. For instance, only 20 percent of 2013 high school graduates were fully ready for college based on their ACT results.[155] In addition, Alabama has one of the worst high school dropout rates in the nation. Between 2002 and 2012, roughly 30 percent of Alabama's high school students failed to graduate within four years.

Higher standards, across-the-board reductions in class size, more stringent teacher qualification requirements, promises to improve political and administrative accountability based on test scores, and large per-pupil spending hikes have all failed. Alabama is not getting nearly enough in return for its massive investment in K–12 schooling. Figure 33 provides a breakdown of per-pupil K–12 expenditures in Alabama between 2000 and 2014. As shown, expenditures rose significantly between 2000 and 2008, from $5,653 per pupil to $7,029. Although the Great Recession led to a significant reduction in expenditures, spending was roughly $6,100 per pupil thereafter, with the trend appearing to increase through this range as well.

The good news is that evidence from school choice programs across the nation strongly shows that expanding school choice in Alabama would boost educational performance in the state. A comprehensive study of charter schools in Michigan finds that in 52 of 56 tested outcomes, charter schools performed better than conventional public schools.[156] An even more comprehensive study of the empirical evidence on school choice from around the

154. Daniel J. Smith, "Troy Economist: Alabama Chose Liquor Stores over Driver's License Offices," *Yellowhammer News*, October 16, 2015, http://yellowhammernews.com/politics-2/troy-economist-alabama-chose-liquor-stores-over-drivers-license-offices-opinion/.
155. John Merrifield and Jesse Ortiz, "Reinventing the Alabama K–12 School System to Engage More Children in Productive Learning," in *Improving Lives in Alabama: A Vision for Economic Freedom and Prosperity*, ed. Daniel Sutter (Manuel H. Johnson Center for Political Economy, Troy, AL, n.d.).
156. Michael Van Beek, "Michigan Charter Schools a Smashing Success," Mackinac Center for Public Policy blog, January 15, 2013, http://www.mackinac.org/18170.

FIGURE 33. ALABAMA PER-PUPIL EDUCATION EXPENDITURES, 2000–2014




Source: National Center for Education Statistics, Common Core of Data, "State Nonfiscal Public Elementary/Secondary Education Survey Data," accessed February 21, 2016, https://nces.ed.gov/ccd/stnfis.asp (school years 1990/91 through 2011/12; State Public Elementary and Secondary Enrollment Projection Model, 1980–2023).

nation finds nearly universal evidence that school choice improves outcomes for students in new programs and public schools, reduces racial segregation, and saves taxpayer money.[157]

A recent Johnson Center publication suggests that expanding the number and types of K–12 schools in Alabama and empowering parents to decide which school is best for their children will lead to better academic outcomes.[158] The current one-size-fits-all approach in Alabama demonstrably fails to provide the necessary flexibility to encourage experimentation and to meet the diverse educational needs of parents and students.

The benefits of expanding school choice in Alabama include creating competition, motivating teachers, recognizing and serving diversity by expanding schooling options, and engaging and empowering parents. Competition inspires excellence, regardless of the good or service being delivered. It also

157. Greg Forster, *A Win-Win Solution: The Empirical Evidence on School Choice*, 3rd ed. (Indianapolis, IN: Friedman Foundation, April 2013).
158. Merrifield and Ortiz, "Reinventing the Alabama K–12 School System."

encourages innovation and experimentation. When parents have options, schools are forced to constantly strive to please current families and attract new ones. Giving families more choice in their children's education shifts accountability away from public officials to those who care the most—parents. Parental choice also provides the flexibility to encourage experimentation in educational styles and teaching methods.

School choice also motivates teachers. Specialized schools ensure that teachers have the flexibility and motivation to use innovative approaches in teaching. Schools also have the flexibility to reward excellence in the classroom with salary increases. Allowing flexibility in salaries so as to reward the highest-quality teachers, as well as granting the ability to fire underperforming teachers, will certainly result in better academic outcomes. Currently, there are few, if any, tangible rewards for outstanding performance. The single-salary schedule discourages high achievers from entering the teaching profession in the first place by basing pay on general credentials and experience, creates shortages of some types of teachers, and stifles innovation and the pursuit of excellence. Furthermore, experience and educational attainment levels have not been found to be strong indicators of teacher performance.

Recognizing and serving diversity by expanding education options is another benefit of school choice.[159] Children are not all the same—they have unique talents and abilities and certainly different learning styles. By expanding education options, Alabama schools could cater to this diversity and help engage students who are disenfranchised by the current one-size-fits-all approach, leading to better performance. Finally, school choice improves education outcomes by engaging and empowering parents. Currently, parents are denied control of some of the most basic aspects of their children's education. Essentially, the current system relegates parents to passive roles. School choice would enable them to be active participants.

Several different policy options could be pursued to implement school choice in Alabama. The biggest opportunity has come from the legalization of charter schools in 2015 and the 2013 Alabama Accountability Act.[160] Although the legalization of charter schools in Alabama was sharply curtailed to just 10 school districts, by removing the restriction on the number of charter schools, state leaders could expand the benefits of school choice to more Alabama

159. Scott Alex Beaulier, Daniel J. Smith, and Benjamin G. Tegethoff, "Education in a Robust Political Economy" (working paper, 2012), available through SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2147724.
160. Alabama Policy Institute, "The Alabama Accountability Act," accessed February 24, 2016, http://www.alabamapolicy.org/wp-content/uploads/2013-Alabama-Accountability-Act-GTI.pdf.

“Given Alabama students’ poor academic performance—in absolute terms and compared with students in other states—education reform should continue to be a priority for Alabama.”

youth. Doing so would also put more systematic pressure on public schools to reform and to provide an avenue for more experimentation with education approaches.

Another option beyond charter schools is a system of universal tuition tax credits. Under this system, Alabama families would receive a refundable tuition tax credit of a set amount per child, with eligible taxpayers receiving a check for unused portions of the tax credit. A universal tax credit could help foster specialized schooling options, which would substantially increase competition, motivate teachers, cater to diversity, and engage parents.

A final option to consider is education savings accounts to be used for a variety of purposes, including private schools and community college tuition, tutoring, and education-related therapies.[161] The system introduced in Nevada allows parents to put any leftover money in their child’s account toward college tuition. This type of system gives parents more flexibility in finding the schooling options that best meet the needs of their children.

Given Alabama students’ poor academic performance—in absolute terms and compared with students in other states—education reform should continue to be a priority for Alabama. A continually failing K–12 education system ultimately requires significant public expenditures later for remedial education at the college level, public assistance, and workforce training programs. Good education systems, on the other hand, will attract businesses and residents to Alabama. Systematically expanding school choice has a proven track record of improving education outcomes.

## TAX REFORM

Although Alabama faces both short- and long-term budget woes, state leaders should think twice before increasing taxes to fill the gaps. While increased tax revenues may

161. Clint Bolick, “Nevada Places a Bet on School Choice,” *Wall Street Journal*, June 14, 2015, http://on.wsj.com/1GmVtMY.

solve short-term budget woes, there is a large literature on taxation and economic growth suggesting that relatively high tax rates often reduce revenues in the long run. This inverse relationship exists because higher taxes discourage entrepreneurship, new business formation, and population growth.[162] Examining 30 years of state-level data, Randall Holcombe, a professor of economics at Florida State University, and Donald Lacombe, an associate professor of economics at the Regional Research Institute at West Virginia University, find that raising taxes ultimately leads to slower income growth.[163]

A report by the Public Affairs Research Council of Alabama finds that the state has the lowest per capita state tax revenue in the nation.[164] Rather than providing a justification for raising taxes, this report highlights the need to cut taxes in Alabama to make the state more competitive. Low, fair, and straightforward tax structures expand states' economies, attract residents and businesses, and eventually bring in more tax revenues. While Alabama's tax revenues per person may be low compared to other states, Alabama's tax rates are not.

Alabama is in competition with other states, especially neighboring states, for residents and businesses. Taxes and economic freedom in general are major factors that residents and businesses take into consideration. In its 2015 State Business Tax Climate Index, the Tax Foundation ranks Alabama's business tax climate 28th. Regionally, Alabama falls behind Florida, Mississippi, Tennessee, and Texas.[165] Even without raising taxes, this ranking puts Alabama behind its neighbors when it comes to attracting residents and businesses. Table 8 breaks out some of the taxes levied by Alabama and its regional neighbors. For instance, Louisiana is the only regional state that has a higher corporate income tax rate than Alabama (Tennessee has the same rate of 6.5 percent).

162. Arthur B. Laffer and Stephen Moore, "Taxes Really Do Matter: Look at the States" (Laffer Center for Supply-Side Economics, Austin, TX, September 2012); Eric Fruits and Randell Pozdena, "Tax Myths Debunked" (American Legislative Exchange Council, Arlington, VA, January 2013); Barry W. Poulson and Jules Gordon Kaplan, "State Income Taxes and Economic Growth," *Cato Journal* 28, no. 1 (2008): 53–71; William McBride, "What Is the Evidence on Taxes and Growth?" (Special Report No. 207, Tax Foundation, Washington, DC, December 2012); Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review* 100, no. 3 (2010): 763–801.
163. Randall G. Holcombe and Donald J. Lacombe, "The Effect of State Income Taxation on Per Capita Income Growth," *Public Finance Review* 32, no. 3 (2004): 292–312.
164. Public Affairs Research Council of Alabama, "Lowest Per Capita Tax Collections in the Nation," December 4, 2015, http://parcalabama.org/lowest-per-capita-tax-collections-in-the-nation-2/.
165. Scott Drenkard and Joseph Henchman, "2015 State Business Tax Climate Index," Tax Foundation, October 28, 2014, http://taxfoundation.org/article/2015-state-business-tax-climate-index.

### TABLE 8. REGIONAL COMPARISON OF STATE TAXES

| | Alabama | Florida | Georgia | Mississippi | Tennessee | Texas | Louisiana |
|---|---|---|---|---|---|---|---|
| 2015 state business tax climate rank[a] | 28th | 5th | 36th | 18th | 15th | 10th | 35th |
| State government tax collections per capita[b] | $1,916 | $1,779 | $1,845 | $2,530 | $1,803 | $2,050 | $2,085 |
| State and local individual income tax collections per capita[c] | $648 | $0 | $826 | $503 | $28 | $0 | $539 |
| State income tax rate[d] | 5% | 0% | 6% | 5% | 0%* | 0% | 6% |
| Corporate income tax rates[e] | 6.5% | 5.5% | 6.0% | 5.0% | 6.5% | 0.0% | 8.0% |
| Sales tax collections per capita[f] | $863 | $1,106 | $929 | $1,030 | $1,325 | $1,182 | $1,451 |
| State and local tax rates[g] | 8.51% | 6.62% | 6.97% | 7.00% | 9.45% | 8.15% | 8.89% |
| Gas taxes—cents per gallon[h] | 20.87 | 36.42 | 32.62 | 18.78 | 21.40 | 20.00 | 20.01 |
| Property tax collections per capita[i] | $539 | $1,507 | $1,096 | $853 | $795 | $1,562 | $748 |
| Property tax rates[j] | 0.43% | 1.06% | 0.95% | 0.80% | 0.75% | 1.90% | 0.51% |
| State excise taxes per capita[k] | $551 | $599 | $320 | $479 | $451 | $573 | $526 |
| State spirit taxes[l] | $18.22 | $6.50 | $3.79 | $7.46 | $4.46 | $2.40 | $2.50 |
| Beer taxes[m] | $1.05 | $.48 | $1.01 | $.43 | $1.29 | $.20 | $.43 |
| Wine taxes[n] | $1.70 | $2.25 | $1.51 | – | $1.27 | $.20 | $.11 |

* Tennessee has a 6 percent tax on dividend and interest income.

Sources: (a) Scott Drenkard and Joseph Henchman, "2015 State Business Tax Climate Index," Tax Foundation, October 28, 2014, http://taxfoundation.org/article/2015-state-business-tax-climate-index; (b) Henry J. Kaiser Family Foundation, "State Government Tax Collections Per Capita," accessed March 1, 2016, http://kff.org/other/state-indicator/state-collections-per-capita/; (c) Liz Malm, "State and Local Individual Income Tax Collections Per Capita (Fiscal Year 2012)," *Tax Policy Blog* (Tax Foundation), May 28, 2015, http://taxfoundation.org/blog/state-and-local-individual-income-tax-collections-capita-fiscal-year-2012; (d) Jared Walczak, "State Individual Income Tax Rates and Brackets for 2015," Tax Foundation, April 15, 2015, http://taxfoundation.org/article/state-individual-income-tax-rates-and-brackets-2015; (e) ibid.; (f) Liz Malm and Morgan Scarboro, "Map: State and Local General Sales Tax Collections Per Capita," *Tax Policy Blog* (Tax Foundation), June 11, 2015, http://taxfoundation.org/blog/map-state-and-local-general-sales-tax-collections-capita; (g) Scott Drenkard, "State and Local Sales Tax Rates in 2014," Tax Foundation, March 18, 2014, http://taxfoundation.org/article/state-and-local-sales-tax-rates-2014; (h) Colby Pastre, "How High Are Gas Taxes in Your State?," *Tax Policy Blog* (Tax Foundation), July 23, 2015, http://taxfoundation.org/blog/how-high-are-gas-taxes-your-state; (i) Richard Borean, "Monday Map: State & Local Property Tax Collections Per Capita," *Tax Policy Blog* (Tax Foundation), June 10, 2013, http://taxfoundation.org/blog/monday-map-state-local-property-tax-collections-capita; (j) Jared Walczak, "How High Are Property Taxes in Your State?," *Tax Policy Blog* (Tax Foundation), August 13, 2015, http://taxfoundation.org/blog/how-high-are-property-taxes-your-state; (k) Liz Malm, "How Much Does Your State Collect in Excise Taxes Per Capita?," *Tax Policy Blog* (Tax Foundation), August 28, 2015, http://taxfoundation.org/blog/how-much-does-your-state-collect-excise-taxes-capita; (l) Samantha Jordan and Scott Drenkard, "Map of State Spirits Excise Tax Rates in 2015," *Tax Policy Blog* (Tax Foundation), July 2, 2015, http://taxfoundation.org/blog/map-state-spirits-excise-tax-rates-2015; (m) Scott Drenkard, "How High Are Beer Taxes in Your State?," *Tax Policy Blog* (Tax Foundation), May 22, 2015, http://taxfoundation.org/blog/how-high-are-beer-taxes-your-state; (n) Samantha Jordan and Scott Drenkard, "How High Are Wine Taxes in Your State?," *Tax Policy Blog* (Tax Foundation), June 23, 2015, http://taxfoundation.org/blog/how-high-are-wine-taxes-your-state.

In addition to examining business taxes in the state, the Tax Foundation's State Business Tax Climate Index includes a measure of income taxes, because many businesses are actually set up as pass-through entities that are taxed at the personal income rate, not the corporate business tax rate. Thus, Alabama's personal income tax rates are also an important factor that business owners or potential business owners take into consideration. Alabama does not fare well when it comes to personal income taxes either. Florida, Tennessee, and Texas have no state income tax.

While raising taxes will likely reduce Alabama's economic growth, fixing the tax system, which is in serious need of reform, could bolster economic growth. The nonprofit research organization Institute for Taxation and Economic Policy issues an annual state report that examines the distribution of taxes across different income groups in each state. According to the 2015 report, the bottom 20 percent of families in Alabama paid 10 percent of their income in state and local taxes, while the top 1 percent paid only 3.8 percent.[166] Alabama's tax system falls disproportionately on the poor for two reasons. First, the allowance for deducting federal income and payroll taxes on Alabama's state tax returns reduces Alabama taxes disproportionately for the wealthy. Second, compared with other states, Alabama has some of the highest taxes on beer, wine, and spirits.[167] These "sin taxes" disproportionately affect the poor.[168]

Because broad-based tax systems that levy low taxes without special loopholes and privileges for different groups tend to be the most conducive to economic growth, Alabama's tax system should be reformed to more fairly distribute the burden of taxes.[169] However, reforms should be undertaken in a revenue-neutral manner. Undertaking tax reform in a manner that raises taxes may offset the economic benefits of tax reform and also politically block needed tax reforms.

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166. Carl Davis et al., "Who Pays? A Distributional Analysis of the Tax Systems in All Fifty States," 5th ed. (Institute on Taxation and Economic Policy, Washington, DC, January 2015).
167. Scott Drenkard, "How High Are Beer Taxes in Your State?," *Tax Policy Blog* (Tax Foundation), May 22, 2015, http://taxfoundation.org/blog/how-high-are-beer-taxes-your-state; Samantha Jordan and Scott Drenkard, "How High Are Wine Taxes in Your State?," *Tax Policy Blog* (Tax Foundation), June 23, 2015, http://taxfoundation.org/blog/how-high-are-wine-taxes-your-state; Samantha Jordan and Scott Drenkard, "Map of State Spirits Excise Tax Rates in 2015," *Tax Policy Blog* (Tax Foundation), July 2, 2015, http://taxfoundation.org/blog/map-state-spirits-excise-tax-rates-2015.
168. Michael L. Davis et al., "Taxing the Poor: A Report on Tobacco, Alcohol, Gambling, and Other Taxes and Fees that Disproportionately Burden Lower-Income Families" (Policy Report No. 300, National Center for Policy Analysis, Dallas, TX, June 2007).
169. Shahira ElBogdady, "The Inefficiency of Targeted Tax Policies" (Joint Economic Committee Republicans, Washington, DC, April 1997); Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, CA: Hoover Institution Press, 2007).

One tax structure that has fostered economic success elsewhere is elimination of state income tax and replacement with a consumption tax. Economists Arthur Laffer and Stephen Moore compare the nine states that eliminated their income tax to the states with the highest income taxes. They find that the states that eliminated their income tax then had population growth two and one-half times higher, in addition to having higher tax revenue growth.[170]

To situate Alabama for fiscal sustainability, tax reform is necessary. Taxes should be reformed to be low and shared equally, without loopholes or privileges. Some states, such as Texas, have created environments that are conductive to business by eliminating corporate and personal income taxes. By shifting from taxes that penalize personal and business income (and thus discourage economic growth) to taxes that instead fall on consumption, many states have been able to reduce the economic harm that comes from taxes.

## REGULATORY REFORM

Complex, contradictory, and costly regulatory barriers represent an increasing threat to business growth and formation in Alabama and the United States. Regulation, often passed as a means to protect consumers, unfortunately tends to be captured by the regulated industry.[171] Thus, rather than advancing consumer interests, regulation ends up being used to advance the interests of the regulated industry, namely by restricting entry into the industry. This restriction reduces competition, thereby allowing incumbents to charge higher prices and be less responsive to consumer demands.

While a whole range of industries across Alabama faces substantial regulatory hurdles, we focus on state regulation that is affecting entrepreneurship, healthcare markets, alcohol markets, and labor mobility and freedom. Additionally, we provide recommendations for reforming the actual review process through which new and existing regulations are evaluated to better foster the removal of economically inefficient regulations and thereby increase the state's competitiveness and promote entrepreneurship and growth.

170. Laffer and Moore, "Taxes Really Do Matter."

171. Simeon Djankov et al., "The Regulation of Entry," *Quarterly Journal of Economics* 117, no. 1 (2002): 1–37; Hernando de Soto, *The Other Path: The Economic Answer to Terrorism* (New York: Basic Books, 1990); Andrei Shleifer and Robert W. Vishny, "Corruption," *Quarterly Journal of Economics* 108, no. 3 (1993): 599–617; Gilbert Becker, "The Public Interest Hypothesis Revisited: A New Test of Peltzman's Theory of Regulation," *Public Choice* 49, no. 3 (1986): 223–34; George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics* 2, no. 1 (1971): 3–21.

## Entrepreneurship

Only one current Fortune 500 company is headquartered in Alabama.[172] This statistic does not appear to be something that will change in the near future. Further, Alabama has the eighth-lowest rate of new entrepreneurs in the nation (tied with Kansas, Illinois, and Virginia), the absolute lowest opportunity share of new entrepreneurs, and the fourth-lowest start-up density.[173] Even a regional comparison shows Alabama substantially behind its neighbors in start-up activity (see table 9). In fact, the rate of business ownership in Alabama dropped from 7.28 percent in 1984 to 4.04 percent in 2015, the lowest in our regional comparison.[174] This does not bode well for future economic prosperity in Alabama, because entrepreneurship contributes to both economic growth and job creation.[175]

**TABLE 9. ALABAMA REGIONAL COMPARISON OF ENTREPRENEURSHIP, 2015**

| | Alabama | Florida | Georgia | Mississippi | Tennessee | Texas | Louisiana |
|---|---|---|---|---|---|---|---|
| Kauffman state rankings for start-up activity | 49th | 9th | 40th | 22nd | 45th | 17th | 13th |
| Kauffman rate of new entrepreneurs | 0.22% | 0.35% | 0.29% | 0.34% | 0.24% | 0.36% | 0.33% |
| Kauffman opportunity share of new entrepreneurs | 69.0% | 80.3% | 69.7% | 79.7% | 70.0% | 80.6% | 89.2% |
| Kauffman start-up density | 92.7 | 188.7 | 126.0 | 88.4 | 99.3 | 130.4 | 112.7 |
| Kauffman rate of business ownership | 4.04% | 7.16% | 5.83% | 5.11% | 5.44% | 5.93% | 6.25% |
| Kauffman established small businesses per 100,000 residents | 879.9 | 1,009.1 | 850.9 | 869.4 | 829.3 | 790.4 | 994.0 |

Sources: Ewing Marion Kauffman Foundation, "State Rankings," *The Kauffman Index* website, accessed February 24, 2016, http://www.kauffman.org/microsites/kauffman-index/rankings/state; Ewing Marion Kauffman Foundation, "State Profiles," *The Kauffman Index* website, accessed February 24, 2016, http://www.kauffman.org/microsites/kauffman-index/profiles/state.

172. Daniel J. Smith, "Reform Needed to Restore Economic Freedom," *Montgomery Advertiser*, August 2, 2013.
173. Ewing Marion Kauffman Foundation, "State Rankings," *The Kauffman Index* website, accessed February 24, 2016, http://www.kauffman.org/microsites/kauffman-index/rankings/state.
174. Ewing Marion Kauffman Foundation, "State Profiles" with Alabama selected, *The Kauffman Index* website, accessed February 24, 2016, http://www.kauffman.org/microsites/kauffman-index/profiles/state?State=Alabama.
175. Ryan Decker et al., "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives* 28, no. 3 (2014): 3–24.

Regulations can impose costly barriers on entrepreneurs, reducing business formation and expansion. Regulation acts as a barrier to new entrants to an industry, protecting high-cost producers from more efficient rivals.[176] Additionally, Simeon Djankov, a visiting professor at the London School of Economics, and his colleagues find that countries with more regulation experienced more corruption and black markets, as well as higher costs of regulation with little measurable social benefit from regulation.[177]

## Healthcare Regulation

Alabama's healthcare costs have increased significantly over time, following national trends. Although the state's healthcare costs are lower than the national state average, the quality of health care in Alabama is substantially worse than in most other states.[178] In 2015, Governor Bentley recognized the need to improve the quality, accessibility, and affordability of health care in the state when he issued an executive order to create a panel of experts tasked with making recommendations to address the problem for the 2016 legislative session.[179] This is certainly a step in the right direction, but it is critical that these meetings include the available research and expertise in order to make real progress in improving health care in Alabama.

A 2015 study by scholars at the Mercatus Center at George Mason University could provide a roadmap to real healthcare reform in Alabama.[180] It finds that Alabama could improve the quality of (and lower the costs for) health care by eliminating certificate-of-need (CON) laws, relaxing scope-of-practice laws, and removing physical exam laws. Table 10 shows how Alabama's rules compare to those of its neighbors.

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176. Raymond Fisman and Virginia Sarria Allende, "Regulation of Entry and the Distortion of Industrial Organization," *Journal of Applied Economics* 13, no. 1 (2010): 91–111.
177. Djankov et al., "Regulation of Entry."
178. Henry J. Kaiser Family Foundation, "Health Care Expenditures Per Capita by State of Residence," accessed February 24, 2016, http://kff.org/other/state-indicator/health-spending-per-capita/; Commonwealth Fund, Health System Data Center, "Alabama: State Health System Ranking," accessed February 24, 2016, http://datacenter.commonwealthfund.org/scorecard/state/2/alabama/; United Health Foundation, America's Health Rankings, "State Data: Alabama," accessed February 24, 2016, http://www.americashealthrankings.org/AL.
179. Elizabeth Beshears, "Bentley Packs Healthcare Task Force with Democrats, Medicaid Expansion Advocates," *Yellowhammer News*, April 6, 2015, http://yellowhammernews.com/politics-2/bentley-packs-healthcare-task-force-with-democrats-medicaid-expansion-advocates/.
180. Matthew Mitchell, Anna Mills, and Dana Williams, "Three Prescriptions for States to Improve Health Care" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, January 2015).

TABLE 10. ALABAMA REGIONAL COMPARISON OF HEALTHCARE REGULATIONS

| | Alabama | Florida | Georgia | Mississippi | Tennessee | Texas | Louisiana |
|---|---|---|---|---|---|---|---|
| Certificate-of-need regulation | Yes | Yes | Yes | Yes | Yes | No | Yes |
| Nurse practitioner scope-of-practice autonomous practice rules | No | No | No | No | Yes | No | No |
| Nurse practitioner scope-of-practice independent prescribing rules | No | No | No | No | No | No | No |
| Physical exam laws | Yes | Yes | No | Yes | Yes | Yes | Yes |

Source: Matthew Mitchell, Anna Mills, and Dana Williams, "Three Prescriptions for States to Improve Health Care" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, January 2015).

CON laws for health care unnecessarily restrict the options and availability of services for patients by requiring various levels of approval for a new healthcare facility to open, often including approval from would-be competitors. Alabama's CON laws are particularly cumbersome, especially in comparison with those of other states. In fact, only Maine, North Carolina, Vermont, and West Virginia have more CON laws than Alabama (Georgia and Tennessee have the same number).[181] For example, Alabama requires that all new hospital and nursing home services, including buildings and renovations, pay substantial fees and gain the approval of their competitors.[182] The Alabama Policy Institute reports that CON laws have restricted new healthcare facilities in the Madison County area, leaving patients with long commutes to receive care.[183] National studies show that states with CON laws limit access to such healthcare services as MRI and CT scans.[184]

Healthcare regulations in Alabama also prevent qualified nurse practitioners from setting up independent practices and from writing prescriptions for common illnesses through restrictive scope-of-practice laws. With general practitioners' offices filled with waiting patients—and with the shortage of primary care providers expected to worsen, especially in rural areas—these laws

181. Christopher Koopman, Thomas Stratmann, and Mohamad Elbarasse, "How State CON Laws Restrict Access to Health Care," Mercatus Center at George Mason University, May 13, 2015, http://mercatus.org/publication/how-state-con-laws-restrict-access-health-care.
182. Anna Velasco, "Bill Introduced in Alabama House That Would Abolish the Certificate of Need Process for Health Services," *AL.com*, February 12, 2009.
183. Alabama Policy Institute, Guide to the Issues, "Certificate of Need (CON) Laws," accessed February 24, 2016, http://www.alabamapolicy.org/wp-content/uploads/GTI-Brief-Certificate-of-Need-Laws.pdf.
184. Thomas Stratmann and Jake Russ, "Do Certificate-of-Need Laws Increase Indigent Care?" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, July 2014).

substantially raise the cost of health care in Alabama and provide no additional improvements in quality.[185]

A final commonsense reform that Alabama could take to improve health care is to eliminate or reduce physical exam laws for prescriptions. The average patient in America waits 29 days for an appointment, and the average cost for Medicaid patients is $88 per visit. These laws restrict new technologies from revolutionizing the healthcare industry. For example, modern technology can be used to take a photograph of a change in a mole to send to a dermatologist for review, possibly saving the patient from an office visit and freeing the dermatologist to see more patients.

"Occupational licensing represents the area of labor law in most need of reform in Alabama and across the nation."

## Labor Laws

Although Alabama ranks fairly highly when it comes to labor market freedom in the Economic Freedom of North America ranking, there is room to improve Alabama's labor markets to increase economic mobility and labor freedom.[186] Occupational licensing represents the area of labor law in most need of reform in Alabama and across the nation. President Barack Obama's Council of Economic Advisers, the US Department of the Treasury, and the US Department of Labor released a report in 2015 concluding that occupational licensing imposes substantial costs on workers and consumers and recommending major reform.[187]

Currently, Alabama licenses more than 140 different occupations, amounting to one-quarter of the state's

185. US Department of Health and Human Services, Health Resources and Services Administration, "Projecting the Supply and Demand for Primary Care Practitioners through 2020," November 2013.
186. Economic Freedom Network, "Economic Freedom of North America 2015," Fraser Institute, accessed February 24, 2016, http://www.freetheworld.com/efna.html.
187. Department of the Treasury Office of Economic Policy, the Council of Economic Advisers, and Department of Labor, "Occupational Licensing: A Framework for Policymakers," White House, July 2015.

workforce.[188] Licensed occupations in Alabama include many with no discernible need for licensing, such as barbers, auctioneers, and hair shampooers. To work in Alabama, barbers have to complete 1,000 hours of school or a 2,000-hour apprenticeship, pass an entrance exam, and pay an initial licensing fee of $40, a biannual license renewal fee of $80, and a $150 initial barber shop fee—for a profession that poses no risk to Alabamians other than a bad haircut and that has an expected annual salary of $24,400.[189] These licensed industries ultimately use licensing to restrict entry into the profession in order to increase industry wages. Robert Thornton, a professor of economics at Lehigh University, and Edward Timmons, associate professor of economics at Saint Francis College, find that occupational licensing for massage therapy—currently licensed in Alabama—increases the wages for massage therapists by as much as 16.2 percent.[190]

The nonprofit public interest law firm Institute for Justice ranks Alabama as having the 38th most burdensome licensing laws in the nation and as being the 24th most broadly and onerously licensed state.[191] In a regional comparison, Alabama is the 5th worst in the burden of occupational licensing and 5th worst in how broad and onerous the state's occupational licensing laws are (see table 11).

TABLE 11. ALABAMA REGIONAL COMPARISON OF OCCUPATIONAL LICENSING LAWS

| | Alabama | Florida | Georgia | Mississippi | Tennessee | Texas | Louisiana |
|---|---|---|---|---|---|---|---|
| Occupational licensing ranking—burdensome | 38th | 4th | 18th | 45th | 34th | 17th | 43rd |
| Occupational licensing ranking—broad and onerous | 24th | 7th | 37th | 18th | 13th | 32nd | 8th |

Source: Dick M. Carpenter II et al., "License to Work: A National Study of Burdens from Occupational Licensing" (Institute for Justice, Arlington, VA, May 2012).

188. Daniel J. Smith, "Reforming Occupational Licensing in Alabama," in *Improving Lives in Alabama: A Vision for Economic Freedom and Prosperity*, ed. Daniel Sutter (Troy, AL: Manuel H. Johnson Center for Political Economy, n.d.).
189. Daniel J. Smith, "Let Alabamians Get to Work: Occupational Licensing Restricts Job Choice and Mobility," *AL.com*, April 21, 2014, http://s.al.com/YYyPliJ.
190. Robert J. Thornton and Edward J. Timmons, "Licensing One of the World's Oldest Professions: Massage," *Journal of Law & Economics* 56, no. 2 (2013): 371–88.
191. Dick M. Carpenter II et al., "License to Work: A National Study of Burdens from Occupational Licensing" (Institute for Justice, Arlington, VA, May 2012).

Occupational licensing is a system of industry-created legal requirements, including tests, education, fees, and inspections, that practitioners must meet to work in a particular industry. Although defended as a way to protect consumers from fraudulent or harmful practices, occupational licensing ultimately provides a way for industries to restrict entry into a profession, enabling them to artificially increase wages at the expense of consumers burdened with higher prices. Another harmful side effect is that occupational licensing restricts entry into the licensed industry, thereby disproportionately harming low-income and minority Alabamians. Consumer safety can be better protected through voluntary occupational certification, competitive markets, and well-functioning legal systems.

Policymakers in Alabama can better protect consumers, support economic growth, and increase economic freedom by sensibly scaling back occupational licensing requirements for professions that pose little risk to consumers. Transitioning to a system of private occupational certification, rather than occupational licensing, would provide the most economic benefit to the state. Relaxing occupational licensing laws in Alabama could potentially increase job growth by 20 percent.[192]

## Regulatory Review Reform

The economic theory of regulation can be considered along two approaches: the public-interest approach and the public-choice approach. The public-interest approach to regulation assumes that regulators are "other" interested and will therefore promote regulations that minimize market failures, thereby maximizing social welfare. When applied, the basic assumption of this model is that regulators have perfect information regarding the impact of a proposed regulation and will only pass regulations that increase social welfare.

The public-choice approach, however, considers regulators to act rationally in their own self-interest, which often can result in the passage of inefficient regulations that benefit special interests at the expense of consumers and citizens. Importantly, even if the public-interest theory of regulation is accepted, it is important to realize that perfect information does not exist. Therefore, even public-interest officials can implement regulations with short- or long-run costs that exceed their benefits. Long-run costs are particularly hard to predict given unintended consequences that often become

192. Morris M. Kleiner, *Licensing Occupations: Ensuring Quality or Restricting Competition?* (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2006).

apparent only over time after a regulation has been passed. Changing economic circumstances also can raise the costs of regulation over time. Thus, it is important that states maintain proper regulatory oversight both ex-ante (at the stage of enactment) and ex-post (through periodic review of the efficacy of a regulation). Not only will this help prevent costly regulations from being implemented in the first place, it will also help expediently remove enacted regulation that turns out to have higher costs than anticipated. Finally, proper regulatory oversight will help reduce potential public-choice problems from emerging, such as regulatory capture. Regulatory capture describes a situation in which a regulated industry actually "captures" the regulatory process through lobbying, resulting in regulation that advances the interests of the regulated industry to the detriment of consumers.

In a comprehensive study of regulatory review—the processes that exist within a state for both ex-ante analysis of the impact that a given regulation would have along with ex-post review of its actual impact—Alabama received a grade of "C," which places it roughly in the middle compared with other states. Compared to other states in the region, Alabama fares relatively well, with Florida also receiving a C, Mississippi and Tennessee each receiving a D, and Georgia, Texas, and Louisiana each receiving a D-minus.[193]

Although Alabama receives a relatively high grade compared with other states in the region, there is significant room for improvement. Alabama's main oversight agency is the legislature's Joint Committee on Administrative Regulation Review (JCARR), which is tasked with reviewing and holding public hearings on all proposed rules. Officially, the review process can follow one of four actions: (1) approve the rule or accept through nonaction (after 35 days), (2) allow the agency to withdraw the regulation for amendment, (3) disprove the rule, or (4) disprove the rule with a proposed amendment.[194]

Factors that JCARR must weigh when reviewing any proposed regulation include public health and safety, whether a less costly alternative exists, the direct and indirect costs of a rule, and any potential harm to consumers from increased prices.[195] An approved regulation must then be ratified by the legislature and approved by the governor for it to become effective. Additionally, all regulatory agencies are required to provide an economic impact study regarding the potential economic effects of a proposed regulation.

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193. Jason A. Schwartz, *52 Experiments with Regulatory Review: The Political and Economic Inputs into State Rulemakings* (New York: Institute for Policy Reform, 2010).
194. Ibid.
195. Ala. Code § 41-22-23 (1)–(7).

Although the oversight and regulatory review procedures appear to be straightforward, they are far from ideal. These procedures could be improved by providing greater transparency and better alignment of relative costs and benefits. This improvement could be accomplished through a few reforms. First, there is no actual ex-post review of existing regulations by JCARR, meaning any review that does occur is made case by case by the entire legislature. This process severely limits the ability to rapidly streamline any resulting benefit and remove inefficient regulations. Further, JCARR does not issue a written opinion when deciding whether to approve or to deny a proposed regulation.[196] Thus entrepreneurs have difficulty predicting what will and will not be approved and what criteria will be used in decision-making, which may discourage economic development.

Also, regulatory agencies are statutorily required to make all economic impact studies available to the public, but in practice this rarely happens.[197] This lack of availability makes the regulatory process less transparent and increases the likelihood of regulatory capture. Where economic impact studies do exist, their content tends to be insufficient. As Jason A. Schwartz, legal director at the Institute for Policy Integrity, indicates,

> The small handful of recent and readily available fiscal notes suggests that even some of the more thorough economic analyses fall short of the promise of Alabama's Administrative Procedure Act. Though costs, benefits, and even distributional effects are discussed in qualitative terms, quantification and analytical support is limited, and there is no real analysis of alternative options that might better maximize net benefits. Much more disconcerting is the lack of consistency on when agencies label rules as having an "economic impact": some rules with annual effects as low as $3,000 are analyzed, while others with arguably equal or greater impacts do not include a fiscal note.[198]

Given all these issues, it is important for Alabama to find ways to increase accountability and transparency. In an analysis of regulatory review with economist Russell Sobel, John Dove (one of the authors of this paper) finds that the most effective way to streamline the regulatory structure of a state

196. Marie Leech, "Teacher Ethics Code Is Rejected, Plan Too Vague, AEA Argues," *Birmingham News*, August 13, 2009.
197. See Schwartz, *52 Experiments with Regulatory Review*.
198. Ibid.

is by attaching sunset clauses to all new regulations, requiring an analysis of alternative policies that could achieve the same goal at lower cost, requiring a cost-benefit analysis on a state's revenue, and (to a lesser degree) requiring independent third-party cost-benefit analysis and legislative oversight.[199]

Alabama should empower JCARR to achieve the goals it is tasked with and should require state agencies to produce quantitative analyses from independent third parties. Additionally, the state should require any regulation to sunset periodically and should require the state legislature to then determine whether a given rule should remain in effect, with nonaction automatically resulting in the sunset of a regulation under review. This requirement will provide greater scrutiny of the regulatory process and increase the likelihood that a particular regulation meets its intended goals over time, and will also help reduce the prevalence of onerous and costly regulations.

## Alcohol Regulation

According to the Mackinac Center for Public Policy, Alabama is ranked as a moderate-control state in terms of alcohol regulations, along with nine other states.[200] Only three states have a stricter alcohol control regime. In addition to operating state liquor stores that compete with private liquor stores (which are required to purchase their liquor from the state stores), Alabama has a three-tiered distribution system that creates a wholesale alcohol monopoly. The three-tiered system requires that licensed brewers sell alcohol directly to licensed wholesalers, which in turn are the only entities legally entitled to sell alcohol to licensed retailers. Wholesalers around the nation spend millions of dollars lobbying to keep these unfair privileges.[201]

In comparison to its regional neighbors, Alabama has much stricter alcohol laws (see table 12). The Mackinac Center for Public Policy categorizes states into four buckets by their degree of liquor control: heavy-control, moderate-control, light-control, and license states (heavy-control states have the strictest alcohol laws, and license states have the least restrictive). Because Alabama maintains a monopoly on the sale of liquor in the state, it falls into the moderate-control group. All Alabama's neighboring states have more relaxed liquor laws.

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199. Russell S. Sobel and John A. Dove, "Analyzing the Effectiveness of State Regulatory Review," *Public Finance Review*, November 28, 2014, doi:10.1177/1091142114557723.
200. Mackinac Center for Public Policy, "Alcohol Control and Social Outcomes."
201. Liz Essely Whyte, "Alcohol Distributors Ply Statehouses to Keep Profits Flowing," *Time*, August 6, 2015, http://time.com/3986536/alcohol-distributors-lobbying/?xid=tcoshare.

TABLE 12. ALCOHOL CONTROL LAWS BY SELECT STATES

| | Alabama | Florida | Georgia | Mississippi | Tennessee | Texas | Louisiana |
|---|---|---|---|---|---|---|---|
| Mackinac Center alcohol control category | Moderate control | License | License | Light control | License | License | License |

Source: Mackinac Center for Public Policy, "Alcohol Control and Social Outcomes," accessed February 24, 2016, https://www.mackinac.org/depts/fpi/alcoholcontrol.aspx.

Alabama is the only state in the nation that completely prohibits all forms of to-go beer sales (e.g., six-packs and sealed growlers), taking away an important source of sales for small craft brewers.[202] This prohibition acts as a form of protectionism for Alabama's alcohol distributors, who predictably oppose legalizing to-go sales because they would no longer get a cut of the revenue.[203] Additionally, Alabama distributors actually have a strong incentive to keep in-state and out-of-state craft brews off the shelves, because large out-of-state breweries provide wholesalers with substantial monetary incentives to sell primarily their own brands, leaving less room for craft beers.[204]

Alabama's alcohol laws also are unusually favorable to distributors, who essentially gain an exclusive monopoly once a brewery establishes a relationship with a distributor. Thus Alabama's distributor laws make it very difficult for brewers to terminate a distributor relationship once initiated. This favorable position for distributors places new breweries into an artificially disadvantaged bargaining position with those distributors, meaning contract terms tend to disproportionately favor the distributor. This situation would be similar to a law mandating that new artists entering the music industry be simultaneously required to sign an exclusive deal with a record label for life *and* prevented from any form of self-distribution of their music through the Internet or CD sales at bar concerts. Primarily because this requirement is so onerous, nearly 75 percent of states allow self-distribution for breweries in at least some form.[205]

The primary justification for Alabama's strict regulatory control of the alcohol industry is public safety. A comprehensive state study, however, finds

202. Alabama Brewers Guild, "5 Facts about Brewery Direct and Retail Sales Laws," July 6, 2015, http://albeer.org/blog/archives/5230.
203. Brian Lawson, "Beer To-Go Bill Making Progress in Alabama Legislature," *AL.com*, May 19, 2015, http://s.al.com/kOyrizd.
204. Tripp Mickle, "Craft Brewers Take Issue with AB InBev Distribution Plan," *Wall Street Journal*, December 7, 2015, http://on.wsj.com/21BgdLL.
205. Alabama Brewers Guild, "38 States Allow Brewery Self-Distribution, but Not Alabama," July 8, 2015, http://albeer.org/blog/archives/5239.

that alcohol market controls do not increase public health and safety.[206] Ultimately, Alabama's alcohol laws amount to a racket that enriches wholesalers and big breweries at the expense of consumers and small breweries and wineries.[207] It also comes at the expense of job growth, tax revenue, and quality of life for Alabamians.[208] The National Brewers Association reports that in 2013 alone craft beer sales grew by 17.2 percent in the United States and US exports of craft beer increased by nearly 50 percent.[209] Yet this growth has not reached Alabama. In 2013, Alabama had only 13 breweries, while neighboring Tennessee had 35 and Florida had 66.[210] Bringing Alabama's craft beer production up to the national average by relaxing state regulations could result in up to 3,000 more jobs for Alabamians.[211] It is also estimated that increasing craft brewing to this level would increase state tax revenues by roughly $12 million annually.[212]

Relaxing onerous alcohol control laws could improve the quality of life for Alabamians by increasing competition in the alcohol industry and by unleashing more job growth and opportunity. It would also help

"Alabama's alcohol laws amount to a racket that enriches wholesalers and big breweries at the expense of consumers and small breweries and wineries."

206. Mackinac Center for Public Policy, "Alcohol-Market Controls Like Michigan's Do Not Appear to Advance Public Health and Safety, Study Finds," news release, May 14, 2012, https://www.mackinac.org/16904.
207. Daniel J. Smith, "Alabama Taxpayers Should Not Be Duped by Modern 'Bootleggers & Baptists,'" *Yellowhammer News*, May 11, 2015, http://yellowhammernews.com/business-2/alabama-taxpayers-should-not-be-duped-by-modern-bootleggers-baptists-opinion/.
208. Lucy Berry, "Craft Beer Continues to Climb in Alabama as Brewers Push for Statewide Growler Sales," *AL.com*, June 16, 2015, http://s.al.com/2DYoNKH.
209. Brewers Association, "Statistics: National Beer Sales & Production Data," accessed February 24, 2016, https://www.brewersassociation.org/statistics/national-beer-sales-production-data/.
210. Brewers Association, "Statistics: State Craft Beer Sales & Production Statistics, 2014," accessed February 24, 2016, https://www.brewersassociation.org/statistics/by-state/.
211. Lucy Berry, "Alabama Ranks 50th in Per-Capita Economic Beer Impact; Policy Makers Must Remove Manufacturing Barriers to Support Growth," *AL.com*, February 11, 2015, http://s.al.com/YC9pAmW.
212. Center for Economic Development and Business Research, "An Economic Impact Analysis of the Effects on Alabama Breweries of Off-Premises Consumption of Alcohol," Jacksonville State University, June 2015.

eliminate what is arguably the most entrenched collection of special interest groups in the state and help eradicate cronyism.

## CONSTITUTIONAL REFORM

Alabama's current constitution was adopted in 1901, replacing the previous constitution of 1875. This constitution is widely regarded as greatly centralizing power in the state legislature, thereby keeping most local governments from being able to quickly address local issues. Largely as a result of the concentration of power that the constitution grants the state legislature, Alabama's constitution is now the lengthiest in the world, at 276,006 words.[213] This size is largely a result of the 880 amendments that have been adopted since its inception, most dealing specifically with local issues. This makeup has turned Alabama's constitution into a book of statutes rather than a document of fundamental law meant to constrain and limit state and local governments.

As a result of its cumbersome size and local scope, two attempts have been made to ratify an entirely new state constitution. The most recent attempt was in 1983, when the state legislature drafted and adopted a new constitution, only to see it declared unconstitutional by the state supreme court. However, because of the enormity and complexity of the existing state constitution, especially regarding local autonomy and the taxing power of state and local governments, there has been continual agitation to adopt a new state constitution.

As it is currently structured, Alabama's constitution denies local governments the opportunity to self-govern and to rapidly meet and deal with local problems. The constitution bogs down the part-time state legislature by requiring it to address local issues. Also, Alabama's constitution hampers economic growth with its labyrinthine construction, particularly its inability to formally constrain state government spending. Given all these issues, the best solution would be for the state to call a constitutional convention to adopt an entirely new and streamlined document. The second-best solution would be to, at the least, grant home rule to county and municipal governments throughout the state, adopt strict tax and expenditure limits (TELs) on the state and local governments, and provide for expanded direct democracy through both the initiative and the referendum process.

213. Council of State Governments, *The Book of the States* (Lexington, KY: Council of State Governments, 2014).

The importance of providing home rule to local governments grows out of the economics of fiscal federalism.[214] The economic argument is that government autonomy, authority, and the provision of publicly provided goods should be decentralized up to the point where all externalities are internalized. In other words, with different governmental jurisdictions, it is quite possible that some policies pursued by one jurisdiction will have a negative and unintended effect on neighboring jurisdictions. When such an effect is the case, policy decisions should be made by a higher level of government, so that the consequences are uniformly borne by all jurisdictions. For example, the federal government is charged with the regulation of interstate commerce (not the states), while states are charged with the regulation of intrastate commerce (not county or local governments).

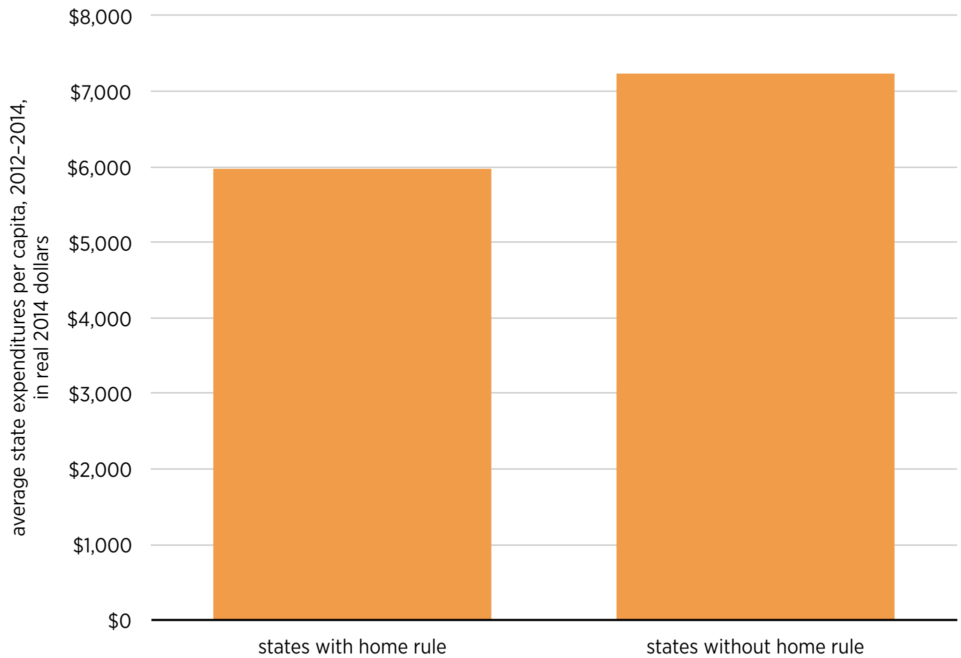
In Alabama this decentralized autonomy is almost impossible. Outside of only a handful of local governments, all local decisions require approval by the state legislature before they can be adopted. The mode by which this occurs is adoption of a local measure by either (1) unanimous agreement to the proposal by members of the legislature or (2) a statewide popular vote, which usually requires a constitutional amendment (hence all the amendments now found in the state's constitution). Unfortunately, many problems are associated with this approach, and they could be dealt with better through a decentralized authority granted to local and municipal governments.

First, unanimous agreement is extremely difficult to achieve, and it also takes the part-time state legislature's valuable time away from dealing with truly statewide issues. Given that the legislature is in session only three months of the year, local issues can take months to resolve or, depending on the urgency of other issues before the legislature, even years. Second, sending a local issue, (e.g., increasing the salary of Pike County's dogcatcher) to a statewide vote and requiring a constitutional amendment makes electoral ballots more burdensome and confusing for voters. Such a vote is especially confusing for citizens who are not and never will be affected by Pike County's proposal to increase that salary or by any other issue that may arise. Therefore, the state should address this inefficiency by adopting a uniform home rule amendment. Figure 34 suggests that some negative correlation exists between home rule and greater fiscal decentralization relative to per capita expenditures.

Decentralizing decision-making reduces the need for greater intervention by the state legislature and allows local governments to better craft ordinances

214. Wallace E. Oates, "Toward a Second-Generation Theory of Fiscal Federalism," *International Tax and Public Finance* 12, no. 4 (2005): 349–73.

FIGURE 34. DIFFERENCE IN PER CAPITA EXPENDITURES IN STATES WITH AND WITHOUT HOME RULE, 2012–2014




Sources: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/; Bert Waisanen, "State Tax and Expenditure Limits—2010," National Conference of State Legislatures, accessed December 13, 2015, http://www.ncsl.org/research/fiscal-policy/state-tax-and-expenditure-limits-2010.aspx.

that fit the local issue at hand while finding the appropriate means to fund the solution. This action may reduce the need for the state to expend resources on purely local matters. Again, a cursory inspection of the data in figure 34 at least suggests that states that provide home rule authority have per capita expenditures of just under $6,000 relative to states that do not grant home rule and that have per capita expenditures of roughly $7,200. Overall, home rule provides for greater flexibility and predictability in the law and better delimits the roles of state and local jurisdictions, which is essential for a flourishing economy and consistent with theories of fiscal federalism.

Importantly, based on the theory of fiscal federalism, local governments in Alabama should have greater home rule authority. This shift of power would grant local governments the authority to raise revenues, determine outlays, and apply zoning and other land-use restrictions (among other options) as they see fit. Municipal governments in Alabama are already subject to a strict balanced budget requirement, just as the state is. Additionally, as will be discussed later, to minimize the negative effects that could arise from granting home rule authority, local governments should be subject to strict TELs.

Although theoretically such authority could be abused, several factors may limit such abuse. The first two would be those noted above: a balanced budget requirement and TELs. Additionally, residents could potentially exit the locale. Where local governments have greater autonomy, relatively overbearing policies are rejected when people "vote with their feet" and leave the jurisdiction. Thus, over time local jurisdictions will end up producing the bundle of publicly provided goods that is most desired by the individuals living there and that will minimize the tax burden borne by other individuals throughout the state.[215] Case studies of Illinois and Florida show that, where home rule authority does exist, local elected officials do not generally raise taxes unilaterally[216] and expenditures and the mix of publicly provided goods better match the preferences of local citizens.[217]

Another important aspect of any state constitution is the necessity for it to provide effective constraints to ensure that sustainable fiscal policy is pursued on an annual basis, allowing for economic growth and development. Importantly, Alabama currently has a strict balanced budget requirement, which requires the governor to propose a balanced budget and the state legislature to pass one. A balanced budget amendment such as the one that exists in the Alabama constitution is an important constraint on government growth, as is the strict borrowing limit that exists.

Although the balanced budget requirement is a constraint that should remain even if a new constitution were to be adopted, several other important fiscal limits should be imposed as well. These would include strict and binding TELs and an initiative or a referendum to allow ballot measures to appear by direct citizen efforts. Figures 35 and 36 indicate some initial evidence in support of TELs. States with strict TELs have lower per capita state expenditures relative to states that do not.

From figure 35, the correlation suggests that states with binding TELs have had average per capita expenditures of just under $6,000, whereas states without such a constraint have had per capita expenditures of almost $6,800. Further, figure 36 considers the impact that only expenditure limits have on per

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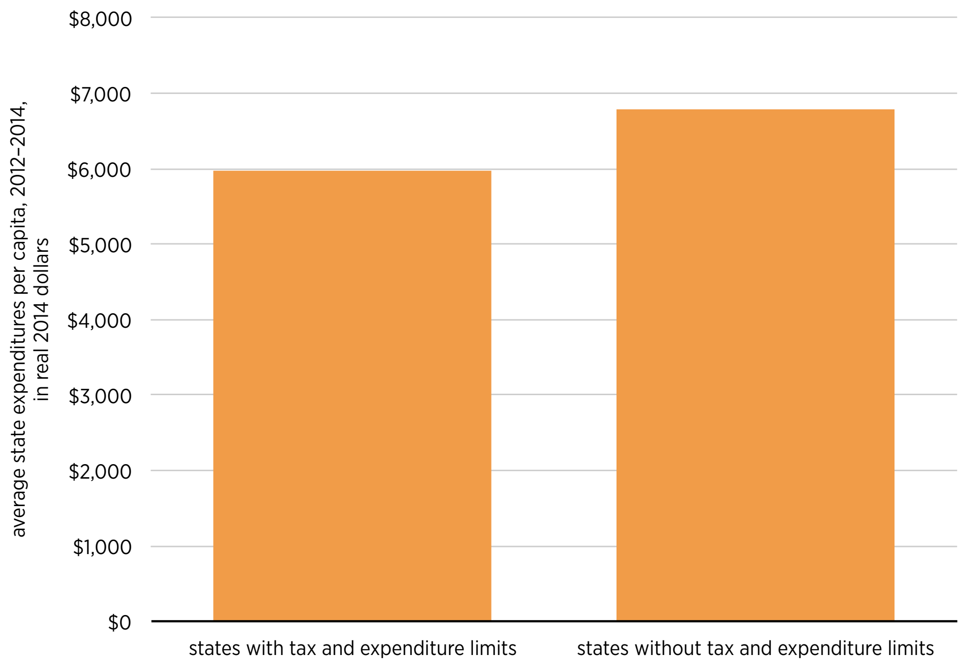
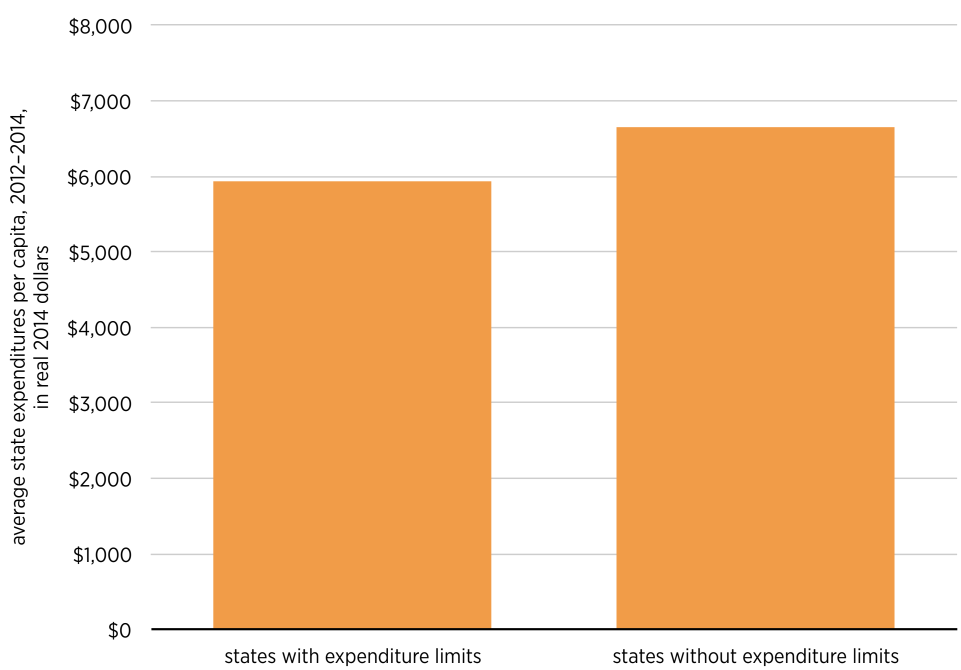
215. Charles M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64, no. 4 (1956): 416–24.
216. James M. Banovetz, "Illinois Home Rule: A Case Study in Fiscal Responsibility," *Journal of Regional Analysis & Policy* 32, no. 1 (2002): 79–98.
217. Jaclyn Bunch, "Does Local Autonomy Enhance Representation? The Influence of Home Rule on County Expenditures," *State and Local Government Review* 46, no. 2 (2014): 106–17.

**FIGURE 35. DIFFERENCE IN PER CAPITA EXPENDITURES IN STATES WITH AND WITHOUT TAX AND EXPENDITURE LIMITS, 2012–2014**




Sources: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/; Bert Waisanen, "State Tax and Expenditure Limits—2010," National Conference of State Legislatures, accessed December 13, 2015, http://www.ncsl.org/research/fiscal-policy/state-tax-and-expenditure-limits-2010.aspx.

**FIGURE 36. DIFFERENCE IN PER CAPITA EXPENDITURES IN STATES WITH AND WITHOUT EXPENDITURE LIMITS, 2012–2014**




Sources: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/; Bert Waisanen, "State Tax and Expenditure Limits—2010," National Conference of State Legislatures, accessed December 13, 2015, http://www.ncsl.org/research/fiscal-policy/state-tax-and-expenditure-limits-2010.aspx.

capita state expenditures. Here, states with strict expenditure limits have had per capita state expenditures of roughly $5,950, whereas states with no limits have had per capita state expenditures of roughly $6,650.

Importantly, these simple correlations have found some corroborating evidence in the academic literature even when more rigorous statistical analysis is used. A number of scholars have found a reduction in state and local expenditures when faced with TELs.[218] Additionally, evidence suggests that more restrictive TELs actually lead to higher growth rates for low-income states, which may be especially important for Alabama.[219] Most importantly, the overall impact of a TEL significantly depends on its actual restrictiveness.[220]

Therefore, Alabama should adopt a strict expenditure limit for annual state expenditures to the sum of the inflation rate, population growth rate, or both. This limit should include a prohibition on any ability to override it and should preclude any exemptions from the limit (which has been shown to be an effective way for states to evade TELs).[221] In the case of Alabama, a variation that should be considered would be to limit annual expenditure increases to either the population growth rate or the personal income growth rate. This limit would better streamline fiscal growth consistent with market and demographic fundamentals. Additionally, the state should require a simple majority legislative voting rule to raise taxes within that limit. Coupled with a supermajority voting limit to issue any constitutionally valid debt, this action would better ensure that funds are available to meet existing debt obligations as they come due; would further minimize the incentive to debt finance public expenditures (and thereby create fiscal illusion); and would make voters more aware of the actual cost and burden that public expenditures create.

Figure 37 shows the effect that either of these proposed expenditure limits would have had on per capita state expenditures relative to the actual growth in Alabama state expenditures since the mid-1970s. As indicated,

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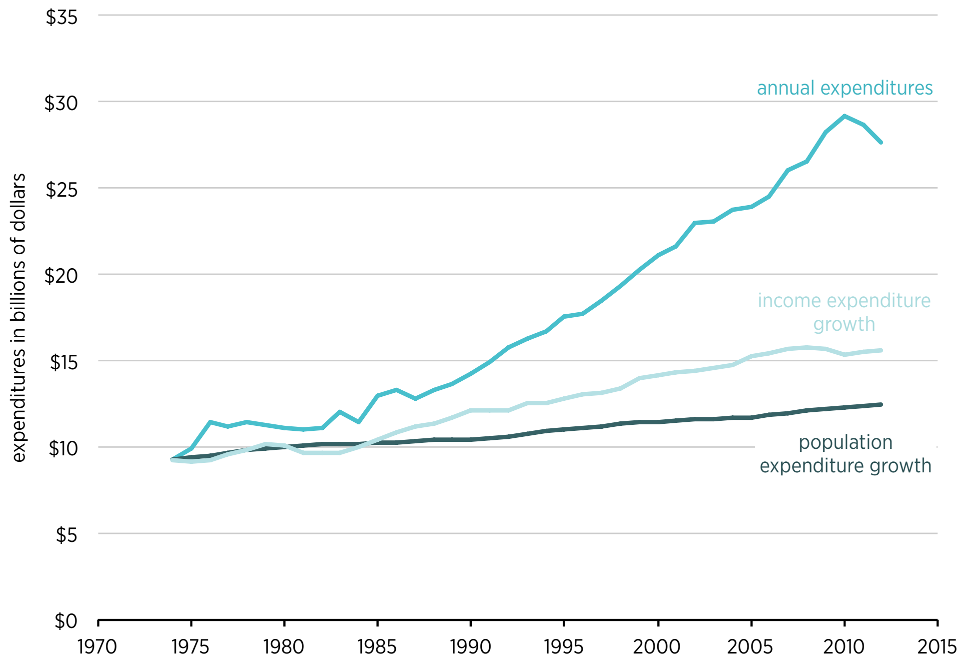
218. Dale Bails and Margie A. Tieslau, "The Impact of Fiscal Constitutions on State and Local Expenditures," *Cato Journal* 20, no. 2 (2000): 255–77; Ronald J. Shadbegian, "Do Tax and Expenditure Limits Affect the Size and Growth of State Government?," *Contemporary Economic Policy* 14, no. 1 (1996): 22–35; Ronald J. Shadbegian, "Do Tax and Expenditure Limitations Affect Local Government Budgets? Evidence from Panel Data," *Public Finance Review* 26, no. 2 (1998): 118–36; Suho Bae and Thomas Gais, "The Effects of State-Level Tax and Expenditure Limitations on Revenues and Expenditures" (Policy Brief, Rockefeller Institute, Albany, NY, May 2007).
219. Steven Deller, Judith I. Stallmann, and Lindsay Amiel, "The Impact of State and Local Tax and Expenditure Limitations on State Economic Growth," *Growth and Change* 43, no. 1 (2012): 56–84.
220. Lindsay Amiel et al., "Does the Restrictiveness of State Tax and Expenditure Limitations Affect State Revenues and Expenditures?," *International Journal of Public Administration* 37, no. 4 (2014): 237–48.
221. Deller, Stallman, and Amiel, "Impact of State and Local Tax and Expenditure Limitations."

FIGURE 37. ALABAMA ANNUAL STATE EXPENDITURES, 1974–2012




Source: US Census Bureau, "State & Local Government Finance" (various years), accessed December 13, 2015, http://www.census.gov/govs/local/.

there was a clear break in total state expenditures beginning in the mid-1980s, which resulted in current state expenditures of roughly $27.5 billion. Expenditure limits based on either income or expenditure growth, however, would have significantly reduced those expenditures and would have left them more in line with fundamental market and demographic conditions. Specifically, an income limit would have left current state expenditures at roughly $15.5 billion, and a population limit would have left expenditures at roughly $12.5 billion.

The state should also consider expanding direct democracy through the establishment of an initiative, a referendum, or both. The academic literature clearly shows that both initiatives and referenda significantly limit state and local spending, with state spending falling by roughly 10 percent and local spending by roughly 5 percent. The evidence also suggests that initiative states shift funding of services toward user fees and away from broad-based taxes, meaning tax policy more closely aligns with the benefits principle and reduces overall redistribution. Additionally, initiative states tend to adopt legislative and gubernatorial term limits and also pay relatively lower salaries to public officials. The academic research finds that these outcomes are the ones most desired by voters and are not necessarily driven by special interest effects.[222]

Importantly, there may be potential for special interest influence to drive particular legislation. However, evidence indicates that special interest effects in states with an initiative, a referendum, or both have been no worse than legislation adopted or influenced through the legislative process. This finding offers additional evidence of the benefits initiatives or referendums may provide Alabama.[223]

## CORRUPTION

Corruption—even perceived corruption—can have a strong impact on economic performance. For example, a 2007 study finds that corruption has a more harmful effect on business growth than does taxation.[224] When corrupt public officials direct tax money toward sectors receptive to bribery, such as transportation and construction, or to self-serving functions, such as wage and salary increases, they create an inequitable political and economic environment on the backs of taxpayers. In a study of corruption in the United States, economists David Mitchell and Noel Campbell find that concentrating resources on reducing corruption at the state level is more effective in producing business growth than economic incentive programs.[225] Even the perception of corruption causes real damage to the business environment in states by discouraging investment.[226] Corruption in politics not only makes a state less attractive for business investment—meaning less job growth and fewer opportunities—but it also costs each resident in 9 of the 10 most corrupt states, including Alabama, an estimated $1,308 per year.[227]

Thus, examination of the extent and cost of corruption in Alabama is an important endeavor for putting the state on a path toward fiscal sustainability and limited government. Unfortunately, Alabama does not fare well when it

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222. For a review of the literature, see John G. Matsusaka, "Direct Democracy Works," *Journal of Economic Perspectives* 19, no. 2 (2005): 185–206.
223. John G. Matsusaka, "The Eclipse of Legislatures: Direct Democracy in the 21st Century," *Public Choice* 124, no. 1 (2005): 157–77.
224. Raymond Fisman and Jakob Svensson, "Are Corruption and Taxation Really Harmful to Growth? Firm-Level Evidence," *Journal of Development Economics* 83, no. 1 (2007): 63–75.
225. David T. Mitchell and Noel D. Campbell, "Corruption's Effect on Business Venturing within the United States," *American Journal of Economics and Sociology* 68, no. 5 (2009): 1135–52.
226. Smith and Sutter, "Gauging the Perception of Cronyism in the United States."
227. Cheol Liu and John L. Mikesell, "The Impact of Public Officials' Corruption on the Size and Allocation of U.S. State Spending," *Public Administration Review* 74, no. 3 (2014): 346–59.

comes to levels of corruption. In their study, Oguzhan Dincer, an associate professor of economics at Illinois State University, and Michael Johnson, a professor of political science at Colgate University, rank Alabama as one of the most corrupt states in the nation, considering both illegal and legal corruption.[228] Table 13 breaks down the rankings by category—legal and illegal corruption—and branch of government. The study defines legal corruption as legal political gains, such as campaign contributions and endorsements, given in exchange for benefits to private groups or individuals, and it defines illegal corruption as benefits given to private groups and individuals as illegal gifts or cash. A separate state-level corruption study corroborates these findings and also lists Alabama as one of the most corrupt states in the nation.[229]

TABLE 13. ALABAMA REGIONAL COMPARISON OF CORRUPTION

| | Alabama | Florida | Georgia | Mississippi | Tennessee | Texas | Louisiana |
|---|---|---|---|---|---|---|---|
| Illegal corruption—executive branch | Moderately common | Moderately common | Moderately to very common | Slightly to moderately common | Slightly common | Moderately common | – |
| Illegal corruption—legislative branch | Very common | Very common | Moderately common | Moderately common | Slightly common | Moderately common | – |
| Illegal corruption—judicial branch | Slightly common | Not at all common | Slightly common | Slightly common | Slightly common | Slightly common | – |
| Legal corruption—executive branch | Moderately common | Very common | Very common | Very common | Slightly common | Very common | – |
| Legal corruption—legislative branch | Extremely common | Very common | Very common | Very to extremely common | Slightly to moderately common | Moderately common | – |
| Legal corruption—judicial branch | Moderately common | Slightly common | Slightly to moderately common | Moderately common | Slightly common | Slightly common | – |

Note: – = not available.

Source: Oguzhan Dincer and Michael Johnston, "Measuring Illegal and Legal Corruption in American States: Some Results from the Corruption in America Survey," Edmond J. Safra Center for Ethics, Harvard University, December 1, 2014, http://ethics.harvard.edu/blog/measuring-illegal-and-legal-corruption-american-states-some-results-safra.

Because corruption has a negative impact on economic growth and development, it is a policy problem that should be taken seriously in Alabama. State leaders can reduce both real and perceived corruption in Alabama by

228. Oguzhan Dincer and Michael Johnson, "Measuring Illegal and Legal Corruption in American States: Some Results from the Corruption in America Survey," Harvard University, Edmond J. Safra Center for Ethics, December 4, 2004, http://ethics.harvard.edu/blog/measuring-illegal-and-legal-corruption-american-states-some-results-safra.
229. Liu and Mikesell, "Impact of Public Officials' Corruption."

expanding and maintaining public accountability and transparency. Ensuring present and future Alabamians that public officials will be held accountable is one way to reduce both real and perceived corruption.

That means public accountability across the board. The current lack of transparency in Alabama contributes to the state's corruption problems. In its Corruption Risk Report Card, the State Integrity Investigation gave Alabama an overall grade of "C−," ranking it 17th among all states in the extent and effectiveness of its anticorruption laws.[230] Alabama's lowest rankings were in the categories of public access to information, political financing, redistricting, legislative accountability, and state pension fund management. Alabama receives a grade of C+ in a separate report that ranks states by their online access to government spending data.[231] Radically increasing the transparency of the political process and giving the public access to more information could drastically reduce corruption in Alabama.

A related, but no less important, issue when it comes to corruption in Alabama is the state's ownership of media outlets through the RSA.[232] Media freedom is highly correlated with greater political knowledge, political participation, and voter turnout.[233] State ownership of media outlets can lead to media manipulation, corruption, and ultimately reduced economic growth.[234] Thus, ownership of various media outlets through the RSA is a potential cause of concern for those interested in limiting corruption in Alabama and the nation. Currently, the RSA owns, or has investments in, several print and television stations across Alabama through Community Newspaper Holdings Inc. and Raycom Media.[235] To ensure media freedom, all public-sector entities should be prohibited from making media-related investments in Alabama.

230. Ed Mullins, "Alabama Gets C− Grade in 2012 State Integrity Investigation," Center for Public Integrity, November 2, 2015, http://www.stateintegrity.org/alabama.
231. Benjamin Davis, Phineas Baxandall, and Ryan Pierannunzi, "Following the Money 2012: How the 50 States Rate in Providing Online Access to Government Spending Data" (U.S. PIRG Education Fund, March 2012).
232. US Securities and Exchange Commission, "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama," March 6, 2008, https://www.sec.gov/litigation/investreport/34-57446.htm.
233. Peter T. Leeson, "Media Freedom, Political Knowledge, and Participation," *Journal of Economic Perspectives* 22, no. 2 (2008): 155–69.
234. Peter T. Leeson and Christopher J. Coyne, "Manipulating the Media," *Institutions and Economic Development* 1, no. 2 (2005): 67–92; Christopher J. Coyne and Peter T. Leeson, *Media, Development, and Institutional Change* (Cheltenham, UK: Edward Elgar, 2009).
235. Brandon Moseley, "Alabama House Members Calling for Review of RSA Performance," *Alabama Political Reporter*, December 18, 2011, http://www.alreporter.com/alabama-house-members-calling-for-review-of-rsa-performance/.

Reducing political corruption, both real and perceived, in Alabama will require expanding and maintaining accountability and transparency in all areas of state regulation, spending, and employment. Ultimately, tackling corruption in Alabama will save taxpayers money and increase economic performance in the state.

## CONCLUSION

Alabama has been traveling down the road of increased government spending, a growing regulatory burden, and declining economic freedom. However, as outlined above, an opportunity exists for Alabama to pursue an alternative road of reform that will promote long-run stability. This can be done by constraining spending with a tax and expenditure limitation, consolidating the state's budget, and removing earmarks. The state can also improve the tax environment by restructuring its tax code and eliminating tax incentives and other subsidies to favored businesses in order to better foster entrepreneurship. In addition, sources of growing fiscal liabilities, such as Alabama's public pension system, should be addressed now.

The state faces further problems besides traditional fiscal issues. Unnecessary regulations restrict occupational choice for Alabama workers and impede healthcare innovations, entrepreneurship, and business growth. The lack of systematic school choice drags down educational performance for Alabama youth, leaving them unequipped for college or the workforce. The lack of home rule for local jurisdictions inhibits local governmental units from rapidly and appropriately responding to the needs of their residents. Finally, Alabama's economic prosperity is undermined by a lack of transparency and public accountability in the state government, opening the door to corruption.

# APPENDIX A: RSA ALABAMA OPEN RECORDS REQUEST

Dr. Daniel J. Smith
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Monday, November 09, 2015

Ms. Leura G. Canary
General Counsel
Retirement Systems of Alabama
201 South Union St.
Montgomery, AL 36104

Dear Ms. Canary:

I am writing to follow up on an unofficial request for information I submitted to your office on September 8, 2015. Pursuant to the Alabama Open Records statute, Ala. Code § 36-12-40 *et seq*., and any other applicable statues or regulations, I am requesting copies of the following public records:

- A listing of the complete stock and bond portfolio for the Teachers' Retirement System (TRS), the Employees' Retirement System (ERS), and the Judicial Retirement Fund (JRF) holdings for each fiscal year-end from 2000 to 2015. Each Retirement Systems of Alabama (RSA) Comprehensive Annual Financial Report mentions that these are available upon request.
- Separately issued, audited financial statements for the TRS, ERS, and JRF for each fiscal year-end from 2000 to 2015. Each RSA Annual Report mentions that these are available upon request.

- RSA reports on the rates of return on preferred stock, private placements, and real estate (the summary of manager performance) for the overall RSA, the TRS, ERS, and JRF for each fiscal year-end from 2000 to 2015.
- The total amount of forfeited employer contributions from withdrawn members for each fiscal year-end from 2000 to 2015, for the overall RSA, the TRS, ERS, and JRF.

If you elect to charge fees in excess of $50 for searching and reproducing the above-referenced materials, please notify me of the cost prior to filling this request and provide me with an itemized invoice. However, I am respectfully requesting a waiver of all such fees. The requested information is for use in my academic research on the changes in the risk profile of Alabama's public pension investments over the past 15 years. This research is in the general public interest and will contribute to the public's understanding of Alabama's fiscal condition. The requested information is not sought for commercial purposes.

Thank you for your time and for your prompt attention to this official Alabama Open Records request. If you have any questions or need any further information, please do not hesitate to contact me at your earliest convenience.

Best Regards,

Daniel J. Smith

## ABOUT THE AUTHORS

John A. Dove, PhD, is an assistant professor of economics at the Manuel H. Johnson Center for Political Economy, Troy University. Dove's research focuses mainly on the effect that fiscal institutions have on state and local public finance. His research has been published in *Public Finance Review*, *Economic Systems*, *Journal of Institutional Economics*, *Journal of Macroeconomics*, *Economics of Governance*, and *Contemporary Economic Policy*.

Daniel J. Smith, PhD, is an associate professor of economics at Troy University and the associate director of the Manuel H. Johnson Center for Political Economy. He serves as the book review editor for the *Review of Austrian Economics*. Smith has published more than 80 academic journal articles, book chapters, policy papers, book reviews, and columns for op-ed pages. His op-ed columns have been published in the *Wall Street Journal* and by *CNBC*, the *Daily Caller*, and *Investor's Business Daily*. He writes a regular column for *Yellowhammer News*.

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