INTERVIEW

Russell Sobel

Editor's Note: *This is an abbreviated version of RF's conversation with Russell Sobel. For the full interview, go to our Web site: www.richmondfed.org*

West Virginia has long been one of the poorest states, despite decades of government programs aimed at stimulating growth. In a new book, 25 scholars take the question of West Virginia's struggling economy head-on and offer a number of solutions — none of which have to do with state-run economic development programs. The book was edited by West Virginia University (WVU) economist Russell Sobel, who also contributed several articles.

A native of South Carolina, Sobel brought a unique free-market orientation to the book. His research has focused on ways to foster entrepreneurship, restrain government spending, and use tax codes to promote economic growth. He has also investigated government failures in disaster relief efforts, most recently with the response to Hurricane Katrina. Sobel's varied fields of inquiry have encompassed the implications of increased safety features in NASCAR and the preferability of the Articles of Confederation to the Constitution. His research has been published in the *Journal of Political Economy*, *Economic Inquiry*, and the *Journal of Economic Perspectives*, among other journals. He is also the co-author of a leading economics textbook, *Economics: Private and Public Choice.*

Sobel joined WVU's economics department straight out of graduate school in 1994. He served as founding director of the school's Entrepreneurship Center and now holds the James Clark Coffman Distinguished Chair in Entrepreneurial Studies. His classroom innovations, including the use of walkie-talkies in large lecture classes, have won him several teaching awards. Doug Campbell interviewed Sobel on the WVU campus in Morgantown on July 3, 2007.

PHOTOGRAPHY: TIM TERMAN, DIRECTOR OF COMMUNICATIONS, WEST VIRGINIA UNIVERSITY

RF: How did you come to edit the recently published book, *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It?*

Sobel: If you have a friend who is a medical doctor, when they go to parties they are always asked, "Hey doc, I have this rash. Can you look at it?" Being an economist in West Virginia is a lot like that, because our economy is just so horrible, not only in the level of per-capita income but also in growth statistics. This economy is just not doing very well, and it's on a lot of people's minds here in West Virginia. So I get asked all the time: "What can we do about it? You're an economist. What can we do to fix the West Virginia economy?" The problem is that it's not a one-sentence answer. I've been wanting for the longest time to put together some scholars to take a hard look at the policy questions in West Virginia to see how we could change our policies in order to help increase economic growth. We ended up getting 25 scholars from across the nation together, including an editor of a leading economic journal and some legal scholars. They analyzed different West Virginia public policies, like the tax code and the legal system, and we put their papers together in a book.

RF: Your assessment is that West Virginia's policies are largely to blame for the state's poor economic performance. A lot of people believe that natural resources and geography are the major determinants of economic growth. Why, in your opinion, is that notion mistaken?

Sobel: The best way to think about an economy is that everyone starts with some ingredients, some inputs to work with. Then you've got to bake those ingredients — that's what the institutions are, the way your economy is organized. Do you organize your economy based on markets or based on central planning? Comparing North Korea to South Korea is useful. They have the same inputs to work with, the same land, same climate, same population, and same history. But they have wildly different economic outcomes, and it's not due to differences in inputs. It's due to differences in the way they structure their economies. It's not to say the inputs aren't important, but what you can make from your inputs depends on the efficiency of the economy in which inputs are utilized. To make the most productive use of those inputs is key.

I'm not saying policies are responsible for everything that's wrong in West Virginia, but look and compare us to other similar states ...

In West Virginia we've been dumping dollar after dollar at the state level into increasing education funding, building interstates, and all of these other inputs. But the problem is that we can't get the oven turned on so we keep throwing these inputs in there. We've got all these people now going to college who weren't before, but they're leaving the state after graduation and going to North Carolina and Virginia and other places. The problem is that investments in education are never going to pay off until the jobs are here for those people to take.

I'm not saying policies are responsible for everything that's wrong in West Virginia, but look and compare us to other similar states, and then growth rates speak volumes for how much of the difference is due to different policies. Charleston, W.Va., and Charlotte, N.C., 50 years ago had identical populations and identical per-capita incomes. Now Charlotte is 10 times the size of Charleston. Charleston is shrinking. North Carolina is a good comparative state because it lost much of its textile industry to foreign competition. It is very rural except for the Research Triangle and Charlotte areas. It's a similar kind of state that has experienced a lot of devastating things. But all economies experience devastating things. All economies go through creative destruction, where firms die and industries die. The key is to have an economy that's vibrant enough to replace those with new industries and new businesses. North Carolina has been very successful with that, especially Charlotte. Those banking headquarters didn't locate there because of something underneath the ground. They could have located anywhere. They could have just as easily gone to Charleston, W.Va., but they have a good business climate in North Carolina that attracts businesses.

RF: Which specific policies in West Virginia do you believe are most in need of reform?

Sobel: You need to look at our policies in West Virginia relative to other states. Our book goes into a lot of different areas, but if you look at taxes and the legal system, I think those are the two biggest barriers to growth in West Virginia. We levy very high taxes on capital investment in West Virginia, for example. One of the things I do with the book is show photos of the state border. MeadWestvaco, originally called the West Virginia Pulp and Paper Co., a Fortune 500 company, has a plant on the other side of the border in Maryland. That's billions of dollars in capital right there on the other side of our border, and when you're investing that much money, small differences in the tax code matter.

We have two taxes that hit capital investment very heavily here in West Virginia. There is a business franchise tax based on gross receipts, not profits; and we have a very high property tax on machinery, inventory, and equipment. It's so high, in fact, that when Toyota negotiated its plant in Buffalo, W.Va., the whole negotiation centered on having the state own all their equipment and lease it back to them. That makes them exempt from state property taxes because it's state-owned property. A lot of the local economic development agencies do the same thing. They own all the machinery and lease it back to firms so they can avoid the high taxes. Well, that's great if you're Toyota and can negotiate that. But if you're a small entrepreneur without a lot of political pull, what then? We've got a very heavy tax on capital investment, which is really a shame because capital investment is so critical for increasing labor productivity and getting people tools and machinery to work with, not to mention jobs.

Piece two of the puzzle is legal reform. We have lawsuit abuse. When you look at the legal climate rankings, West Virginia is at the bottom of those as well. One problem is venue shopping. We allow plaintiffs to pick which court they want to try their case in, so you can shop around for sympathetic judges. All the asbestos cases came here to West Virginia. We also have a problem with joint and several liability, which is when several people are negligent in different proportions for damage. Here in West Virginia, we sue both of them for 100 percent. Everybody tries to tag on Wal-Mart or a big firm to every lawsuit, someone with deep pockets. The firms here in West Virginia are sued a lot and they have very high legal costs.

Another problem is how judges are elected. About half the U.S. states appoint judges, and the others use elections, but only a handful of those do it on a partisan basis. When you run for a judgeship in West Virginia, you run as either a Republican or a Democrat on a political platform. Our last Supreme Court race was a good example: You had a Democrat saying, "If you elect me, I will decide cases in favor of labor," and a Republican saying, "I will decide cases in favor of businesses." In most states that elect judges, you run on your name and record. We have a very politicized legal system in West Virginia. So overall I'd say 80 percent of the problem is the tax code and our legal system. We also have some regulatory problems and we look at those in the book as well.

RF: You have written a number of papers on the economics of the Federal Emergency Management Agency (FEMA). Your analysis suggests that the failure of FEMA to respond effectively to Hurricane Katrina was wholly unsurprising. Why?

Sobel: Before Katrina, I wrote a paper with a then-graduate student, Tom Garrett, now at the St. Louis Fed. We were looking at the process for disaster declarations and the funding that's allocated for disasters when they occur. What we found is that, with the disaster declaration program, which is controlled by the president, all of the last five presidents had the largest numbers of disasters declared in their presidencies during their re-election years, their fourth years. They were also much more likely to declare them in battleground states. Last time, West Virginia was a battleground state, and I was joking that it was going to be a bad year for the weather.

Now, Hurricane Katrina was a no-brainer in terms of declaring it a disaster. But those kinds of storms are just a handful of the hundreds of disasters that are declared every year. The majority is for severe rain and windstorms, and they're a judgment call. So politics plays a huge role in terms of whether a disaster is declared or not. The second part is, given a disaster declaration, is there politics at play in terms of how much funding an area gets? We found that is the case. The funding is most influenced by congressional oversight. So if you have a representative on the FEMA oversight committee, then your area is likely to get more funding than if not. (This was before FEMA was moved under the Department of Homeland Security.)

We ended up doing four or five specific papers on what went wrong with Katrina and how we can reform FEMA to better handle natural disaster relief in the United States. Our research points to several things. One is the bureaucracy. In any government organization, the result can be something that Michael Heller called "the tragedy of the anti-commons," which is when too many people have veto rights, so it becomes hard to get permission to do anything and it slows down the process. That was the case with Katrina. Also, much like the FDA, which economists have criticized for being too cautious with approvals for new drugs, that same incentive seems to be at work with FEMA in that they were very cautious about allowing people into disaster zones, because if something happens to one person, then they are under pressure for letting that happen.

RF: What is the biggest problem you identified?

Sobel: It is that essentially what FEMA does in these disaster areas is it goes in and basically imposes central planning on the economic activity within the disaster area. For instance, Greyhound Bus Lines was willing to evacuate people from the Superdome for free. They kept calling and couldn't get an answer. If you want to go in and help in the disaster area, or if you're a demander in the disaster area who wants something, you have to go through FEMA. All these demands and supplies have to be communicated to the central agency and matched up. The day before Katrina hit, the Coca-Cola Company could deliver as much Dasani bottled water into New Orleans as it wanted without any special approval. But then all of a sudden bottled water is needed more than ever and Coca-Cola can't get into New Orleans because they can't get approval from FEMA to deliver the truckloads of bottled water they have. We need to separate out this aspect of economic activity, which is really that after a disaster, the fundamental problem at hand is a problem of getting resources into an economy and figuring out which resources are needed and finding suppliers and matching them up. That's what a market economy does really well, and we are basically shutting out that process in these natural disaster areas.

What we suggest would be much better is this: In a market economy, there is a fundamental role for government to protect individuals and their property to eliminate coercion and violence, to enforce the legal system, and to provide basic public goods such as infrastructure, roads, and those kinds of things. The government role after a natural disaster should be very similar to its role in the everyday economy. Its most important role is to go in and secure law and order and start repairing roads and bridges and infrastructure, providing the fundamental things that an economy needs to work with. But then it should let Coca-Cola and others in the private sector worry about the bottled water. There is no reason why they needed special permission. If the government wants to help with bringing in free bottled water, that's fine, let them support the process to help provide people in need with the things they need, but don't shut out private enterprise. We had a lot of men and women after Katrina ready to go in and give relief, and we need to use those talents to a much greater extent. The people in government aren't evil; they don't have bad intentions. They really want to do things right, but they don't have a fundamental knowledge of economics.

RF: Your research suggests that states fall into fiscal crises primarily because of cyclical downturns. Why don't policymakers ensure that rainy day funds aren't short during the inevitable times of need?

Sobel: I started my research on state fiscal crises while in graduate school. I became interested after the recession in early 1991, with fiscal crises everywhere. Along with my co-authors, I started looking at rainy day funds and wondered why most states ran their funds to zero very quickly during a recession. They simply didn't have the surplus built up in their rainy day funds to help them weather their recessions. Why do they have these things if they're not funding them, and how big of a role do they play in trying to ease the fiscal stress that's associated with recessions? What we found is that there is a big difference across states in their rules over these funds. Some states have rules and requirements on when money can be deposited and withdrawn from the account. With others it's just an account that the legislature can deposit or withdraw money from anytime it wants. Other states have it set up it so that withdrawals and deposits are based on how far your actual revenues are off from your forecasted revenues. That's what we have in West Virginia, so here you can only access the rainy day fund when revenues come in short of what was forecasted. Well, you could be in the middle of an economic boom and have revenues fall short of forecast and withdraw money out of the fund. On the other hand, you could be in a recession but you just happen to have accurately forecast revenues so you can't access the rainy day fund.

We asked whether these rules matter in terms of how much states are able to build up their funds and whether they're able to weather recessions without cutting spending and raising taxes. Sure enough, those states with requirements on deposits and withdrawing money were much more effective at building up the surpluses they needed to help them weather recessions. If you're going to have an unstructured rainy day fund, you might as well not have one.

RF: You argue that, in some ways, the Articles of Confederation were preferable to the Constitution. Could you briefly explain?

Sobel: One of the things I was very interested in was comparing the Articles of Confederation to the Constitution because of my dissertation research on the United Nations (U.N.). Almost every year a proposal comes up in the U.N. General Assembly to give the organization the power of international taxation. Most people argue, "No, we don't want to do that," because most prefer having their funding of the U.N. come from contributions from member states. The members give money or can withdraw themselves if they don't like what's going on. Ironically, that's exactly the system of financing our federal government had under the Articles of Confederation. The federal government did not have the power of taxation. It had a budget allocated across the states, and the states then raised the money and sent it to the federal government. When we moved to the Constitution, we gave the federal government the power of taxation. Some of my research has looked into this contribution mechanism of financing government. I think it has a lot of potential to really promote economic efficiency and good government.

It transfers a lot of power back to the states and decreases centralization. You get a lot more control over your federal government. Like with the U.N., member states can say they'll take their money elsewhere unless it's reformed. So it served as a constraint on the federal government when the states had that ability. More interestingly, it puts state-level intergovernmental competition to work in raising federal revenue. You can have the same size government, federal and state, as you do now with the other mechanism. But it's just that instead of the federal government collecting one-size-fits-all taxes across all states — right now we have the same federal income tax rate in all states and the same types of federal taxes in all states — it may be that in West Virginia the revenue would be more efficiently raised by taxing natural resources. Or maybe the optimal tax rate here isn't the same as in California. So it puts that intergovernmental competition to work in raising federal revenue.

We found that during the Civil War, the Confederate States of America experimented with a similar mechanism, where they levied a property tax on the Confederate states

Russell S. Sobel

➤ Present Position

James Clark Coffman Distinguished Chair in Entrepreneurial Studies, West Virginia University

➤ Previous Academic Appointment

Director, WVU Entrepreneurship Center (2002-2006)

➤ Education

B.B.A., Francis Marion College (1990); M.S., Florida State University (1993); and Ph.D., Florida State University (1994)

➤ Selected Publications

Co-author of the economics textbook, *Economics: Private and Public Choice* (2006). Co-author and editor of *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It* (2007). Author or co-author of dozens of academic papers, including "Automobile Safety and the Incentive to Drive Recklessly: Evidence from NASCAR" (2007); "The Political Economy of FEMA Disaster Payments" (2003); and "Theory and Evidence on the Political Economy of the Minimum Wage" (1999)

➤ Awards

Kenneth G. Elzinga Distinguished Teaching Award, the Southern Economic Association; and June Harless WVU Teaching Award

and allowed states the option of submitting the revenue to the national government. If the state submitted the revenue, then they would not levy the tax in that state. And all but one state opted to do that. The states were given the option to levy the taxes in alternative ways to a property tax to raise that money, and the Confederate government got all the money it wanted.

The nice thing about that structure is it overcomes the free rider problem. People worry in contribution systems about scenarios like — what if California doesn't pay? Well, the nice thing about the Confederate solution was that if the state didn't submit the money, then the national government could go in and levy the taxes and collect them itself. In a hybrid model that I proposed in a paper, the states could elect to submit to the federal government the revenues that would replace the federal income tax burden on West Virginia. If we wanted, we could levy that as a sales tax and do away with the federal income tax in West Virginia. That's one of the favorite issues I've worked on, but certainly relative to FEMA and state policy research that may have an impact, I doubt this will have an impact.

RF: Many people believe that Wal-Mart causes significant harm to the small, "mom and pop" business sector of the economy. Is that consistent with your empirical findings?

Sobel: This idea came up when I was directing the entrepreneurship center here at WVU. People kept saying, "How can we compete with the big-box stores like Wal-Mart?" Certainly, we see in those communities where Wal-Mart moves in, that stores go out of business. Wal-Mart beats small businesses that are competing in direct lines of merchandise. But here in Morgantown, some years after Wal-Mart came, all those storefronts are filled today by new and different things — by law offices, antique stores, and so on. They fill those same storefronts that were once things like general merchandisers, building suppliers, and hardware stores. The creative destruction process has replaced those things with new ones, and many of those new things aren't even retail. Yes, Wal-Mart creates failures. But with Wal-Mart, we all save money so we can spend money on more things. We have new small businesses pop up. The question I was interested in was, when looking at aggregate measures of small business in the economy today, has that sector been influenced by the influx of Wal-Mart stores?

We looked across states at the relationship between Wal-Mart stores and the size of the small-business sector along several different measures — sole proprietorships, firms with one to four employees, and even firms with five to nine employees. Through time we found that there was no effect in either direction relative to Wal-Mart. There are just as many small businesses today in the United States as there were when Wal-Mart was just one store in Arkansas. Some states have a lot of Wal-Marts per capita and other states few, sometimes because state laws have kept them out. But we don't see a much-larger proportion of small businesses in states that have kept Wal-Mart out. So the conclusion of our research seems to be pretty clear: that today's small-business sector has not been, as a whole, handicapped by the presence of Wal-Mart. In fact, it's just created reallocations within the small-business sector.

Now, people say, "Of course, there are still small businesses but they're worse," that somehow they're not as good. We looked at average revenues and profits of small businesses and can't find an effect there either. So this is a case we came at with the question of what did the data say, and interestingly enough, the data say zero. This is a case where we just can't find an impact, either positive or negative, on the size of the small-business sector. It doesn't mean that Wal-Mart doesn't cause certain small businesses to fail. But if you're someone in the Small Business Administration promoting small-business activity in the United States, our research clearly suggests that Wal-Mart should be the least of your worries.

RF: Can you briefly explain how NASCAR drivers have responded to safety improvements in their cars?

Sobel: In the economics literature, the root of all this is Sam Peltzman's argument in 1970 that safety improvements in automobiles would lead to more reckless driving and therefore would have some secondary effects that would offset the positive effects from the safety features. It's been more than 30 years since that article was published and people have been looking for these effects. The problem is that most of the data are state level and they are hard to use, because, for example, we have snow in West Virginia that causes more accidents. You can't control for everything, and you can't control for compliance as to whether people are wearing their seatbelts. So it's a problem in looking at measures and trying to find the existence of the Peltzman effect. The day I came up with the idea, I was teaching my principles of economics class and was talking about the famous example that is usually attributed to Gordon Tullock: that a dagger placed in the middle of the steering wheel, eliminating the seat belt, would cause people to drive more safely. I always wished I had the opposite. What do people do when cars are really safe? And then it came out of my mouth: When cars get so safe that you can flip them and roll them over and walk away without a scratch, people drive them at 200 mph on a little round track inches away from each other.

What I wanted to do was go back and look at NASCAR. A graduate student of mine was a big NASCAR fan. He collected all the data. It's an ideal environment to test this in because there are so many things we can't control for in the real world that are already controlled for by NASCAR. For example, they don't race in the rain. You know they are all complying and we can actually measure how reckless people drive, how many wrecks there are or how many cautions, and we can measure what the true odds of getting hurt are. Going way back in NASCAR history the cars were not all that safe. In the early road races there were guys in convertibles with motorcycle helmets. So safety has been increasing

and we can measure what the conditional probability of injury is, what the odds are of getting injured or killed, for every year. The simple question we look at is, as these cars have become safer, given that drivers are much less likely to get injured or killed today than 20 years ago, what effect has that had on measures of reckless driving and accidents within NASCAR? We find that, no matter how you measure it, there have been increases in accidents as cars have become safer in NASCAR. We even took a subsample of the five to 10 drivers who were there throughout the entire history and just looked at their behavior and found that they got into more accidents as their cars became safer.

Of course, the reason why is they want to win races and you've got to take risky maneuvers to win races, to pass other cars. We find very strong support for the Peltzman effect in NASCAR. But if those effects are big enough, you could end up with safety improvements causing more harm than good. Luckily, we didn't find that large of an effect. In fact, it seems like a win-win. As you make the cars safer in NASCAR we do end up with more accidents. Fans like to watch races, in part, for the accidents, and we are getting more of them, but fewer drivers are getting injured because the safety improvements have been so large.

RF: By extension, can we assume that, on average, today's everyday motorists are also driving more recklessly because they are behind the wheels of safer cars?

Sobel: It's an interesting question. We certainly can demonstrate it exists in NASCAR, but a NASCAR driver might be different in a lot of ways from the average driver. They might be more risk-loving than the average driver. But there are possible similarities. If you're a NASCAR driver, you're making a choice to take a maneuver that will save you time to get you ahead, and the reason for doing that is to win the race. Every day on my way to work, I've got a goal, which is to get to work quickly. So when I'm on my way somewhere in the car, I've got the same choices in terms of cutting in between cars or running a yellow light. In a very fundamental sense, the marginal decisionmaking is the same in those two instances.

RF: You've used walkie-talkies as a way to increase classroom participation. How did you come up with that idea and has it worked?

Sobel: When I got here and started teaching large lecture classes, I wanted to find a way to increase class participation. One day when a teaching assistant was giving the lecture, I sat in the back of the class. Lo and behold, I could hear talking all around me, and they were talking about economics and leaning over and asking me questions. I realized that people in the back of the room really do want to talk to me and ask questions. It's much harder, though, when you've got to stand up and yell out in front of 300 students to get those answers. So I came up with the idea of using walkie-talkies. When I suggested it to my department chair and my wife, they laughed at me. I went to Radio Shack and got some cheap walkie-talkies and passed them out in the class. Then I took one of them and put it up as a podium microphone, so that anything said over any one of the walkie-talkies comes out over the speaker system just as loud as my cordless microphone. I started experimenting and passing them out and, sure enough, the students loved them. The process evolved and pretty much now in all my large lecture classes I give out walkie-talkies every day. They have numbers and then I say, "OK, who's got walkie-talkie number 1," and then talk to them for a minute and learn their name and find out a bit about them. I call on them for examples. The people with walkie-talkies, even on days when they don't take them, are now much more likely to speak because they have stood up and spoken to me before. The interesting part of it is getting to know my students and making them feel like I care about their participation, and getting input on the class. I talk very fast so I let them use a beep button to pause me. It's not high-tech but it's been very successful and helped me win some teaching awards. I used the award money to buy new walkie-talkies.

RF: What are you working on now?

Sobel: I was watching "Law and Order" with my wife and the episode was about the district attorney (DA) being up for re-election. What happened is that someone confessed to a crime, but as a viewer you're thinking that they didn't really do it but they just got pressured into confessing because they wanted the conviction before the DA's re-election. So I started wondering if that really happens, because that's an issue of whether the political process of elections plays a role in the outcomes of our legal system. The innovation of our paper is that we were able to actually find the timing of these DA elections. The question remained: How do you measure false confessions or false convictions? After a year of thinking about it, I found the ideal data set. There are several programs, such as the Innocence Project, that look at questionable cases from the past and use DNA evidence to free people wrongly convicted. They have now freed 500 to 1,000 people scattered throughout history based on overturning those convictions with modern DNA evidence. What we're doing is going back and looking at all the cases overturned, looking at the distribution of the timing of the original conviction — for example, what month of the year and was it near an election. We have found that Octobers of election years have more than four times as many convictions later overturned as any other month of any other year in the data. The people from the Innocence Project say they don't look at timing at all, they just pick the cases based on merit. So you'd expect this to be a randomly scattered distribution throughout months of the year looking at original dates of conviction. What we're finding is that there are some incentives at play to get convictions around election time. The Duke Lacrosse case is relevant because that happened right around that DA's election. **RF**