How Can Social Networks Affect Policy Effects?

By Jason Fletcher

All of us interact with a variety of other people. Some of these interactions are face to face, while others are by phone, email, or social media websites such as Facebook. Our views are shaped by these people's thoughts, and theirs by ours. These interactions form our social network. To understand our own values and choices, we need to understand how the values and choices of those who are part of our social network think and behave. Similarly, to understand if policies work or not, we need to take into account how a program's effect on us influences the values and choices of others in our network. Similarly, we need to understand program impacts on others to gain insight on how those effects change our own values and choices.

It is easy to forget how pervasive these social networks are and how the interactions with others influence us. To see how important these relationships are, a group of researchers traced the interactions of users of Facebook with other people wherever they may live. Figure 1 is a social interaction network map that shows the strength or intensity of interactions among people depending on where they live. The whiter the area, the greater the level of interaction; differing levels of grey show less frequent ties. This map shows that people in the eastern part of the United States interact with other eastern U.S. people a great deal; people in western Europe interact primarily with others living in their area, and so on. However, there are also many interactions between people living far away from each other. The grey paths from the United States to Western Europe, from the West to India, and from the eastern United States to Hawaii show some of these.

Indeed, analysis of these data has shown that we all (or 99.91% of us, to be exact) are connected through our links. That is, if we begin a journey from any single Facebook member, we can follow friends' and friends of friends' links to all other Facebook members on the planet! This analysis confirms the legendary “six degrees of separation” phenomenon, this time on a global scale. In effect, on average, people are six or fewer steps away from any other person in the world. As a character in John Guare's 1990 play Six Degrees of Separation stated, the president of the United States can be connected to a gondolier in Venice through a trail of six people.

How does this network phenomenon relate to how we analyze the effects of public policy? A critical component of policy analysis is measurement of policy and program impacts. Through such analyses we evaluate whether our policies are working and attempt to understand how and why some policies fail.

In practice, the typical study designed to estimate policy effects makes use of survey or administrative data and asks whether there appear to be systematic
differences in the outcomes of people (workers, children, etc.) who took part in a program or policy compared to similar people who did not take part. The difference in outcomes (i.e., labor force participation from a job trainings program or student test scores in school provided additional teacher training) across groups captures an important part of whether the policy seems to work and whether it works well, given its expense.

The existence of social networks, however, requires more than this with-without comparison of impacts on participants relative to nonparticipants. A full policy analysis needs to take into account how social networks can foster (or dampen) the spread of technologies, health habits, employment opportunities, and other outcomes of a policy intervention.

Social network analysis is an approach that brings together techniques from across multiple disciplines, such as sociology, economics, mathematics, computer science, etc. to propose a set of tools to calculate how networks transmit (or do not) important information and resources. At its core, social network analysis is about relations and relationships between people. It draws heavily from graphic imagery and is grounded in systematic empirical data.

Social network analysis is in many respects fundamentally different from how we analyze surveys and administrative datasets. Also, social network analysis differs from our typical approaches to using data to evaluate programs and policies. In 1968, sociologist Allen Barton summarized nicely the limits of survey research:

“For the last thirty years, empirical social research has been dominated by the sample survey. But as usually practiced, … the survey is a sociological meat grinder, tearing the individual from his social context and guaranteeing that nobody in the study interacts with anyone else in it.”

Yet, although social interaction is a basic and fundamentally important activity in our lives, recognition of its implications is often missing from policy analyses. Indeed, recognizing these interactions has important implications in changing the way we do policy analyses. Indeed, social network analysis allows us to ask new questions about how policies work through the structures of networks we all have.

For example, Figure 2 shows a snapshot of a friendship network at a single high school. Several points are apparent. First, it would be difficult, if not impossible, for any individual in this school to be able to report the structure of the full network (which is what we have to work with from survey data). Second, most students in this high school are in dense friendship networks (which is true more generally).

If we also think that these connections of best friends matter for information transmission, social norms, and the like, then we begin to realize that typical policy analyses that overlook these links may not be reliable. For example, we want to evaluate whether a teacher training program affected the students of the teachers who were trained, so we compare these students to...
students from the same school who had teachers who were not trained. If we look back at the network and think that students study together and talk with one another (irrespective of which teacher they have), then we may begin to see the difficulty of measuring the impacts of this teacher training policy as effects diffuse through the school’s social network.

There are several difficult issues in measuring policy impacts in the context of social networks. Social networks make it more difficult to find comparison groups (those unaffected by a policy) for the evaluation group (those targeted by the policy or program). To the extent that policy analysts use “the wrong” comparison groups (as in the school teacher training example), policy impacts can be mismeasured in two important and related ways. First, the policy can indirectly affect “the wrong” comparison group, so that when we compare this group to the “treatment” group, our estimate of the impact of the policy or program is too small. We may incorrectly label a policy as a failure because social networks have spread the policy impacts to the comparison group, when in fact the policy is more successful than we realize. A second and related impact of social networks on policy analysis is when we seek to estimate the comprehensive effects of a policy or program, we often (nearly always) fail to capture the benefits that happen through social networks. For example, if we train a teacher, and her student helps his friend with homework based on the training, we fail to capture this indirect effect of the training program. In fact, these issues have been shown to have real-world consequences for policy analysis.

**Undercounting Program Effects through Selecting the “Wrong” Comparison Group**

Research has long documented that, in developing countries, deworming efforts in children do not perform very well. Economists Michael Kremer and Edward Miguel thought that one issue with calculating the impacts of deworming interventions is that the comparison groups were often individuals from the same village and/or the same school. The transmission of worms is thought to occur predominately through children because of their poor hygiene and frequent contact (particularly in schools and through social contact). The authors’ idea was to implement a school-level intervention instead of an individual-level intervention so they could examine whether earlier efforts had failed to capture these social transmission of the impacts of the deworming pills. Indeed, the authors found that 25% of the treatment effect of the deworming medication could be measured at adjacent schools, where children were not treated with the medication.

The notion of “herd immunity” is relevant here. This notion is used when studying contagious diseases that are transmitted.
from individual to individual. The process is likely to be disrupted when large numbers of a population are immune or less susceptible to the disease. Your neighbor getting a flu shot reduces your chance of getting the flu, regardless of whether you get a flu shot. Similarly, if neighborhood children receive deworming medicines, your children are less likely to become infected by worms.

Miguel and Kremer compared the estimated cost-effectiveness of their program in the “old” way (using students in the same school as a comparison group) versus their way. They found that the naïve cost effectiveness calculation would understate the effectiveness of the deworming medication by a factor of four. This slight change in selecting a different comparison group (which lacked social network and geographical connections with the treated children) showed that the program was cost effective and should be expanded.

Undercounting Total Program Effects

A second example of how social networks can change how we should do policy analysis is when we try to perform a benefit-cost or cost-effectiveness analysis. The standard way of doing benefit-cost analysis is to attempt to sum all the benefits of a program and compare them to the sum of all the costs. A key in making this comparison, though, is in comprehensively calculating the costs and the benefits. Because many programs and policies are “on the books” for some level of government (local, state, federal, etc.), calculation of basic program costs is somewhat straightforward. However, in cases where the benefits of a program or policy accrue to individuals not directly targeted (i.e., via social network links), these indirect benefits can be missed. In these cases, we may underestimate, and perhaps substantially so, the total benefits of a program. Again, the most likely scenario is that we do not give enough “credit” to the programs we have administered because we fail to count all the indirect benefits. In doing so, we may mistakenly shut down or change programs that actually provide more benefits than they require costs.

An example can be found in ongoing work of La Follette School affiliated researchers, including myself. We are reanalyzing a large clinical trial that focused on tobacco cessation—the Lung Health Study. While the randomized control trial was typical—it compared “standard care” with a set of treatments (counseling, nicotine patch) to help smokers quit—it was somewhat atypical in that it asked the enrollees to indicate whether his/her spouse was a smoker. The trial asked this question again at follow-up (post-treatment). With this information, we can determine whether spouses of treated individuals (who were not themselves involved in the trial) had different smoking rates than spouses of untreated (standard care) individuals. This example of a potential uncounted benefit of the program—giving one person a nicotine patch might allow two people to stop smoking. Indeed, the randomized control trial was very successful: Individuals receiving the “treatment” were about 30 percentage points less likely to smoke at follow-up than those who received the “standard care.” This effect is a very large effect, as quitting smoking is incredibly difficult. Pushing the evidence further, we are finding that the spouses of the treated individuals themselves are 10 percentage points less likely to smoke at follow-up. This finding suggests that indirect spousal benefits of the program are about 1/3 the size (and typically assumed to be zero) of the main treatment effect. With additional data, we could ask whether friends (or neighbors, parents, children) of treated individuals are also more likely to quit than friends of untreated individuals. Our proof-of-principle results suggest that current efforts to estimate comprehensive benefits from some policies and programs could severely understate these benefits.

Summary

Although we all know that social networks matter in our lives—in how we receive and send information, keep up with friends, etc.—social networks also affect how we can and should conduct policy analysis. Social networks have multiple implications for policy evaluation methods and understanding why policies work or fail. Policy evaluations may undercount effects because of an “incorrect” control group. Benefit-cost analyses may undercount total benefits through family and social spillovers. In many cases, we should expect that failing to take into account social networks when conducting policy analysis will lead us to undervalue policies that work better than we think.
Fiscal Policy Re-Assessed

By Menzie Chinn

In 2010 as the Great Recession was releasing its grip on the world’s economy, the United Kingdom’s newly elected Conservative-Liberal government embarked upon a policy of fiscal consolidation—higher taxes and drastically reduced spending—with the aim of stabilizing the ratio of government debt to gross domestic product (GDP) while spurring economic growth. Reducing the size of government and reducing government borrowing would free up resources to spark a strong recovery driven by the private sector. In the United States, the Obama administration maintained elevated spending through 2011 to stimulate overall demand. In contrast to the predictions of Prime Minister Cameron’s government and contrary to the views of opponents of President Obama’s economic program, American income per capita continued a steady, albeit slow, recovery while per-capita income in the United Kingdom (UK) languished; indeed, the country fell into another recession. Only after the Cameron government relented in 2012 and increased spending did UK growth resume, but even then with a lag. As shown in Figure 1, by the third quarter of 2013, U.S. per-capita income was more than 1 percent higher, while UK per-capita income was more than 6 percent lower than the third quarter of 2007.

The divergent paths in these two economies support a view that in conditions of tremendous economic slack in the economy, and with interest rates at or near zero, fiscal policy can be effective in spurring economic growth. In recent decades, this perspective has been widely criticized and to some extent fallen in disrepute. To many, such as myself, these conclusions will seem unremarkable. However, it’s important to note that a mere six years ago, these assertions would have been contentious at best.

What developments have forced this re-assessment? And why is this re-assessment incomplete, even in mainstream macroeconomic thought? To answer these questions, it’s useful to review how mainstream macroeconomic thinking has evolved.

A Short History of Keynesians, New Classicals, and the New Keynesians

A brief review of macroeconomic thinking begins with the post-World War II interpreters of John Maynard Keynes’ writings. These include Sir John Hicks and Alvin Hansen; the two formalized the Keynesian approach, with the latter popularizing the framework in America. In this approach, the amount of planned total spending determines the level of output during times of economic slack; the level of spending—particularly by firms building new plants and purchasing new equipment—depends upon the interest rate. Changes in government spending and taxes (fiscal policy), and changes in the money supply (monetary policy), shift output by affecting the total amount of planned spending in the economy.

This framework dominated policy discussions in the United States for the two decades after World War II. Whatever controversies existed—such as between monetarist Milton Friedman and Keynesian James Tobin—revolved around the efficacy of fiscal policy versus monetary policy and not the basic channels through which policy affected the economy.

During the late 1960s and 1970s, the acceleration of inflation forced a rethink of the basic model that implied that prices only rose when output exceeded the level of production at which resources were fully utilized, or equivalently when the unemployment rate dropped below full employment. In response, some economists argued the model should be amended to allow for time-varying inflation expectations. In the long run, the productive capacity of the economy determines output. Hence, the Keynesian framework (demand determines output) is melded with the “Classical” model (supply determines output in the long run) into what is often called the Neoclassical Synthesis. Other theorists went further and asserted that expectations should vary over time so that guesses about future inflation by workers, households, and firms were on average correct—a proposition called the rational expectations hypothesis.

The New Classical economists, such as Robert Lucas, proclaimed the view that if workers, households, and firms all make decisions based on rational expectations and, furthermore,
are free to change wages and prices at will, then output will be as high as is possible, up to a random and unavoidable amount. Another branch of the New Classical approach, associated with Ed Prescott and called the Real Business Cycle school, championed the idea that households and workers would not focus only on the present in making their decisions, as in Keynesian models, but also on the future. Firms would base their current investment decisions on sales expected today, next year, and in the far future. Households would set their consumption depending on the income they expected to receive today, next year, and in the far future. In both cases, policy is ineffective or actually counterproductive. In general, these models, while intellectually appealing, failed to capture adequately the real-world characteristics of business cycles. The requirement of the highly counterfactual premise—that wages and prices are perfectly flexible—limited its appeal. Literally interpreted, the Great Depression was an instance of technological regress or, as one economist coined it, “The Great Vacation.”

In the 1990s and first decade of the next century, a synthesis of the Keynesian and Real Business Cycle models—dubbed the New Keynesian approach—came to the fore. New Keynesians models varied but carried the common characteristics of sticky (or unresponsive in the short run) wages and prices. On the eve of the Great Recession of 2008-2009, the New Keynesian perspective dominated macroeconomic policy analysis. These models suggested that monetary policy would have little to moderate impact on output and, in fact, argued that constraining monetary policy to some set of well-defined rules, hence eliminating discretion, would yield the best outcome. The implications of New Keynesian models for fiscal policy were largely unexamined, mostly because conventional wisdom already held that changes in spending and taxes (which require congressional action) would be too difficult to accomplish in time to stabilize the economy.

So, on the eve of the Great Recession, it seems that mainstream macroeconomics had come to a comfortable spot; the basic model was again agreed upon, and the disputes revolved around parameter values. Nonetheless, even the models with estimated impact at the higher end implied modest effects of monetary and fiscal policy.

Then, vociferous debate in the United States over the 2009 stimulus package dispelled the illusion of consensus.

The Stimulus Skeptics, Part 1: United States

In December 2008, the U.S. economy was in freefall. Although few knew it at the time, output in that quarter was falling at an annual rate of nearly 9 percent. The incoming Obama administration proposed a stimulus package, the American Recovery and Reinvestment Act, ultimately totalling $878 billion to be spent over three years. Aside from the size of the package, the approach was utterly conventional—replace lost private spending with public spending and spur additional private consumption with income tax cuts.

The case for fiscal stimulus stems from the following logic. A dollar's worth of increased government spending on goods and services immediately increases GDP by a dollar. But each dollar of spending means a dollar of production, which has to be paid for in wages and profits. The workers and owners consume some portion of the additional dollar's worth of income (say 50 cents); that consumption is added to GDP. The goods and services consumed have to be produced, and somebody receives that income. If one half of that income is consumed, then another 25 cents is added to GDP. The process continues, with ever smaller increments to GDP. In the end, the total impact on GDP is $2, even though the initial amount of government spending was $1. This process by which a dollar's worth of additional spending injected into the economy is recirculated is called the spending multiplier. A dollar's worth of tax cuts has a similar, but smaller, impact. By increasing households' disposable (after tax) income, consumption is encouraged, and a similar sequence of recirculation of spending occurs.

Some observers voiced opposition to the stimulus package on the grounds that the recession would not be particularly
severe or would have run its course by the time these stimulus measures kicked in. In hindsight, these views rested on a serious misreading of the recession, which turned out to be the deepest and longest since the Great Depression.

Other opposition was based on what turned out to be essentially a New Classical view—that any increased government spending would be offset by an equivalent decrease in private spending and result in no net change in output. A related view held that the economy’s productive capacity was reduced because housing demand was less after the boom compared to before the Great Recession. With vast amounts of resources tied up in empty houses and with construction workers no longer needed, the country’s natural productive capacity was lower, and no amount of government spending—irrespective of its composition—could change the economy’s productive capacity. In this view, only by letting inefficient firms die and workers move to different occupations could resources be reallocated to more productive uses and growth be resurrected.

One problem with this argument is that employment was distributed across all sectors of the economy. Although unemployment rates were higher for construction workers than for workers in manufacturing, joblessness was also high in manufacturing. It was hard to argue that manufactured goods weren’t still needed—and in fact the rapid pace of productivity growth in manufacturing suggested that resources in that sector were efficiently utilized.

In the end, the U.S. economy moved from contraction to expansion in the third quarter of 2009—when the stimulus package spending and tax cuts came online. And around the world, countries where governments increased their spending to provide stimulus found that their economies turned around. The timing might have been merely coincidental (monetary policy was also expansionary); however, a plethora of statistical studies indicates that tax cuts and increases in government spending affect output, so it seems strange to assert that the 2009 episode was a mere coincidence.

The Stimulus Skeptics, Part 2: Europe 2010

In 2010, increasing doubts about the ability of Greece to service its sovereign debt led to a crisis. Foreign investors were fleeing Greek debt, sending the country’s borrowing costs soaring and accelerating the pace at which the government accumulated debt. Soon, similar worries were voiced about Portugal, Ireland, and Spain. In exchange for assistance from the European Union, the European Central Bank, and the International Monetary Fund, these countries embarked upon programs of fiscal consolidation—reduced spending and increased taxes—in order to shrink budget deficits. The ultimate aim was to pull down the trajectory of debt relative to output, so that investors would be convinced that they would be repaid and would therefore charge lower interest rates. Lower interest rates would, in this scenario, lead to a resumption of growth that in turn would make the debt load (expressed as a proportion of output) more tolerable. This rosy scenario, dubbed “expansionary fiscal contraction” failed to be realized.

Figure 2 shows the correlation between economic growth and the change in fiscal policy (toward reduced deficits/increased surpluses) from 2010 through 2012, for a set of advanced economies. If the expansionary fiscal contraction thesis held, the observations should be on a line that slopes upward from left to right. Instead of a positive correlation, what is apparent is a negative correlation: The more the budget deficit (adjusted for cyclical factors) shrank, the lower the pace of economic growth.

Several countries in the sample are the euro-area countries

---

**Figure 2: Consolidation and Growth, 2010-12**

Cumulative GDP growth and change in cyclically adjusted budget balance as a share of potential GDP, 2010-2012, for advanced economies.

Source: International Monetary Fund
facing sovereign debt problems: Greece, Ireland, Italy, Portugal, and Spain. Austerity was imposed upon these countries as a condition of receiving aid. It is interesting is to consider what happened to countries like the United Kingdom that did not face an imminent sovereign debt crisis and yet embarked upon a program of fiscal consolidation. As noted above, in 2010, the new Conservative-Liberal government implemented a program of fiscal consolidation by shrinking its size and reducing its debt—the UK fell into another recession. Recent experience, then, suggests that expansionary fiscal policy is in the end expansionary.

Why Was the Consensus Wrong?

The view that the impact of government spending was relatively small was common to analysts with both the Keynesian and New Keynesian perspectives. One reason that view proved wrong was that experts predicated it on “normal times.” But the times were hardly normal, for at least three reasons:

- Short-term interest rates remained stuck near zero for more than five years, what is called the zero lower bound.
- The extent of economic slack was much greater than experienced during other any recession after World War II.
- The financial system was severely impaired.

The Zero Lower Bound

In typical times, the United States’ central bank, the Federal Reserve, sets the short-term interest rate in a way that stabilizes output around the perceived level of output consistent with the full use of resources (sometimes called potential GDP) and the inflation rate around 2 percent. When output falls below potential GDP (or unemployment rises above the natural rate), the Fed lowers the interest rate to spur economic activity. If inflation rises above the target rate, then the Fed raises the interest rate to cool off the economy. In this context, if government spending were to rise so as to increase GDP (and possibly inflation), the Fed would offset some of that stimulus by raising interest rates. Thus, the impact of government spending could be pretty small, depending on how vigorously the Fed reacted to fiscal policy.

In 2008-09, output dropped so precipitously that the gap between what the economy could normally produce and what it actually produced (what is called the “output gap”) yawned to an unprecedented 7.5 percent; at the same time, inflation plunged to 0 percent (from more than 5.5 percent earlier in the year). The rule to which the Fed typically adheres would imply a negative interest rate—something that could not occur. Instead, the Fed set the interest rate essentially at zero and has kept it at that level since the end of 2008. This means that an increase in government spending meets no offsetting Fed interest rate increase.

Moreover, higher borrowing costs that could accompany the higher budget deficits—spending increases or tax cuts have to be financed—are also negated by the Fed’s aim to keep interest rates at zero (partly by keeping the short-term interest rate low, partly by purchases of long-term Treasury securities and mortgage backed securities). Figure 3 shows federal government borrowing costs at historically low levels, despite massive budget deficits—deficits that hit 8.6 percent of GDP in in the first half of 2010.

If the federal government’s borrowing demand was having a large enough effect to push private borrowers out of the market for credit, the 10-year interest rate should have risen, rather than continued to decline, even as the deficit increased.

![Figure 3: Federal Government Budget Deficit as Share of Potential GDP and Yield on 10-Year Treasury Bonds](source)
Economic Slack

GDP in 2008-09 was about 7 percent less than what the economy could have produced had workers and factories been fully employed, according to estimates from the Congressional Budget Office. Even after the end of the recession, the output gap remained large and negative. Under these conditions, an increase in government spending can have a big impact because it puts to work resources that would otherwise lie idle. Had the economy been operating at near (or over) capacity, increased government spending would have merely diverted workers from producing goods for the private sector to producing for the public sector.

For instance, according to one study, the impact of one dollar's worth of government spending on goods and services (employing civil servants, building a bridge, or buying jet fighters) leads to a $1.5 dollar increase in GDP during periods of slack, and closer to 50 cents during periods when the economy is operating near full capacity.

The Financial System in Distress

One of the defining features of the recent recession is that the functioning of the financial system was severely impaired. Despite aggressive and unprecedented intervention by the Federal Reserve and the U.S. government (particularly the bank bailout, or Troubled Asset Recovery Program), a large part of the banking system remained in a tenuous position, balanced on the precipice of insolvency, and reluctant to lend.

At the same time, firms and, particularly, households were saddled with debt far in excess of what they could sustain in the dire economic conditions of 2008. When households aren't able to borrow easily, consumption tends to move more in line with after-tax income than in times when they are able to borrow with ease. The higher the sensitivity of consumption to income, the larger multiplier.

Aftermath

The intellectual landscape half a decade after the Great Recession is quite different than it was a decade ago. Mainstream macroeconomic thought took the stable growth-low inflation environment of the previous 20 years as the norm. It assumed that the financial system had evolved to be robust to asset booms and busts. These assumptions proved grossly wrong, and so the need to re-assess many of the conclusions that followed is unsurprising.

If fiscal policy works to spur economic growth during times of economic slack, why has the U.S. economy grown so slowly? First, it’s important to remember that of all the hard-hit major economies, only Germany's per-capita income (along with America's) has re-attained pre-crisis levels.

Second, even though the United States implemented an expansionary fiscal policy, it was insufficiently ambitious, as highlighted by Figure 4’s comparison of government spending on goods and services during the three most recent recoveries.

Government spending at all levels (federal, state, and local) has fallen since the recovery began, in contrast to what occurred in the early 1990s, and particularly in stark contrast to what occurred in the early 2000s: a 6 percent decline rather than an 8 percent increase. Had the policymakers truly implemented the prescriptions for more expansionary measures, the U.S. economy would have grown yet faster. To some extent, fiscal policy was not really tried, and to understand why that was the case, a political scientist needs to weigh in. ✧

Figure 4: Real Government Spending on Goods and Services

The figure shows the log of real government spending on goods and services, normalized to 0 at the end of each recession (trough), for recoveries at the beginnings of 2009’s second quarter, 2001’s fourth quarter, and 1991’s first quarter.

Sources: U.S. Bureau of Economic Analysis and author’s calculations
The Frustrations of U.S. Federalism

By Dennis Dresang

Current policy disputes and partisan conflict occur within the context of federalism, best thought of as an arrangement in which the federal government shares the power to govern with states. Federalism means states can obstruct the implementation of the federal legislation, such as the Affordable Care Act. They also can initiate policies that are at variance with federal legislation. Although the federal government is paying for the expansion of Medicaid, states are free to reject these funds. Likewise, states are able to thwart plans for regional high speed rail by refusing federal dollars. Some states have legalized the use of marijuana, for medical purposes or for recreation. But the federal government is still free to prosecute and punish those who buy, sell, or use this drug. The federal government has authorized American Indian nations to operate casinos, but subject to gubernatorial approval.

One might pose the question of whether an individual’s access to a minimal amount of welfare, health care, or education should depend on the state in which the person lives. Should basic civil liberties vary from one region to another? If pollution does not respect jurisdictional boundaries and modern transportation has important regional and national linkages, then should states have the ability to obstruct national policies?

Yet, the United States is a large country with important cultural and economic differences that are regional in nature. Intuitively and empirically, a one-size-fits-all approach makes little sense.

The rationale for federalism is not based on consistency, simplicity, efficiency, effectiveness, or other public policy ideals. U.S. federalism is rooted in history and is the legacy of political conflict. The preamble to our national constitution begins “We the people of the United States…” and the struggle has been over whether the emphasis should be on we or states. A major task that challenged the authors of the Constitution was to define the respective roles and authorities of the states on the one hand and the national/federal government on the other. In the end, they failed to accomplish this goal. After enumerating some powers of the federal government, like coining money, raising an army, and governing interstate commerce, the founders inserted a catch-all phrase, Article 1, Section 8, empowering the national government to legislate what is “necessary and proper.” But when the states ratified the Constitution, they added the 10th Amendment, with the “reserved powers” clause that gives states authority over issues not specifically assigned to the federal government. In large part, the current and historic relationships between states and the federal government is a continuation between the contradictory messages of Article 1, Section 8, and the 10th Amendment. The United States has never fully reconciled the desire for state diversity and discretion with national policy direction. The contradictory provisions of the Constitution have provided bases for some ambiguous and conflicting rulings by the U.S. Supreme Court.

Wisconsin has played a central role in the development of the U.S. style of federalist governing. Under the leadership of Robert M. La Follette, the Progressives initiated policies designed to address individuals in need at the state level and then served as a brain trust for Franklin D. Roosevelt as he designed a federal response to the Great Depression. Workers’ Compensation and Unemployment Compensation became models of national programs that set common basic standards, but they retained some state discretion and relied heavily on states for implementation. Ira Katznelson’s 2013 book, Fear Itself, provides an insightful analysis of the New Deal and includes a good description of Badger-state involvement.

As Wisconsin’s governor from 1987 to 2001, Tommy Thompson pioneered a new dimension of relationships between the federal and state governments, i.e., waivers. He negotiated an arrangement where federal funds for Medicaid would be mixed with state dollars to extend health-care coverage to families that were poor but had incomes just above that required for the standard Medicaid program. Federal waivers are temporary agreements between individual states and the federal government that provide more flexibility for those states at no additional cost to the federal government. These waivers are now common and extend over a wide variety of policy areas, including environment, transportation, health, and education. One of the core features of the implementation of the
Affordable Care Act, also known as Obamacare, is the waivers some states have negotiated for the use of federal funds for extending the coverage of Medicaid.

**Interstate Commerce**

The application of the interstate commerce clause offers a window to the complexity of federalism. When the founders stipulated that the federal government should have authority over commercial relationships that cross state borders, they could not have imagined current fiscal and technological dimensions of businesses. Likewise, they could not have anticipated the health, safety, environmental, and other concerns prompting federal regulatory policies. It is instructive that the steps the Reagan administration took to de-regulate the trucking industry were short-lived, despite a general feeling that the federal government was becoming too intrusive. Truckers faced with a wide variety of weight limits, speed limits, and the like as they drove from one state to another, pushed for the reintroduction of standardization.

The federal Justice Department used the interstate commerce clause to defend a law sponsored by Wisconsin’s Senator Herb Kohl to establish gun-free zones around schools, in *U.S. v. Lopez* (1995). The department told the Supreme Court justices that the law was constitutional because guns were inevitably produced, financed, marketed, and transported across state lines and therefore the federal government had the authority to ban guns near and in schools. The majority of justices were not persuaded, however. They reasoned that if interstate commerce could be used to justify gun-free school zones, then that clause could virtually justify anything the federal government might do. Instead, they turned to the 10th Amendment and argued that a reserved power of states was land use and zoning. Individual state and local governments would have to act to create gun-free zones around schools.

The Supreme Court also rejected use of the interstate commerce clause to establish the constitutionality of the Affordable Care Act in *National Federation of Independent Business v. Sebelius* (2012). The issue here was the requirement that individuals must have health insurance if they are not covered under Medicare or Medicaid. Other individuals who do not have health insurance through their employers must purchase a plan or pay a penalty. Opponents argued successfully that the interstate commerce clause cannot be used to require the purchase of a good or service, or to impose a penalty in case of noncompliance. The court, led by Chief Justice John Roberts, nonetheless upheld the law, based on the federal government’s ability to tax. The Internal Revenue Service is charged with the enforcement of the individual insurance mandate and in essence levies a tax penalty on those who do not comply.

**Conditional Federal Support**

One way in which the federal government is able to get states to adhere to national policies is through placing conditions on support. An early example of this was the land grant program used to establish public universities. Strapped for cash, the federal government provided new states, like Wisconsin, with land on condition that the land be used to create a public university. Invariably, at least some of the land was used as the campus for the university. Wisconsin also sold or rented land to generate revenue for its university. The Hill Farm residential neighborhood in Madison is an example of the former, and the University of Wisconsin–Madison leased space to stores at the Hilldale Mall. The university sold the mall in 2004.

With the initiation of a permanent income tax in 1913, the federal government had enough money to extend direction over states in a wide variety of policy areas. In *South Dakota v. Dole* (1987) the U.S. Supreme Court ruled that the federal government faced virtually no limits when it attached conditions to money it gave to states. The case arose when the Reagan administration sought to set 21 as the standard age for drinking alcohol. The drinking age, however, was a power reserved to the states. So, the federal government required states to pass a 21-year-old drinking age law as a condition of receiving funds for transportation. South Dakota objected, but the justices said that even though the conditions had to do with social policy and not with transportation, the state must comply if it wanted the money.

The general issue of conditional federal support was visited again in the *National Federation of Independent Business v. Sebelius* case. A provision of the Affordable Care Act was to expand the coverage of Medicaid to a larger population. Medicaid is a federal-state partnership program, funded 60 percent by the federal government and 40 percent by states. The Affordable Care Act included Medicaid funding at 100 percent by the federal government for expansion through 2016 and then at at least 90 percent. The court ruled that states do not need to accept the money and the conditions that go with this expansion. As of February 2014, 21 states refused to participate in the expansion.

**Equal Protection under the Law**

The Civil War settled some fundamental principles of U.S. federalism. Territories are free to petition to join the union as an additional state and enjoy all the rights and privileges as if they were one of the first 13 states. But, states are not free to secede. In the aftermath of the Civil War, amendments to the U.S. Constitution were passed voiding provisions of state constitutions that permitted slavery and prohibited African Americans from voting. The 14th Amendment was included in these changes and requires state and local governments to provide “equal protection under the law.” Initially, the concern was for the fate of freed slaves. The application of the 14th Amendment has since expanded to include treatment of individuals based on race, ethnicity, religion, gender, and sexual orientation.

In 1996, the U.S. Supreme Court ruled in *Romer v. Evans* that Colorado violated the 14th Amendment when voters passed an initiative that prohibited local governments from providing any services or protections to members of the gay community. In 2003, in *Lawrence v. Texas*, the court struck down sodomy laws in 14 states, reasoning that these laws
unfairly prohibited behavior and violated the privacy of same-sex couples. The court had an opportunity in 2013 to apply the equal protection clause in cases regarding same-sex marriage—U.S. v. Windsor and Hollingsworth v. Perry. While the court ruled that the federal government had to recognize the rights of same-sex couples married in states that allow these unions and an appeals court ruling that voided a California ban on same-sex marriage, it did not fully address the basic issue of whether same-sex couples had a right under the Constitution to marry. On December 20, 2013, federal district judge Robert Shelby ruled in Kitchen et al. v. Herbert et al. that Utah violated the equal protection clause of the U.S. Constitution when in 2004 the state amended its constitution to prohibit same-sex marriages. Federal judges in Oklahoma and Virginia followed with similar rulings that the 14th Amendment trumps state bans on same-sex marriages. As of February 2014, cases are pending in Wisconsin and seven other states. The issue is bound to be settled by the U.S. Supreme Court.

Politics of Federalism

The legal and policy landscape of federalism in the United States is anything but tidy or stable. Likewise, conflict and ambiguity in the respective roles of the federal and state governments mean politics is ever-changing. Federalism provides multiple arenas for conflict and policy resolution. That is good news and bad news. If you are unsuccessful in Washington, D.C., then you can probably pursue your objectives in state capitols … and vice versa. Libertarians and tea party activists decry the general power of the federal government, but they vigorously pursue national standards and laws that pre-empt state and local governments from pursuing environmental policies and economic development strategies that local communities may think are right for them. Advocates of social policies often prefer national standards—if it is right for one person or couple, then it is right for everyone. But Plan B is to get victories state by state.

Political fragmentation is to be expected in a political system with a legal framework that scatters authority in ways that are not always rational or efficient. A system that elects two senators from every state, regardless of population and that chooses a president through the Electoral College is bound to force compromises and stalemates that seem nonsensical.

Clearly there are times when individual rights and liberties should not vary according to where someone lives. There are policies where national standards are going to be more effective and efficient than a mosaic of standards set by states. And one can easily envision cases where the resources, challenges, and culture of a community should not be constrained by a quest for national homogeneity. These visions, however, do not describe our country. The United States has set impressive records economically, technologically, and militarily. But these achievements may be in spite of rather than because of our brand of federalism. 

Robert M. La Follette School of Public Affairs
UNIVERSITY OF WISCONSIN–MADISON
1225 Observatory Drive, Madison, WI 53706
(608) 262-3581
policyreport@lafollette.wisc.edu
www.lafollette.wisc.edu

Policy Report
Robert Haveman Faculty Editor
Karen Faster Senior Editor

Faculty
Susan Webb Yackee Director, Associate Professor, Public Affairs and Political Science
Hilary Shager Associate Director
Todd Berry Adjunct Associate Professor of Public Affairs
Rebecca M. Blank University Chancellor
Menzie Chinn Professor, Public Affairs and Economics
Maria Cancian Professor, Public Affairs and Social Work
Dave Cieslewicz Adjunct Associate Professor of Public Affairs
Mark Copelovitch Associate Professor, Public Affairs and Political Science
Dennis Dresang Professor Emeritus, Public Affairs and Political Science
Jason Fletcher Associate Professor of Public Affairs
Robert Haveman Professor Emeritus, Public Affairs and Economics
Pamela Herd Associate Professor, Public Affairs and Sociology
Karen Holden Professor Emeritus, Public Affairs and Consumer Science
Leslie Ann Howard Adjunct Associate Professor, Public Affairs
Isao Kamata Assistant Professor, Public Affairs and Economics
Keith Krinke Associate Adjunct Professor of Public Affairs
Melanie Manion Professor, Public Affairs and Political Science
Christopher McKelvey Lecturer, Public Affairs and Economics
Robert Meyer Research Professor, Public Affairs
Donald Moynihan Professor, Public Affairs
Gregory Nemet Associate Professor, Public Affairs and Environmental Studies
Andrew Reschovsky Professor Emeritus, Public Affairs and Applied Economics
Timothy Smeeding Professor, Public Affairs
Geoffrey Wallace Associate Professor, Public Affairs and Economics
David Weimer Professor, Public Affairs and Political Science
John Witte Professor Emeritus, Public Affairs and Political Science
Barbara Wolfe Professor, Public Affairs, Economics, and Population Health Sciences

© 2014 Board of Regents of the University of Wisconsin System. The La Follette Policy Report is a semiannual publication of the Robert M. La Follette School of Public Affairs, a teaching and research department of the College of Letters and Science at the University of Wisconsin–Madison. The school takes no stand on policy issues; opinions expressed in these pages reflect the views of individual researchers and authors. The University of Wisconsin–Madison is an equal opportunity and affirmative-action educator and employer. We promote excellence through diversity in all programs.
On the Financial Capability of American Families

By J. Michael Collins

Since the Great Recession, financial experts have focused on how well people in the United States manage their finances. Ongoing policy discussions call for greater personal financial responsibility that includes managing debt payments and independent savings for retirement.

Data show that people may be struggling to keep up. A 2012 Financial Industry Regulatory Authority survey shows that 55 percent of people report “living paycheck to paycheck” and 60 percent do not have the funds to cover a financial emergency that costs the equivalent of three months of expenses. Further studies show that the average American cannot correctly calculate compound interest and lacks an understanding of simple financial products like bonds. Media reports suggest that Baby Boomers are not prepared for retirement, and young people are saddled with student loans. Policy discussions on all these topics invariably include some (often quick) mention of the need for people to be better consumers of financial products and services, including increase use of financial education and counseling, as well as information disclosures and warnings about risks.

Proposed policy solutions to these problems range from mandatory financial education in high schools to matched savings programs for adults. Yet none have been widely adopted. Moreover, the evidence of the effectiveness of these strategies is not well developed. A 2013 article in Management Science reviewed more than 130 studies on financial literacy programs, finding weak evidence of very small effects on behavior. A review of state education policies does not find that school mandates for financial education significantly shift personal finance decisions or outcomes of people later in life. Many of these studies on financial education and counseling are less than convincing, as they are affected by problems of selectivity and inadequate statistical control; few are randomized controlled experiments. Studies with small samples tend to be plagued by high rates of attrition, a lack of reliable outcome measures, and poor program fidelity; most of their findings are not convincing to policymakers.

Yet people today face more complex financial decisions than did previous generations. For example, four decades ago, a worker was more likely to have a defined benefit pension and tended to stick with a single employer for much of her or his career. These long-term arrangements made retirement planning straightforward as a formula determined payouts and few, if any, decisions were left to the employee. The Employee Benefit Research Institute reported in 2011 that fewer than 11 percent of all workers have defined benefit plans and most now have defined contribution plans for which employees must set their contribution rate, choose investment options, and then manage their retirement account in their working years and beyond. We saw similar shifts toward personal responsibility in the mortgage market as more people took on loans with variable terms and interest rates that they must monitor and manage, compared to fixed-rate loans that were more common decades ago. Choices in health care, insurance contracts, banking products and services, and investments also have proliferated. Often products have multiple attributes, and comparisons are difficult even for a well-informed consumer. Increased use of technology to manage financial accounts and services perhaps aids some people but may further hamstring those with less access to or experience with technology. Of particular concern are vulnerable populations, including people with disabilities, low levels of education, and seniors facing cognitive decline.

This changing landscape for household financial management has generated attention from both funders and government. The new federal Consumer Financial Protection Bureau was launched under the Dodd-Frank Act in 2010 with the goal of increasing transparency for consumer financial products, especially credit cards, mortgages, and transaction accounts. At the local level, Cities for Financial Empowerment has created model programs to promote financial services, consumer protection and education and counseling as part of municipal services. Philanthropic foundations and corporations have invested in strategies to promote savings and alternatives to high-cost lending. Academic researchers, as summarized in the 2008 New York Times bestseller, Nudge, by Cass Sunstein and Richard Thaler, have promoted greater use of behavioral economics to set defaults and otherwise design systems so that people have fewer opportunities to make “mistakes.”

J. Michael Collins is associate professor of public affairs and faculty director of the Center for Financial Security at the University of Wisconsin–Madison. He studies consumer decision-making in the financial marketplace, including the role of public policy in influencing credit, savings and investment choices.
Greater regulations and prescriptive solutions are not without pitfalls, however. Paternalistic one-size-fits-all strategies can backfire, given the wide variation among people in their age, schooling, life experiences, and financial contexts. Borrowing for one person could create a life-changing opportunity (e.g., financing a degree that results in a much better career trajectory) while for another debt can become a burden (e.g., borrowing to finance an overpriced home at the peak of the housing boom). Saving a portion of one’s current income might be ideal for someone with a stable income and predictable expenses, but an inflexible savings arrangement may result in squeezed monthly budgets for another person who then might resort to high-cost borrowing. What objectively “optimal” financial behavior would be is not often clear.

Take, for example, the high-cost, short-term “payday loan.” Typically one to two weeks in duration, these loans are designed to provide an advance on a paycheck. A borrower might seek $100 today to be repaid on the next payday in 15 days, at a cost of $15. That translates into an annual percentage rate of more than 360 percent if that $100 was continuously borrowed for a full year. But these loans are prevalent in part because of the tradeoffs a liquidity-constrained household has to make. Being short $100 might result in a missed utility payment, which could cost much more than $30 in monthly fees. Missing rent or an insurance payment, or just paying bills late, may result in costs that are more expensive than that payday loan. The context in which people choose needs to be understood in order to make a judgment regarding the appropriateness of a choice: often people are making optimal choices given the options that are available to them. Phenomenon often considered a mistake in the popular press—taking out a payday loan, avoiding the use of a bank account, claiming Social Security early, just to name a few—might actually be an appropriate choice for some people. Policymakers have to use caution before assuming otherwise.

The national dialogue regarding these issues has subtly shifted toward use of the term “financial capability” instead of “financial literacy.” Borrowed from the European Union and the United Kingdom, this broader term de-emphasizes that people just need to know definitions of key financial terms and how to calculate interest. Instead, “financial capability” focuses on how people use their knowledge and tools, resources, and advice to respond to challenging financial issues. The financial capability concept includes a recognition that access to financial products and choices is important, and it recognizes the role of the context in which choices are made.

 Capability is something that people develop and adapt over their life course. A single educational workshop cannot satisfy capability. Perhaps the strongest evidence of this shift in language (and thinking) at the national level is illustrated by the titles of the last two presidential commissions related to personal finance policies. In 2008 the President’s Advisory Council on Financial Literacy was appointed. In 2009, a new incarnation was called the President’s Advisory Council on Financial Capability.

Given the complexity of this situation and the potential that some approaches are ineffective or worse, what insight does policy and evaluation research yield for policymakers interested in advancing financial capability? Are there any guideposts that might help frame the policy debate and trigger innovations in programs and services? The positive news is that since the Great Recession, interest in household finance and consumer behavior has been growing. More studies focus on individual and household decisions related to saving, borrowing, and the use of public and private programs. There is an increased investment in studies with more rigor, larger sample sizes, and the use of randomized assignment, which can offer much more powerful evidence of causal relationships between interventions and later outcomes.

There are quite a few examples of this new generation of studies being conducted relevant for policy makers related to financial capability. These studies offer a glimpse of the more robust, and perhaps more nuanced, evidence that is developing that will inform policies and programs aimed at addressing the financial capability of American families.

**Youth: School-Based Financial Capability Programs**

Economics has been part of high school curricula for nearly 50 years in various forms, including as part of home economics and business courses. But more recently schools, including elementary schools and even pre-schools, have focused on financial topics for younger students. A complement to this strategy is the inclusion of banking services at school, provided by a community financial institution.

In 2010, the University of Wisconsin–Madison Center for Financial Security cooperated with the Corporation for Enterprise Development and the U.S. Department of Treasury to evaluate two school-based financial education programs combined with in-school banking. The mere presence of a bank or credit union branch appears to be associated with student understanding of financial concepts and awareness of financial services. This presence also tends to increase the rate at which students themselves had savings accounts. Students also tended to have more confidence and trust in financial institutions based on being exposed to an in-school bank branch. The curricula of these programs are integrated into math and language arts classes.

Further innovations seem possible. For example, the My Classroom Economy program provides teachers a model to help students incorporate financial thinking by having to make decisions that require this thinking; for example, students may have to earn resources to “rent” their desks or consumer supplies. These applied experiential learning programs have the potential to help students to develop basic financial management skills and learn economic concepts such as opportunity costs and the value of a marginal dollar of earning. While not rigorously evaluated, these novel approaches have great potential to enhance long-run financial capability and behavior.
Expert Advice: Targeted Financial Counseling

Education and experiential learning, when appropriately applied, appear to have promise in advancing financial capability. However, in other situations, people need more prescriptive information and recommendations. The most prominent example of the last decade is the need for counseling regarding mortgage foreclosure. Borrowers who cannot make their required payments are financially constrained and emotionally stressed. Understanding the technicalities of mortgage contracts and foreclosure laws is not something most people are likely to master. A qualified counselor can help people understand their alternatives and choose a course of action. A 2012 study I co-authored found that counseling reduces the rate at which loans were repossessed and helped borrowers to modify their loans with more affordable terms.

Sometimes people do not need detailed advice, but rather a much simpler reminder about important but easily neglected financial actions, such as paying bills on time. A pilot study on first-time homebuyers had people commit to financial goals and then receive letters, emails, and phone calls from a third-party reminding borrowers of their goals and the importance of paying their mortgage and other bills on time. People who were randomly assigned to the reminders had significantly lower rates of missed payments. People face many distractions and have limitations on their ability to pay attention to mundane details; keeping actions “front and center” can stimulate attention and focus people on actions that can otherwise be overlooked.

Another example is advice or reminders related to the mortgage market that can be embedded in the legal system, such as third-party mediation. In these cases people are not provided information or expertise, but borrowers and lenders are required to meet with a mediator before foreclosures can be filed. Getting parties to the table to reveal information can result in improved loan repayments relative to similar loans without mediation, I found in a co-authored analysis to be published in 2014. These strategies are different applications of mechanisms to help people make better financial decisions and improve outcomes in the housing area; the same principles can be applied to other financial markets.

Disclosures and Warnings

In addition to active forms of support for understanding financial choices, an often under-appreciated technique for aiding consumers in various markets is an information label. A close look at items in the grocery store or pharmacy demonstrates that standardized information labels and warnings are common in other consumer markets. Under the 2010 Dodd-Frank Act disclosures have been added to credit cards, mortgages, and other financial products with the goal of helping people understand costs and risks related to borrowing. The use of technology and more user-friendly formats for conveying information has the potential to transform labels from a sea of legalese to a

At Work: Employer-Based Financial Capability Programs

Another means for improving people’s financial capability is in the workplace. This approach is specifically appropriate for retirement planning since employers often offer retirement plans that require an understanding of investment options and contribution amounts. Most employers do not have the internal capacity to provide educational workshops. Online education offers an opportunity for employees to complete course work in a flexible format as time permits, working incrementally through learning modules. For example, I found in a 2012 study that an online course provided by a network of employers in Wisconsin shows that people report not only learning about financial content through an online course, but also self-report increased use of retirement accounts and elevated savings levels. As learning technology advances, opportunities may become even greater for delivering education in a “just in time” manner so that people can learn about their options in a timely fashion and then choose to act.
few key salient pieces of information that can influence how people choose and use various forms of borrowing. Studies of the impact of disclosures and warnings for financial products are scarce, but, as I find in a study to be published in 2014, some evidence suggests that risk warnings, especially when spelled out in simple terms that highlight the worst-case scenario, can cause people to reconsider the costs and benefits of a financial product. The effects are more pronounced when combined with a signature by the consumer acknowledging the disclosure and even more when combined with referrals to a financial counselor related to the risks the disclosure describes. While labels clearly complement other strategies, they are part of the menu of options that policymakers need to keep in mind when addressing financial capability issues.

Looking Ahead

A wide range of financial capability topics needs further exploration. The issue of student loans is one example. How well people understand the costs and benefits of the educational credential they seek and the costs of financing the schooling required is a hot topic in the media and not well-informed by current research. The role of financial counseling, student aid, or academic advisors and other forms of information and advice has not been rigorously evaluated.

Another issue related to financial capability that will become increasingly critical as the Baby Boom ages is how to best support people as they enter retirement and face the daunting task of managing their defined contribution retirement accounts. As people age and their cognitive abilities decline, finding simple strategies to manage money will become more important, as will protecting vulnerable people from bad advice or malicious advisors and salespeople.

Another issue needing further understanding is how to support people who have acquired financial capability and developed well-informed plans, but fail to execute those plans due to inattention or procrastination. Potentially, peers and social networks can help people stick to the behaviors they intended. The emerging field of financial coaching offers an innovative way to help people form financial goals and then to adhere to them over time. A recent proposal by the Consumer Financial Protection Bureau will pilot the use of coaches at 100 locations nationally, targeting vulnerable populations such as military veterans.

Even the age-old topic of savings deserves more consideration. While efforts to support (and subsidize) savings for retirement, small businesses, or homeownership have met with mixed success, especially for low-income families, unrestricted savings in case of an emergency or other contingency savings clearly is an important avenue to promote well-being.

In response to the Great Recession, policymakers have taken an increase interest in ways to boost the ability of people to manage and improve their finances. The evidence supporting traditional workshops or short courses in the last year of high school is weak. The examples presented above offer some insights into the potential for new public policies and programs to support financial capability. New ideas need to be critically evaluated; the situations people face are complex and highly heterogeneous. There are no “one size fits all” style solutions. Financial capability is an area ripe for further academic research, and it deserves more attention from policymakers at all levels, as well as professionals in nonprofits and private corporations. ♦
Speaker Vos said he heard “many, many positive comments from participants” and looked forward to helping make it happen again.

In earlier comments, Vos said the partnership is valuable: “I am pleased that the Assembly can partner with the university to provide this professional development. It will also give staff another opportunity to work in a bipartisan fashion as they collaborate on their policy projects.”

In announcing the class, Barca had agreed: “It’s great when the university is able to reach out and come on site to help the Legislature, businesses and any other organization work together and learn new skills.” Barca is a 1982 graduate of the Center for the Study of Public Policy and Administration, a precursor of the La Follette School.

We at La Follette were excited, of course, to work with both sides of the aisle to offer this program. But collaborating with our Legislature is something we have done many times during the 30 years since the Legislature reshaped the Center for the Study of Public Policy and Administration into the La Follette Institute of Public Affairs:

- Since 1994, we have teamed with the Midwest office of the Council of State Governments to offer the Bowhay Institute for Legislative Leadership Development. This weeklong program, held on the University of Wisconsin–Madison campus, is designed for legislators in 11 Midwestern states and four Canadian provinces to explore policy issues and personal development. Its 20th class will meet in August and, as always, include Wisconsin legislators. Of our nearly 60 Wisconsin graduates over the years, we count U.S. Senator Tammy Baldwin and Wisconsin Department of Health Services Secretary Kitty Rhodes.
- From 1991 to 2009 in partnership with the Legislative Council, La Follette School faculty briefed newly elected Wisconsin legislators on current policy at their biennial orientation issues.
- We helped start and staff the Wisconsin Senate Scholars Program in 2006 in which high school students from around the state come to Madison to learn about policy and politics. The program, now in its ninth year, has expanded to three sessions each year to accommodate the interest.
- Since 2006, we have worked with the Legislative Council and the Population Health Institute to present the Evidence-Based Health Policy Project to provide legislators with research and data to help them make timely decisions. We have presented more than 20 sessions on public health topics ranging from drunken driving to early brain development.
- Our faculty are routinely asked to serve on Legislative Council study committees and present to the Legislature on a variety of policy issues. In addition, we sponsor dozens of speakers, programs, and conferences yearly on policy issues for legislators, public agencies and other policy stakeholders.

The list of how we work with our Legislature and public agencies could go on and on. Our Spring Symposium this year will focus on performance management, and we expect to work with the Legislative Reference Bureau, legislative staffs, executive agency staff and others on helping them achieve results-based governance.

We look forward to continuing to strengthen our decades-long relationship with our Legislature to inform the practice of public affairs by disseminating knowledge to public policy practitioners.
Strengthening Incentives for Policy Change

By Ingrid Aune

One of the main rationales for foreign aid is to assist poor countries in improving the standard of living for their citizens. Traditionally foreign aid has been awarded on a so-called ex ante rewards basis where aid is based on need or strategic interest so that it can improve its conditions in a specific area. In 2004 the U.S. Congress adopted a new strategy for awarding foreign aid by establishing the Millennium Challenge Corporation (MCC). This federal agency determination of potential eligibility for foreign aid is based on an ex-post rewards system: The MCC selects countries for assistance based on their policy performance. The MCC’s overall goal is to reduce poverty and promote sustainable economic growth in potential recipient countries.

Politicians, public servants, and researchers alike have debated whether there is a stronger incentive effect for poor countries to change their policies under an ex-post rewards system than under a traditional ex-ante rewards system. A quantitative analysis of any incentive the Millennium Challenge Corporation creates contributes to this debate. Quantifiable evidence of an “MCC incentive effect” could provide a model for change in the international aid community and strengthen the case for funding for the MCC’s efforts to fight poverty around the world.

This article provides a short introduction to the main facets of the MCC incentive effect. The conclusions are grounded in an extensive quantitative analysis of the MCC eligibility indicators based upon an independently compiled dataset from the original third-party sources that the MCC uses. This analysis provides stronger documentation of the MCC incentive effect than two earlier studies.

Ingrid Aune graduated from the La Follette School in 2013 with a master of international public affairs. This article is based on a report she prepared with Yanyan Chen, Christina Miller, and Joshua Williams for the Millennium Challenge Corporation under the guidance of Professor Melanie Manion. The team presented the report in a national graduate research competition in Washington D.C. in July 2013 and won the Marykathryn Kubat Award given by the American Association for Budget and Program Analysis.

The Millennium Challenge Corporation and the MCC Incentive Effect

The MCC has contributed directly to reducing poverty in poor countries by having allocated more than $8.4 billion in compact and threshold programs to what it deems the best-governed poor countries. In addition, previous studies imply that the MCC’s aid system may also fight poverty indirectly: The possibility of obtaining substantial MCC funding may create incentives for poor governments to change policies so they meet MCC criteria. If they meet the MCC requirements, they also become more likely to receive funding from other countries and donor organizations. Hence, the economic benefits for poor countries may be substantial. When countries seek to change their policies specifically to meet MCC eligibility requirements, the MCC incentive effect is taking place. However, research supporting the existence of such an MCC incentive effect is limited.

The MCC uses policy indicators to gauge the governance of potential recipients. Some qualitative or anecdotal evidence suggests that countries change their policies to improve their scores on these indicators and become eligible for MCC funding. The only two quantitative studies prior to this analysis do report there is quantitative evidence of an “MCC incentive effect.” One of these studies uses a limited time period; the other focuses on just one MCC eligibility criterion. In our analysis, however, we expanded the time period for assessing the incentive effect from four to 10 years and used available data for all of the MCC selection indicators. We compiled data from the original third-party sources the MCC uses to establish a single large panel database. Because the third-party sources revise their historical data as new information becomes available and the MCC does not, our data are more up to date and consistent than those used in previous research on the MCC incentive effect.

Selection Indicators and Quantitative Approach

The MCC’s Board of Directors evaluates countries for eligibility by looking at how they perform compared to countries with similar income levels in one of two groups: low-income countries or lower-middle-income countries. For fiscal year 2013, candidate countries must perform better than their peers—and above the median or absolute threshold in at least half of the
selection indicators. In addition to analyzing all countries as one group, we concluded that enough of a difference exists between low-income countries and lower-middle-income countries to justify separate analyses of each group of countries.

For 98 countries, we adapted 20 selection indicators in the MCC’s Economic Freedom, Investing in People, and Ruling Justly categories. To remove yearly fluctuations for each country, we calculated the rates of reform in each policy area as two-year differences in indicator scores, which helped to remove yearly fluctuations. Drawing on the previous quantitative research, we used a difference-in-difference regression analysis to detect the incentive effect. We calculated rates of reform for each of the 20 indicators for two-year periods from 2002 (two years before the MCC started operation) through 2010 (2002-04, 2004-06, 2006-08, and 2008-10). We find that a country’s earlier policy has a weak effect on later policy.

In two preliminary analyses we assessed how quickly one policy indicator changes over our data compared to the others. Both revealed that the Economic Freedom indicators were the least stable and the easiest to change, suggesting that they are easier to manipulate in the short run. The Investing in People and Ruling Justly indicators were more stable. We found relatively high correlations between the indicators in the Ruling Justly category, which also suggests the permanence of the categories in this area.

Our analysis presumed that some countries have greater incentives to change their policies in accordance with MCC criteria and selection indicators than do others. We then distinguished those countries that, in our qualitative judgment, were more likely to exhibit the MCC incentive effect from the remaining countries. The countries we expected to be most responsive constituted our “treatment groups,” and the remaining countries constituted the corresponding “control groups” in the quasi-experiments that we conducted. We performed quantitative analyses of the treatment groups to strengthen our understanding of the MCC incentive effect. We also performed a series of statistical analyses designed to determine which countries have incentive to modify their policies in order to apply for MCC development aid. We controlled for gross domestic product and population, and we distinguished between countries that are more (treatment) or less (control) likely to exhibit the MCC incentive effect.

Our preliminary analyses indicate that, compared to their control groups, the indicators in some treatment group countries indicate the existence of the MCC incentive effect. Other analyses are mixed or suggest the incentive does not exist, and some even suggest a “negative” MCC effect. (This may be because that a country’s receipt of MCC funds may affect the presence of the MCC incentive effect or that the MCC may have a trade-off between improvement on different policies).

**Results**

Despite having looked for the MCC incentive effect in those countries that, according to the previous studies and our best qualitative evaluation, should be the most likely to be subject to any MCC incentive effect, we do not find a strong, statistically significant MCC incentive effect. Our analysis, unlike the two previous studies, is at best inconclusive as to the existence of the MCC incentive effect. However, our report provides stronger documentation that supports our conclusions, and we provide a road map for how future studies can be conducted. In our analyses we justify quantitatively new treatment groups that will be useful in future quasi-experiments on the MCC incentive effect, we provide an analysis of the indicator categories, and we introduce a path for future studies with a separate analysis of low-income countries and lower-middle-income countries. Furthermore, we provide some suggestions as to how statistical models can be modified to improve the tools for measuring the MCC incentive effect.

Our overall results do not provide strong support for the existence of the MCC incentive effect. Of 645 possible instances of statistical significance, only 38, or 6 percent, exhibit a positive and statistically significant documentation of the MCC incentive effect. The prevalence of negative results is very similar. Unlike the two previous studies, we do not find quantitative evidence that allows us to conclude that the MCC incentive effect exists. About one-third of all the significant results we present are for a treatment group of countries that MCC staff members believe are most likely to be incentivized by aid to change their policies.

When we break down our analysis by country income level, we find statistically significant (albeit limited) quantitative evidence to support the argument that an MCC incentive effect exists. Most of the statistical significant results for each of the two income groups are found in the Investing in People category, but the positive results are distributed differently. Our data suggest that low-income countries may tend to focus on improving Ruling Justly indicators rather than Economic Freedom indicators. This finding is interesting since these indicators, according to our preliminary analysis, are the hardest to change, but they nonetheless show a positive change for the low-income countries. For the lower-middle-income countries the picture is different, most notably because they lack statistically significant positive results.

We are not able to conclude, like one of the previous studies, whether an MCC incentive effect exists and has diminishing returns. When looking strictly at positive results for low-income countries, we find only weak evidence of this pattern for the Economic Freedom and Ruling Justly indicators. This observation should come as no surprise. Explaining that changes in world politics and countries’ rationales for
policies as being due to the existence of a foreign aid agency is a daunting task. Nevertheless, we do find some positive and statistically significant results supporting existence of the MCC incentive effect. It is disappointing that for those country groups that seem most likely to reveal an incentive effect, no such effect is identified.

If an incentive effect existed, positive results would be more likely to appear for the treatment group countries; they do not. While attempting to identify country response to incentives is inherently difficult, perhaps more progress could be made through the use of randomized control methods, the application of more sophisticated empirical methods, or having access to longer periods of analysis.

Can MCC Incentives be Strengthened?
The MCC incentive effect is an interesting effect to study, not only to the MCC, but to anyone who is interested in the incentive effects created by an ex-post rewards system.

Although the MCC provides the opportunity for substantial economic benefits to incentivize poor countries to change their policies, countries may be unaware of such incentives or not interested in or capable of responding to them. There may be some steps that the MCC should consider if it would like to improve the strength of the MCC incentive effect.

If the MCC incentive becomes stronger, it may also become easier to quantify. We have several suggestions for strengthening the MCC incentive effect. In our view, improving knowledge and information about MCC funding opportunities and the criteria used to allocate funds appears to us to be the biggest challenge for the MCC today, and should be rather easy to implement. This step is particularly important, since the MCC has changed its eligibility criteria and compliance requirements on numerous occasions since its inception in 2004. The MCC selection process today is not transparent for outsiders or special interest groups. These changes challenged our efforts to detect an incentive effect and certainly impede countries interested in accessing MCC assistance.

The MCC eligibility criterion has been relative throughout its existence. Today a country can easily learn about its score, but not so easily know how it is doing overall relative to the other candidate countries. We suggest that the MCC publish the ranking of each country to make each country’s standing more transparent. This step will promote interest, knowledge, and competition. Such a ranking would inform countries whether they are close to being eligible and would increase the possibility for them to be incentivized by the new prospects of getting significant foreign funds.

We also suggest reducing the number of indicators, particularly in the Ruling Justly category. These indicators are highly correlated and change very slowly. A simpler process would allow countries to learn where they should focus their political efforts to change policies if they would like to compete for MCC funds. We suggest that the MCC separate country groups by income level and set more distinct individual indicator goals for each of the two income groups toward indicators they respectively show ability to improve.

Finally, to improve knowledge and information, the MCC should establish five-year plans for selection indicators. Maintaining consistency with criteria over a longer period of time would help improve transparency.

Final Thoughts
Our report is at best inconclusive as to determining the existence of the MCC incentive effect. While the 2006 study concludes that the MCC incentive effect exists, the authors did not provide the evidence on which this conclusion rests. Where the 2010 study finds a statistically significant effect on one of the indicators, this effect appears to have diminished over time. Our study is more comprehensive than either of its predecessors. As such, we have provided new perspectives on how the MCC incentive effect should be studied.

We hope that this study will lead to research and actions by the MCC that will more solidly point to and foster the MCC incentive effect. Such research could prove highly beneficial in the long term work to fight poverty and promote economic growth across the globe.