

# Chapter 1: Economic Freedom & the Index

## Introduction

The index of the Economic Freedom of North America is an attempt to gauge the extent of the restrictions on economic freedom imposed by governments in North America. This study employs two indexes. The first is the subnational index, which measures the impact of provincial and municipal governments in Canada and state and local governments in the United States. The second index, called the all-government index, includes the impact of all levels of government—federal, provincial/state, and municipal/local—in Canada and the United States. All 10 provinces and 50 states are included in both indexes. Although this study does not rank Mexican states, future research will endeavour to do so.

The study examines the impact of economic freedom on both the level of economic activity and the growth of economic activity. The econometric testing presented in this paper shows that in North America economic freedom fosters prosperity and growth. Economic freedom increases the affluence of individuals. This finding is consistent with other studies of economic freedom.<sup>1</sup> The results are highly significant and remarkably stable through a number of different sensitivity tests.

The majority of US states have high levels of economic freedom and prosperity. Only a handful of states, most notably West Virginia, have consistently low levels of economic freedom. Other states, such as Colorado, Tennessee, Nevada, Indiana, Georgia, Connecticut, Louisiana, and Texas, have consistently high levels of economic freedom. All, with the exception of Louisiana, either exceed the United States' average per-capita GDP or have been exceeding average economic growth in the United States. The states that have consistently low levels of economic freedom—West Virginia, Maine, New Mexico, Arkansas, Alaska, and Rhode Island—either suffer from a GDP that is below the national average or that is declining against the national average.

Some states have dramatically changed their economic freedom rating over the period. Massachusetts went from the bottom five to the top five in all-government rankings over the period. During this period, its economy, which had been under-performing the national average, became one of the three richest states in the United States. Oklahoma fell dramatically in the economic freedom rankings and in relative wealth over the period.

Unfortunately, Canadian provinces are poorly positioned to benefit from economic freedom. With the exception of Alberta and, to a lesser extent, Ontario, they are all clustered at the bottom of the economic freedom ratings and are the poorest jurisdictions in North America. Figures 1 and 2 illustrate economic freedom scores and the large differences between US states and Canadian provinces.

Alberta's economic freedom scores put it roughly in the middle of the pack. It also has a middling level of economic activity within the North American context, hardly the star performer usually visualized in Canada. Ontario has a more typically Canadian score in economic freedom. As for wealth, in 2000, the most recent year for which comprehensive data are available, Ontario places ahead only of the three poorest US states, West Virginia, Mississippi, and Montana. This is a very disappointing result for the province that is normally considered Canada's industrial heartland, though its prosperity ranks far behind advanced, industrial US states.

## What is Economic Freedom?

Gwartney et al. defined economic freedom as follows:

Individuals have economic freedom when (a) property they acquire without the use of force, fraud, or theft is protected from physical invasions by others and (b) they are free to use,

exchange, or give their property as long as their actions do not violate the identical rights of others. Thus, an index of economic freedom should measure the extent to which rightly acquired property is protected and individuals are engaged in voluntary transactions. (1996: 12)

The freest economies operate with a minimal level of government interference, relying upon personal choice and markets to answer the basic economic questions such as what is to be produced, how it is to be produced, how much is produced, and for whom production is intended. As government imposes restrictions on these choices, the level of economic freedom declines.

The research flowing from the data generated by the *Economic Freedom of the World* reports,<sup>2</sup> a project The Fraser Institute initiated almost 20 years ago, shows that economic freedom is important to the well-being of a nation's citizens. This research has found that economic freedom is positively correlated with per-capita income, economic growth, greater life expectancy, lower child mortality, the development of democratic institutions, civil and political freedoms, and other desirable social and economic outcomes. Just as *Economic Freedom of the World* seeks to measure economic freedom on an international basis, *Economic Freedom of North America* has the goal of measuring differences in economic freedom between the Canadian provinces and US states.

This study looks at the 10 Canadian provinces—excluding Yukon, the Northwest Territories, and Nunavut—and the 50 US states from 1981 to 2000. Each province and state is ranked on economic freedom at the subnational and all-government levels. This helps isolate the impact of different levels of government on economic freedom in North America.

In extending the work on economic freedom, it would seem obvious to include the tried and tested measures used in *Economic Freedom of the World*. This is not as easy as it sounds. Some categories of the world index have too little variance among North American jurisdictions to be measured accurately. For example, the stability of the legal system (one of the areas used in *Economic Freedom of the World*) does not differ much among states and provinces. Variables such as the private ownership of banks, avoidance of negative interest rates, monetary policy, freedom to own foreign currency, the right to international exchange, struc-

ture of capital markets, and black-market exchange rates are ineffective for an inquiry into the state of economic freedom within North America, particularly at a subnational level.

However, economic freedom varies across North America in three important aspects, which we attempt to capture in this index: size of government; takings and discriminatory taxation; and labor market flexibility. A fourth, potentially important, area of difference, restriction on the movement of goods within North America, had to be left out due to lack of data. This may be particularly important in the Canadian context, since Canada retains a number of internal trade barriers.<sup>3</sup>

Data limitations also create difficulties in testing relationships between economic freedom and key economic variables. For example, we are only partly able to construct a growth model. Data on investment for individual states, an important part of any growth model, are not available. Fortunately, as discussed later, the effect of omitting investment variable on the estimated economic freedom coefficient is likely to be of little quantitative significance. High school graduation rates are used as a proxy for human capital but in our testing this variable often does not have the expected sign and is seldom significant in the regressions in which it is included.

Due to data limitations and revisions, some time periods are either not directly comparable or are not available. When necessary we have used the data closest to the missing time period as an estimate for the missing data. If there have been changes in this component during this period, this procedure would introduce some amount of measurement error in the estimate of economic freedom for the particular data point. However, omitting the component in the cases when it is missing and basing the index score on the remaining components may create more bias in the estimate of overall economic freedom.

The *theory* of economic freedom<sup>4</sup> is no different at the subnational and all-government level than it is at the global level, although different proxies consistent with the theory of economic freedom must be found that suit subnational and all-government measures. The nine variables chosen fall into three areas: Size of Government, Takings and Discriminatory Taxation, and Labor Market Freedom. Before we discuss what each area includes, it should be noted that most of the variables we use are calculated as a ratio of gross

Figure 1: Summary of 2000 Ratings—All-Government

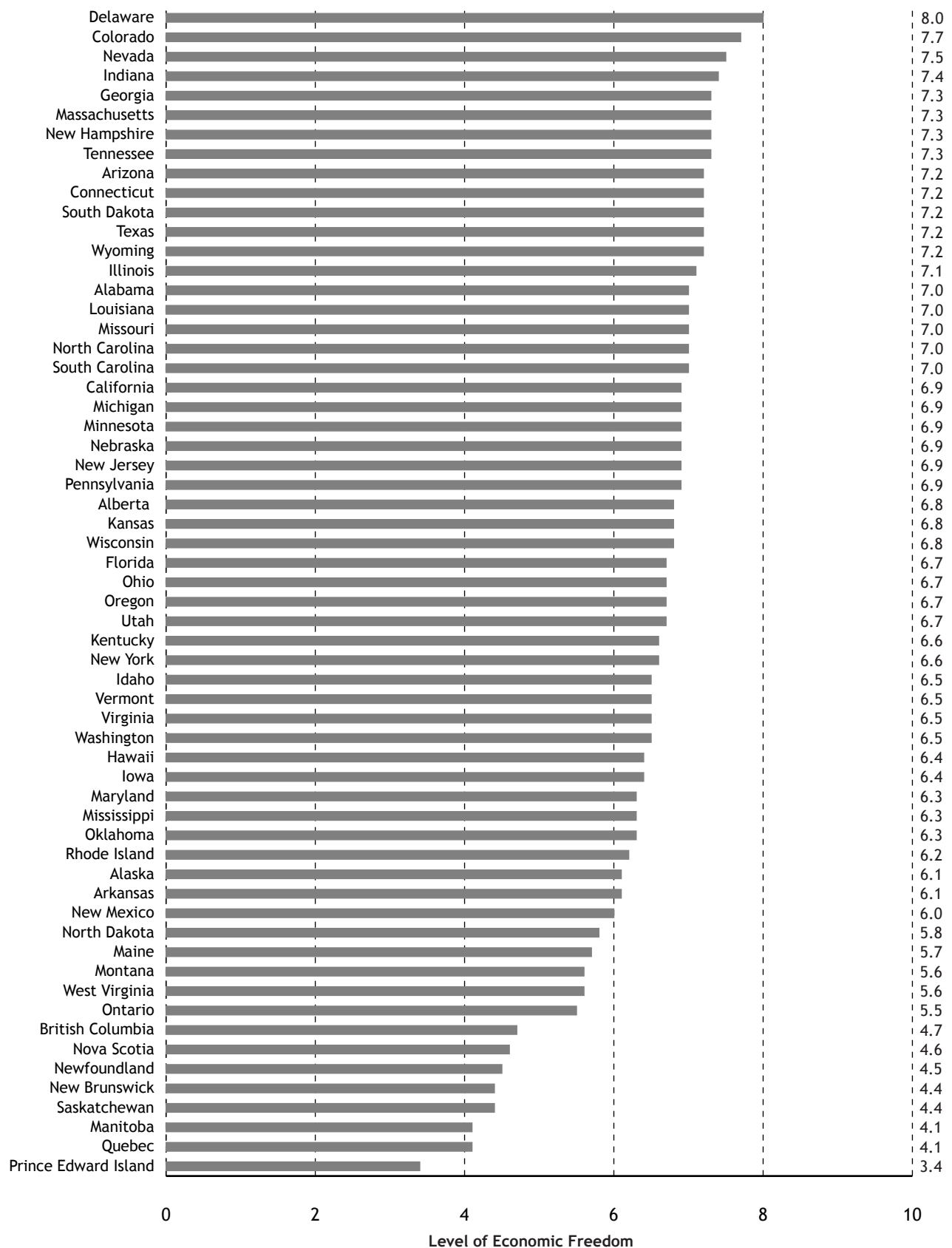
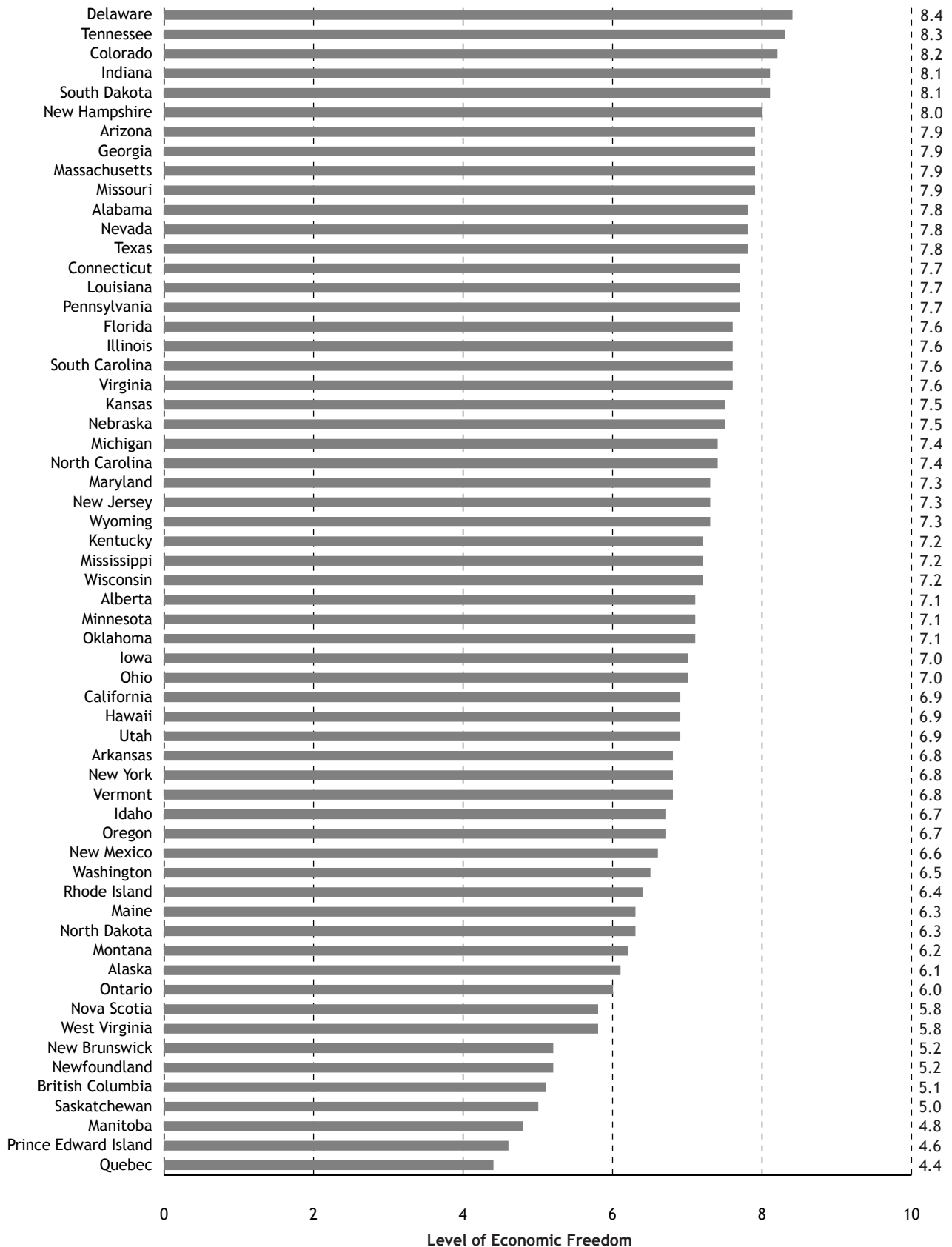


Figure 2: Summary of 2000 Ratings—Subnational



domestic product (GDP) in each jurisdiction and thus do not require translation between exchange rates. The exception is the income-tax rate variable, where the exchange rate is used to calculate equivalent top thresholds in Canada and the United States.

## Description of Variables

Using a simple mathematical formula to reduce subjective judgments, a scale from zero to 10 was constructed to represent the underlying distribution of the nine variables in the index. Ten is the highest possible score and indicates a high level of economic freedom.<sup>5</sup> Thus, this *index* is a relative ranking. The rating formula is consistent across time to allow an examination of the evolution of economic freedom. To construct the overall index without imposing subjective judgments about the relative importance of the variable, each area was equally weighted and each variable within each area was equally weighted (see Appendix C: Methodology (p. 51) for more details).

The index developed in this paper assigns a higher score of economic freedom when a government size variable is smaller in one state or province relative to another. This would seem to contradict the theory of economic freedom, which does not predict that a government size of zero maximizes freedom. Indeed, important government functions, such as the enforcement of the rule of law, are necessary for economic freedom and freedom more broadly. However, all the theory of economic freedom requires is that governments be large enough to undertake an adequate but minimal level of the “protective” and “productive” functions of government, discussed in the next section. It is unlikely that any government considered in this sample is too small to perform these functions at the minimum required level.

In examining the areas below, it may seem that Areas 1 and 2 create a double counting, in that they capture the two sides of the government ledger sheet, revenues and expenditures, which presumably should balance over time. However, in examining subnational jurisdictions, this situation does not hold. In the United States, and even more so in Canada, a number of intergovernmental transfers break the link between taxation and spending at the subnational level.<sup>6</sup> The break between revenues and spending is even more pronounced at the all-government level, which

includes the federal government. Obviously, what the federal government spends in a state or a province does not necessarily bear a strong relationship to the amount of money it raises in that jurisdiction. Thus, to take examples from both Canada and the United States, the respective federal governments spend more in Newfoundland and West Virginia than they raise through taxation in these jurisdictions. The opposite pattern occurs for Alberta and Connecticut.

As discussed below, both taxation and spending can suppress economic freedom. Since the link between the two is broken when examining subnational jurisdictions, it is necessary to examine both sides of the government’s balance sheet.

### **Area 1: Size of Government**

#### **1A: General Consumption Expenditures by Government as a Percentage of GDP**

As the size of government expands, less room is available for private choice. While government can fulfill useful roles in society, there is a tendency for government to undertake superfluous activities as it expands. According to Gwartney et al. “there are two broad functions of government that are consistent with economic freedom: (1) protection of individuals against invasions by intruders, both domestic and foreign, and (2) provision of a few selected goods—what economists call public goods” (1996: 22).

These two broad functions of government are often called protective and productive functions of government. Once government moves beyond these two functions into provision of private goods, goods that can be produced by private firms and individuals, they restrict consumer choice and, thus, economic freedom (Gwartney et al. 1996). In other words, government spending, independent of taxation, by itself reduces economic freedom once this spending exceeds what is necessary to provide a minimal level of protective and productive functions. Thus, as the size of government consumption grows a jurisdiction receives a lower score in this component.

#### **1B: Transfers and Subsidies as a Percentage of GDP**

When the government taxes one person in order to give money to another, it separates individuals from the full benefits of their labor and reduces the real returns of such activity (Gwartney et al. 1996). These transfers represent the removal of property without

providing a compensating benefit and are, thus, an infringement on economic freedom. Put another way, when governments take from one group in order to give to another, they are violating the same property rights they are supposed to protect. The greater the level of transfers and subsidies, the lower the score a jurisdiction receives.

### **Area 2: Takings and Discriminatory Taxation**

**2A: Total Government Revenue from Own Source as a Percentage of GDP;**

**2B: Top Marginal Income Tax Rate<sup>7</sup> and the Income Threshold at Which It Applies;**

**2C: Indirect Taxes as a Percentage of GDP;**

**2D: Sales Taxes Collected as a Percentage of GDP.**

Some form of government funding is necessary to support the functions of government but, as the tax burden grows, the restrictions on private choice increase and thus economic freedom declines. Taxes that have a discriminatory impact and bear little reference to services received infringe on economic freedom even more. "High marginal tax rates discriminate against productive citizens and deny them the fruits of their labor" (Gwartney et al. 1996: 30). In each of the above variables, a higher rate lowers a jurisdiction's score in this component. Top personal income tax rates are also rated by the income thresholds at which they apply. Higher thresholds result in a better score.

Examining the separate sources of government revenue gives the reader more information than just examining a single tax source or overall taxes. Nonetheless, total own-source revenue is included to pick up the impact of taxes, particularly various corporate and capital taxes, not included in the other three variables.

### **Area 3: Labor Market Freedom**

**3A: Minimum Wage Legislation**

High minimum wages restrict the ability of employers and employees to negotiate contracts to their liking. In particular, minimum wage legislation restricts the ability of low-skilled workers and workforce entrants to negotiate for employment they might otherwise accept, and thus minimum wage laws most restrict the economic freedom of workers in these groups and the employers who might otherwise hire them.

This component measures the annual income earned by someone working at the minimum wage

as a ratio of per-capita GDP. Since per-capita GDP is a proxy for the average productivity in a jurisdiction, this ratio takes into account differences in the ability to pay wages across jurisdictions. As the minimum wage grows relative to productivity, thus narrowing the range of employment contracts that can be freely negotiated, there are further reductions in economic freedom, resulting in a lower score for the jurisdiction. For example, minimum wage legislation set at 0.1% of average productivity is likely to have no impact on economic freedom; set at 50% of average productivity, the legislation would limit the freedom of workers and firms to negotiate employment to a much greater extent. Put another way, a minimum wage requirement of \$2 an hour for New York will have little impact but, for a third world nation, it might remove most potential workers from the effective workforce. The same idea holds, though in a narrower range, for jurisdictions within North America.

**3B: Government Employment as a Percentage of Total State/Provincial Employment**

Economic freedom decreases for several reasons as government employment increases beyond what is necessary for government's productive and protective functions. Government, in effect, is using expropriated money to take an amount of labor out of the labor market. This restricts the ability of individuals and organizations to contract freely for labor services since potential employers have to bid against their own tax dollars in attempting to obtain labor. High levels of government employment may also indicate that government is attempting to supply goods and services that individuals contracting freely with each other could provide on their own. It may also be that the government is attempting to provide goods and services that individuals would not care to obtain if able to contract freely. It may also indicate that government is engaging in regulatory and other activities that restrict the freedom of citizens. Finally, high levels of government employment suggest government is directly undertaking work that could be contracted privately. When government, instead of funding private providers, decides to provide directly a good or service, it reduces economic freedom by limiting choice and by typically creating a government quasi-monopoly in provision of services. For instance, the creation of school vouchers may not decrease government expenditures but it will reduce government

employment, eroding government's monopoly on the provision of publicly funded education services while creating more choice for parents and students and, thus, enhancing economic freedom.

### *3C: Occupational Licensing*

As the number of regulated occupations expand, the mobility of labor is reduced. Often those certified in one jurisdiction have difficulty getting certified in another. If there are barriers to movement of qualified labor from one place to another within a country, then economic freedom is reduced. Moreover, in many cases restrictions on entry into a profession serve little public benefit; instead, they may be enacted for the benefit of the regulated group, which is able to maintain a monopoly on certain types of work so that other individuals may not freely contract with whom they might choose. These laws often protect the interests of "insiders" from potential competition. A greater number of regulated occupations results in a lower score for a jurisdiction.

Each of the variables above exists in the two dimensions we have already mentioned: the subnational and the all-government level. Total revenue from own sources, for example, is calculated first for local/municipal and provincial/state governments, and then again counting all levels of government that capture revenue from individuals living in a given province or state.

## Notes

- 1 See Easton and Walker 1997, De Haan and Sturm 2000, and other related papers at [www.freetheworld.com](http://www.freetheworld.com).
- 2 A listing of many of these books and additional information can be found at [www.freetheworld.com](http://www.freetheworld.com).
- 3 Knox 2002.
- 4 See Gwartney et al. 2002. The website [www.freetheworld.com](http://www.freetheworld.com) has references to a number of important papers and books that explore the theory of economic freedom.
- 5 Due to the way variables are calculated, a mini-max procedure discussed in Appendix C: Methodology (p. 51), 10 is not indicative of perfect economic freedom.
- 6 Most governments have revenue sources other than taxation and national governments also have international financial obligations so that the relation between taxation and spending will not be exactly one-to-one, even at the national level. Nevertheless, over time, the relationship will be close for most national governments, except those receiving large amounts of foreign aid.
- 7 See Appendix C: Methodology (p. 51) for further discussion of how the variable for the top marginal tax rate and its threshold was derived.