ECONOMIC FREEDOM IN AMERICA'S 50 STATES

A 1999 ANALYSIS

John Byars
Robert McCormick
Bruce Yandle

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INTRODUCTION

This report provides the results of a first effort to build indexes of economic freedom for the 50 U.S. states.

Economic freedom—the right of individuals to pursue their own interests through voluntary exchange under a rule of law—forms the foundation of all market economies and is the essence of a free society. Many might quarrel with this humble definition, and a better set of words can surely be found to provide greater precision and clarity, but most will surely agree with the conclusion that followed. As Milton Friedman explained: Freedom is indivisible (Friedman 1962). Political freedom cannot long prevail where economic freedom is threatened.

Defining economic freedom and discussing its profound importance for free societies is a vital and honorable endeavor of longstanding, but one that we must shortchange in this report. Even so, we feel obligated to offer a few observations. First, we recognize that higher incomes that expand the scope of choices made by individuals can be said to enlarge economic freedom. Reducing the impact of any constraint, especially a budget constraint, can always be said to expand the freedom of the individual to act. However, if the higher incomes are derived from wealth redistributed from others by the state, it is impossible to conclude that economic freedom for all is enlarged. Our definition of economic freedom holds income constant. Given a person's income, how constrained is that person in pursuing her own interests? What are the other constraints, besides income, that define the ability to act without outside intervention?

We also understand that some might argue that laws restricting the practice of a particular religion, let us say, can expand the economic freedom of others who might despise the religion in question. For us, regulations that benefit special interest groups at the expense of others in society are a threat to economic freedom. Related to this are arguments that restrictions on the importation of foreign automobiles, for example, expand the economic freedom of U.S. autoworkers that seemingly benefit from the restriction. Our definition emphasizes exchange and actions entered into voluntarily by individuals. In short, we know that economic freedom is a controversial concept. We therefore recognize that the tack we have taken in our work will be criticized by those who have other views about freedom.

Even though controversial, the definition of economic freedom we seek to apply accords with the notions of Adam Smith and other classical liberal thinkers who saw the individual as sovereign and urged the state to become a benign instrument for preserving individual sovereignty. By providing enforcement for rules of law and limiting encroachments on opportunities for individuals to engage in voluntary exchange, the state could expand the scope of economic freedom. The converse applies when the state interferes with beneficial voluntary exchange by imposing taxes, regulation, and state competition.

Would that we could actually isolate the true measure of economic freedom that captures the essence of this brief discussion. But alas, measuring economic freedom of necessity involves the use of crude proxies. Thankfully, our work builds on the work of others who sought to measure economic freedom.

Just a few years ago, a number of scholars began work in an effort to meet the measurement challenge.[1] As a result of this effort, one can assemble major studies that probe the measurement problem and provide indicators of economic freedom across countries. The scholarly efforts have paid dividends. Regular reports are now published that provide systematic comparisons of how countries rank in the human struggle to expand freedom (e.g., Gwartney and Lawson, 1997); but the work continues. International conferences are now convened where scholars engage in efforts to refine the tools and data used for measuring economic freedom.

Some Key Theoretical Notions

The 50 U.S. states, operate under a single constitution that assures open borders and facilitates the movement of goods, capital, and people. Added to the fact of one constitution is the fact of one language and one set of national laws and regulations. This national framework preconditions and constrains the actions taken by economic agents nationwide. In this sense, our study of 50 political units within one country is sharply different from studies that examine economic freedom across a diverse set of countries. In short, our work begins with a foundation of uniformity.

Starting with this foundation, each state exercises considerable latitude in taxing, regulating, and providing state-produced goods and services. Some states have no sales taxes, but impose higher income taxes. Some manage all public schools through central authorities while others take a decentralized approach that encourages school choice. Some states require state permission to enter a wide variety of occupations; others leave the door open for less constrained choice. Obviously, the burden imposed by any one state is constrained by citizen action and mobility. Citizens always have access to the ballot box when conditioning the behavior of elected officials. Of equal or perhaps even greater importance, citizens can vote with their feet (Tiebout 1956). We picture the 50 states in competition for

[1] We call particular attention to Easton and Walker (1992), an edited volume of papers on economic freedom and its measurement. Each paper in the volume is worthy attention, as are numerous citations contained therein.

citizens and economic development that will yield sufficient tax revenues to keep each state afloat.

It is easy to perform a thought experiment that moves a hypothetical adult across the 50 states while holding constant the traits and abilities of the individual. The passage across states provides different bundles of state-induced benefits and costs. The tax burden is lower in some locations, but regulation takes a heavier toll. School choice is more expansive in some states, but occupational licensure requirements are heavier. We can picture a freedom index being formed as the individual is moved across the states. In some cases, higher burdens in one functional area are offset by lighter burdens for other sectors. In still other cases, the cumulative burden rises and falls. When the experiment is completed, a set of comparative measures of economic freedom is developed.

We note that this thought experiment did not account for important state characteristics that might offset losses of economic freedom that accompany citizenship. In some cases, climate and other geographical features have an offsetting effect. In still others, specialized economic activities provide higher incomes that offset state-imposed burdens. In other words, the indexes of economic freedom constructed are not final measures of benefits and costs. They are simply what they are: relative measures of economic freedom.

The Approach Taken

When constructing the indexes and rankings found in this report, we began with a commitment to the scientific notion that the resulting indexes would have to pass critical statistical tests that relate to observed human action. That is, we would not just arbitrarily assign rankings to such things as tax burden across the 50 states and sum those numbers with other similar rankings to obtain a final measure. We also committed ourselves to examining a large number of activities that might be used as components for the final index. In short, we would not confine our research to the selection of a few preconceived indicators of what might best measure economic freedom.

This commitment led us to assemble data on more than 200 separate indicators of actions and activities for each of the 50 states, using where possible data for the mid- to late-1990s. Among the variables assembled were tax revenues, tax rates, general government expenditures, school and environmental regulation, labor regulation, litigation, welfare expenditures, and the state of tort reform. These separate indicators were then given a score of from one to 10, with the lower value representing the largest amount of economic freedom. The values were assigned to groupings of 5 states; each state in the lowest decile was given a value of one and so on. These individual indicators were then combined to form five sectors: fiscal, regulatory, judicial, government size, and welfare. Each sector was then scored one to 10 for deciles of states. Different weighting systems were developed for the five sectors, including weights generated by factor analysis. This large data set formed the raw material for constructing our final indexes.

With this raw material in hand, 48 indexes were built using different combinations of data and sector aggregations. We then developed multivariable statistical models for explaining growth in per capita personal income, net immigration, and growth in value added in manufacturing. The competing final indexes were then included—one at a time—in regression models so that we could observe their abilities to explain variation in the model's dependent variable. As economists, we were confident that if we had in fact measured economic freedom, a superior index would be positively associated with growth in income, net immigration, and manufacturing value added across the states. We observed this relationship for several indexes and selected the most robust of these for the final index.

The Organization of the Report

There are three remaining sections in the report and an appendix containing the complete set of background data used in construction of our index. The next section explains how we designed and built different indexes and selected the one we deem to be best. The 50 state economic freedom index ranking is reported in this section along with data that enable the reader to observe factors that underlie the freedom index rankings. Section 3 focuses on the states themselves. Here we provide separate pages for each state, repeating the economic freedom index and giving a brief discussion of the state's economy. These state pages enable a person unfamiliar with a particular U.S. state to locate a state geographically and understand the major economic forces at play in that state.

Section 4 responds to the question: How good is the index? In this case, a good index is one that performs logically in statistical models that explain migration patterns, income growth, and capital investment across the states. The section gives details on three statistical models we developed and reports the findings.

The appendix provides a large amount of background data used in selecting the final economic freedom index. We expect that most readers will focus on the report's first three components, while being able to satisfy their curiosity about data and how the indexes were build by referring to the last section.

Final Thoughts

This report was inspired and supported by Thomas A. Roe of Greenville, SC, a man whose life is dedicated to the expansion of economic freedom for people worldwide.

Widely recognized for his efforts to support the development of free market policy centers in each American state, Tom Roe recognized that some method was needed for determining where and when economic freedom was strongest. The State Policy Network of Indianapolis, Indiana, which serves as a clearinghouse for state policy centers, then organized and funded the research project that generated this report. Byron Lamm, chairman of that organization, coordinated the effort.

As the project progressed, coauthor John Byars developed an economics masters thesis on the topic, which carried the empirical research far beyond the original limits set for the project. Stacie Thomas, another economics masters student, developed background material for each of the 50 states, and Clemson University's Center for Policy & Legal Studies offered assistance.

We are grateful to those who generously supported the project. Without their help and guidance, the project would never have been completed.

John H. Byars
Robert E. McCormick
Bruce Yandle

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