

Economic Freedom of North America

2004 Annual Report

Amela Karabegović, Fred McMahon
& Dexter Samida

with
Glenn Mitchell

The Fraser Institute
Canada



National Center for Policy Analysis
United States of America



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Editing and design by Lindsey Thomas Martin
Cover design by Brian Creswick @ GoggleBox

Printed and bound in Canada

National Library of Canada Cataloguing in Publication Data

Karabegović, Amela, 1977-

Economic freedom of North America: 2004 annual report / Amela Karabegović, Fred McMahon & Dexter Samida; with Glenn Mitchell.

Copublished by: National Center for Policy Analysis.

Includes bibliographical references.

ISBN 0-88975-210-9

1. Free enterprise--Canada. 2. Free enterprise--United States. 3. Canada--Economic conditions--1991- 4. United States--Economic conditions--2001- I. McMahon, Fred. II. Samida, Dexter. III. Fraser Institute (Vancouver, B.C.) IV. National Center for Policy Analysis (U.S.) V. Title.

HC115.K3358 2004

330.971'071

C2004-900255-4

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Acknowledgments

The Lotte and John Hecht Memorial Foundation and the W. Garfield Weston Foundation have generously supported this research. The authors would also like to acknowledge the assistance of Michael Walker, Steven Easton, Robert Lawson, Faisal Arman, and Joel Emes in developing the methodology and collecting the data. Any remaining errors and omissions are the responsibility of the authors.

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About the Participating Institutes

Co-publishers of *Economic Freedom of North America*

The Fraser Institute Canada

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Executive Summary

This is the second edition of the annual report, *Economic Freedom of North America*. The statistical results of this year's study persuasively confirm those published last year: economic freedom is a powerful driver of growth and prosperity and those provinces and states that have low levels of economic freedom continue to leave their citizens poorer than they need or should be.

Economic Freedom of North America presents the first comprehensive economic freedom ratings for US states and Canadian provinces. The study rates economic freedom on a 10-point scale for two indexes. An all-government index captures the impact of restrictions on freedom by all levels of government. A subnational index captures the impact of restrictions by state or provincial and local governments. *Economic Freedom of North America* employs 10 variables in three areas: 1. Size of Government; 2. Takings and Discriminatory Taxation; and 3. Labor Market Freedom. This year's report adds a new variable to Area 3: Labor Market Freedom that is designed to measure how much policy affects workers' freedom to join, or not to join, unions. This variable is discussed in the main body of the report and its appendixes.

Not only is economic freedom important for the level of prosperity, growth in economic freedom spurs economic growth. As expected, the impact of economic freedom at the all-government level is greater than the impact at the subnational level since the first index captures a broader range of limitations on economic freedom than the second.

The econometric testing shows that a one-point improvement in economic freedom on the all-government index increases per-capita GDP by US\$6,235 for US states and by US\$3,276 (C\$4,368) for Canadian provinces. On the subnational index, a one-point improvement increases per-capita GDP by US\$2,954 for US states and by US\$1,737 (C\$2,316) for Canadian provinces.

A 1.00% increase in the growth rate of economic freedom in the all-government index (e.g., from 4.00%

per year to 4.04% per year), will induce an increase of 1.09% in the growth rate of per-capita GDP for US states and an increase of 0.64% in the growth rate of per-capita GDP for Canadian provinces. A 1.00% increase in the growth rate of economic freedom in the subnational index will induce an increase of 0.53% in the growth rate of per-capita GDP for US states and 0.47% increase in the growth rate for Canadian provinces.

The econometric results are remarkably stable and consistent through a number of sensitivity tests presented in this paper, with more to be found on the website, www.freetheworld.com. The importance of these results is reinforced by their consistency with those of last year, despite the addition of data from a further year (2001) and of new variable in Area 3: Labor Market Freedom. The similarity of results regardless of the structure of the index or year of the tests is quite remarkable.

The results show that, while economic freedom has a powerful impact in Canada, its impact on US states is far greater. This is likely because of Canada's fiscal federalism. This system transfers money from rich to poor provinces. Since economic freedom spurs prosperity and growth, fiscal federalism in effect transfers money from relatively free provinces to relatively unfree provinces, muting the impact of economic freedom and perversely creating incentives for provincial politicians to limit economic freedom and, thus, economic growth since this increases the flow of federal transfers, which are directly controlled by these politicians. This enhances their power and their ability to reward friends and penalize enemies.

Generally, US states have been able to realize the gains economic freedom generates while Canadian provinces have lost opportunity due to weak levels of economic freedom and the structure of Canadian federalism.

All provinces, except Alberta, are clustered at the bottom of the rankings of both the all-government

and the subnational economic freedom indexes and also have low levels of prosperity. Canada's next freest province, Ontario, is the only province ahead of at least one state, West Virginia, in both the sub-national and all-government indexes. Yet, its level of prosperity is ahead of only West Virginia and Mississippi, which also score poorly in economic freedom. This is not an encouraging message considering that Ontario is usually thought of as Canada's economic powerhouse; one would never think of calling West Virginia or Mississippi an economic powerhouse even though their levels of prosperity are similar to Ontario's.

Although exceptions occur, changes in prosperity closely follow changes in economic freedom. Massachusetts is an interesting example. In 1981, the beginning of the period under study, Massachusetts had a low economic-freedom score and an economy that performed below the national average. Massachusetts' economic freedom increased through the 1980s and its economy caught up to the national average. Economic freedom declined in the early 1990s and relative prosperity fell back. Massachusetts' economic freedom again increased from the mid-1990s onwards and, by 1998, it was tied as the fourth wealthiest state in the union.

In Canada, Alberta followed a similar pattern. Economic freedom and economic activity weakened into the early 1990s. The province then recorded strong gains in economic freedom through the rest of the 1990s. During this period, the province's economic health was restored.

Measuring economic freedom, however, does not capture all influences on economic activity. A few exceptions are found, such as Alaska, which is wealthier than its level of economic freedom would suggest; and Louisiana, which is poorer than its level of free-

dom would suggest. Factors such as resource wealth, proximity to transportation routes, even a culture of corruption can affect growth rates.

The evolution of economic freedom in North America follows the expected pattern. In the United States, at the all-government level, economic freedom increases through the 1980s, coinciding with the Reagan era. It fell in the early 1990s, following tax increases under the Bush and early Clinton administrations and then begins to rise again. At the subnational level, the pattern is the same but less pronounced. Many states embarked upon Reagan-like government restructuring, but not all, and often not at the same level of intensity, or in the same time frame.

In Canada through the 1980s, economic freedom remained fairly constant at the subnational level while it increased somewhat at the all-government level, perhaps as a result of a change of federal government, and a resulting change in policy, in 1984. In both indexes, economic freedom falls in Canada in the early 1990s and then begins to rise. In early 1990s, Canadian governments began to address debt and deficit problems but more often through increased taxation than through lower spending. As debts and deficits were brought under control, governments began to reduce some tax rates through the mid- and, particularly, late 1990s. Also in this period, fiscally conservative governments were elected in Canada's two richest provinces, Alberta and Ontario.

Overall patterns in Canada and the United States are similar. However, during the late 1980s and early 1990s, Canadian governments relied on taxes to solve the deficit problem more than US governments did. Thus, the gap between Canada and the United States in economic freedom grew through this period, before returning to about its 1981 level in the late 1990s.