

Chapter 2: Overview of the Results

Prior to a detailed discussion of the econometric testing, we will present some simple graphics for illustrative purposes. These charts dramatically demonstrate the important links between prosperity and economic freedom, links that are more fully explored in the econometric testing.

Figure 3 breaks economic freedom into quintiles at the all-government level. For example, the category on the far left of the chart, “Bottom,” represents the jurisdictions that score in the lowest fifth of the economic freedom ratings, the 12 lowest of the 60 North American jurisdictions. Nine of these are Canadian provinces—all except Alberta. The jurisdictions in this bottom quintile have an average per-capita GDP of just US\$20,891 (C\$27,855). This compares to an average per-capita GDP of US\$36,878 (C\$49,170) for the 12 top-ranked jurisdictions.

Figure 4 is the same chart type as Figure 3 but represents economic freedom at the subnational level

el. Here, the bottom quintile has an average per-capita GDP of \$23,237 (C\$30,983) compared to the top quintile with an average per-capita GDP of \$36,237 (C\$48,316). As will be noted in the econometric testing, economic freedom has a smaller impact at the subnational level than at the all-government level. This is expected since only at the all-government level are all government restrictions on economic freedom captured.

Another useful way to review economic freedom is through deviation from the mean. This examines the impact on economic activity of a jurisdiction’s being above or below the average ranking of other national jurisdictions, comparing Canadian provinces with the Canadian average and US states with the US average. Here scatter charts help illustrate the point, though a quick visual inspection will show these diagrams could easily be translated into column graphs like Figures 3 and 4.

Figure 3: Economic Freedom at an All-Government Level and per-Capita GDP, 2001

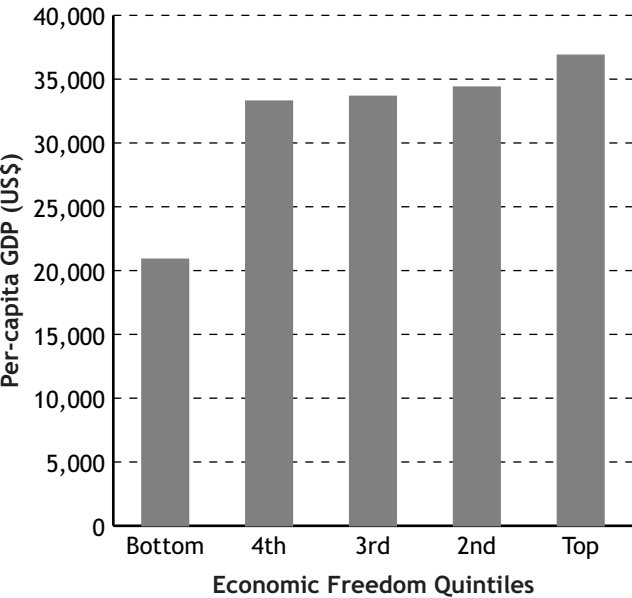
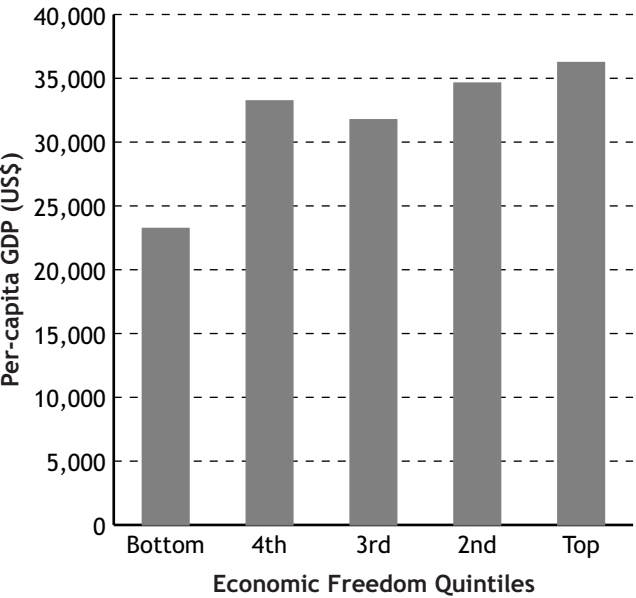


Figure 4: Economic Freedom at a Subnational Level and per-Capita GDP, 2001



Figures 5 and 6 relate prosperity to economic freedom, with economic freedom plotted along the horizontal axis and per-capita GDP plotted along the vertical axis. Once again these charts illustrate the connection between economic freedom and prosperity. Here too, as expected, the subnational relationship is weaker than the all-government one.

Finally, in this illustrative section, we look at the relationship between growth of economic freedom and the growth of a jurisdiction's economy, another topic more fully explored in the following testing. In Figures 7 and 8, growth in economic freedom is plotted along the horizontal axis while growth in GDP per capita is plotted along the vertical axis. Again, the expected relationships are found, with economic growth strongly linked to growth in economic freedom.

Comparing the Two Indexes

In general, rankings at an all-government level are not drastically different from rankings at a subnational level when US states, as a group, are compared with Canadian provinces, as a group. This is partly due to the way the subnational variable is constructed. Subnational responsibilities in Canada and the United States differ. Thus, government spending and taxation patterns cannot be directly compared. Instead, an "adjustment factor," explained in Appendix D: Adjustment Factors (p. 53), is used. One effect of this adjustment factor is to give Canadian provinces, on average, similar relative rankings to US states in both indexes. Nonetheless, the two indexes produce different results when the rankings of individual states and provinces is examined.

For most Canadian provinces and US states, rankings do not change radically between the all-government and the sub-national index. For Canada, Alberta is the only exception to this rule, falling from 10th on the all-government index to 25th on the sub-national index. This is because the federal government spends so little money in Alberta that on the all-government index Alberta does very well on the in Area 1: Size of Government.

In the United States, only one state, Maryland—24th on the sub-national index and 39th on the all-government index—changes position as much as Alberta. For Maryland, high federal spending in the state is the key reason its rank in the all-government index is substantially lower than in the sub-national

index. Two states, California and Wyoming, are 14 ranks higher on the all-government index than the sub-national index, and one state, Florida, is 14 points lower. Wyoming's all-government advantage lies in a relatively low federal spending. California has "all-government" advantages in all areas. Florida ranks considerably better on sub-national index in Area 1 and Area 2 than on the all-government index. The reader is directed to the tables at the back of this report, also available at <http://www.freetheworld.com>, to examine other differences in individual scores and ranks between the two indexes.

The Evolution of Economic Freedom in North America

As can be seen from Tables 1 and 2 (page 14), the evolution of economic freedom in North America follows an expected pattern. In the United States, at the all-government level, economic freedom increases through the 1980s, coinciding with the Reagan era. It then falls 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, again as one might expect. 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.¹

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, federal, provincial, and municipal governments began to address their debts and deficits but typically more through increased taxation than through lower spending. However, as debts and deficits were brought under control, governments began to reduce some tax rates through the mid-, and particularly the 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. Both nations fought debts and deficits in the early 1990s with tax increases. However,

Figure 5: Average per-Capita GDP and Average Economic Freedom at an All-Government Level

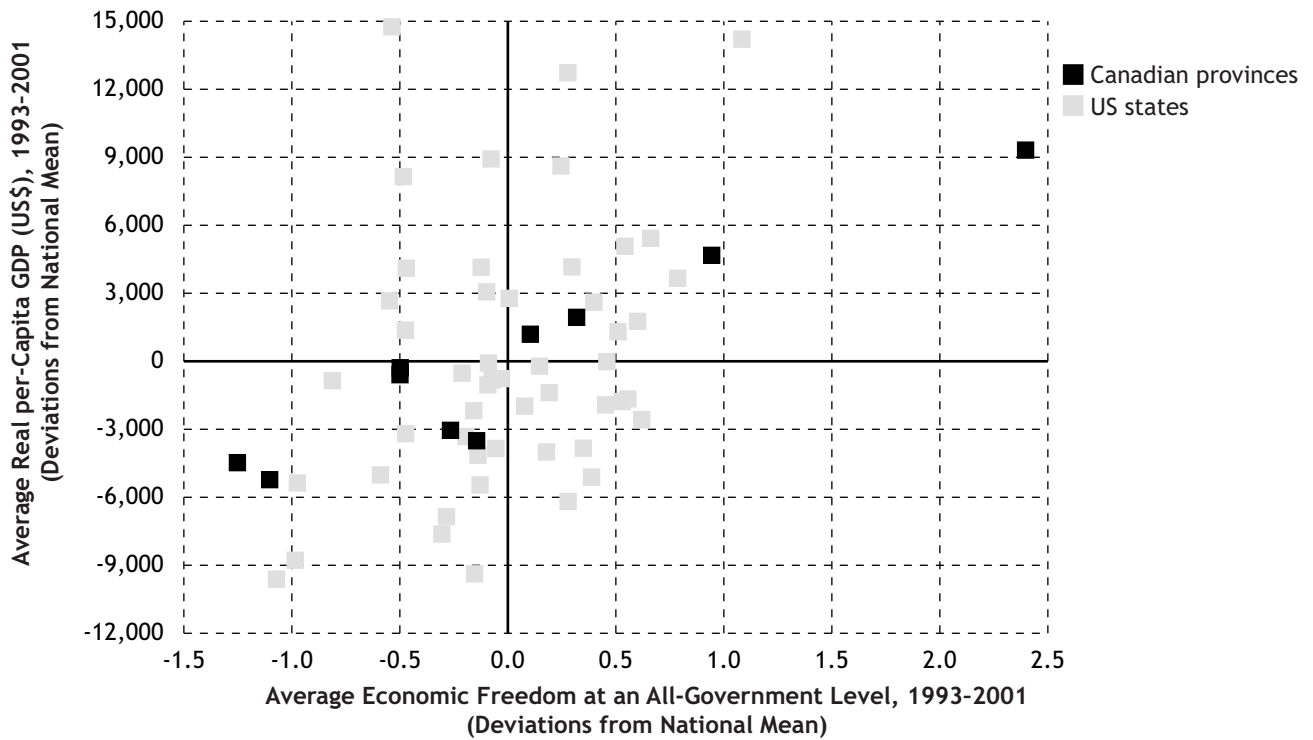


Figure 6: Average per-Capita GDP and Average Economic Freedom at a Subnational Level

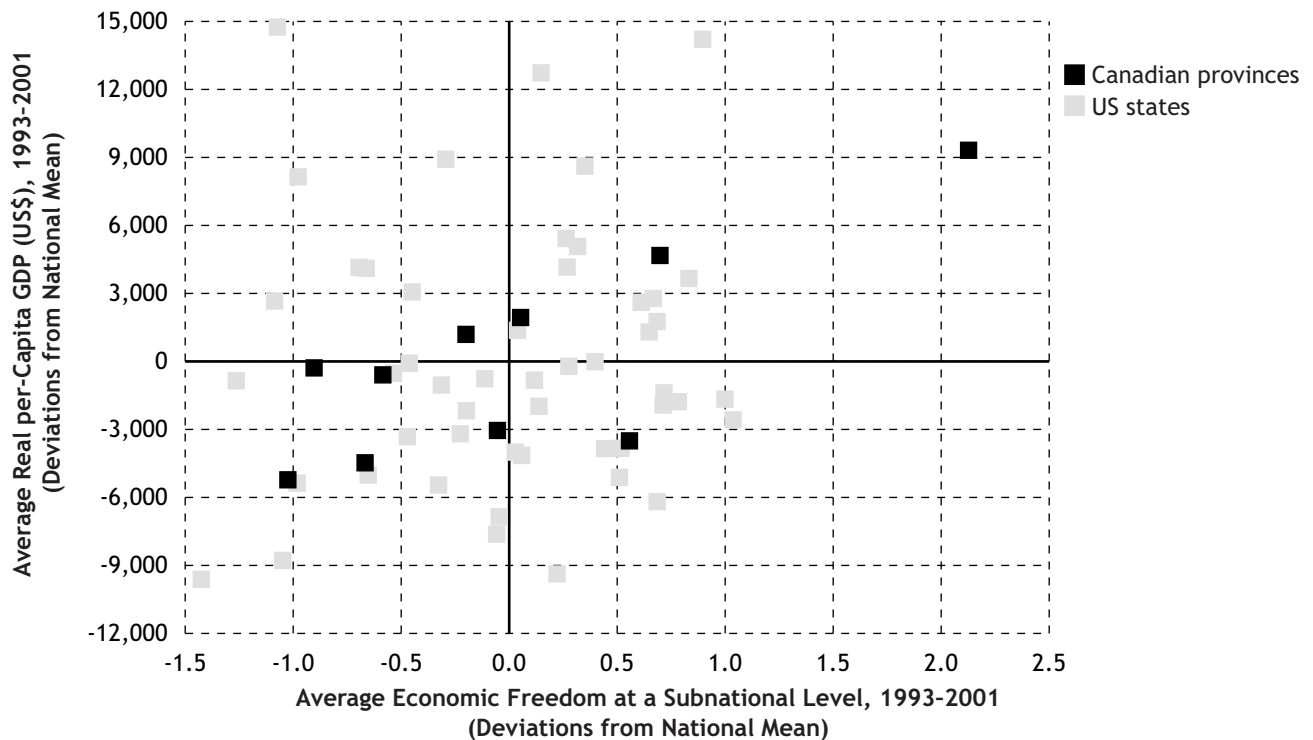


Figure 7: Average Growth in per-Capita GDP and Average Growth in Economic Freedom at an All-Government Level

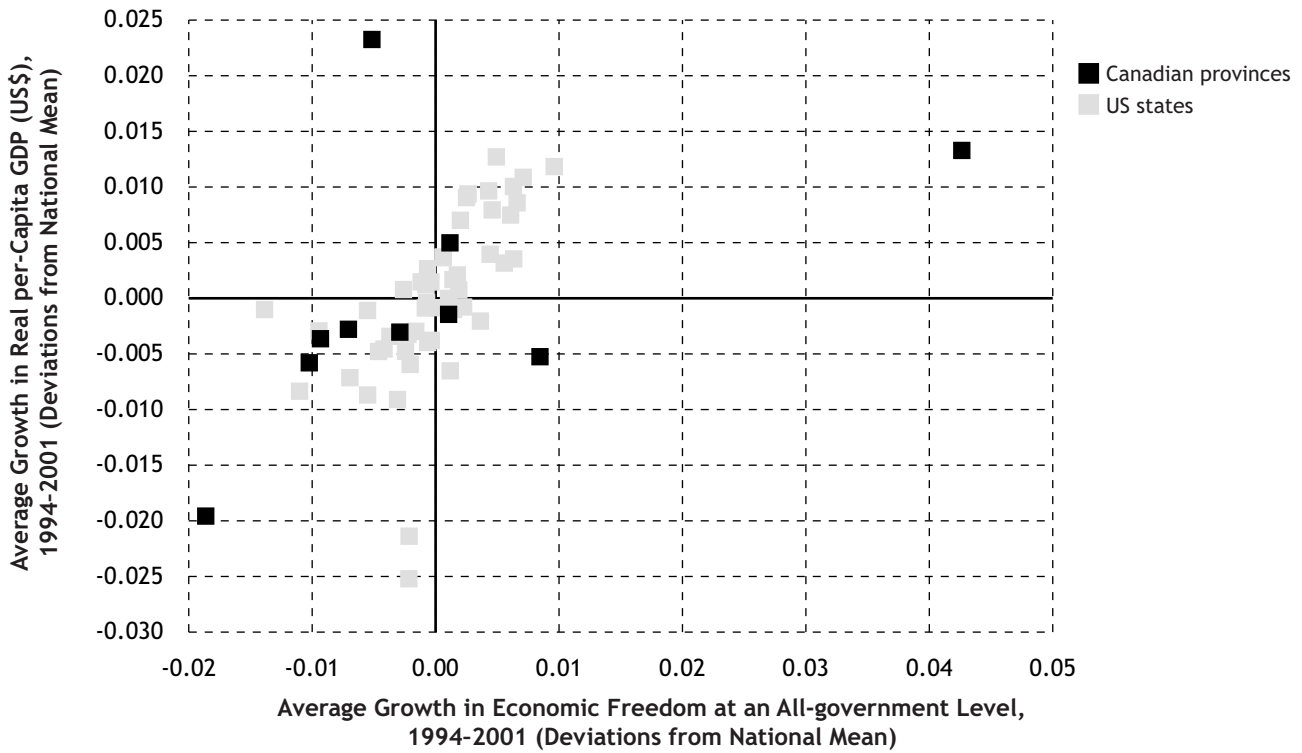


Figure 8: Average Growth in per-Capita GDP and Average Growth in Economic Freedom at a Subnational Level

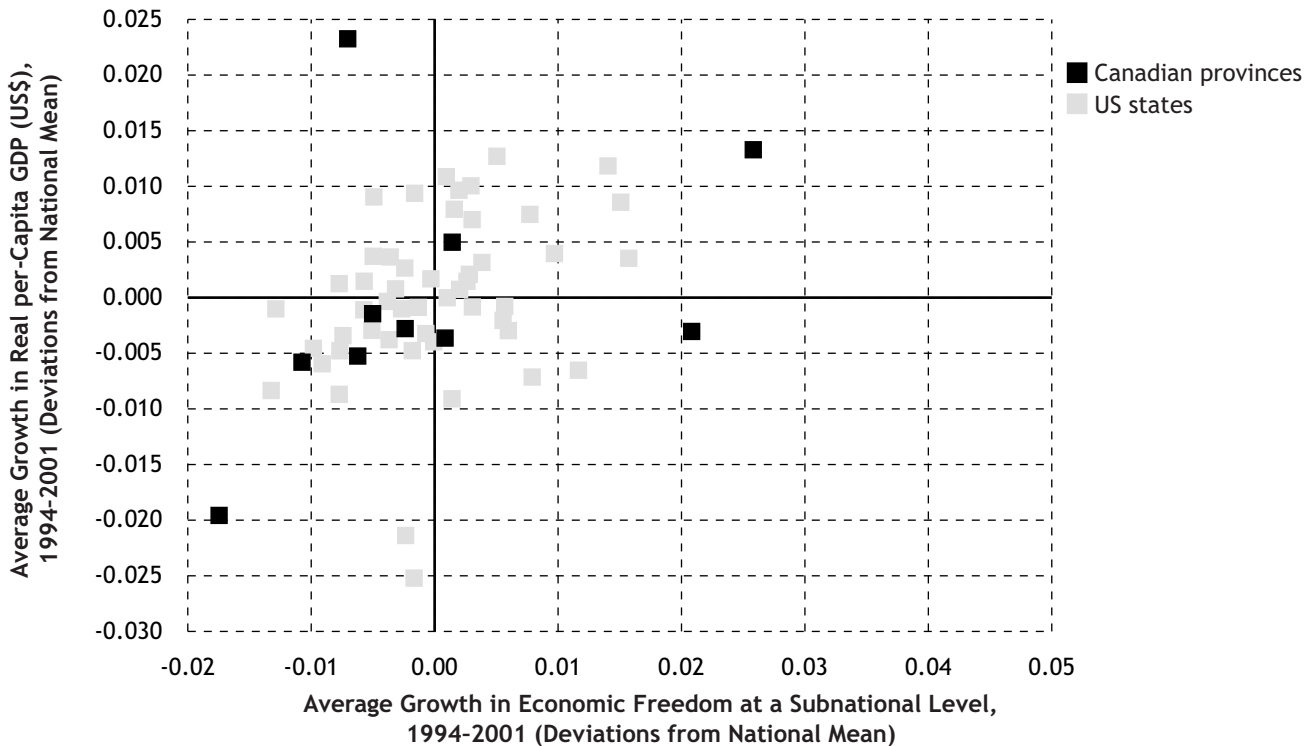


Table 1: Average Economic Freedom Scores at an All-Government Level

	1981	1985	1989	1993	1994	1995	1996	1997	1998	1999	2000	2001
Canada	4.0	4.1	4.5	3.9	4.0	4.2	4.3	4.4	4.5	4.6	4.8	4.8
United States	6.0	6.3	6.9	6.6	6.5	6.6	6.6	6.7	6.7	6.7	6.7	6.7
Difference	2.0	2.2	2.4	2.7	2.5	2.4	2.3	2.3	2.2	2.1	1.9	1.9

Table 2: Average Economic Freedom Scores at a Subnational Level

	1981	1985	1989	1993	1994	1995	1996	1997	1998	1999	2000	2001
Canada	4.7	4.7	4.9	4.2	4.4	4.6	4.8	5.0	5.2	5.3	5.5	5.4
United States	6.8	6.9	7.0	6.7	6.9	6.8	7.0	7.0	7.2	7.2	7.3	7.2
Difference	2.1	2.2	2.1	2.5	2.5	2.2	2.2	2.0	2.0	1.9	1.8	1.8

Canada raised taxes more aggressively as can be seen in the increasing gaps in economic freedom in the two nations during this period. From 1981 to 2001, the gap between Canada and the United States in economic freedom at the subnational and the all-government level first rose and then fell back to just below its 1981 level in the late 1990s and stabilized at that.

Overview of the Results for the United States

US states can move up and down in the rankings quite substantially. We will focus on the all-government index in this section, for simplicity's sake since this index captures the full impact of economic freedom, while the sub-national index only captures restrictions put in place by province/state and local governments.

The econometric work in this paper provides the substance of the link between economic freedom and prosperity since individual examples may not be typical. Nonetheless, for illustrative purposes, it is interesting to look at those states that moved by more than 30 ranks on the all-government index in the two decades from 1981 to 2001. During this period, the average increase in inflation-adjusted per-capita GDP was 41% in the United States. Four states fell on the index by 30 ranks or more—Alaska, Oklahoma, North Dakota, and Montana. Leaving aside Alaska for the moment, all under-performed the national average increase in income: Oklahoma's per-capita GDP actually fell by one percentage point; North Dakota's increased by only 7%, and Montana's by 4%. Alaska's per-capita GDP was cut in half over this period but this is largely due to swings in the resource sector.

On the other hand, two states moved up the index by more than 30 ranks or more. New Hampshire climbed 30 spots and Massachusetts, 37 spots. Both roughly doubled average per-capita GDP from 1981 to 2001. New Hampshire's per-capita GDP grew 78% over the period while Massachusetts' grew by 84%.

Although the econometric work in this paper shows a strong and highly significant link between economic freedom and economic activity, a link found in the vast majority of states, exceptions to this relationship also occur, since any number of external factors such as resource wealth and proximity to transportation routes affect economic growth. Such outliers will be discussed below.

Top States

Several states have remained in the top third of the rankings through all or most of the period. They are Delaware, Colorado, Tennessee, Nevada, Indiana, Georgia, Connecticut (since the late 1980s), Texas (though its relative rank among the top 16 states has deteriorated), and Louisiana. A few of the states in the top third have per-capita GDP below the national average though, on average, the states in the top third exceed the US average per-capita GDP by 12%. As a group, the top-ranked states do very well economically, as would be expected. While the average increase in per-capita GDP across US states was \$8,600 between 1981 and 2001, in the top third of states it increased by \$11,600. On average, US states saw an increase of 34% in per-capita GDP. The top-rated states increased average GDP by 43%.

The Middle Ranks

The middling states, roughly speaking, have remained middling in both economic freedom and eco-

economic activity through most of the period. Since the late 1980s, most of these 17 states have had more or less stable economic freedom rankings while the average per-capita GDP of these states has not varied from the national average by much more than five percentage points.

The middling states saw an increase of per-capita GDP of 38%, slightly higher than the national average. Per-capita income also is virtually identical to the national average, though these states slightly exceeded the national average in per-capita GDP growth, gaining \$9,290, almost \$700 above the national average. (Readers should remember that percentages are calculated over the average per-capita GDP in each third of states, so the base GDP on which increases are calculated will be highest in the top third and lowest in the bottom third.)

The Worst Performers

Some states seem to want to keep economic freedom at bay. West Virginia has by far the worst record. It also has the the second lowest per-capita GDP in the United States, just above Mississippi, though only by about \$50. For Oklahoma, North Dakota, and Mississippi, the rejection of economic freedom is a relatively new taste. All four states have suffered declines against the national average of economic activity, with the declines in Mississippi being the least severe. On average, the bottom third of states have significantly under-performed other states. Average per-capita GDP in the least economically free third of states is only 94% of the state average. Per-capita GDP has grown by only 17%, or about \$4,583, over this period, both significantly below the national rate of growth.

The Outriders

Economic freedom does not, nor is it meant to, capture all things that affect economic activity. Thus other factors, resource wealth for instance, will break the strong relationship between economic freedom and economic activity discussed here and shown in the econometric testing. Among the outriders are Louisiana, with a weaker economy than its level of economic freedom would suggest, and Alaska and New York, with the opposite pattern. Indiana has weak economic growth compared to its high level of economic freedom. The purpose here is not to explain these anomalies—that would require a detailed discussion of each of state's economy—but rather to draw the reader's attention to the fact that exceptions exist.

Overview of the Canadian Results

Canadian provinces consistently have lower scores than US states and thus are clustered near the bottom of the ranking.

Top Provinces

Alberta is the only province that has consistently done better than at least some states. It ranked 10th at an all-government level and 25th at a subnational level in 2001. Although Alberta's economic freedom declined through the 1980s and early 1990s before recovering after the mid-1990s, in all years it has remained ahead of at least one state, usually West Virginia, in the rankings of both indexes. Alberta's lowest scores and rankings were 1989 and 1993. Since then, Alberta's score and ranking in both indexes have improved considerably.

Ontario placed ahead of six states at the all-government level in 1981 and one state, West Virginia, in 1985. At the subnational level, it ranked ahead of several states in the 1980s. However, in the late 1980s and early 1990s, Ontario's economic freedom declined sharply. Economic freedom recovered through the mid- and late 1990s but only the scores for 2000 and 2001 show Ontario regaining, roughly speaking, the level of economic freedom it had in 1981. Over the same period, average scores in the United States also rose, leaving Ontario further behind the US average than it was two decades ago. Ontario is now behind all states, except West Virginia, in both indexes.

Nova Scotia is ahead of West Virginia on the sub-national index but the huge size of federal spending in the province pushes it below West Virginia on the all-government index. The three top-rated provinces on the all-government index, Alberta, Ontario, and British Columbia, have an average per-capita GDP of \$25,560 (C\$34,080), compared to a national provincial average of \$20,490 (C\$27,320), 25% above the provincial average.

The Middle Ranks

Despite declines in economic freedom relative to the rest of the nation in the 1990s, this deterioration was not large enough to push British Columbia below the 4th highest ranking among Canadian provinces in both rankings throughout the full period discussed in this report. The three provinces that are middling in economic freedom on the all-government index—Nova Scotia, Saskatchewan, and New Brunswick—have a middling economic performance

with an average per-capita GDP of \$18,640 (C\$24,860) or 91% of the provincial average.

The Worst Performers

The four lowest ranking provinces in the all-government index are Quebec, Manitoba, Newfoundland, and Prince Edward Island. The same four occupy the bottom ranks of the sub-national index. Prince Edward Island, in fact, comes dead last in both the sub-national and all-government index. Average per-capita GDP in these four provinces is \$18,080 (C\$24,100) or 88% of the provincial average.

Canadian Fiscal Federalism

The Government of Canada may well be unique in the amount of money it transfers among provinces and regions. For example, in Canada's Atlantic Provinces, the nation's most economically depressed region, *net* federal spending—the difference between federal revenues raised in the region and the amount of federal spending—typically equaled between 20% and 40% of regional GDP during the period under consideration. Although transfers between levels of government occur within the United States, the magnitude of these transfers is much smaller than in Canada.²

Inter-regional transfers in Canada create a fiscal drain on "have" regions. This is obvious at the federal level where tax revenues are in effect transferred from "have" to "have-not" provinces but it also occurs at the provincial level. The federal taxation burden reduces room for provincial taxation in all provinces. This is a significant problem for "have" provinces but not for "have-not" provinces since a considerable portion of federal transfers to "have-not" regions go directly to provincial governments, which are thus more than compensated for the loss of taxation room.

Nonetheless, one would expect that most of the negative impact of fiscal federalism would be found at the all-government level, which directly includes the impact of federal taxation and transfers. Indeed, this is what the data show. This is unfortunate because it is at the all-government level, which calculates the impact of all governments on economic freedom, where the effects of economic freedom are strongest.

Explaining a Puzzle

Canadian fiscal federalism may help explain a puzzle found in the following discussion of the econo-

metric results. The impact of economic freedom on Canadian provinces is considerably weaker than on US states at both the all-government and subnational level. This may be because of the interaction between Canada's fiscal structure, economic freedom, and economic growth.

To understand the impact of Canada's fiscal federalism, consider a province that reduces economic freedom by, for example, increasing taxes. This will likely have a negative impact on the provincial economy, as both the following results and international testing show. However, the weaker provincial economy means the province will receive an increase in federal payouts (or a reduction in the fiscal outflow if the province in question is a "have" province). The greater the reduction in economic freedom, the greater the negative impact on the economy and the greater the amount of money the province will receive from the federal government. This inflow of funds will, at least in the short term, partly offset the negative impact on GDP and mute the impact of economic freedom, or its loss, on the economy. (In the longer term, the inflow of funds will also weaken the economy but this impact is likely beyond the time horizon of the tests conducted here.)

On the other hand, if a province increases economic freedom, for example by reducing taxes, and its economy grows, the result is an increased outflow of government revenues to other jurisdictions and a heavier tax burden, given the progressivity of Canadian taxes, which in turn suppresses increases in economic freedom and economic growth. In other words, fiscal federalism mutes the impact of economic freedom in Canada. Economic growth itself, because of Canada's fiscal structure, reduces a province's economic freedom and thus brakes further growth. Despite the problems created by Canada's fiscal structure, economic freedom still proves to be a powerful stimulant for increasing prosperity in Canada.

Impact of Fiscal Federalism

Unfortunately, Canada's fiscal federalism seems to harm both rich and poor provinces. The discussion above shows how fiscal federalism frustrates the ability of some provinces to improve their economic freedom and, thus, their prosperity. However, the effects are at least as unfortunate in the poorer provinces, where a rich menu of government spending pushes out other economic activity and politicizes the economy. As a result, the rate of convergence³ of Canada's

poorer regions is about a third to a half of the rate of convergence of poor regions in the United States, Europe, and Japan. (See Barro and Sala-I-Martin 1995 for international results on convergence.)

The incentives created by fiscal federalism are also damaging. Because fiscal federalism mutes the ability of provinces to move towards economic freedom and thus weakens the positive impact of economic freedom, the incentive for provinces to increase the freedom of their economies weakens.

Even worse, the elites in “have-not” provinces have incentives to limit economic freedom. Low levels of economic freedom reduce economic activity and increase the flow of federal transfers. These transfers are predominately captured by the political and business elites, meaning they face incentives to keep economic growth low. As well, Canada’s Employment Insurance system alters the incentives facing many voters, since they can benefit from the structure of the EI system, which also weakens economic growth by removing large segments of the population from the year-round workforce so long as economic activity remains weak.

While all segments of the population would deny being influenced by such incentives, there has been no significant economic reform movement in Atlantic Canada, even though there is much evidence from around the world that the region’s policy mix damages growth.

Notes

- 1 Gwartney and Lawson (2003) show steadily rising scores for Canada and the United States through this period. This is because of variables that can only be examined at the national level, such as price level. Obviously, states and provinces do not have their own independent monetary policy.
- 2 A discussion of fiscal federalism can be found in McMahon 2000b: chapter 3. The US fiscal structure is discussed in McMahon 2000a: chapter 4.
- 3 The rate of convergence is the rate at which poorer jurisdictions catch up to richer ones.