

# Appendix A

## Methodology

### Calculating the Scores

To avoid subjective judgments, objective methods were used to calculate and weight the components. For all components, each observation was transformed into a number from zero to 10 using the following formula:  $(V_{\max} - V_i)/(V_{\max} - V_{\min}) \times 10$ , where  $V_{\max}$  is the largest value found within a component,  $V_{\min}$  is the smallest, and  $V_i$  is the observation to be transformed. For each component, the calculation included all data for all years to allow comparisons over time.

To transform the individual components into areas and the overall summary index, Areas 1, 2, and 3 were equally weighted, and each of the components within each area was equally weighted. For example, the weight for Area 1 was 33.3%. Area 1 has three components, each of which received equal weight in calculating Area 1, or 11.1% in calculating the overall index.

Calculating the income-tax component was more complicated. The component examining the top marginal income-tax rate and the income threshold at which it applies was transformed into a score from zero to 10 using Matrix 1 and Matrix 2. Canadian nominal thresholds were first converted into constant 2005 Canadian dollars by using the Consumer Price Index and then converted into US dollars using the Purchasing Power Parity between Canada and US for each year. US nominal thresholds were converted into real 2005 US dollars using the Consumer Price Index. This procedure is based on the transformation system found in *Economic Freedom of the World: 1975–1995* (Gwartney et al., 1996), modified for this study to take into account a different range of top marginal tax rates and income thresholds.

Matrix 1 was used in calculating the score for Component 2B, Top Marginal Income Tax Rate and the Income Threshold at Which It Applies, at the all-government level; Matrix 2 was used to calculate the score for Component 2B at the subnational level.

In setting the threshold levels for income taxes at the subnational level, we faced an interesting quandary. In the United States, most state thresholds were below US federal thresholds in the 1980s and 1990s. In Canada, provincial thresholds were frequently higher than federal thresholds. Whenever the provincial or state threshold was higher than the federal threshold, the federal threshold was used at the sub-national level since, when a provincial threshold is above the national level,

**Matrix 1: Income Tax Matrix for Component 2B at the All-Government Level**

Top Marginal Tax Rate	Income Threshold Level (US\$2005)		
	Less than \$50,000	\$50,000 to \$100,000	More than \$100,000
27% or less	10.0	10.0	10.0
27% to 30%	9.0	9.5	10.0
30% to 33%	8.0	8.5	9.0
33% to 36%	7.0	7.5	8.0
36% to 39%	6.0	6.5	7.0
39% to 42%	5.0	5.5	6.0
42% to 45%	4.0	4.5	5.0
45% to 48%	3.0	3.5	4.0
48% to 51%	2.0	2.5	3.0
51% to 54%	1.0	1.5	2.0
54% to 57%	0.0	0.5	1.0
57% to 60%	0.0	0.0	0.5
60% or more	0.0	0.0	0.0

**Matrix 2: Income Tax Matrix for Component 2B at the Subnational Level**

Top Marginal Tax Rate	Income Threshold Level (US\$2005)		
	Less than \$50,000	\$50,000 to \$100,000	More than \$100,000
1.5% or less	10.0	10.0	10.0
1.5% to 3.0%	9.0	9.5	10.0
3.0% to 4.5%	8.0	8.5	9.0
4.5% to 6.0%	7.0	7.5	8.0
6.0% to 7.5%	6.0	6.5	7.0
7.5% to 9.0%	5.0	5.5	6.0
9.0% to 10.5%	4.0	4.5	5.0
10.5% to 12.0%	3.0	3.5	4.0
12.0% to 13.5%	2.0	2.5	3.0
13.5% to 15.0%	1.0	1.5	2.0
15.0% to 16.5%	0.0	0.5	1.0
16.5% to 18.0%	0.0	0.0	0.5
18.0% or more	0.0	0.0	0.0

Note: The range of the top marginal tax rates in Matrix 1 and Matrix 2 should be written "27.00% to 29.99%" or "1.50% to 2.99%" and so on but for convenience we have written them as "27% to 30%" or "1.5% to 3.0%."

the cause is typically the imposition of a relatively small surcharge on those earning high incomes. Because of the structure of these matrixes, this can produce perverse scoring results. For example, in Matrix 2 a jurisdiction gets a score of 2.5 if it has a top marginal income-tax rate of, say, 12.5% for incomes over \$50,000. Let us say the jurisdiction imposes a surcharge for income earners above \$100,000, increasing the top marginal income-tax rate to 13%. In Matrix 2, even though additional taxes in the form of a surcharge have been imposed, the state's score perversely increases to 3.0 because of the increase in the threshold level.

Our decision to use the federal threshold as the default threshold when the provincial threshold was higher is, frankly, a matter of judgement. Thus, it was important to understand whether this would affect the results significantly. To see whether this was so, we calculated the overall index both ways and found that changes were small and that the overall results were not significantly affected.

## Adjustment Factors

Due to constitutional differences and variations in policy, in the United States sub-national jurisdictions take a proportionately smaller share of overall government spending than in Canada. In 2002, for instance, provinces and local governments accounted for about 79% of government consumption in Canada while, in the United States, state and local government are responsible for 63% of government consumption, just 80% of the level in Canada:  $0.63/0.79 = 0.80$ . This is what we term the adjustment factor:  $R_U/R_C$ , where  $R_U$  is the percent of total government spending at the state level in the United States, and  $R_C$  is the percent of total government spending at the provincial level in Canada. Because of this difference in government structure in the United States and Canada, a direct comparison would not be appropriate. Instead, we use this adjustment factor, multiplying provincial and local government consumption in Canada by 0.80 so that it will be comparable to US data. The adjustment factor itself is adjusted every year to the relative differences in spending patterns between Canada and the United States.

At the subnational level, similar adjustment factors are calculated for each year for each component in Areas 1 and 2 as well as for component 3B: Government Employment as a Percentage of Total State/Provincial Employment. For example, the adjustment factor for 2A: Total Tax Revenue as a Percentage of GDP at the subnational level is calculated as the percentage of total government revenue at a state level in the United States divided by the percentage of total government revenue at a provincial level in Canada. No adjustment factor is necessary at the all-government level because every level of government is counted. Note that Component 2D: Sales Tax Collected as a Percentage of GDP is not adjusted because the United States does not have a federal general sales tax and Canada does.

We faced another common problem in comparing statistics across time, changes in the structure of some series over time. Similarly, some Canadian spending

categories were not strictly comparable to those in the United States. This required the use of judgment in some cases. Spending on medical care, for example, is structured as government consumption in Canada and as a set of transfer programs in the United States. Given that the index captures the impact of both government consumption and of transfer programs, we decided the most accurate method of accounting was to reflect the actual nature of the spending, a transfer program in the United States and government consumption in Canada, rather than artificially include one or other in an inappropriate component.

A further complication arose in applying the adjustment factor to the income-tax component at the subnational level. To construct this adjustment factor, the Canadian top marginal tax rates at the subnational level are multiplied by the ratio of (a) the percentage of total personal tax revenue at a state level in the United States; and (b) the percentage of total personal tax revenue at a provincial level in Canada. For example, in 2002, in Canada, provinces collected 37% of the income-tax revenue raised in Canada. In the United States, states collected 19% of all income taxes. Thus,  $\frac{19}{37}$  equals 51%. In Ontario, for example, the top marginal rate in 2002 was 17.4%. This is reduced to 8.9% when the adjustment factor is applied.

# Appendix B

## Explanation of Components and Data Sources

### Area 1 Size of Government

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

General consumption expenditure is defined as total expenditures minus transfers to persons, transfers to businesses, transfers to other governments, and interest on public debt. Data for Quebec is adjusted for Quebec abatement at the subnational level.

##### *Sources for Canada*

Statistics Canada, *Provincial Economic Accounts, 2007*.

Statistics Canada, Public Institutions Division, Financial Management System, 2005, 2007.

Special request from Finance Canada, Federal-Provincial Relations and Social Policy Branch, Federal-Provincial Relations Division (November 2007).

##### *Sources for the United States*

US Census Bureau (2007). *Annual Survey of State and Local Government Finances and Census of Governments (1981–2005)*. <<http://www.census.gov/main/www/access.html>>.

US Department of Commerce, Bureau of Economic Analysis. <<http://www.bea.gov/>> (December 18, 2007).

US Census Bureau, *Statistical Abstract of the United States* (various editions).

US Census Bureau, *Consolidated Federal Funds Report* (various editions).

Special request from US Census Bureau, Governments Division (December 14, 2007).

Special request from US Census Bureau, Governments Division, Federal Programs Branch (February 2, 2005).

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

Transfers and subsidies include transfers to persons and businesses such as welfare payments, grants, agricultural assistance, food-stamp payments (US), housing assistance, etc. Foreign aid is excluded. Data for Quebec is adjusted for Quebec abatement at the subnational level.

### *Sources for Canada*

Statistics Canada, *Provincial Economic Accounts, 2005*;

Special request from Finance Canada, Federal-Provincial Relations and Social Policy Branch, Federal-Provincial Relations Division (November, 2007).

### *Sources for the United States*

US Census Bureau (2007). *Annual Survey of State and Local Government Finances and Census of Governments (1981–2005)*. <<http://www.census.gov/main/www/access.html>>.

US Department of Commerce, Bureau of Economic Analysis, <<http://www.bea.gov/>> (December 18, 2007).

US Census Bureau, *Statistical Abstract of the United States* (various editions).

US Census Bureau, *Consolidated Federal Funds Report* (various editions).

Special request from US Census Bureau, Governments Division, (December 14, 2007).

Special request from US Census Bureau, Governments Division, Federal Programs Branch (February 2, 2005).

## **1C Social Security Payments as a Percentage of GDP**

Payments by Employment Insurance, Workers Compensation, and various pension plans are included in this component.

### *Sources for Canada*

Statistics Canada, *Provincial Economic Accounts, 2007*.

### *Sources for the United States*

US Census Bureau (2007). *Annual Survey of State and Local Government Finances and Census of Governments (1981–2005)*, <<http://www.census.gov/main/www/access.html>>.

US Department of Commerce, Bureau of Economic Analysis, <<http://www.bea.gov/>> (December 18, 2007).

Special request from US Census Bureau, Governments Division (December 14, 2007).

## Area 2 Takings and Discriminatory Taxation

### 2A Total Tax Revenue as a Percentage of GDP

Total Tax Revenue is defined as a sum of income taxes, consumption taxes, property and sales taxes, contributions to social security plans, and other various taxes. Note that natural resource royalties are not included. Data for Quebec is adjusted for Quebec abatement at the subnational level.

#### *Sources for Canada*

Statistics Canada, *Provincial Economic Accounts, 2007*.

Special request from Finance Canada, Federal-Provincial Relations and Social Policy Branch, Federal-Provincial Relations Division (November, 2007).

#### *Sources for the United States*

US Census Bureau (2007). *Annual Survey of State and Local Government Finances and Census of Governments (1981–2005)*, <<http://www.census.gov/main/www/access.html>>.

US Department of Commerce, Bureau of Economic Analysis, <<http://www.bea.gov/>> (December 18, 2007).

Tax Foundation (Washington, DC), <<http://www.taxfoundation.org/research/show/22685.html>> (December 19, 2007).

### 2B Top Marginal Income Tax Rate and the Income Threshold at Which It Applies

See Matrix 1 and Matrix 2 in Appendix A for information on how the final scores were calculated. Data for Quebec is adjusted for Quebec abatement at the subnational level.

#### *Sources for Canada*

Canadian Tax Foundation, *Finances of the Nation* (various issues).

Canadian Tax Foundation, *Canadian Tax Journal, Provincial Budget Roundup (2003, 2002, 2001, 2000)* (by Deborah L. Ort and David B. Perry).

Palacios, Milagros (2008). Purchasing Power Parity, United States and Canada, 1981–2005. Fiscal Studies, Fraser Institute.

Statistics Canada, *Provincial Economic Accounts, 2007*.

Temple, James (2007). *Purchasing Power Parities and Real Expenditures, United States and Canada, 1992–2005*. Income and Expenditure Accounts Technical Series. Cat. 13-604-MIE--No 053. Statistics Canada.

#### *Sources for the United States*

Tax Foundation, *Facts and Figures on Government Finances* (various editions).

Tax Foundation (Washington, DC). [website], <<http://www.taxfoundation.org/statefinance.html>> (Oct. 1, 2003; December 21, 2007).

US Department of Labor, Bureau of Labor Statistics, <<http://www.bls.gov/cpi/>> (December 28, 2007).

US Census Bureau (2007). *Annual Survey of State and Local Government Finances and Census of Governments (1981–2005)*, <<http://www.census.gov/main/www/access.html>>.

## **2C Indirect Tax Revenue as a Percentage of GDP**

Indirect tax revenue includes property taxes, contributions to social security insurance (i.e., Employment insurance, Workers Compensation, and various pension plans), and other various taxes. Income-tax revenue, sales-tax revenue, and natural resource royalties are not included in this component.

### *Sources for Canada*

Statistics Canada, *Provincial Economic Accounts, 2007*.

### *Sources for the United States*

US Census Bureau (2007). *Annual Survey of State and Local Government Finances and Census of Governments (1981–2005)*, <<http://www.census.gov/main/www/access.html>>.

US Department of Labor, Bureau of Labor Statistics, <<http://www.bls.gov/cpi/>> (December 18, 2007).

Tax Foundation, *Facts and Figures on Government Finances* (various editions).

Tax Foundation (Washington, DC), <<http://www.taxfoundation.org/research/show/22685.html>> (December 19, 2007).

## **2D Sales Taxes Collected as a Percentage of GDP**

Sales tax revenue includes revenue from general sales tax as well as revenue from liquor and tobacco taxes.

### *Sources for Canada*

Statistics Canada, *Provincial Economic Accounts, 2007*.

### *Sources for the United States*

US Census Bureau (2007). *Annual Survey of State and Local Government Finances and Census of Governments (1981–2005)*, <<http://www.census.gov/main/www/access.html>>.

US Department of Labor, Bureau of Labor Statistics, <<http://www.bls.gov/cpi/>> (December 18, 2007).

Tax Foundation, *Facts and Figures on Government Finances* (various editions).

## Area 3 Labor Market Freedom

### 3A Minimum Wage Legislation

This component was calculated as minimum wage multiplied by 2,080, which is the full-time equivalent measure of work hours per year (52 weeks multiplied by 40 hours per week) as a percentage of per-capita GDP. For the Canadian provinces, provincial minimum wage was used to compute both of the indices (subnational and all-government). For US states, we used state minimum wage at the subnational level whereas at the all-government level federal minimum wage was used whenever the federal minimum wage was higher than the state minimum wage.

#### *Sources for Canada*

Human Resources Development Canada, <<http://srv116.services.gc.ca/wid-dimt/mwa/menu.aspx>> (December 28, 2007).

Statistics Canada, *Provincial Economic Accounts, 2007*.

#### *Sources for the United States*

Division of External Affairs, Wage and Hour Division, Employment Standards Administration, US Department of Labor, <<http://www.dol.gov/esa/programs/whd/state/state.htm>> (December 28, 2007); see <[http://www.dol.gov/esa/contacts/state\\_of.htm](http://www.dol.gov/esa/contacts/state_of.htm)> for a list of State Labor Offices with contacts and URLs).

Special requests from various state Labor Departments; see <[http://www.dol.gov/esa/contacts/state\\_of.htm](http://www.dol.gov/esa/contacts/state_of.htm)> for a list of State Labor Offices with contacts and URLs).

US Department of Commerce, Bureau of Economic Analysis, <<http://www.bea.gov/>> (December 18, 2007).

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

Government employment includes public servants as well as those employed by government business enterprises. Military employment is excluded.

#### *Sources for Canada*

Statistics Canada, Public Institutions Division, Financial Management System (various years);

Statistics Canada, *Provincial Economic Accounts, 2007*.

#### *Sources for the United States*

Regional Economic Information System, Bureau of Economic Analysis, US Department of Commerce, <<http://www.bea.gov/>> (January 2, 2008).

US Department of Labor, Bureau of Labor Statistics, <<http://www.bls.gov/lau/>> (January 2, 2008).

### 3C Union Density

For this component, our goal was to determine the relationship between unionization and public policy, other than the level of government employment, which is captured in 3B. We regressed union density on the size of the manufacturing sector and on the size of the government sector. Data were not available to allow a regression on rural compared to urban populations. The manufacturing sector did not prove significant while the government sector proved highly significant. Thus, the scores were determined holding public-sector employment constant.

#### *Sources for Canada*

Statistics Canada, CANSIM.

Statistics Canada, *Labour Force Historical Review 2006* (CD-ROM).

Statistics Canada, Public Institutions Division, Financial Management System (various years).

Statistics Canada, Provincial Economic Accounts, 2007.

#### *Sources for the United States*

Barry T. Hirsch and David A. Macpherson (2008). *Union Membership and Coverage Database from the Current Population Survey*, <<http://www.unionstats.com/>> (January 3, 2008).

Regional Economic Information System, Bureau of Economic Analysis, US Department of Commerce, <<http://www.bea.gov/>> (January 2, 2008).

US Dept. of Labor, Bureau of Labor Statistics, <<http://www.bls.gov/lau/>> (Jan. 2, 2008).

## **Additional Data Sources Used in Regression Analysis**

#### *Sources for Canada*

Palacios, Milagros (2008). Purchasing Power Parity, United States and Canada, 1981–2005. Fiscal Studies, Fraser Institute.

Statistics Canada, *Provincial Economic Accounts, 2007*.

Temple, James (2007). *Purchasing Power Parities and Real Expenditures, United States and Canada, 1992–2005*. Income and Expenditure Accounts Technical Series. Cat. 13-604-MIE--No 053. Statistics Canada.

Statistics Canada, *Labour Force Historical Review*, 2001 and 2006 (CD-ROM).

#### *Sources for the United States*

Regional Economic Information System, Bureau of Economic Analysis, US Dept. of Commerce, <<http://www.bea.gov/>> (January 2, 2008).

US Census Bureau, Population Division, Education & Social Stratification Branch, <<http://www.census.gov/population/www/socdemo/educ-attn.html>>.

US Census Bureau, Population Division, <<http://www.census.gov/popest/estimates.php>>.

US Dept. of Labor, Bureau of Labor Statistics, <<http://www.bls.gov/cpi/>> (Dec. 28, 2007).

## Appendix C

# Selected Publications Using Ratings from *Economic Freedom of North America*

Ashby, Nathan J. (2007). Economic Freedom and Migration Flows between U.S. States. *Southern Economic Journal* 73, 3: 677–97.

This paper looked at an impact of economic freedom on gross migration flows among the 48 US states using the data from the US Census Bureau's 2000 survey. The results show that economic freedom does have an impact on gross migration flows. Specifically, it was found that individuals migrate to states with relatively low restrictions on labor markets and low tax burdens. However, it was also found that some components of economic freedom such as government spending and transfers have the opposite effect on migration flows. In other words, states that have high income transfers and high levels of government spending on social programs, which lead to lower levels of economic freedom, also attract migration flows.

Ashby, Nathan J., and Russell S. Sobel (2008). Income Inequality and Economic Freedom in the U.S. States. *Public Choice* 134, 3–4: 329–46.

The paper examined the impact of economic freedom on income inequality in the US states. The authors used income inequality data produced by the Economic Policy Institute and the economic freedom data from *Economic Freedom of North America* for 48 continental US states for three different time periods, 1980–1982, 1990–1992, and 2001–2003. After controlling for factors such as percentage of individuals with a high school education, percentage of population living in metropolitan area, and median income, they found that positive changes in economic freedom are associated with higher income levels and economic growth and with decreases in income inequality. The impact of economic freedom level on income inequality remains mainly insignificant. The authors also looked at the impact of specific components of economic freedom on income inequality and found that reductions in state minimum wages and tax burdens would be most effective in reducing income inequality and promoting high levels of income and growth.

Bezmen, Trisha L., and Craig A. Depken II (2006). Influences on Software Piracy: Evidence from the various United States. *Economics Letters* 90: 356–61.

The authors looked at which socioeconomic factors have a significant influence on the software piracy rates in 50 US states from 1999 to 2001. They found that higher income, lower tax burdens, and higher level of economic freedom lead to lower levels of software piracy in US states.

Campbell, D. Noel, and Tammy M. Rogers (2007). Economic Freedom and Net Business Formation. *Cato Journal* 27, 1: 23–36. <<http://www.cato.org/pubs/journal/cj27n1/cj27n1-2.pdf>>.

The authors examined the impact of economic freedom on business formation measured as the difference between business births and deaths. They used data for all 50 US states from 1990 to 2001. After controlling for state population, income, median age, federal intergovernmental revenue, minority population as a percentage of total population, and commercial lending, they found that a higher level of economic freedom in a given state leads to more new businesses being formed. Furthermore, they concluded that policies aimed at increasing economic freedom would be much more effective than policies aimed at increasing lending in creating a higher number of net business start-ups.

Hall, C. Joshua, and Russell S. Sobel (2007). Institutions, Entrepreneurship and Regional Differences in Economic Growth. Unpublished working paper, West Virginia University. <[http://joshua.c.hall.googlepages.com/Institutions\\_Entrepreneurship\\_and\\_Re.pdf](http://joshua.c.hall.googlepages.com/Institutions_Entrepreneurship_and_Re.pdf)>.

The paper looked at the impact of economic freedom on entrepreneurial activity, measured by the Kauffman Index of Entrepreneurial Activity. The authors hypothesized that the mechanism through which institutions, as measured by economic freedom, increase economic growth is by increasing entrepreneurial activity. Using the data for 50 US states, the authors found that this is indeed the case. High levels of economic freedom lead to increases in entrepreneurial activity.

Kreft, F. Steven, and Russell S. Sobel (2005). Public Policy, Entrepreneurship, and Economic Freedom. *Cato Journal* 25, 3 (Fall): 595–616. <<https://www.cato.org/pubs/journal/cj25n3/cj25n3-15.pdf>>.

The authors examined the direction of causation between entrepreneurial activity, measured by sole proprietorship and patent activity (i.e., number of utility patents received for general inventions and innovations), and venture capital in 50 US states. They found a one-way, causal relationship by which entrepreneurial activity attracts venture capital and not the other way around. Furthermore, they found that higher levels of economic freedom lead to higher levels of entrepreneurial activity. In other words, the “results show that state policymakers need to ensure that economic freedom exists in their state in order to promote entrepreneurial growth, which in turn naturally attracts the necessary venture capital” (p. 608).

Sobel, Russell S. (forthcoming). Testing Baumol: Institutional Quality and the Productivity of Entrepreneurship. *Journal of Business Venturing*.

In this paper, the author tested Baumol's theory by examining the impact of institutional quality on the levels of productive and unproductive entrepreneurship in 48 US states. Baumol's theory states that the economic, political, and legal institutions determine how individuals channel their efforts. That is, these institutions determine whether an individual engages in productive or unproductive activity. Productive entrepreneurship is defined as those actions that lead to positive-sum economic activities. Voluntary transactions in competitive markets are positive-sum transactions as both parties gain as a result of the transaction. Unproductive entrepreneurship, on the other hand, refers to those transactions that use up resources when capturing zero-sum transfers such as those from lobbying. Using five different measures of productive entrepreneurship and four measures of unproductive entrepreneurship, the author found that better institutional quality, measured by economic freedom, leads to higher levels of productive and lower levels of unproductive entrepreneurial activity.

Wang, Lu (2005). Economic Freedom and Economic Growth in the United States. Unpublished working paper, Department of Social and Decision Sciences, Carnegie Mellon University.

The study examined the impact of economic freedom on economic growth in 48 US states. Using data for four four-year periods from 1981 to 1997, the author found that growth in economic freedom leads to economic growth. Specifically, increases in economic freedom by one standard deviation increases economic growth by one standard deviation as well.

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