

# **Economic Freedom of North America**

**2008 Annual Report (Canadian Edition)**

Amela Karabegović & Fred McMahon

with Nathan J. Ashby & Russell S. Sobel

**The Fraser Institute**  
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# About the Contributors

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# Acknowledgments

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# Executive Summary

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

## Background

The index published in *Economic Freedom of North America* rates economic freedom on a 10-point scale at two levels, the subnational and the all-government. At the all-government level, the index captures the impact of restrictions on economic freedom by all levels of government (federal, state/provincial, and municipal/local). At the subnational level, it captures the impact of restrictions by state or provincial and local governments. *Economic Freedom of North America* employs 10 components in three areas: 1. Size of Government; 2. Takings and Discriminatory Taxation; and 3. Labor Market Freedom.

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.

## Economic Freedom and Prosperity

The econometric testing shows that a one-point improvement in economic freedom at the all-government level increases per-capita GDP by US\$6,232 for US states and by US\$4,474 (C\$5,413, using a conversion rate of 1.21) [1] for Canadian provinces. At the subnational level, a one-point improvement in economic freedom increases per-capita GDP by US\$4,825 for US states and by US\$3,846 (C\$4,654) for Canadian provinces.

A 1.00% increase in the growth rate of economic freedom at the all-government level (e.g., from 4.00% per year to 4.04% per year) will induce an increase of 1.08% in the growth rate of per-capita GDP for US states and an increase of 0.60% in the growth rate of per-capita GDP for Canadian provinces. A 1.00% increase in the growth rate of economic freedom at the subnational level will induce an increase

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[1] This is the average exchange rate for 2005 (Sauder School of Business, UBC, 2008).

of 0.77% in the growth rate of per-capita GDP for US states and 0.57% increase in the growth rate for Canadian provinces.

The econometric results are stable and consistent through a number of sensitivity tests. The importance of these results is reinforced by their consistency with those in previous reports, despite the addition of data from two years (2004, 2005). The similarity of results regardless of the structure of the index or year of the tests is quite remarkable.

### **Canadian Headlines**

There is an interesting contrast between Ontario and British Columbia. Between 1995 and 2000, economic freedom in British Columbia was growing at a slower pace than that in Ontario at both the all-government and subnational levels. During this period, British Columbia's economic growth was just 5%, compared to Ontario's 14%. British Columbia suffered from relatively weak economic freedom growth while Ontario benefited from relatively strong growth.

In the most recent five-year period, 2000 to 2005, economic freedom in British Columbia has increased while Ontario, which had escaped from the bottom 10, has now slipped back. As economic freedom grew in British Columbia, so did its economy, by 10%; in Ontario, economic freedom declined during this period and the economy grew at just over 2%, the lowest rate of growth of all Canadian provinces. Although Ontario remains slightly ahead of British Columbia in economic freedom, in considering economic growth, the rate of change is the key factor. If economic freedom in Ontario continues to show weak growth, the econometric testing here suggests the province will continue to lag in prosperity growth.

From 2000 to 2005, the province of Newfoundland & Labrador had the greatest increase in economic freedom at both the all-government and subnational levels, albeit from a low base. Newfoundland & Labrador has also had by far the fastest economic growth in Canada, 43%, during this period. However, the province has benefited from oil and gas development and it would be hazardous to draw any connection to economic freedom.

There is a clear connection between levels of economic freedom and prosperity throughout Canada: the five freest provinces had an average per-capita GDP for 2005 of US\$39,233 compared to US\$27,751 for the least-free provinces.

### **US Headlines**

The states that have had the worst record for growth of economic freedom between 2000 and 2005 at the all-government level are New Mexico (the only state with negative growth), Arizona and, tied for third worst, Connecticut, Michigan, South Carolina, New York, and Ohio. The states with the best record in economic freedom are predominately western states. The fastest growth was achieved by North Dakota, Wyoming and Montana are tied for second, and South Dakota, Nevada, Nebraska, Iowa, and Florida are tied for fourth. Over that period, per-capita GDP in the United States grew by 9%, compared to 5% in the states with the worst growth record and 18% in the states with the best record.



## Differences between Canada and the United States

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, which 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.

All provinces, except Alberta, are clustered at the bottom of the rankings for economic freedom at both the all-government and the subnational levels; they also have low levels of prosperity. Alberta is tied for 8<sup>th</sup> at the subnational level and for 2<sup>nd</sup> at the all-government level. The higher score in the latter index, which includes federal spending, is because Ottawa's expenditures in Alberta are very low, much lower than the federal tax take from Alberta. This lower level of spending increases economic freedom by leaving more economic space for transactions to which individuals and firms voluntarily agree.

## The Evolution of Economic Freedom

The evolution of economic freedom in Canada and the United States 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 first President Bush and the early administration of President Clinton, and then begins to rise again, particularly in the new century. At the subnational level, the pattern is similar 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.

In Canada through the 1980s, economic freedom remained fairly constant at the subnational level, save for a significant decline at the beginning of the decade, 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. At both the all-government level and the subnational level, 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 more often 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. In the early years of the new century, economic freedom rose in Canada at the all-government level while it remained fairly stable at the subnational level.

Overall patterns in Canada and the United States are similar. Both nations fought debts and deficits in the early 1990s with tax increases. However, Canada

raised taxes more aggressively, as can be seen from changes in economic freedom during this period. From 1981 to 2005, the gap between economic freedom in Canada and that in the United States at both the subnational and the all-government levels first widened and then narrowed again until 2000, and has been roughly stable since.

## **New Research**

### **Economic freedom and entrepreneurship in the United States**

In chapter 2, Russell S. Sobel, Professor of Economics at West Virginia University, discusses the theoretical reasons that economic freedom, rather than state intervention, should spur entrepreneurship. Holding other relevant factors constant, he undertakes statistical testing of the relationship, showing, for example, that a one-point increase in economic freedom results in

- ❧ an increase of US\$32.13 in venture capital investment per capita
- ❧ an increase in the number of patents by 8.2 per 100,000 population
- ❧ and an increase of 4.2% in the growth of sole proprietorships

among other positive outcomes related to entrepreneurship. Another way of looking at the impact of economic freedom is to compare the records of the top five and bottom five states in economic freedom. The top five states average US\$138.74 per capita in venture capital investment compared to just US\$15.57 in the bottom states; the top five states generated 29.9 patents per 100,000 population compared to 8.8 among the bottom five states; and the growth rate of sole proprietorships is 4.2% among the top states compared to 2.8% among the bottom states.

### **The economic freedom of Mexico**

The ultimate goal of this project is to include all three North American nations in the index. Problems with the comparability of Mexican data have limited the index to Canada and the United States. Chapter 4 by Nathan J. Ashley of the University of Texas at El Paso is a major step towards including Mexico in the index. He notes his results are preliminary and therefore subject to revision. Nonetheless, the data he gathered enabled him to construct components that demonstrate that variance in the well-being of Mexicans is strongly connected to differences in economic freedom. For example, the top quintile of economically free states in the preliminary index have an average income of MX\$98,415 compared with MX\$40,562 for the bottom quintile. He notes that the principal remaining hurdles to constructing an index of economic freedom for Mexico are finding or imputing reliable data for government employment at the state level, finding trustworthy data on total social security payments, and constructing comparable data for the Legal Structure and Property Rights in Canada and the United States.