JOINT ECONOMIC COMMITTEE
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Let Freedom Ring: Policies That Promote Freedom Also Promote Prosperity

Introduction

The current national economic recovery is the slowest since 1930. The recovery began seven years ago in the summer of 2009 and, since then, there has not been a year when the real GDP growth rate has reached 3 percent. The Bureau of Economic Analysis (BEA) tracked the growth rate back to 1930, and this is the first time that there has been seven consecutive years of sub 3 percent growth. However, while the national economy as a whole is sluggish, there are some encouraging signs coming out of the states.

Numerous studies have attempted to identify what causes one state to have a stronger economy than another. Those studies have found that industrial diversity (the amount of different industries within the state), the portion of the population with a college degree, the portion of the population that is in the labor force (working or looking for a job), and a few other characteristics determine the economic strength of a state. One of the lesser-known areas of study is how state-government policies that embrace economic freedom impact the wellbeing of residents in a state. The conclusions of research in this area are clear: substantial economic benefits are available to people in states that have adopted policies that promote economic freedom.

Recently, in a ranking based largely on national policies, America as a whole has moved away from free-market principles. At the turn of the 21st century, the United States was one of the highest-ranked economies in terms of economic freedom; in 2000, it ranked 2nd in the world below Hong Kong. By 2013, the United States had fallen to 16th place. With the well-documented benefits of economic freedom at the state level, adopting similar policies nationally will help all hard-working Americans. Hopefully, the nation can relearn the lessons seemingly forgotten, and restore the capabilities that made it such an attractive a place to live, work and ultimately thrive. [1]

What is Economic Freedom?

The Fraser Institute broadly defines economic freedom as "…the ability of individuals to act in the economic sphere free of undue restrictions." At the state level, these "undue restrictions" come primarily from state and local governments through excessive spending, excessive taxation, and laws that interfere with labor markets. The Fraser Institute annually generates data on state-level economic freedom in these three areas. However, its broad measure includes regional characteristics, as well as government policies, making it a less effective measure to evaluate public policy. For example, a state that is home to industries that historically are unionized would score low in the Fraser ranking even though lawmakers had passed pro-freedom policies. Therefore, focusing on the components of freedom that reflect recent public policy, within the Fraser categories, better captures how well lawmakers serve the residents of the state.[2]

Three important measures capture the degree of lawmakers' adherence to policies that promote economic freedom: (1) state and local government spending as a percent of state GDP, (2) a tax climate that is conducive for economic growth, and (3) a state-level minimum wage not higher than the federal level and right-to-work protection.

Government Spending

Government spending is necessary and appropriate for public safety and to safeguard economic freedom. For example, if those expenditures are to protect individuals and their property from harm and theft with police protection and a judicial system, government spending does not reduce economic freedom. Additionally, governments can spend money providing a few goods and services so long as they are unlikely to be provided by private firms and are available to everyone, such as local roads and street lights. Once governments begin spending money on items beyond these basic functions, they interfere with markets and the result is fewer firms, fewer jobs, and fewer goods and services for consumers. When people lose their choices, they lose economic freedom.

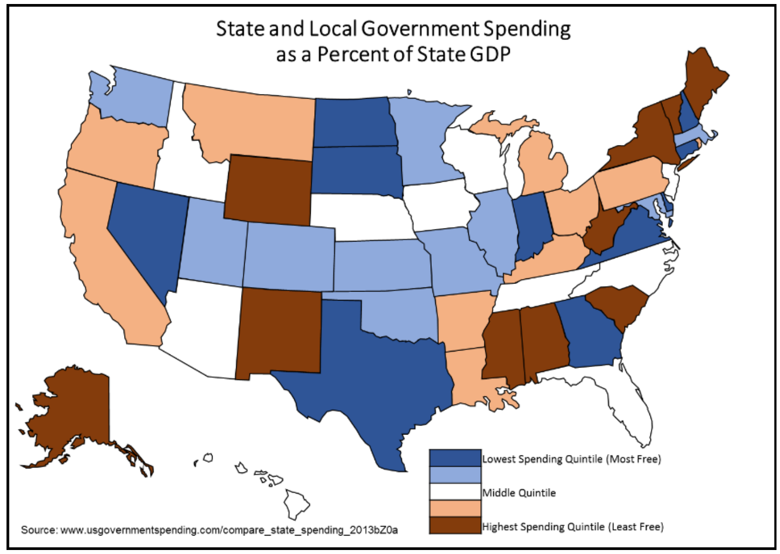

Figure 1

Thus, the lower the portion of state GDP that is attributed to state and local government spending the better. Figure 1 shows which states are the freest, using data from 2013 (the most recent available) and ranking states from the lowest spending states to the highest spending states.

Taxes

Taxation is probably the most intuitive example of how a particular policy can reduce economic freedom. Even though taxes are necessary to fund governments, when an individual's money is seized through any type of tax, they are left with less money to buy what they want. This reduces economic freedom. Additionally, taxes reduce the after-tax profit of businesses and may cause firms to close, relocate to a lower-tax location and possibly prevent new business start-ups.

The Tax Foundation annually publishes its Business Tax Climate Index. It ranks all 50 states from the best tax climate to the worst. Figure 2 shows how states rank in terms of tax climate for businesses and households.

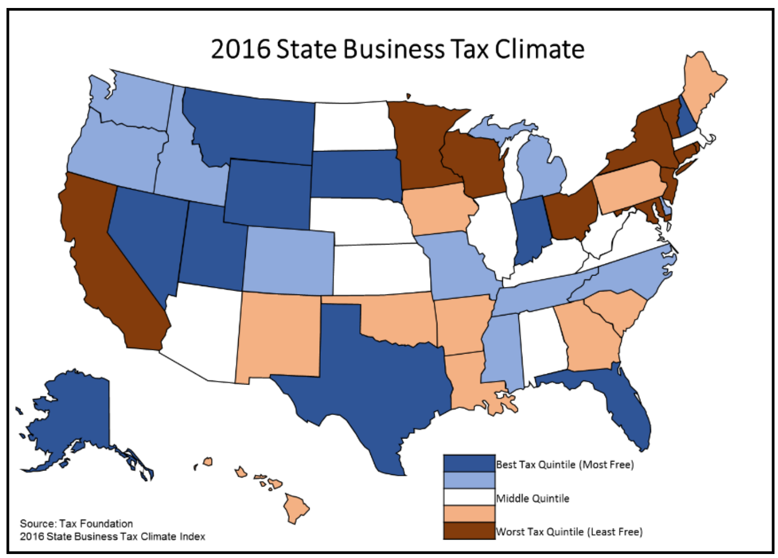

Figure 2

Labor Market Freedom

The most important public policy characteristic in terms of labor market freedom is whether it improves the ability of an employer and an employee to negotiate the terms of employment. This freedom is eliminated when government fails to protect workers from forced union membership as an employment condition or imposes a minimum wage in excess of the federal mandate.

Some workers might prefer to be a member of a labor union while others would rather not. Forced union membership is costly, not only to the worker but also to the entire state. The worker must pay union dues, which amounts to a pay cut; the state suffers because businesses might relocate to a right-to-work state. Also, new start-ups looking for a business location might choose a more business-friendly environment, such as a right-to-work state. The implications of a minimum wage on the workforce is well-documented and severe. A minimum wage increases the level of unemployment compared to the absence of a minimum wage requirement, especially for the least-skilled workers. States that choose to have a minimum wage higher than the federal level decrease economic freedom and harm workers. Figure 3 identifies right-to-work states and the general level of minimum wage.[3]

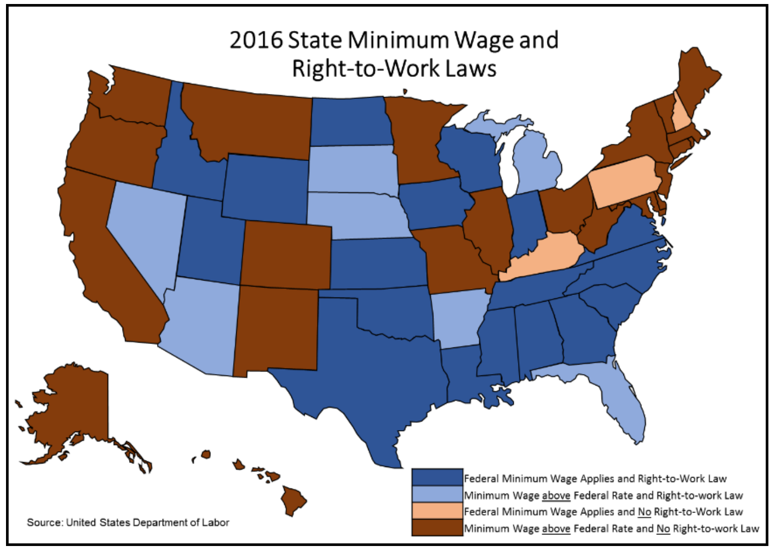

Figure 3

Of these measures of economic freedom, Indiana and Texas scored the highest in all three categories, indicating that their lawmakers understand the benefits of economic freedom and promote policies consistent with freedom. States that were in two of the three top categories include Georgia, Nevada, New Hampshire, North Dakota, South Dakota, Utah, Virginia and Wyoming (Figure 4).

Best States for Economic Freedom

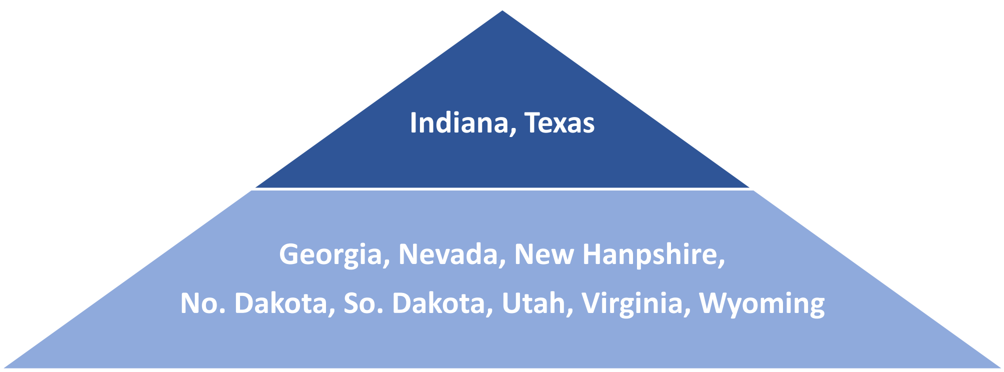

Figure 4

The Many Benefits of Economic Freedom

Unemployment is lower in states that embrace economic freedom. The national unemployment rate was 4.9 percent in June 2016. If someone lived in one of the top ten states in terms of economic freedom, they enjoyed an average rate of 4.3 percent. The broader U-6 measure of unemployment, which includes discouraged workers and involuntary part-time workers, shows similar benefits to economic freedom. For example, July 2015 through June 2016, the top ten states averaged 8.6 percent as opposed to the national rate of 9.9 percent.[4]

More comprehensive economic analyses drew the following conclusions:

States with higher levels of economic freedom have higher rates of employment growth. In addition to having lower unemployment, states with a high level of economic freedom create jobs at a faster rate than states that have less economic freedom.[5]

Economic freedom increases incomes faster and decreases income inequality. All income levels benefit from economic freedom through a higher income growth rate than less-free states. The universal income growth in a state with more economic freedom results in greater earning opportunities and less income inequality.[6]

The greater the degree of economic freedom, the more that state's economy grows. State economic growth measures the increase in the amount of goods and services produced within a state (the percent change in state GDP). Greater economic freedom causes a higher growth rate, which translates into more jobs, higher incomes and more goods and services available to consumers.[7]

Foreign companies that decide to build factories in the United States will generally choose a state that has more economic freedom. When a multinational corporation wishes to expand its operations to the United States, it will choose a state that is more welcoming to business, entrepreneurs and their employees; that is, they'll choose a state that embraces economic freedom.[8]

Government is less likely to seize private property in a state that has a high level of economic freedom. Eminent domain is government seizure of private property for public use. While the owners of the seized property are compensated financially, they are often forced into the transaction. Over the years, the use of eminent domain has expanded in scope from exclusively government-owned projects, like schools and highways, to now include privately-owned projects, such as shopping centers. States with more economic freedom use eminent domain less.[9]

In states where economic freedom is high, business turnover is high, and consumers win. States that have a high level of economic freedom make it relatively easy for entrepreneurs to start a new business and consequently there are many more start-ups. Additionally, with all of the new businesses, there is increased competition resulting in the replacement of less efficient businesses. The net effect is that the elevated level of business activity benefits all customers by giving them more goods and services to choose from and lower prices from competition. The churn of new start-ups is constantly providing new jobs for state residents not previously available.[10]

Conclusion

With the decline of economic freedom and the subsequent slow economic recovery of the last seven years, it is clear that America is moving away from the very ideals that made it a major global presence and exemplar of high living standards. Hopefully, lawmakers can make better decisions and preserve the freedoms that made the United States the largest and most dynamic economy in the world. If Congress and the Administration applied to national policies the lessons learned by many state lawmakers in terms of protecting economic freedom, then America can return to the growth and prosperity that it enjoyed in the past and not have to settle for the weak economic conditions of the past seven years.

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[1] James Gwartney, Robert Lawson and Joshua Hall. *Economic Freedom of the World: 2015 Annual Report.* Fraser Institute 2015.
[2] *Economic Freedom of North America 2015*, p. 9 - 13
[3] D. Neumark and W.L. Wascher, Minimum Wages and Employment, Foundations and Trends in Microeconomics, vol. 3, no. 1+2, pp 1-182, 2007.
[4] Bureau of Labor Statistics, August 3, 2016.
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[6] Ashby, Nathan J., and Russell S. Sobel. "Income inequality and economic freedom in the US states." *Public Choice* 134.3-4 (2008): 329-346.
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