U.S. ECONOMIC FREEDOM INDEX
2008 REPORT

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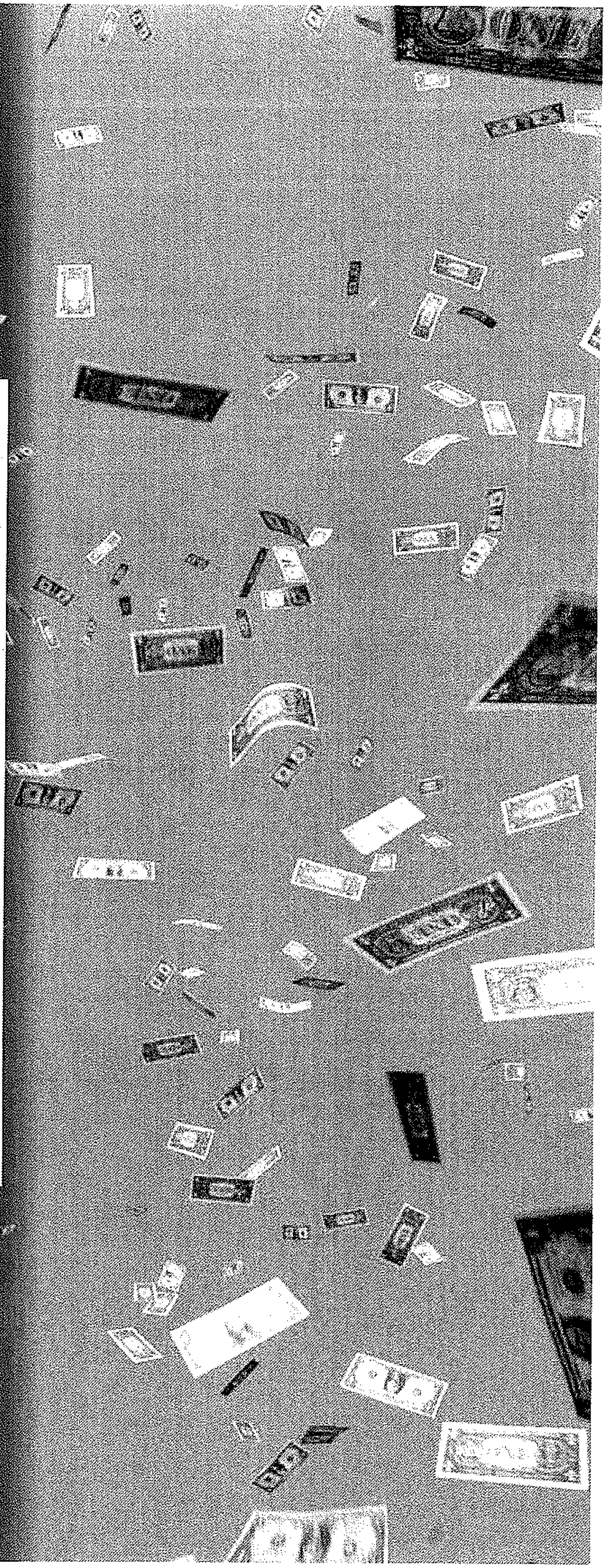
Foreword by Arthur B. Laffer

PRI PACIFIC RESEARCH INSTITUTE IN ASSOCIATION WITH Forbes



When you can measure what you are speaking about, and express it in numbers, you know something about it. But when you cannot measure it, when you cannot express it in numbers, your knowledge is of a meager and unsatisfactory kind: it may be the beginning of knowledge, but you have scarcely, in your thoughts, advanced to the stage of science, whatever the matter may be.

Lord Kelvin
19th-century British physicist

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Preface

As president of the Pacific Research Institute (PRI), I am pleased that the *U.S. Economic Freedom Index: 2008 Report* now emerges in its third edition. Like previous editions, this one is grounded in the same rigorous statistical analysis and will serve as an important tool for measuring how friendly, or unfriendly, each state government is toward free enterprise and consumer choice. That is important for policy makers to know, but not them alone.

The *Index* provides a reliable metric of economic freedom, and encourages a discussion among the public and in state legislatures about economic freedom, along with areas for policy reform. Legislators can also use the *Index* to ponder the consequences of inaction. Two effects of limiting economic freedom, the report confirms, are that people flee economically oppressive states, and those residents who remain are made poorer. Legislators can change those outcomes by expanding economic freedom in their states, and the *Index* will help them in that task.

Dr. Lawrence J. McQuillan, director of Business and Economic Studies at PRI and the project director, first proposed that PRI undertake the *Index*. He is due our profound thanks for guiding the project every step of the way. Dr. Michael T. Maloney, the project's chief statistician, added his experience and academic rigor to the data collection and statistical analysis. I would also like to thank Dr. Eric Daniels for his brilliant introduction and Dr. Brent M. Eastwood for a new econometric application of the *Index*.

PRI's *U.S. Economic Freedom Index: 2008 Report* enjoyed support and encouragement from Dr. Edwin J. Feulner, president of the Heritage Foundation, and Tracie Sharp, president of State Policy Network. The Searle Freedom Trust made the project possible through a generous donation.

Special thanks also go to Steve Forbes, Tom Post, and Kurt Badenhausen for making the association between *Forbes* magazine and PRI on this project a reality and a success. Finally, I would like to thank Arthur B. Laffer for writing an insightful foreword.

PRI develops and promotes public-policy solutions that empower individuals to solve problems through voluntary association and exchange in free markets. Through its research, commentary, and outreach activities, PRI also educates the public. This volume represents a synthesis of PRI's objectives to research and to educate.

As PRI approaches its 30th anniversary, we are more committed than ever to promoting a wider discussion of key policy issues. Greater knowledge, more analytic thinking, and a national dialogue will contribute to reasoned and informed policy decisions. PRI remains fully committed to a prominent role in this process, and the *U.S. Economic Freedom Index* makes a valuable contribution.

Sally C. Pipes
President and Chief Executive Officer
Pacific Research Institute

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Eric Daniels thanks: Bruce Yandle, Dean Emeritus and professor of economics emeritus, Clemson University, for his guidance and cheerful willingness to explain lucidly everything economics to me; Bobby McCormick, professor of economics and BB&T Scholar, Clemson University, and Bob Tollison, J. Wilson Newman Professor and BB&T Senior Fellow, Clemson University, for always providing insight and criticism into the nature of economic freedom and how we measure it; John A. Allison IV, chairman and CEO, BB&T Corporation, for his principled belief in and tireless action on behalf of economic freedom and the study of capitalism; and Brad Thompson, executive director of the Clemson Institute for the Study of Capitalism and BB&T Research Professor of Political Science, for his belief in my abilities, his support for my efforts, and his review of my draft.

Michael T. Maloney thanks professors McCormick, Tollison, and Yandle, who have been colleagues and coauthors over many years. And thanks go to my research assistant on this project, Arpita Biswas, who was a diligent worker and an imaginative thinker as we revisited the twists and turns of the notion of economic freedom.

The authors also thank Russell S. Sobel, professor of economics and James Clark Coffman Distinguished Chair in Entrepreneurial Studies, West Virginia University, Morgantown, West Virginia, for his formal review of this study. Any remaining errors or omissions are the sole responsibility of the authors.

The views and conclusions of the authors do not necessarily represent those of the board, supporters, or staff of the Pacific Research Institute.

Lawrence J. McQuillan
Michael T. Maloney
Eric Daniels
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Executive Summary

LAWRENCE J. MCQUILLAN, PH.D.

It has been said that liberty is a whole, and that to deny economic liberty is finally to destroy all liberty. Irrespective of our love for freedom, the authors of this report set out on an empirical journey, not a romantic one. Our goal is to measure economic freedom across the 50 U.S. states using the methodology of the 1999 and 2004 editions.

This report was first released in 1999 by John D. Byars, Robert E. McCormick, and T. Bruce Yandle, all of Clemson University, as *Economic Freedom in America's 50 States: A 1999 Analysis*, published by State Policy Network. This was the first index to measure economic freedom in the U.S. states and is still the most comprehensive assessment of economic freedom on the market today.

The report was updated in 2004 by Ying Huang, Robert E. McCormick, and Lawrence J. McQuillan as the *U.S. Economic Freedom Index: 2004 Report*, published by the Pacific Research Institute. The 2008 edition is an effort to update the 2004 edition using recent data that reflect changes in state policies since the previous edition.

It is hoped that by measuring economic freedom and studying its effects, people will gain a fuller appreciation of the important imprint it makes on the economic and political fabric of America and will encourage new state legislation that advances economic liberty.

WHAT IS ECONOMIC FREEDOM?

Economic freedom is the right of individuals to pursue their interests through voluntary exchange of private property under a rule of law. This freedom forms the foundation of market economies. Subject to a minimal level of government to provide safety and a stable legal foundation, legislative or judicial acts that inhibit this right reduce economic freedom. Government acts that advance this right increase economic freedom. This report focuses on state and local government actions as they relate to economic freedom; we do not judge the wisdom, merit, or purpose of specific government programs.

Our definition of economic freedom, along with the economics literature, guided our judgment as to which indicators were included in the full data set and how we scored each indicator's freedom effect.

THE METHODOLOGY AND INDICATORS

The methodology consists of four parts: (1) we compiled a set of indicators for economic freedom and from that we created five data sets; (2) these data sets were converted into 35 unique indexes using different weighting techniques; (3) we compared each index to the others in terms of its ability to explain, other things equal, human migration across the 50 U.S. states; and (4) the index with the greatest statistical link to migration was chosen as the best and was used to rank the U.S. states in terms of economic freedom.

INDICATORS

We gathered data on 143 indicators per state (data set 1, listed in appendix A). This snapshot included tax rates, state spending, occupational licensing, environmental regulations, income redistribution, right-to-work and prevailing-wage laws, and tort reform, to name just a few. Next, we cut some redundant indicators and averaged similar indicators for compactness (appendix B explains this process). This data parsing resulted in five different data sets (data sets 1–5).

CONSTRUCTION OF COMPETING INDEXES

For each of the five data sets, we calculated sector scores for each state. For example, data set 1 had 143 indicators. We put each indicator into one of five sectors: fiscal (51 indicators), regulatory (53), judicial (22), government size (7), and welfare spending (10). Each state's sector scores were calculated by ranking each indicator within a sector from 1 (most free) to 50 (least free). Then we averaged the indicator rankings within each sector to arrive at a sector score for each state. For example, data set 1 had 51 fiscal-sector indicators. A state's fiscal-sector score for data set 1 was calculated by ranking each fiscal indicator from 1 to 50 and then calculating an average ranking from these 51-indicator rankings. The same process was used to calculate scores for the other four sectors. This process was repeated for each of the five data sets.

After sector scores were calculated for each state over all five data sets, various sector-score weighting techniques were applied, ranging from assigning arbitrary weights to using statistical procedures such as principal components analysis to determine weights. Finally, weighted sector scores were added together to arrive at overall index scores for each state. The various combinations of data sets and weighting techniques yielded 35 unique indexes.

The Selection Criterion

These 35 indexes competed with each other to explain net population migration rates for the 50 U.S. states, from 2003 through 2007, using regression analysis. In the jargon of econometrics, the index we chose as best yielded the highest R-squared among those equations having an index coefficient t-value significant at the five-percent level or greater. This procedure selects the best, or final, index empirically, and it conforms to the proper statistical methodology for choosing among two or more equally plausible specifications.

Our criterion for selecting the best index among 35 indexes applies a market-based definition of freedom. We believe people want to be free: they strive and work to be free, and search out locations, governments, and situations where freedom reigns. Migration is the purest expression of individuals responding to differences in freedom, including economic freedom. We adopt a migration metric for economic freedom. If people are moving from one state to another, other things equal, we assert that this is a market-based response to differences in freedom. Ordinary people, voting with their feet, define freedom and that, in the end, is a clear advantage of our index: it is evaluated in the marketplace by where people decide to live.

The Best Index

The index having the greatest statistical link to migration was Index4A, constructed by weighting data set 4 using first principal components weights. The final indexes in 1999 and 2004 were also weighted using principal components. Principal components weighting has been used for years in political science. The technique weights each sector based on the degree of useful information (variation) in the sector, which enables finer distinctions among states to be clearly drawn.

The sector-score weights used to compute the final 2008 index score for each state were:

Index = (0.2313 × Fiscal Score) + (0.2159 × Regulatory Score) + (0.1894 × Judicial Score) + (0.1208 × Government-Size Score) + (0.2426 × Welfare-Spending Score)

The index score can range from 1 (most free) to 50 (least free), and state rankings were derived from the index scores. Appendix C provides point-by-point responses to critics and criticism of our methodology and the resulting index.

Not surprisingly, the net migration rate for the 20 freest states was 27.36 people per 1,000, while it was a shockingly low 1.17 people per 1,000 for the 20 most economically oppressed states. People are moving to the freest states and fleeing the least-free states as our market-based migration metric of economic freedom predicts. Index4A was statistically significant and negatively related to net migration, that is, a lower index rank implies more economic freedom, which leads to more net in-migration.

For every one-place index ranking improvement, a state's net migration per 1,000 people typically increased about one person. This means that in Michigan, for example, a one-spot improvement in its economic freedom ranking would result in a net increase of about 10,000 people to the state—much needed workers, consumers, investors, and entrepreneurs.

THE ECONOMIC FREEDOM RESULTS

Table 1 on page 11 presents the economic freedom scores and rankings for the 50 U.S. states in 2008. Kansas topped the 2004 list but dropped to 10 in 2008. South Dakota has assumed the lofty spot as the nation's most economically free state—it was 15 in 2004—followed closely by Idaho, Colorado, and Utah, all of which ranked well in 2004.

In contrast, Pennsylvania, California, New Jersey, Rhode Island, and New York bring up the rear. New York retains the dubious distinction of being the most economically oppressed state since 1999. Some states such as New York, Pennsylvania, and Utah have been remarkably stable since 1999—preserving their relative status quo for good or for bad. Other states have been on the move.

Turning first to the states that made the biggest improvements in relative economic freedom from 2004 to 2008, we found that South Dakota advanced 14 places, but even better were Minnesota, Illinois, and Wisconsin, which jumped 18, 19, and 20 places, respectively. There is an economic-freedom Renaissance in the Upper Midwest, and it is no accident that they are all neighbors—when one state reforms it puts pressure on its neighbors to improve or be at a competitive disadvantage for attracting people and capital.

In contrast to the advancing states, Texas fell 14 spots; Alaska, Delaware, and North Carolina each dropped 12 spots; and Arizona fell 10. These states are headed in the wrong direction.

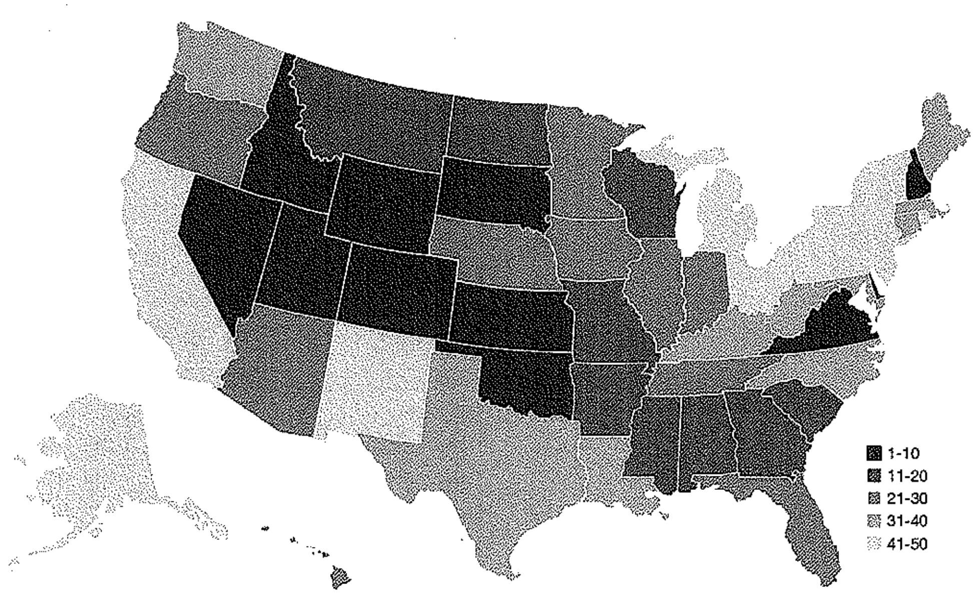
TABLE 1. U.S. ECONOMIC FREEDOM INDEX, 2008

2008 Rank	State	Score	2004 Rank	1999 Rank
1	South Dakota	14.54	15	5
2	Idaho	14.81	4	1
3	Colorado	14.91	2	14
4	Utah	15.16	5	3
5	Wyoming	15.39	9	4
6	Nevada	15.70	12	20
7	Oklahoma	16.74	6	18
8	New Hampshire	17.07	7	6
9	Virginia	17.99	3	2
10	Kansas	18.06	1	10
11	Georgia	18.22	19	12
12	North Dakota	18.56	18	21
13	Montana	18.56	21	26
14	Arkansas	18.82	23	15
15	Missouri	18.90	10	13
16	Alabama	19.03	25	11
17	South Carolina	19.08	13	16
18	Wisconsin	19.15	38	37
19	Mississippi	19.28	28	9
20	Delaware	19.61	8	7
21	Arizona	19.78	11	25
22	Iowa	19.88	16	24
23	Indiana	19.92	14	22
24	Hawaii	19.92	35	39
25	Nebraska	19.93	20	23
26	Minnesota	20.92	44	43
27	Illinois	21.16	46	36
28	Florida	21.16	22	30
29	Tennessee	21.18	26	19
30	Oregon	21.24	29	41
31	Texas	21.32	17	8
32	Louisiana	21.36	40	31
33	Massachusetts	21.72	41	47
34	Maryland	21.73	27	35
35	Maine	21.81	30	42
36	North Carolina	21.87	24	17
37	Washington	21.92	31	40
38	West Virginia	22.55	32	32
39	Connecticut	22.66	48	46
40	Kentucky	22.71	39	29
41	New Mexico	22.82	37	28
42	Vermont	22.87	36	34
43	Michigan	23.08	34	27
44	Ohio	23.34	43	33
45	Alaska	23.38	33	38
46	Pennsylvania	23.88	45	45
47	California	23.89	49	44
48	New Jersey	23.94	42	48
49	Rhode Island	24.18	47	49
50	New York	27.39	50	50

Figure 1 below plots economic freedom from coast to coast, and distinct patterns emerge. The Great Plains and Rocky Mountain states, colored in darkest green, have the most economic freedom. New Hampshire persists in defying the pattern in the Northeast. Maybe there is something to their motto "Live Free or Die." Virginia stands as a citadel of economic freedom in the South, which overall performs fairly well, but likely not as well as most people would expect.

The states with the least economic freedom, colored in lightest green, are clustered in the Northeast plus Alaska, California, and New Mexico. Many of the nation's most densely populated states are also some of the least economically free. This is consistent with leading economic theories of the determinants of government intervention in markets. The Upper Midwest has improved significantly since 2004, the obvious exception being Michigan.

FIGURE 1. U.S. DISTRIBUTION OF ECONOMIC FREEDOM, 2008



In conclusion, the overseers of the Consumer Price Index, one of the oldest indexes in economics, write: "An index is a tool that simplifies the measurement of movements in a numerical series." The *U.S. Economic Freedom Index* is a tool for measuring relative economic freedom. Measurement is the first step to understanding, and understanding is required for reasoned discussion and sound reform. It is hoped that the *U.S. Economic Freedom Index* will ultimately contribute to sound policy reforms that preserve and advance economic freedom for all Americans.

Chapter 1. What Is Economic Freedom?

ERIC DANIELS, PH.D.

All eyes are opened, or opening, to the rights of man. The general spread of the light of science has already laid open to every view the palpable truth, that the mass of mankind has not been born with saddles on their backs, nor a favored few booted and spurred, ready to ride legitimately, by the grace of god.

—Thomas Jefferson, letter to Roger C. Weightman, June 24, 1826

Writing in anticipation of the 50th anniversary of America's Declaration of Independence, Jefferson optimistically believed that the example of American freedom and individual rights had opened the eyes of the world to the value of liberty. Nearly two centuries after Jefferson wrote, it is clear that America has indeed been the shining example of freedom for the rest of the world. Since Jefferson wrote, people around the globe have sought either to imitate the example of American freedom by replicating its institutions or to enjoy that freedom directly by migrating to the United States.

The example of American freedom is a powerful one. Nowhere else has the liberty of average citizens been greater, more secure, and more protected. Lovers of freedom have admired all its aspects, from our protection of religious conscience to our free elections, from our freedom of speech to our impartial judicial system to our ability to choose our own private associations and more. One of the most persuasive features of our freedom, of course, is America's high degree of economic freedom and the wealth and widespread abundance that has resulted from it.

Surveying the record of American productivity and prosperity is an inspiring task. In the space of just one-and-a-half centuries, American standards of living not only rose above those of most of the rest of the world, but they also rose beyond all expectation. Who among the most visionary forecasters of the mid-19th century could have imagined both the nearly unlimited economic opportunities available to Americans in the 21st century and the fact that these opportunities would be available to everyone who strived to achieve them without regard to race, creed, noble birth, or the accidents of fortune?

Our ancestors would scarcely recognize a world where jet airliners can whisk people from hemisphere to hemisphere in less than a day, where information about world events is available instantaneously, where corporations coordinate the economic activity of tens of thousands of employees around the globe (working in modern, climate-controlled high-rise offices, no less) while producing products to be sold to tens of millions, where diseases, plagues, and famines are a rare and tragic exception and not an accepted part of life.

Even the richest American in the early 19th century would likely marvel at what is available to the average worker in 2008—the dizzying variety of food (from year-round fresh fruits and vegetables to exotic meats to instantly prepared meals-on-the-go), the comforts of life (from cheap clothing and transportation to modern housing and appliances), and the provision for optimal health (from MRIs and laser surgeries to organ transplants and universal vaccination), and beyond. That same 19th-century elite would be flabbergasted and stupefied by the fact that obesity—essentially, the consumption of too many calories and expenditure of too little physical labor—is a leading problem among the poor. In sum, by all economic measures, each successive generation of Americans enjoys indisputably better lives than previous ones. They work less and earn more, they can spend less on necessities and more on conveniences, and they live longer more pleasurable and more productive lives.[1]

Economic freedom not only correlates with economic growth and prosperity, but also is a direct cause of and necessary condition for it.

It is not just migrants and imitators, however, who have noticed the superior material results that accrue to Americans as a result of their high levels of freedom. Over the past 20 years, scholars have increasingly directed attention to the problem of measuring different levels of prosperity around the world and correlating those observations with the differing levels of freedom.[2] Since 1995, the Heritage Foundation and the *Wall Street Journal* have produced the annual *Index of Economic Freedom*, which scores the nations of the world on a multi-factor formula that determines their level of economic freedom. Since 1996, the Fraser Institute and Cato Institute have teamed with an international network of free-market think tanks to produce and distribute the annual *Economic Freedom of the World* reports.

These studies' conclusions are unambiguous and clear—economic freedom not only correlates with economic growth and prosperity, but also is a direct cause of and necessary condition for it. Likewise, comparing these lists of the most economically free countries with the annual ranking of countries according to levels of political freedom and civil liberties by Freedom House, titled *Freedom in the World*, shows a direct link between levels of political and economic freedom.

ECONOMIC FREEDOM IN AMERICA

The United States as a nation has consistently scored in the top 10 of each of these studies, confirming the high degree of economic and political freedom enjoyed by Americans. Despite the high level of economic freedom in America generally, there is, nevertheless, a wide degree of variation in the United States itself. That uneven level of freedom forms the heart of our study and poses the central questions for it. How does economic freedom vary in the United States? What are the causes and the results of that variation?

Despite the high aggregate levels of economic freedom found in the United States, especially as compared with other nations, there is, nevertheless, a lack of uniformity in the distribution of that freedom. Within the United States, different groups of citizens experience different levels of economic freedom, often with drastic results. The lines that divide the levels of freedom in America are not based on class or race or sex. Instead, the origin of variation is found in the very nature of the American political compact—the federal nature of our republic. Because each of the 50 states has the sovereign power to direct local economic policy within its boundaries, there can be 50 different climates of economic freedom in the United States.

Despite the high level of economic freedom in America generally, there is, nevertheless, a wide degree of variation in the United States itself.

Supreme Court Justice Louis Brandeis once observed that the states could serve as "laboratories of democracy" by "try[ing] novel social and economic experiments." Brandeis hoped that the states could experiment with economic policy and thereby encourage more economic planning, more regulation, and more intervention on the socialist model.[3] His observation about the potential for the states to serve as laboratories is an apt one, even if the results are the opposite of what he might have expected. Instead of embracing the socialist model through state-level experimentation, Americans have demonstrated their belief in economic freedom by adopting the most basic strategy available to them—by doing what economist Charles Tiebout called "voting with their feet."[4] That is, given the freedom of Americans to move from jurisdiction to jurisdiction, we have found that Americans move away from states that impose regimes of less economic freedom in favor of those upholding more economic freedom.

SOME DEFINITIONS, ASSUMPTIONS, AND METHODS

At first blush, freedom can be a difficult concept to measure. Freedom, as a concept, is as old as written history itself. The earliest example of its written form dates to the 24th century B.C.[5] It initially seems quite simple—nearly everyone recognizes the visceral reaction when one's freedom is restricted. When people do or do not feel restrained or curtailed by some authority, there we might find a rough measure of the extent of their freedom. Yet this is too simplistic. We cannot rely merely on self-reporting to measure something as important as freedom. We need a more objective standard by which we can determine whether a society or a government upholds and protects freedom or restricts and denies freedom. In short, we need a set of criteria based on an explicit definition of economic freedom whereby we can measure objectively the levels of freedom state-by-state. Thus, we must begin our study with a clear definition of freedom.

Economic freedom is an application of political freedom. The most basic distinction at the heart of the concept of freedom is the distinction between *voluntary action* and *compulsion* or *coercion*. Where individuals can choose their thoughts and actions, where they are free from physical coercion, they are free. We operate from a negative definition of freedom—it means the *absence* of physical restraints that halt or forcibly redirect one's thoughts or actions. In the economic realm, this means that economic freedom is the freedom to produce and trade goods and services according to one's own judgment, unrestrained by the physical coercion or compulsion of others, including the government. One must be free to acquire, use, and dispose of private property. Individuals must be free to enter into voluntary contractual relationships. The root identification here is that no man has a moral right to stake a claim on the productive activity of another against his will.

The implementation of freedom in society requires the identification and protection of individual rights, including property rights, and the creation of a government restrained by the rule of law, with the sole purpose of that government being the protection of those rights. Thus, the proper functions of government are the provision of a realm of freedom for individuals to engage freely in economic transactions. To do this, a government must protect its citizens from bodily harm or physical coercion from criminals or hostile foreign powers. It must also provide a system of courts and laws that objectively define the rules of social interaction among individuals—that is, they must prohibit the initiation of force and place the retaliatory use of force under the control of a properly delimited government. Under such a system, individuals are free to exercise their rights in any manner that does not violate the rights of others. In the economic realm, this means that the government must provide a legal system whereby individuals' rights to property and contract are upheld and where disputes can be settled by law, not violence.

We define economic freedom as the right of individuals to pursue their interests through voluntary exchange of private property under rule of law.

In summary, we define economic freedom as the right of individuals to pursue their interests through voluntary exchange of private property under rule of law.

Thus, to make the measurement of different levels of economic freedom more objective requires that we specify a series of indicators and tie them to whether they advance or inhibit the proper functions of government in regard to an economy. In cases where an indicator leads, for example, to a greater ability of individuals to contract voluntarily with their fellow citizens, such a variable indicates a greater degree of freedom. Where an indicator leads to a diminished capacity for individuals to acquire, use, or dispose of their private property, for example, such a variable indicates a lesser degree of freedom.

This central insight has been the heart of a continuing project of studying and evaluating economic freedom in America. This *2008 Report* is the third edition of the *U.S. Economic Freedom Index*, which began in a 1999 study[6] by John D. Byars, Robert E. McCormick, and T. Bruce Yandle, and was revised in 2004 by Ying Huang, Robert E. McCormick, and Lawrence J. McQuillan.[7] It measures the differing levels of economic freedom on a state-by-state basis. By applying a methodology similar to the comparison of economic freedom between countries, we have endeavored to measure differing levels of economic freedom between states. That is, we have compiled criteria that illustrate a range of characteristics that indicate levels of freedom and that can vary between states. (A more complete discussion of the methodology is in chapter 2.)

WHAT OTHERS HAVE SAID

The literature on economic freedom has been growing significantly in recent years. Since the original publication of this index, scholars have focused more attention on the basic questions we investigate and their implications. Does economic freedom vary in significant ways in the United States? Can we observe a movement of people and human capital across state borders in response to differing levels of freedom? Are economic growth and personal income higher in states with more economic freedom?

In a wider conception, however, the literature on economic freedom was already well established and historically rich when this index was first published. Great minds throughout history have observed and remarked on the relationship between political and economic freedom and have arrived at the same conclusions. Our purpose here will be to survey their thought briefly and then review the modern literature.

The founder of modern economics, Adam Smith (1723–1790), was a strong proponent of free markets and free trade. His treatise, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), is arguably the first investigation into how different levels of economic freedom affect economic growth and prosperity. Though Smith did not endeavor to index levels of freedom, his work makes a forceful argument that supports our conception of economic freedom. Smith believed that our "propensity to truck, barter, and exchange one thing for another" would lead to "general opulence."[8] Such a system, Smith believed, required that "every man, as long as he does not violate the laws of justice, [be] left perfectly free to pursue his own interest his own way."[9]

The French classical economist Jean-Baptiste Say (1767–1832), writing in the early 19th century, improved on Smith's formulations and extended his analyses. Say made the connection between a limited government and economic productivity explicit in his *Treatise on Political Economy* (1803). Say recommended comparing the economic situation of the nations of Western Europe with those of Asia and Africa with an eye to their government. "[O]f all the means by which a government can stimulate production," he noted, "there is none so powerful as the perfect security of person and property, especially from the aggressions of arbitrary power. This security is of itself a source of public prosperity that more than counteracts all the restrictions hitherto invented for checking its progress. Restrictions compress the elasticity of production; but want of security destroys it altogether."[10]

Influenced by both the classical economists and Enlightenment political philosophers such as John Locke, the American Founders also articulated a defense of economic freedom as a means of securing prosperity and happiness. As Jefferson noted in 1785, "I think all the world would gain by setting commerce at perfect liberty."[11] The Founding generation believed that property rights and economic freedom were absolutely essential to freedom and liberty more generally. "The right of property is the guardian of every other right," explained Arthur Lee, "and to deprive a people of this, is in fact to deprive them of their liberty."[12]

In their disputes with Britain during the Revolutionary Era, the Founders contested the mother country's excessive taxation, her invasive trade regulations, her bounties and subsidies for favored industries, her prohibition of certain trades, and in general, her attempt to control and manage an economy that they believed should be left free.[13]

The best analysis of the relationship between economic freedom, prosperity, and government came from the pen of James Madison in an essay he published in 1792, titled, simply, "Property."[14] The proper end of government, Madison noted, "is to protect property of every sort; as well that which lies in the various rights of individuals, as that which the term particularly expresses." The crucial point that Madison made is that there is a deep connection between economic rights and all of our other rights. As he noted, "as a man is said to have a right to his property, he may be equally said to have a property in his rights." There was, for Madison, no possibility of happiness, prosperity, or security under a government that did not protect both economic and political rights equally. For Madison, these were mutually necessary and mutually reinforcing.

Government, Mises observed, "is a guarantor of liberty and is compatible with liberty only if its range is adequately restricted to the preservation of what is called economic freedom."

This vital connection between the economic and political rights of the individual is a theme that 20th-century thinkers have picked up and advanced in important ways. The free-market economists Friedrich von Hayek and Ludwig von Mises each observed that economic freedom can only exist where individuals have the right to determine for themselves the course of their own thoughts and actions. "Economic control is not merely control of a sector of human life which can be separated from the rest," Hayek noted in 1944, "it is the control of the means for all our ends. And whoever has the sole control of the means must also determine which ends are to be served, which values are to be rated higher and which lower—in short, what men should believe and strive for."[15] Government, Mises observed, "is a guarantor of liberty and is compatible with liberty only if its range is adequately restricted to the preservation of what is called economic freedom."[16]

These economists shared with their colleague Milton Friedman a belief that economic freedom and political freedom went hand in hand, and that such a unity of liberty was the only means of achieving prosperity. "Freedom in economic arrangements," Friedman wrote in 1962, "is itself a component of freedom broadly understood, so economic freedom is an end in itself. . . . [but] economic freedom is also an indispensable means toward the achievement of political freedom."[17] He believed that "competitive capitalism—the organization of the bulk of economic activity through private enterprise operating in a free market" is "a system of economic freedom and a necessary condition for political freedom."

Among the thinkers who advocated economic freedom in the 20th century, philosopher Ayn Rand stands out as a staunch champion of that cause. In her novels and non-fiction works, Rand explained the crucial relationship between economic and political freedom as being rooted in the requirement of human beings to have freedom of thought and action. "*Intellectual* freedom cannot exist without *political* freedom," she noted in 1961, "[and] political freedom cannot exist without *economic* freedom; *a free mind and a free market are corollaries.*"[18]

Economic freedom and prosperity, happiness, development, and growth are maximized under a system of freedom, which means a system of capitalism.

Rand also emphasized the crucial distinction between freedom as a political concept and freedom as an economic concept. Politically, Rand defined freedom as "freedom from government coercion." It does not mean, she continued, "freedom from the landlord, or freedom from the employer, or freedom from the laws of nature which do not provide men with automatic prosperity."[19]

Rand argued that the key to human prosperity was the protection of individual rights. Since the reasoning mind, she argued, is the source of our ability to produce material values, and since its use must remain free to follow its conclusions, the political system necessary for prosperity was capitalism, the only system that fully and uncompromisingly protects man's rights. "History and, specifically, the unprecedented prosperity-explosion of the nineteenth century," Rand noted, gave a dramatic illustration that "capitalism is the only system that enables men to produce abundance—and the key to capitalism is individual freedom."[20]

In all, these thinkers illustrate the fact that economic freedom and prosperity, happiness, development, and growth are maximized under a system of freedom, which means a system of capitalism.

RECENT INVESTIGATIONS OF ECONOMIC FREEDOM

The literature on economic freedom is a growing and diverse one. A brief search of the EconLit database indicates that more than 350 articles investigate some aspect of the question of how economic freedom interacts with other factors. Although much of this literature has focused on the international context, an encouraging trend is the appearance of more investigation of economic freedom in the United States.

For scholars who believe in the value of competition, one of the highlights of recent years has been the appearance of competing indexes of economic freedom that focus on a state-by-state comparison instead of just international ones. Since 2002, the Fraser Institute has published *Economic Freedom of North America*, which includes each of the American states and Canadian provinces in their analysis.[21] In 2007, the American Legislative Exchange Council published *Rich States/Poor States: ALEC-Laffer State Economic Competitiveness Index*.[22] Although both of these studies adopt a different set of variables to examine the levels of economic freedom, readers interested in the topic of economic freedom in the United States now have three richly researched sources to consider.

One of the areas where promising work remains to be done is the investigation of different applications of the basic conclusion of our study, that different levels of economic freedom in the states affect economic performance and outcomes. Recent studies have investigated the effects of different levels of economic freedom among the states on net business formation,[23] levels of interstate migration,[24] human capital migration (also known as "brain drain"),[25] entrepreneurship,[26] and income inequality.[27] These studies have all illustrated the vital role that economic freedom plays in determining positive economic outcomes, but more research needs to be done.

A recent study and policy analysis of West Virginia edited by Russell S. Sobel, *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It*,[28] investigates the reasons why West Virginia consistently ranked near or at the bottom of average income and why its policies have been hostile to capitalism. The particular genius of the approach of *Unleashing Capitalism* is the observation that residents of West Virginia have not just ranked lower in average income across the state when compared to other states, but that residents in the counties of West Virginia that lie immediately across the border from Virginia or Kentucky have lower incomes than people who live in almost identical environments.

Economic freedom is the key to growth, development, happiness, and well-being, indeed to supporting the very system of political freedom itself. This is why it is so important to measure economic freedom.

In addition to income levels, Sobel and his co-authors illustrate the different levels of economic growth and investment that appear to halt magically at the West Virginia border. By applying the fact of varying economic freedom across state boundaries, Sobel et al. have confirmed that incomes are lower where economic freedom is lower. The dramatic illustrations of *Unleashing Capitalism* recall the vivid differences that Julian Simon illustrated between the free and unfree peoples of South Korea and North Korea, or West Berlin and East Berlin, or Taiwan and China—what Andrew Bernstein has called "the great laboratories of capitalism and socialism."[29]

In sum, scholars are beginning to produce a rich literature describing the empirical connection between economic freedom and various measures of economic performance. Recent work has even suggested that scholars can measure the higher levels of aggregate happiness that accrue to those who experience higher levels of freedom.[30] As more scholars work in the field, we are confident that the details will bear out the more general conclusions that we draw here in this index—that economic freedom is the key to growth, development, happiness, and well-being, indeed to supporting the very system of political freedom itself. This is why it is so important to measure economic freedom.

The next chapter explains the methodology and indicators used to create the economic freedom ranking across the 50 U.S. states.

Chapter 2. The Methodology and Indicators

LAWRENCE J. MCQUILLAN, PH.D.,
AND MICHAEL T. MALONEY, PH.D.

The *U.S. Economic Freedom Index* was the first index to measure economic freedom in the 50 U.S. states beginning in 1999. It is also the most comprehensive assessment of economic freedom on the market today. Our goal is to measure economic freedom in the 50 U.S. states using the methodology from the 1999 and 2004 editions but applying up-to-date data that reflect changes in state policies since the previous edition.

The *U.S. Economic Freedom Index* was the first index to measure economic freedom in the 50 U.S. states beginning in 1999. It is also the most comprehensive assessment of economic freedom on the market today.

We collected and ranked 143 indicators comprised of 209 underlying variables from five sectors for each state. Indicator data are the actual observations of specific laws or freedoms. These data are generally of two types.

First, we might have a continuous indicator that is either ordinal or cardinal. Minimum-wage laws are an example of a continuous cardinal indicator. The higher the minimum wage, the greater the infringement on the right to contract and the less economic freedom. Second, we might have a discrete indicator. The existence of a law requiring individuals to attend public school would be a zero-one indicator, where states with a law requiring public education would be coded with a one—less freedom. Some states might have licensing restrictions on some trades or services, say barbers. Here the indicator is either off or on, 0 or 1. In this example, the indicator 1 would denote regulation of barbers and imply a restriction on the right to contract and less economic freedom for individuals in that state.

There is unavoidable redundancy in some indicators, but this is only an issue to a limited extent. Multiple indicators, just like mean, variance, skewness, and kurtosis in statistics, pick out minor nuances of data and act to stress the little things that are different. In the end, we do not think that redundancy creates a problem for our measurement. Indeed, since we are using these indicators to rank the states ordinally, it is not an issue at all. Appendix A lists the indicators by sector: fiscal, regulatory, judicial, government size, and welfare spending.

After the indicator data were collected and put into sectors, they were scored and ranked. The state with the freest indicator was assigned the rank of 1 (the most freedom). The state with the least-free indicator was ranked 50. Some indicators are either on or off, such as regulation of barbers or embalmers. In these cases, we assigned a value of 1 to the states without regulation; the other states received a rank equal to 1 plus the number of the states without license. So if 16 states do not require embalmers to be licensed and 34 do, 16 states are ranked 1 and 34 states are ranked 17.

In other cases, there might be a license required to practice an occupation in one state based on a lengthy education or training program, a certificate required in another state based on filling out a form and paying a required fee and waiting for the certificate, and no regulations in a third. Here we assigned a score of 50 for the licensed states, 25 for the certificate states, and 1 for the unregulated states. There are a few cases where we used rankings created by others. An example would be "strictness of gun laws." Here we took rankings from the relevant index.

After the indicators were grouped into sectors, ranked, and averaged for each state, subjective and objective sector-weighting methods were applied to build 35 unique indexes with a separate overall score for each state. These 35 indexes competed with each other to explain net population migration rates for the 50 U.S. states from 2003 through 2007. The explanatory capacity of each index was tested using regression analysis and the best index was chosen as the final index.

THE SECTORS

For the purpose of the index, we assumed that all relevant economic-freedom indicators in every state are greater than the levels needed for a "minimal state" to provide the rule of law necessary for high levels of economic freedom to flourish. As a result, for example, jurisdictions that tax relatively more are less economically free.

THE FISCAL SECTOR (51 INDICATORS)

Taxation is a government infringement on free markets and private property rights. Taxes alter markets by changing the relative prices of goods and services and by generally creating deadweight losses to social welfare. Taxes alter not only people's current choices, but also their future choices. Additionally, legal and illegal tax-avoidance activities consume resources.

Taxes, therefore, have tremendous direct and indirect effects on the free use of individual wealth. We collected data on the most recent revenues and rates of taxation. The higher the tax rates and tax revenues, the more that government is violating economic freedom.

THE REGULATORY SECTOR (53 INDICATORS)

Government regulation imposes restrictions on people's behavior. Governments enact regulations to maintain social order or achieve certain stated purposes, usually touted as promoting the general welfare. This report is not concerned with the purpose of regulations, but with the reality that they affect the free allocation of private resources, thus reducing economic freedom. Examples include mandatory regulations on labor, education, and the environment, to name a few. There are also a few regulations that preserve and extend economic freedom such as right-to-work laws.

THE JUDICIAL SECTOR (22 INDICATORS)

Ideally, the judiciary is "extra-market," meaning it is outside the market realm and acts as an impartial referee to resolve disputes arising from market interaction. The judiciary provides the "rule of law" necessary for economic freedom to flourish—these are the restraints and restrictions we place on our own freedoms ultimately to achieve a safer and more prosperous civil society.

But in reality, the judiciary is not always effective and rarely perfect. An inappropriate system might encourage frivolous lawsuits and expose individual assets to a higher risk of unreasonable confiscation.[31] The medical-liability crisis is an example.

According to the American Medical Association, the nation's medical-liability system is broken. Escalating jury awards and the high cost of defending lawsuits are driving liability premiums through the roof. In response, physicians are choosing to limit services, retire early, or move to states with reforms. As they see it, a crisis exists in many states and it threatens patient care in states without liability reform.

Access to the court system is a basic freedom under the rule of law. Unbridled economic punishment is not. Access to the courts to redress contract and tort grievances is a basic economic freedom. Is a courthouse with a wide-open door, however, a free place? Clearly, more empirical guidance is needed here. We include as an indicator whether the state is in a health-care crisis to show how adversely the judicial system can affect economic freedom.

Common provisions of state laws on medical-liability reform such as mandatory minimum liability insurance and damage caps are included. Minimum insurance requirements are a restriction imposed by governments on physicians, but as one of the liability-reform measures, we categorize it as extra-market and part of the rule of law that provides the foundation for market exchange and economic freedom.

In states with mandatory insurance, physicians found negligent generally have less risk that their assets will be depleted, and injured parties are assured payment of damages. Damage caps can be an effective way of stabilizing liability premiums by prohibiting excessive damage awards. It is assumed, therefore, that states with these statutes are freer than those without.

We also include more indicators on tort reform, the number of lawyers, compensation for judges and attorneys general, and judges' terms. It is not easy to interpret these indicators, in part because the judiciary is structured to divorce judicial action from economic incentives. We assume states with tort reform are freer than states without tort reform; and states with fewer lawyers, shorter terms, and higher compensation enjoy more economic freedom.

THE GOVERNMENT-SIZE SECTOR (7 INDICATORS)

Without enforcement machinery, a government tax code or regulation is just so many words on paper. The government can create all the rules and regs it wants to, but little economic freedom is lost without oversight and enforcement. We include the government-size sector as a measure of the state government enforcement machinery (people, capital, and money) used to enforce government infringements on economic freedom.

Without enforcement machinery, a government tax code or regulation is just so many words on paper.

The proper role of government is to enforce rights through the rule of law. We assume that every state has instituted more government than is required to provide this minimal state to enforce the rule of law. A larger government size, therefore, implies less economic freedom. We include indicators such as the number of government units and the number of government employees as indicators of government size.

THE WELFARE-SPENDING SECTOR (10 INDICATORS)

Welfare programs are intended to improve the living standards of some people by transferring money from one group to another. We singled out this government spending as its own sector because we believe it is the most egregious violation of economic freedom: resources are forcibly transferred from one private individual to another without anything given in exchange and no tangible public asset produced. We include indicators measuring expenditures or payments for Food Stamps, Social Security, Medicare, and other programs.

We believe it is the most egregious violation of economic freedom.

Note that we are not concerned about the wisdom, merit, or purpose of these government programs. Our concern is that they are financed by the involuntary transfer of private assets; therefore, they reduce economic freedom. The indicators we chose measure how much money is redistributed through direct transfers, and reflect the degree of lost economic freedom.

ABOUT THE DATA

We collected data on each indicator for each of the five sectors. We used the most recent data available for each indicator. From these, sector scores were calculated. These were then used to compute various indexes, which were evaluated and one chosen as best. Details of this process are reported in this section. For the sake of continuity, the indexes were constructed using the same methodology as the 1999 and 2004 editions. Indicator data were collected for each state across 143 indicators.

Appendix A lists the indicators by sector. The data are available at http://special.pacificresearch.org/pub/sab/entrep/2008/Economic_Freedom/.

THE CATEGORIZING AND WEIGHTING

As noted above, data were collected and put into five sectors: fiscal, regulatory, judicial, government size, and welfare spending. We chose to group the indicators by sector rather than treating every indicator separately, since this method allows us to see quickly in which areas a state is strong or weak. Sector scores were created by averaging the indicator ranks (1–50) in each sector for each state. The regulatory and fiscal sectors included 53 and 51 indicators, respectively, while the remaining three sectors consisted of fewer indicators.

Next, five data sets were created. They differ from each other in that some redundant indicators were dropped and some indicators were grouped into subcategories to create cleaner, more refined data sets. A detailed description of these data sets is in appendix B.

The judgment involved in this process is subjective, but the purpose is to weight sectors and construct indexes in many different ways since there is no absolutely correct method. Sector scores are calculated using each of the five data sets, and weighted using various subjective and objective techniques. The final index was built by weighting the five sector scores and adding them together.

A total of 35 unique indexes were created. The best index was selected based on an objective criterion: ability to explain net population migration rates in the 50 U.S. states from 2003 through 2007.

THE SUMMARY DETAILS OF REDUNDANCY PARSING

We chose to eliminate some nearly duplicate indicators. For example, there is a strong redundancy in tax rates and total taxes. We parsed some obvious duplicate indicators across sectors into a more concise and less duplicative representation of state economic freedom.

Our procedure for eliminating redundancy was empirical and involved a step function. First, we eliminated some redundancy by averaging similar indicators within a group, usually two or three, but sometimes more. Starting from what we call the "full house," data set 1 with 143 indicators, we constructed data set 2 by cutting and averaging some indicators, reducing the number from 143 to 127. For data set 3, only 47 indicators were used. Most of the indicators are averages of groups of indicators that are closely related.

Data set 4 is a variant of data set 2 with one important distinction. In a Friedmanian sense, it can be argued that tax rates and government expenditures are better measurements of the loss of economic freedom than are tax revenues.

As this argument goes, government expenditures are a better measure of the control or intervention by the government in the economy than tax receipts because the government can borrow money, which implicitly taxes future generations, if not the current one, and results in less capital for private-sector investment. So expenditures are a more complete measure of government control over the economy than tax revenues.

Government expenditures are a better measure of the control or intervention by the government in the economy than tax receipts because the government can borrow money.

Nevertheless, current tax rates are important because they directly affect behavior by changing relative prices. So data set 4, which leaves out tax revenues in favor of government expenditures and tax rates, is based on the argument that these indicators give a truer picture of the control by government over the economy.

Hence, where there were suitable alternative indicators, indicators of the magnitude of tax revenue were replaced. Data set 5 is constructed from data set 4 using the same method that was applied to data set 2 to generate data set 3. The details are reported in appendix B.

Data set 4 turned out to be the best and most appropriate set of indicators, consisting of 116 indicators constructed by engaging in the following steps:

- Several redundant indicators dealing with sales, excise, license, and corporate and personal income taxes were removed.
- Since there is a high correlation between taxes and expenditure, few of the state and local expenditure indicators were not used.
- The number of indicators in the fiscal sector was thus collapsed from 51 to 35.
- In the regulatory sector, occupational-licensing and education-requirement indicators for each profession were averaged into three indicators instead of considering them separately.
- The regulatory sector ended up having 50 indicators.
- In the judicial sector, multiple indicators on each of judges' salaries, term lengths, and selection methods were averaged and reduced.
- Similarly, medical-liability reform was reduced from three to one.
- In total, the judicial sector was compressed to 17 indicators.
- No new indicators were constructed for the government-size sector and welfare-spending sector. They were constructed with six and eight indicators, respectively.

THE FINAL INDEX CONSTRUCTION AND SELECTION

Using each data set, we constructed each index using the following process: first, sector scores were computed for each state by adding together the ranks it earned on each indicator within a sector and calculating an average sector score. Second, the overall index score was created by adding together the weighted sector scores. We used both subjective and objective methods to weight the sector scores. Besides giving arbitrary weights (for instance, equal weighting), two statistical methods were used.

The first regressed the net population migration rate on the five sector scores to see their relative significance in explaining population movement. The weight for each sector is the ratio of its coefficient to the sum of all five coefficients. The coefficients for the five sectors were each negative, suggesting less freedom (higher scores) in any of the five policy areas is connected with less in-migration.

The second statistical method for weighting the sector scores was principal components analysis, a weighting technique used for years in political science. A principal component is a linear combination of the explanatory variables (in our case the sector scores) that captures as much of the variation across states in the scores as possible, subject to a "normalization condition."

Principal components analysis extracts from the data the true sources of variation among the states by more heavily weighting those sectors that varied most, that is, those sectors where the states differed most. The analysis gave greater weight to sectors that had more useful information relative to sectors with less useful information. By giving greater weight to sectors with more variability, finer distinctions were clearly drawn since states differ most in those sectors.

By giving greater weight to sectors with more variability, finer distinctions were clearly drawn since states differ most in those sectors.

The analysis assigns coefficients to each sector score so that a principal component is created. There are as many principal components as there are explanatory variables (a first principal component, a second principal component, etc.; five in our case). The coefficients are chosen to maximize the variance of each respective principal component, capturing as much of the total variation in the explanatory variables (sector scores) as possible. The normalization condition applied to the coefficients is that the sum of their squares must sum to one. The coefficients are divided by their sum to create sector weights that also sum to one.

Each principal component is uncorrelated with the others (mutually orthogonal), and each succeeding principal component accounts for as much of the variation in the explanatory variables as possible that was unaccounted for by preceding principal components. The variance of the first principal component usually captures the major portion of the total variation of the explanatory variables.[32]

Armed with these many differently weighted indexes using different data sets, we chose as the best metric of economic freedom the index with the greatest statistical link to net population migration rates for the 50 U.S. states.[33] Migration rates are the sum of the net number of people migrating into a state from 2004 through 2007, divided by the state's population in 2003.

In the jargon of econometrics, the index we chose as best yielded the highest R-squared among those equations having an index coefficient t-value significant at the five-percent level or greater. This procedure selects the best, or final, index empirically, and it conforms to the proper statistical methodology for choosing among two or more equally plausible specifications.

The best index was Index4A, constructed by weighting data set 4 using the first principal components weights. The final indexes in 1999 and 2004 were also weighted using principal components.

Not surprisingly, the net migration rate for the 20 freest states was 27.36 people per 1,000, while it was a shockingly low 1.17 people per 1,000 for the 20 most economically oppressed states. People are moving to the freest states and fleeing the least-free states as our market-based migration metric of economic freedom predicts. Index4A was statistically significant and negatively related to net migration, that is, a lower index rank implies more economic freedom, which leads to more net in-migration.

People are moving to the freest states and fleeing the least-free states as our market-based migration metric of economic freedom predicts.

For every one-place index ranking improvement, a state's net migration per 1,000 people typically increases about one person. This means that in Michigan, for example, a one-spot improvement in its economic freedom ranking would result in a net increase of about 10,000 people to the state—much needed workers, consumers, investors, and entrepreneurs.

The sector-score weights used to compute the final 2008 index score for each state were:

INDEX = (0.2313 × FISCAL SCORE) + (0.2159 × REGULATORY SCORE) + (0.1894 × JUDICIAL SCORE) + (0.1208 × GOVERNMENT-SIZE SCORE) + (0.2426 × WELFARE-SPENDING SCORE)

These sector weights were similar to the sector weights that we found by using regression analysis directly on the sector scores.

The principal components' weights are themselves revealing. The fiscal, regulatory, and welfare sectors are nearly equally weighted. The judicial sector and the government-size sector carry less weight.

We used net population migration rates for the 50 U.S. states to select the final index because freedom is best viewed through the eyes of the beholder.

The approach taken here appears agnostic on the surface, but is actually a market-based definition. Our technique creates freedom indexes and then searches across them, finding the one that best maps into actual human behavior that is arguably driven by freedom.

If we see people climbing the Berlin Wall, swimming the Florida Straights, or applying for visas to live in the United States, we can, to some extent, claim that these people are "in search of freedom." Therefore, we adopted a migration metric for economic freedom. If people are moving from one state to another, other things equal, we assert and believe that this is a market-based response to differences in freedom and perhaps the purest expression of individual responses to differences in economic freedom.

As President Ronald Reagan said, and we believe it is the essence of the correct way to measure freedom using market tests: "Mr. Gorbachev, open this gate! Mr. Gorbachev, tear down this wall!" What else could Reagan have meant except freedom is the right to live where one wishes. People define freedom by voting with their feet.

In summary, our method uses the classical approach of using our judgment and the scholarly literature to compile a list of relevant indicators of economic freedom. These indicators are then converted into a number of indexes using various techniques. We then compare each index to the others in terms of its ability to explain human migration, other things the same. The best index is then used to rank the U.S. states in terms of economic freedom.

Our index offers the clear advantage that it is evaluated in the marketplace, by people's actual decisions of where to live. Our technique works and measures what we want it to: relative economic freedom as seen through the eyes of ordinary people. We note that this approach is Rawlsian in nature.[34] If a system is just and fair, and people value these things, as we believe they do, then migration is a proper measure of one social implication of differences in economic freedom. [Appendix C provides point-by-point responses to critics and criticism of our methodology and the resulting index.]

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The next chapter presents the results of the statistical analysis and discusses in depth the economic freedom rankings across the 50 U.S. states.

Chapter 3. The Results

MICHAEL T. MALONEY, PH.D.,
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States are not homogeneous within their own borders with respect to economic freedom.

Table 2 on page 34 reports each state's unweighted sector scores and rankings (for reference, the order of the sector weights, from heaviest (1) to lightest (5), is in parenthesis). The table reveals that states are not homogeneous within their own borders with respect to economic freedom. For example, Alabama ranks second in the fiscal sector, but quite low in the government-size sector and the welfare sector, 36 and 27, respectively. Wisconsin ranks very poor in the fiscal sector, 49, but it does much better in government size, 9.

TABLE 2: SECTOR SCORES AND RANKINGS, 2008

	Fiscal (2)		Regulatory (3)		Judicial (4)		Government Size (5)		Welfare Spending (1)	
State	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank
Alabama	17.83	2	12.22	15	12.07	19	29.29	36	26.56	27
Alaska	24.63	30	12.89	24	12.07	19	26.57	31	38.78	49
Arizona	21.46	14	15.98	43	14.67	32	20.43	11	25.22	23
Arkansas	20.54	10	13.78	31	15.73	37	21.86	13	22.56	17
California	25.63	35	17.76	48	15.93	38	23.29	18	34.22	46
Colorado	19.17	6	12.47	18	10.67	11	16.71	6	15.44	4
Connecticut	29.11	45	13.27	29	17.47	43	21.86	13	29.33	35
Delaware	27.43	41	10.44	4	23.33	50	15.29	3	19.56	13
Florida	28.54	44	17.36	45	11.80	15	25.29	26	22.78	18
Georgia	18.57	3	10.76	6	11.93	17	30.71	38	23.22	20
Hawaii	21.34	13	14.49	38	14.87	34	16.14	5	29.22	33
Idaho	23.74	26	11.62	10	8.27	3	20.00	10	11.67	2
Illinois	27.17	40	11.18	8	14.33	30	28.29	34	26.11	26
Indiana	20.86	11	15.31	39	13.73	25	24.71	22	25.56	25
Iowa	23.06	23	12.44	17	11.73	14	29.14	35	25.22	23
Kansas	22.66	20	11.82	13	11.87	16	31.57	40	17.33	8
Kentucky	23.09	24	13.4	30	13.93	28	32.43	42	32.67	43
Louisiana	24.11	28	19.09	50	14.80	33	22.86	16	25.11	22
Maine	25.60	33	12.6	20	15.53	36	22.43	15	31.00	41
Maryland	28.11	43	13.22	28	19.87	47	25.29	26	22.89	19
Massachusetts	25.89	36	10.2	3	22.60	49	23.00	17	26.67	28
Michigan	25.60	33	13.84	32	14.33	30	33.00	45	30.78	40
Minnesota	26.20	38	14.24	36	10.13	10	27.86	33	26.78	29
Mississippi	18.94	4	11.82	13	8.33	4	34.00	48	27.44	30
Missouri	20.26	9	14.24	36	11.67	13	32.86	44	20.44	14
Montana	22.66	20	9.956	1	9.53	8	19.71	8	28.78	32
Nebraska	29.63	46	13.07	25	13.80	26	20.86	12	21.11	15
Nevada	26.71	39	11.64	11	10.07	9	10.71	1	15.67	5
N. Hampshire	19.77	8	12.71	22	13.07	21	24.57	21	17.78	9
New Jersey	31.46	50	16.64	44	13.067	21	32.571	43	27.44	30
New Mexico	22.26	18	15.47	41	18.2	46	23.857	19	33	44
New York	30.17	48	14.04	35	17.467	43	37.714	50	39.22	50
N. Carolina	26.09	37	13.89	33	16.267	39	31.714	41	24.44	21
N. Dakota	19.43	7	11.51	9	7.6667	1	25.143	25	29.22	33
Ohio	29.94	47	15.62	42	8.2	2	33.714	47	30.56	39
Oklahoma	21.51	15	12.4	16	8.4	5	29.714	37	16.11	6
Oregon	25.43	32	15.33	40	9.40	7	23.86	19	30.44	38
Pennsylvania	27.69	42	12.56	19	18.13	45	33.14	46	30.22	37
Rhode Island	23.83	27	17.56	46	21.80	48	13.57	2	37.56	48
S. Carolina	22.80	22	13.89	33	13.93	28	25.00	24	21.22	16
S. Dakota	16.57	1	10.89	7	12.00	18	17.14	7	16.56	7
Tennessee	23.69	25	10.64	5	13.60	24	26.29	29	31.56	42
Texas	24.51	29	18.67	49	13.87	27	37.43	49	18.44	10
Utah	20.86	11	10.13	2	8.73	6	15.57	4	19.00	12
Vermont	24.66	31	12.87	23	17.00	42	25.71	28	33.22	45
Virginia	22.09	17	12.67	21	16.93	41	31.14	39	13.11	3
Washington	21.91	16	11.67	12	13.47	23	27.43	32	34.89	47
W. Virginia	22.31	19	17.56	46	16.73	40	26.29	29	29.89	36
Wisconsin	31.37	49	13.11	27	11.13	12	19.86	9	18.78	11
Wyoming	19.09	5	13.07	25	15.47	35	24.71	22	9.22	1

TABLE 3. U.S. ECONOMIC FREEDOM INDEX, 2008

2008 Rank	State	Score	2004 Rank	1999 Rank
1	South Dakota	14.54	15	5
2	Idaho	14.81	4	1
3	Colorado	14.91	2	14
4	Utah	15.16	5	3
5	Wyoming	15.39	9	4
6	Nevada	15.70	12	20
7	Oklahoma	16.74	6	18
8	New Hampshire	17.07	7	6
9	Virginia	17.99	3	2
10	Kansas	18.06	1	10
11	Georgia	18.22	19	12
12	North Dakota	18.56	18	21
13	Montana	18.56	21	26
14	Arkansas	18.82	23	15
15	Missouri	18.90	10	13
16	Alabama	19.03	25	11
17	South Carolina	19.08	13	16
18	Wisconsin	19.15	38	37
19	Mississippi	19.28	28	9
20	Delaware	19.61	8	7
21	Arizona	19.78	11	25
22	Iowa	19.88	16	24
23	Indiana	19.92	14	22
24	Hawaii	19.92	35	39
25	Nebraska	19.93	20	23
26	Minnesota	20.92	44	43
27	Illinois	21.16	46	36
28	Florida	21.16	22	30
29	Tennessee	21.18	26	19
30	Oregon	21.24	29	41
31	Texas	21.32	17	8
32	Louisiana	21.36	40	31
33	Massachusetts	21.72	41	47
34	Maryland	21.73	27	35
35	Maine	21.81	30	42
36	North Carolina	21.87	24	17
37	Washington	21.92	31	40
38	West Virginia	22.55	32	32
39	Connecticut	22.66	48	46
40	Kentucky	22.71	39	29
41	New Mexico	22.82	37	28
42	Vermont	22.87	36	34
43	Michigan	23.08	34	27
44	Ohio	23.34	43	33
45	Alaska	23.38	33	38
46	Pennsylvania	23.88	45	45
47	California	23.89	49	44
48	New Jersey	23.94	42	48
49	Rhode Island	24.18	47	49
50	New York	27.39	50	50

Keeping in mind the weights used for the overall index, these results suggest that, for example, Virginia is better positioned than West Virginia in terms of economic freedom. Sector scores warrant additional scrutiny later. First, we turn to the overall U.S. economic freedom scores and rankings for 2008 as detailed in table 3 above.

Kansas topped the 2004 list but dropped to 10 in 2008.[35] South Dakota has assumed the lofty spot as the nation's most economically free state—it was 15 in 2004—followed closely by Idaho, Colorado, and Utah, all of which ranked well in 2004.

South Dakota has no corporate income tax, no personal income tax, no personal property tax, no business inventory tax, and no inheritance tax. In 2007, the Small Business Survival Foundation ranked South Dakota as the best business climate for entrepreneurs.[36] In 2008, *Forbes* magazine ranked Sioux Falls as the best smaller metro area for business and careers.[37] Rapid City, South Dakota, was ranked 7. (See chapter 4 for a discussion of the link between state economic freedom and city economic performance.)

In contrast, Pennsylvania, California, New Jersey, Rhode Island, and New York bring up the rear. New York retains the dubious distinction as being the most economically oppressed state since 1999. Some states such as New York, Pennsylvania, and Utah have been remarkably stable since 1999—preserving their relative status quo for good or for bad. Other states have been on the move.

Turning first to the states that made the biggest improvements in relative economic freedom from 2004 to 2008, we found that South Dakota advanced 14 places, but even better were Minnesota, Illinois, and Wisconsin, which jumped 18, 19, and 20 places, respectively. There is an economic-freedom renaissance in the Upper Midwest and it is no accident that they are all neighbors—when one state reforms, it puts pressure on its neighbors to improve or be at a competitive disadvantage for attracting people and capital.

There is an economic-freedom renaissance in the Upper Midwest.

There is some evidence of a tiny "Schwarzenegger effect" in California. Since 2004—his first full year in office—the Golden State's relative economic freedom ranking has improved by two places from 49 to 47—nothing to crow about, however.

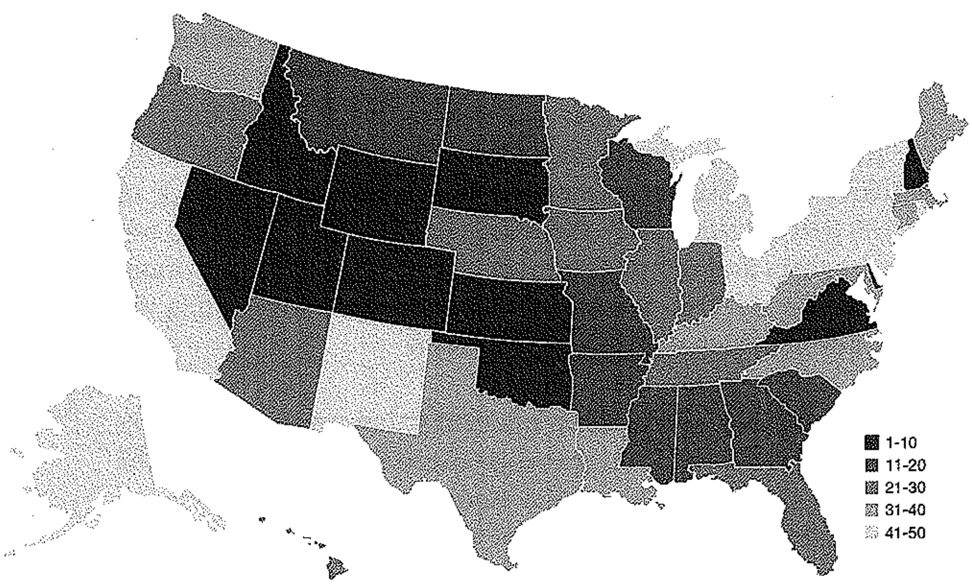
In contrast to the advancing states, Texas fell 14 spots; Alaska, Delaware, and North Carolina each dropped 12 spots; and Arizona fell 10. These states are headed in the wrong direction.

Figure 2 on page 37 plots economic freedom from coast to coast, and distinct patterns emerge. The Great Plains and Rocky Mountain states, colored in darkest green, have the most economic freedom. New Hampshire persists in defying the pattern in the Northeast. Maybe there is something to their motto "Live Free or Die." Virginia stands as a citadel of economic freedom in the South, which overall performs fairly well, but likely not as well as most people would expect.

Virginia stands as a citadel of economic freedom in the South.

The states with the least economic freedom, colored in lightest green, are clustered in the Northeast plus Alaska, California, and New Mexico. The Upper Midwest has improved significantly since 2004, the obvious exception being Michigan.

FIGURE 2. U.S. DISTRIBUTION OF ECONOMIC FREEDOM, 2008



POLICY CHANGES, 2004–2008

To discern changes in the rankings of individual indicators, we calculated the square of the difference between a state's previous ranking and its current ranking for each indicator, and summed over all 50 states. This sum is an approximate measure of overall variation in ranking pattern for an indicator. We then repeated this procedure for each quantitative indicator, and then compared the sums to find which indicators had the most variation in rankings across the states from 2004 to 2008.

In the fiscal sector, excise taxes on gas, state sales taxes, and individual income taxes had the most variation. Among indicators in the regulatory sector, school choice and weapons crime index had the most variation. The medical-liability-crisis indicator and most of the welfare indicators also had large variation from 2004 to 2008.

Below we give a flavor for some specific state policy changes in recent years that have improved or worsened a state's economic freedom rank.

- Higher tax rates and tax revenue reduce economic freedom by distorting relative prices and confiscating private resources for government use. New York increased an assortment of taxes since 2003 including personal income and unemployment. Also, the excise tax rate on gas increased much more in New York compared to the national average. Though it reduced its property-tax rate and capital-gains tax rate some, its overall performance in the fiscal sector remained quite low. New York stayed at the bottom of the barrel, ranking 48 in the fiscal sector and dead last overall.

High-income earners in New York faced the greatest increase in tax burden, up $2,300. Once again, New York remained at the bottom of the barrel.

- Twenty-five states increased tobacco excise taxes from 2004 to 2008. Iowa, Maine, Maryland, and Wisconsin increased their excise tax per pack of cigarettes by 100 percent since 2004. Wyoming, on the other hand, did not change any excise taxes and reduced indirect income taxes and corporate-tax rates; so, in the fiscal sector, Wyoming jumped from 35 to 5, and in the overall index it jumped from 9 in 2004 to 5 in 2008.

- Florida, New Jersey, and Ohio raised dramatically their motor fuel levies since 2004. In Florida, the levies increased by more than 100 percent; the excise tax for diesel also rose a substantial amount—Florida's ranking fell 38 spots. Surprisingly, the gas tax rate did not vary much in the above mentioned states.

- The tax burden on high-income people fell from an average across all 50 states of $14,453 per high-income family in 2004 to $13,854 in 2008. Connecticut had the greatest reduction in high-income tax burden, followed closely by New Jersey and Iowa. California, Colorado, and Oregon imposed higher tax burdens. High-income earners in New York faced the greatest increase in tax burden, up $2,300. Once again, New York remained at the bottom of the barrel.

- In the judicial sector, most states increased the number of active attorneys, which we coded as a reduction in economic freedom due to the greater threat of frivolous lawsuits and higher excessive tort costs. New York had the greatest increase of 7,491, followed closely by California with an increase of 6,562. In the judicial sector, New York ranked low at 43 and California was 38. On the other hand, North Dakota, where the number of attorneys increased by only 71, secured the top spot.

CHANGES IN ECONOMIC FREEDOM, 2004–2008

To understand better how the states performed in the different sectors in 2008 compared to 2004, we looked at the variation in sector-score rankings of states to see which states experienced the most changes in each sector over time:

- In the fiscal sector, the rankings of 24 states went up, and 22 states went down. The most remarkable changes were Washington up from 36 to 16, and Florida down from 20 to 44.
- In the regulatory sector, the rankings of 21 states went up, and 24 states went down. Illinois rises from 48 to 8, and South Carolina goes down from 5 to 33.
- In the judicial sector, the rankings of 23 states went up, and 24 states went down. Utah goes up from 48 to 6, and California goes down from 3 to 38.
- In the government-size sector, 26 states improved their rankings, and 23 states lowered their rankings. The most notable change is Montana ascending from 45 to 8, and Texas descending from 19 to 49.
- In the welfare-spending sector, 29 states went up, and 19 states went down. Compared to the other sectors, variations are less extreme. Louisiana is up from 45 to 22, and Oregon is down from 16 to 38.

Table 4 summarizes the changes in sector rankings over time.

TABLE 4. SECTOR-RANK CHANGES, 2004–2008

Sector	States Up	States Down	Salient Examples
Fiscal	24	22	Washington (36 to 16), Florida (20 to 44)
Regulatory	21	26	Illinois (48 to 8), South Carolina (5 to 33)
Judicial	23	24	Utah (48 to 6), California (3 to 38)
Government Size	26	23	Montana (45 to 8), Texas (19 to 49)
Welfare Spending	29	19	Louisiana (45 to 22), Oregon (16 to 38)

Finally, we compared the sector scores in table 2 vertically to discern regional patterns within sectors. Generally, as was also the case in 2004, the Northeast suffers the most infringement of economic freedom. This pattern is especially evident in the fiscal, regulatory, and welfare-spending sectors, the sectors that mattered most in our final index ranking. Table 5 shows sector rankings for six Northeastern states.

Generally, as was also the case in 2004, the Northeast suffers the most infringement of economic freedom.

TABLE 5. SECTOR RANKINGS OF NORTHEASTERN STATES, 2008

State	Fiscal	Regulatory	Welfare Spending
New York	48	35	50
Massachusetts	36	3	28
Rhode Island	27	46	48
Connecticut	45	29	35
New Jersey	50	44	30
Pennsylvania	42	19	37

Another notable state is California, which ranks 35 in the fiscal sector, 48 in the regulatory sector, and 46 in the welfare sector in 2008, continuing its low performance from 2004. These rankings put California at a distinct competitive disadvantage compared to its neighbors (see figure 2).

Though the Northeastern states still perform poorly in 2008, their relative rankings improved from 2004 in 10 of the 18 sector cells above. There is a faint glimmer of hope that these states are finally moving to unshackle their economies, albeit at a snail's pace.

That the nation's most densely populated states are also some of the least economically free is consistent with leading economic theories of the determinants of government intervention in markets.

IMPLICATIONS FOR THE FUTURE

The 2008 *Index* rankings will provide a good forecast of which states will prosper, and which will falter, in the year or two ahead. Our index is a good predictor, as the 2004 *Index* results confirmed.

In 2005, per-capita personal income grew 31 percent faster in the 15 most economically free states (as determined by the 2004 *Index*) than it did in the 15 states at the bottom of the list.[38] And employment growth was a staggering 216 percent higher in the most free states.

In 2005, the 15 states with the most economic freedom saw their general fund tax revenues *grow* at a rate more than 6 percent higher than the 15 least free states, despite their lower effective tax rate. Taxpayers paid 14 percent less in effective tax rates in 2005 in the most economically free states than did the taxpayers in the least free states. Effective tax rates are based on what people actually pay after deductions, exemptions, and credits.

Census data showed an astounding 245-percent difference in net state-to-state migration rates in 2005 between the freest states (net inflow) and least-free states (net outflow). "Live Free or Move" is fast becoming the national motto. The 2008 *Index* will be a good predictor of future state economic performance. Economic freedom, and its surrounding issues, will also impact future political developments.

In 2008, the uniquely wide-open race for president has sharply focused Americans' attention on economic issues from immigration to the mortgage crisis, from the price of oil to the outsourcing of jobs, from free-trade agreements to farm subsidies. The conclusion is inescapable—economic issues provoke our interest and divide Americans in important ways.

We believe the conclusions of this study can make an important contribution to the debate. As Americans ponder the source of their prosperity or their hard times, they would be well advised to look beyond their local jurisdictions. Is it like this everywhere? Why or why not? If residents of Ohio are upset that there have been significant job losses and economic hard times in their state, should they consider whether the boom in Nevada has any relation to it?