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Formal and informal constraints on state government and economic freedom

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Abstract

Both formal and informal institutions can limit collective action. In the US context, there is a large literature on formal and informal institutions at the state level. The focus of this literature has generally been on whether these institutions constrain fiscal policy. Fiscal constraints on government activity are consistent with economic freedom, although economic freedom is a much broader concept. There is also a growing literature on the determinants of economic freedom. In this paper, we use data from 1983-2013 to quantify the extent to which formal and informal institutions can help explain the level of economic freedom across states. Our findings indicate that divided government and ideology can both constrain fiscal policy.

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1 Introduction

Several papers have espoused the benefits of economic freedom at the national and sub-national level. In most cases economic freedom is on the right hand side of a regression explaining economic growth, entrepreneurship, etc. (Hall and Lawson, 2014). More recently, scholars have looked at the determinants of economic freedom (Lawson et al., 2020).

US states have formal and informal institutions that constrain fiscal policy. Formal institutions are rules that are established and enforced through official channels. Informal institutions are rules established through emergent order, and enforced through unofficial channels (North, 1991). Formal fiscal constraints include statute or constitutional rules about balanced budgets. Informal constraints such as divided government emerge out of the decisions of citizens. Both formal and informal constraints may be intended to limit the power of government consistent with economic freedom (Calcagno and Lopez, 2012; Hou and Smith, 2010). The question remains as to which constraints are correlated with economic freedom. Using data from 1983-2013 we examine whether these formal and informal constraints affect a state’s economic freedom.

Our approach in this empirical note builds off the work of Bjørnskov and Potrafke (2013) who argue that divided government can counteract ideological policymaking. Here we argue it is an informal constraint that emerges from the choices of citizens at the ballot box (Calcagno and Lopez, 2012, 2017). Specifically, formal constraints are designed to limit the power of specific policy makers often with respect to fiscal issues including limiting spending or taxation (Alt and Lowry, 1994; Poterba, 1995). In this paper we add formal constraints to the informal measures from Bjørnskov and Potrafke (2013) to see how both formal and informal constraints are associated with economic freedom.

2 Data and Empirical Approach

We model our paper after Bjørnskov and Potrafke (2013) using state-level data from 1983-2013. Economic freedom is the extent to which a regions policies are consistent with the ability of individuals to use their property and talents free from governmental interference. The *EFNA* index places the concept of economic freedom within the classical liberal tradition that emphasizes the importance of private property, free trade, and a limited role for government. The *EFNA* measures economic freedom from zero to ten with ten being the most economically free. Higher scores are accorded to states with lower taxes, less interference in labor markets, and smaller state government. Variation in economic freedom across states exists, with scores ranging from 4.24 to 8.5 in our sample. States also change over time, for example Indiana went from 5.76 in 1981 to 6.95 in 2017.

To examine the effects of these constraints on economic freedom we test the following model:

$$EFNA_{it} = \alpha_0 + \beta_1 \mathbf{X}_{it} + \gamma_2 \mathbf{Z}_{it} + \eta_j + \epsilon_{it} \quad (1)$$

Here $EFNA_{it}$ indicates economic freedom for state i at time t . We control for economic and demographic characteristics and formal and informal constraints. The matrix \mathbf{X}_{it} represents

economic and demographic characteristics, the \mathbf{Z}_{it} matrix is made up of our formal and informal constraints. Some of our constraints are time-invariant so η_j represents j regions and not state fixed effects. We use the nine US Census Divisions (New England, Middle Atlantic, East North Central, West North Central, South Atlantic, East South Central, West South Central, Mountain, and Pacific) as our regions.

In terms of demographic and economic controls, we include real per capita income (*Income*) and the state unemployment rate (*Unemployment*), both lagged by a year. We control for income inequality (*Gini*), the % of citizens over age 65 (*PctPop65*), % African-American (*PctBlack*), % female (*PctFemale*), and college attainment rate of those 25 and older (*College*). The % of the population that is employed by the state government (*PopGov*) is included to account for the impact of this large interest group on the electoral process. Both the citizenry of a state and its government can have an ideological leaning, and they can be independent of one another. We account for the ideological difference between the government and citizens ideology (*IdeologyDiff*) obtained from Berry et al. (2013) and following the methodology of Calcagno and Lopez (2012) of taking the squared difference between the citizen and government ideology indices. Both indices range from 1100 with higher values implying a more liberal ideology. The variable is constructed using roll-call votes and congressional election outcomes.

Our formal constraint measures consist of four variables intended to limit government. Our first is a dummy indicating whether a state has a tax and expenditure limit (*TEL*). TELs came into existence in the late 1970s and by the early 1980s about a third of states had adopted a TEL. Their success in limiting taxation is mixed. Elder (1992) finds some initial success in reducing tax burden growth. Kousser et al. (2008), however, argues that TELs have become ineffective over time as state governments have turned to fees or borrowing. Another constraint is the balanced budget rule (*BBR*). Introduced over time, today all states but Vermont have some type of *BBR*. Poterba (1995) argues that strict or more complete budget rules are more likely to reduce deficits and create a balanced budget. While Poterba (1995) notes that there are variations in the balanced budget rules across states, this data has been updated irregularly (Hou and Smith, 2010) and thus our indicator is only a binary variable taking 1 if the state has a *BBR* in that year and 0 otherwise.

Our next two formal constraints limit the number of terms in office of the governor (*GovTermLimit*) or the state legislature (*LegTermLimit*). Term limits are designed to prevent career politicians, create more competitive elections, and limit the power of incumbents to grow government. The literature on term limits has shown them to be ineffective, however, in reducing government spending (Lopez, 2003; Escaleras and Calcagno, 2009).

Our informal constraints on state government are types of divided government. Rogers (2005) notes that in a two-party presidential system with a bicameral legislature there are eight distinct categories for unified and divided government. Due to limited or no observations in two of the possibilities (i.e., divided legislature with Republican governor and Republican control of upper chamber), we test the following six informal constraints:

1. unified Democratic (*UnifiedDem*)
2. unified Republican (*UnifiedRep*)
3. divided branch with a Democratic governor (*SplitBranchD*)

4. divided branch with a Republican governor (*SplitBranchR*)
5. divided legislature with a Democratic governor and Republican control of upper chamber (*SplitLegD*)
6. divided legislature with a Republican governor and Democratic control of upper chamber (*SplitLegR*)

Divided government is not like formal institutions such as (*BBRs*) and (*TELS*), which are designed to constrain government. Divided government is an undesigned byproduct of electoral politics (Calcagno and Lopez, 2012).

3 Empirical Results

In Table 1 we look just at the role of formal and informal constraints on economic freedom. Column 1 contains means and standard deviations for each variable. Column 2 introduces basic economic and demographic variables. The results show economic freedom to be a normal good, with lagged *Income* being positive and statistically significant.

Similarly, the older the population, the higher the level of economic freedom. Finally, the higher lagged *Unemployment*, the lower a state's economic freedom. These findings hold for all of our specifications. In Column 3 we add *PopGov* and *IdeologyDiff*. *PopGov* is not statistically significant, but *IdeologyDiff* is positive and significant. This suggests that the greater the difference between government and citizen ideology, the higher the level of economic freedom in a state.

In column 4 we add the formal constraints. Three of our four formal constraints are statistically significant. *TEL* and *BBR* are both statistically significant, but with opposite signs. *TELS* are associated with higher levels of economic freedom, while balanced budget rules lead to lower EFNA. *GovTermLimit* is positive and statistically significant, while *LegTermLimit* is positive but insignificant. This finding would seem to be inconsistent with the findings of Lopez (2003) and others regarding the effects of term limits.

Finally, in column 5 we add five measures of divided government (*UnifiedRep* is the excluded category). Four of our five divided government variables are negative and statistically significant, suggesting that compared to *UnifiedRep* four of five informal institutions are associated with lower levels of economic freedom. When we include all our variables, *TEL* is no longer statistically significant, while *College* is now positive and statistically significant. We also note that *Gini* is negative and statistically significant in Columns 3-5, suggesting greater income inequality is associated with lower economic freedom in a state.

Given that all of our formal and informal constraints are binary variables, comparison across them is straightforward. In terms of being associated with higher levels of economic freedom, *UnifiedRep* dominates *GovTermLimit* in magnitude. Using the coefficients from Column 5, governor term limits are associated with a 0.121 unit change in EFNA, less than one-fifth of a standard deviation. Compared to the excluded *UnifiedRep*, a unified Democratic state government is associated with a 0.352 unit change in EFNA, or about half

Table 1: Formal and Informal Constraints and Economic Freedom

Variable	(1)	(2)	(3)	(4)	(5)
PopGov	0.02 (0.01)		-13.32 (9.04)	-13.40 (9.01)	-12.50 (8.81)
IdeologyDiff	426.63 (454.43)		0.0002*** (0.0000)	0.0002*** (0.0000)	0.0002*** (0.0000)
TEL	0.49 (0.50)			0.0719** (0.0263)	0.049 (0.025)
BBR	0.96 (0.19)			-0.374*** (0.073)	-0.368*** (0.0675)
GovTermLimit	0.63 (0.48)			0.111*** (0.029)	0.121*** (0.028)
LegTermLimit	0.16 (0.36)			0.075 (0.039)	0.003 (0.039)
UnifiedDem	0.24 (0.49)				-0.352*** (0.037)
SplitBranchR	0.19 (0.39)				-0.366*** (0.045)
SplitBranchD	0.09 (0.29)				0.023 (0.048)
SplitLegR	0.07 (0.26)				-0.309*** (0.055)
SplitLegD	0.08 (0.27)				-0.246*** (0.053)
Lagged Income (1000s)	32.67 (7.42)	0.048*** (0.003)	0.048*** (0.004)	0.054*** (0.004)	0.060*** (0.004)
Lagged Unemployment	5.93 (2.05)	-0.098*** (0.008)	-0.104*** (0.008)	-0.100*** (0.008)	-0.092*** (0.008)
PctPop65	12.63 (2.02)	0.040*** (0.010)	0.044*** (0.009)	0.046*** (0.009)	0.055*** (0.009)
PctBlack	10.02 (9.39)	0.003 (0.003)	0.005* (0.002)	0.003 (0.002)	0.005 (0.005)
PctFemale	50.87 (0.88)	-0.017 (0.029)	-0.068 (0.037)	-0.069 (0.036)	-0.016 (0.037)
College	23.76 (8.13)	0.002 (0.002)	0.002 (0.002)	0.003 (0.002)	0.004** (0.002)
Gini	0.53 (0.06)	-0.511 (0.293)	-0.699* (0.278)	-0.838** (0.284)	-0.737** (0.278)
R-squared		0.442	0.485	0.506	0.548

Note: Dependent variable is *EFNA*. Column (1) contains variable mean with standard deviation in parentheses. Regional fixed effects included but not reported. *** denotes significant at 1% level; ** significance at 5% level; and * significance at the 10% level. The number of observations equals 1550. Results excluding Nebraska because its unicameral legislature are similar, except PctPop65 is no long statistically significant and legislative term limits become statistically significant at the 10% level.

of a standard deviation in EFNA. All of our remaining constraints are associated with lower levels of economic freedom.

4 Conclusion

While many studies have demonstrated the benefits of economic freedom, few studies have tried to explain economic freedom. We examine the association between formal and informal constraints on government activity and the level of economic freedom across U.S. states. Using data from 1983-2003 and a regional fixed effects model, we find results consistent with Bjørnskov and Potrafke (2013), namely that the informal constraint of divided government can be effective in constraining government so that there is more economic freedom. Four of our five divided government variables are negative and statistically significant, that compared to *UnifiedRep* four of five informal institutions are associated with lower levels of economic freedom. These results seem consistent with Potrafke (2018) and Hankins and Hoover (2019). The lack of informal constraints depend upon party control, with Republican legislatures being associated with higher levels of economic freedom. In addition, similar to Bjørnskov and Potrafke (2013) ideology does affect economic freedom.

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