Do Institutions Matter for Prosperity in Texas and Beyond?

by

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Updated **November 2018**

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Executive Summary

Texas' job creation success has often been called the "Texas miracle." However, a miracle implies the success came by coincidence and will be short-lived. The Texas miracle is neither. It is instead the result of consistent application of the principles on which this country was founded. For instance, while God may have blessed Texas with abundant natural resources that have contributed to prosperity, other U.S. states, like California and New York, also have large amounts of natural resources. The difference is that Texas allows its citizens to use those resources, whereas many other states do not. In addition, the success story has not been short-lived. **Table 1** provides a comparison of Texas with the U.S. average and the other three largest states in terms of population and economic output (i.e., California, Florida, and New York) for 14 key measures of competitiveness and standard of living over time.

Texas leads the pack in most of these measures.[1] While improvements are needed in Texas to make its business tax climate more competitive and spending lower, the Lone Star State generally has an institutional framework composed of relatively low spending and taxes, no personal income tax, and sensible regulation. Such a framework provides a high level of economic freedom that supports greater economic prosperity in almost all economic measures. Furthermore, measures of income distribution and poverty show that Texas has a more equal

Key Points

- The Texas Model of limited government provides an institutional framework supporting more prosperity than frameworks allowing a more interventionist government in comparable states and the U.S.
- The Texas Model can and should be improved to remain competitive and support greater prosperity by reducing and eliminating government barriers to competition.
- By making these improvements, Texas will continue to prove that the American dream is not dead, it has simply moved to the Lone Star State.

Table 1. Summary of key economic measures of the four largest states (in terms of population and economic output) and the U.S.[1]

MEASURE	U.S.	TEXAS	FLORIDA	CALIFORNIA	NEW YORK
Economic Freedom of North America (2018)	6th (World)	3rd	1st	47th	50th
State Business Tax Climate Index (2018)	--	15th	4th	48th	49th
State-Local Spending (2016)	--	37th	48th	6th	3rd
State-Local Tax Burden (2016)	--	46th	34th	6th	1st
Exports to Foreign Countries (2017)	--	1st	8th	2nd	4th
Avg. U-3 Unemployment Rate (2000-17)	6.4%	5.8%	6.3%	7.7%	6.2%
Avg. U-6 Underutilization Rate (2003-17)	11.6%	10.5%	12.0%	14.3%	11.1%
Avg. Labor Force Participation Rate (2000-17)	65.0%	66.1%	61.7%	64.6%	62.1%
Avg. Employment-Population Ratio (2000-17)	61.0%	62.3%	58.0%	59.9%	58.3%
Avg. Emp-Pop 25-54 year old Ratio (2000-17)	77.6%	77.3%	77.5%	75.2%	76.1%
Total Civilian Emp (12/07-12/17), exclude TX	+5,723,000	+2,024,000	+979,000	+1,564,000	+132,000
Total Nonfarm Emp (12/07-12/17), exclude TX	+7,424,000	+1,790,000	+728,000	+1,523,000	+804,000
Avg. Top 10% Income Shares (2000-15)	47.8%	47.0%	55.0%	50.2%	57.1%
Supplemental Poverty Measure (2015-17)	14.1%	14.7%	18.1%	19.0%	15.5%

Notes: Dates in parentheses are for publication year or data per measure. Data shaded in blue indicate "best" and in red indicate "worst" per category.

[1] Seasonally adjusted data from the U.S. Bureau of Labor Statistics are used throughout the paper unless noted otherwise.

income distribution and less poverty. Florida's limited government framework also supports a highly competitive economy with mostly positive economic outcomes. The lower shares of the total population in the labor force and of the employed is due to the fact that many people retire in Florida. Alternatively, the institutional frameworks of expansive, progressive governments with relatively high spending and taxes, redistributionary policies, and excessive regulation, like those in California and New York, support less human flourishing.

The evidence is clear: the institutional framework known as the Texas Model of limited government provides an economic environment that fosters more opportunities to prosper for entrepreneurs and all people. Other states and the federal government in D.C. would be wise to consider a similar institutional framework that champions individual liberty, free enterprise, and personal responsibility.

However, even in Texas there is room for improvement. Improvements to the Texas Model include reducing government barriers to opportunity by effectively—

- limiting the growth in government spending,
- eliminating the state's onerous business franchise tax,
- reducing barriers to international trade,
- reducing the escalating burden of property taxes, and
- relieving Texans from burdensome occupational licenses.

With these institutional improvements, Texas will continue to prove that the American dream is not dead. It has simply moved to the Lone Star State.

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Institutions Matter

Institutions matter for the structure and change of societies and economies throughout human history. These institutions are not just economic institutions such as capitalism and socialism that can determine the allocation of resources, but also social institutions such as families, charities, and churches that can support the needy, and political institutions such as democracies and authoritarianism that determine property rights and enforce contracts. Historically, people have opted for some combination of these institutions, creating frameworks covering a spectrum of freedom or serfdom with varying degrees of economic success.

A number of Nobel Prize laureates in economics have highlighted the importance of institutions.

Buchanan outlined in his 1986 Nobel Prize in economics lecture the importance of institutional rules, such as a constitution. These rules of the game help to decrease the likelihood that politicians, who act in their best interest just like the public, do not misallocate someone else's resources and ultimately cause government failure and resulting poverty. North noted in his 1993 lecture: "They [institutions] are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies" (1993, II). North expanded on this in his work: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic. Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change" (1990, 3). An institutional framework that allows individuals the best chance to prosper over time given these constraints is essential in a civil society. Specifically, Friedman, who won the Nobel Prize in economics in 1976, wrote in *Capitalism and Freedom* that "increases in economic freedom have gone hand in hand with increases in political and civil freedom and have led to increased prosperity; competitive capitalism and freedom have been inseparable" (ix).

More recently, Acemoglu and Robinson (2012) built on the importance of institutions by separating them into inclusive and extractive institutions. Inclusive institutions are political, like democracies, and economic, such as capitalism, which include "secure private property, an unbiased system of law, and a provision of public services that provides a level playing field which can exchange and contract; it also must permit the entry of new businesses and allow people to choose their careers" (74-75). On the other hand, extractive institutions include political, such as authoritarianism, and economic, like socialism, that "have opposite properties" to inclusive ones, "because such institutions are designed to extract incomes and wealth from one subset of society to benefit a different subset" (76).

Comparison of Four Largest U.S. States

Economists often assume *ceteris paribus*—all other factors remaining constant—to simplify the world when constructing models; but all else is never constant in the dynamic real world, leaving many models incomplete. Given that the system of federalism in the U.S. provides an opportunity for each state to devise different policies within a federal institutional framework of laws, fiscal policy, monetary policy, regulations, foreign trade policy, and other rules, this system provides a laboratory of competition among states to set their own institutional framework where all other factors are closer to remaining constant. This allows for an examination of each state's economic results to determine which policies may support more prosperity than others.

Demographics also play a part in states' economic institutions and results; therefore, it is important to compare states that are as similar as possible to provide less biased comparisons, *ceteris paribus*. The four largest states in terms of population and real (inflation-adjusted) private gross state product (GSP) in 2017 are California with 39.5 million residents and $2.1 trillion, Texas with 28.3 million residents and $1.4 trillion, New York with 19.9 million residents and $1.2 trillion, and Florida with 21 million residents and $743 billion (Census Bureau 2018a; Bureau of Economic Analysis).

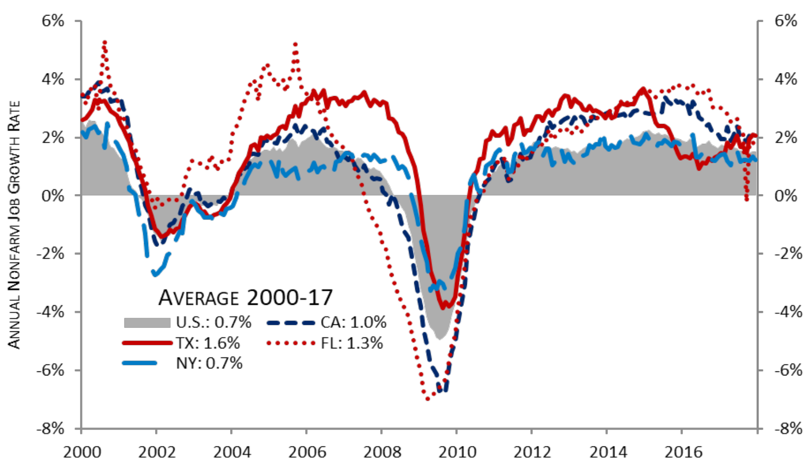
Countries or states with extractive institutions typically have less economic activity, more poverty, and a lower standard of living overall. Countries or states with inclusive institutions generally support more economic activity, less poverty, and a higher standard of living.

Ranking States in Economic Freedom

California, Texas, New York, and Florida tend to have very different institutions. Here are four metrics that account for the level of economic freedom and pro-growth economic environment for each of these four large states.

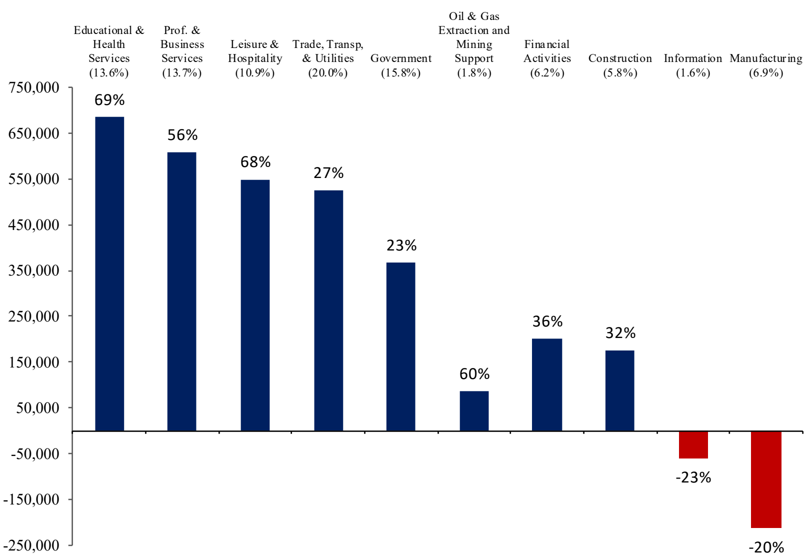
- *Economic Freedom:* Stansel et al. rank states' level of economic freedom based on the size of government, takings and discriminatory taxation, and labor market freedom. They find that Florida is the freest state and Texas ranks 3rd while California ranks 47th and New York ranks last (7). Over 230 scholarly articles by independent researchers have used this report to examine economic freedom at the state level, with the vast majority of this research finding that areas economically free from excessive government intervention overwhelmingly experience positive outcomes, including more economic prosperity (Stansel and Tuszynski). These findings support those found by Hall and Lawson regarding the association of good economic outcomes and freer countries in their similar but broader index for economic freedom globally, in which the U.S. ranks 6th most free (Gwartney et al., 8).
- *Business Tax Climate:* Walczak et al. provide another state comparison in their *2019 State Business Tax Climate Index* that is based on how well states structure their tax system. They find that Florida ranks 4th best, Texas 15th, California 48th, and New York 49th (3). The authors note that Texas' burdensome property taxes and onerous business franchise tax, otherwise known as the margins tax, hold the state back from moving up. For example, eliminating the margins tax could generate billions in new personal income and hundreds of thousands of new private sector jobs (Ginn, 13), as could eliminating property taxes (Hunker et al. 2015, 10).
- *State and Local Government Burdens:* Chantrill provides a comparison of state and local government spending per capita, the ultimate burden of government per state. In 2016, Florida's $8,052 spending per capita ranks as the 4th lowest burden, Texas' $9,218 ranks 4th, California's $12,852 ranks 45th, and New York's $16,122 ranks 48th. Alternatively, Malm and Prante calculate the state and local tax burdens as a percentage of state income for the fiscal year 2012—latest data available; they find New York ranks 1st with the highest tax burden, California 6th, Florida 34th, and Texas 46th (1).
- *International Trade Freedom:* Ginn et al. note the benefits of NAFTA to the Texas economy, including increased economic diversification from a broader market with Texas now being the nation's leader in exports for the 16th consecutive year (5-7). Comparatively, the Census Bureau (2018b) provides 2017 data for international exports in terms of dollars and share of U.S. total exports showing that Texas ranks 1st, California 2nd, New York 4th, and Florida 8th. These high rankings relative to other states are understandable because of the size of these four large states, but Texas' international trade flows have outpaced its size and other states, as trade flows of computer and electronic products and petroleum and coal products have rapidly increased (International Trade Administration).

Figure 1. Annual nonfarm job creation, 2000-17



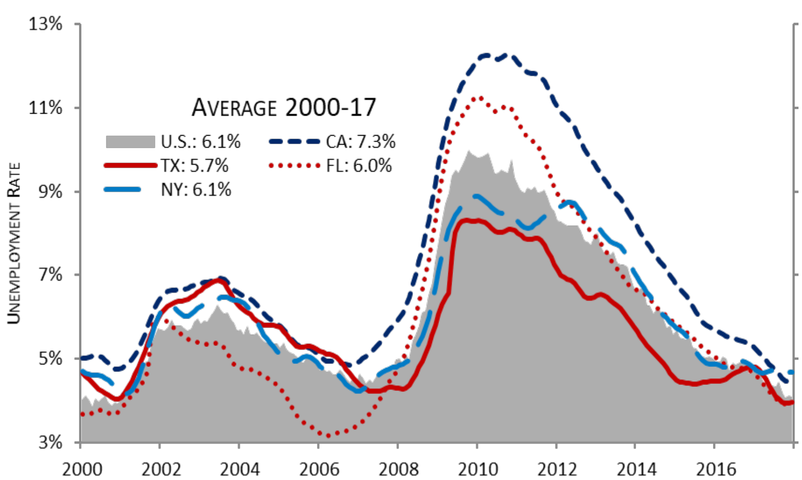
Source: Bureau of Labor Statistics

Figure 2. Job creation by sector in Texas, 2000-17



Note: Data are from the Bureau of Labor Statistics and numbers in parentheses are total shares of Texas nonfarm employment accounted for by each industry.

Figure 3. Share of labor force unemployed, 2000-17



Source: Bureau of Labor Statistics

These rankings indicate that California and New York tend to have more extractive institutions, as they rank the worst in economic freedom with the two highest top marginal personal income tax rates nationwide, high levels of government spending per capita, and burdensome regulations. Countries or states with these types of extractive institutions typically have less economic activity, more poverty, and a lower standard of living overall. On the other hand, Texas and Florida tend to have more inclusive institutions as they do not have a personal income tax, have relatively less government spending per capita, and more labor market freedom. Countries or states with inclusive institutions generally support more economic activity, less poverty, and a higher standard of living.

Economic Prosperity in Texas and Beyond

The most inclusive institutions tend to best reward people and create an environment that is conducive to prosperity for all. While multiple economic indicators may be considered in determining which policy outcomes most benefit the residents of these largest states, the best path to prosperity is through work. This section examines multiple labor-market measures, including the distribution of income, during the 2000 to 2017 period in the four largest states and the U.S.

Labor-Market Categories

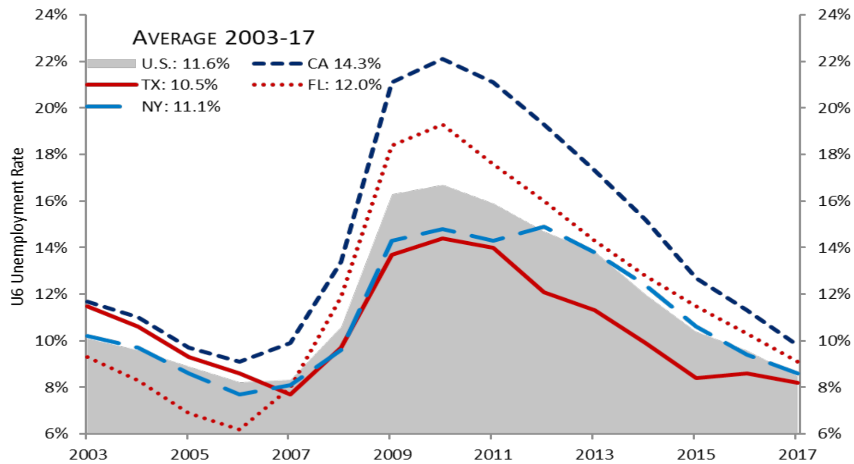
Texas employers created 3,041,000 nonfarm jobs, or 19 percent of the U.S. total nonfarm jobs, during the last 18 years. **Figure 1** shows that these additional jobs contributed to a higher average annual job-creation rate in Texas than in other large states and across the U.S. More recently, Texas has fared better and created jobs at a faster pace than many states recovering from the Great Recession.

Figure 2 shows that most Texas industries have seen double-digit percentage increases in job creation since 2000, with the oil and gas extraction and mining support industry up 60 percent. Job creation declined in only two industries. The mining industry, dominated by oil and gas activity, comprised 21 percent of the state's private sector activity in 1981, but was reduced over time to less than 10 percent in 2017 as the economy expanded and diversified from a number of factors, including expanded international trade after NAFTA (Ginn et al., 6). Because the Texas economy is so diversified, even though there was a large percentage increase in the mining industry in the last 18 years, it comprised less than

2 percent of the total labor force, while other industries represented a much larger share of the labor force and created many more jobs.

This quick pace of job creation statewide among most industries, especially in the last five years, has led to Texas having one of the lowest unemployment rates in the country. **Figure 3** presents evidence that Texas' U-3 (official) unemployment rate, the rate reported most often that includes the share of the labor force of those who are unemployed and have searched for a job during the last four weeks, has been at or below the overall U.S. unemployment rate since September 2006 and the rates of other large states around the same time. Texas ended 2017 with an unemployment rate of 4 percent, lower than in Florida, California, New York, or the U.S. average.

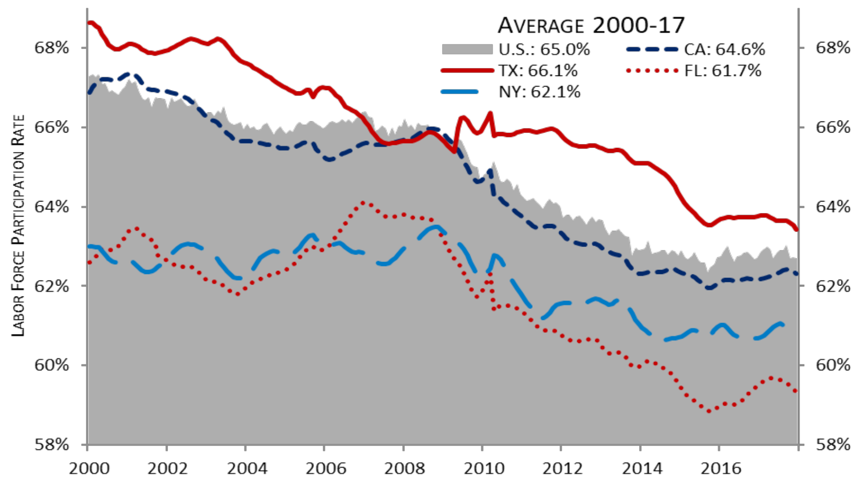
Figure 4. Share of labor force unemployed, underemployed, or discouraged, 2003-17



Source: Bureau of Labor Statistics

However, with many people dropping out of the labor force nationwide after an unsuccessful job search or choosing an alternative lifestyle (e.g., retirement, college, staying home with family, disability, or the military), the U-3 rate may be misleading (Krueger, 17). In addition, part-time workers are counted as employed in the U-3 rate even though some may prefer a full-time position. The broader U-6 underutilization unemployment rate includes those counted as unemployed in the U-3 rate along with discouraged and underemployed workers. **Figure 4** presents the available data for the U-6 rates, noting that Texas' 2017 rate was one percentage point lower than the U.S. average, compared with a U-3 rate that was only 0.3 percentage point lower. California's and Florida's labor markets indicate weaknesses throughout much of the 2003 to 2017 period, as their U-6 rates were higher than the rates for the U.S. and Texas.

Figure 5. Share of population employed or unemployed, 2000-17



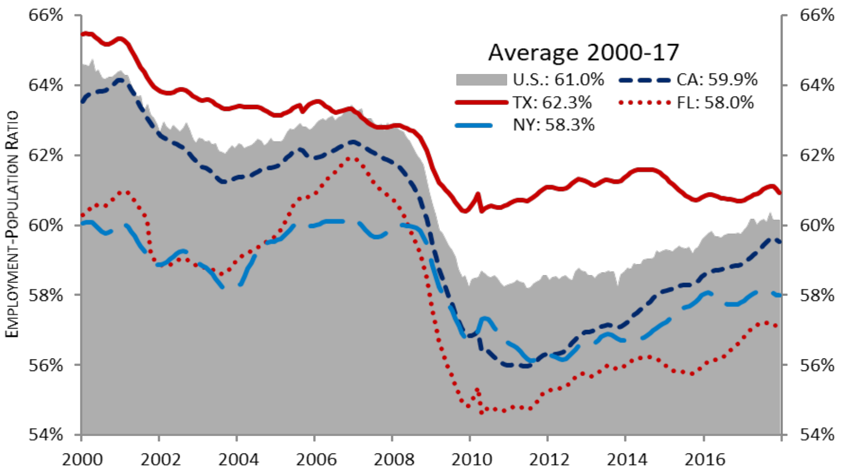
Source: Bureau of Labor Statistics

Figure 5 notes that Texas' labor force participation rate has proven to be relatively more stable since the Great Recession. California's average rate comes the closest, yet is still substantially behind and is consistently below the U.S. average, with New York's and Florida's falling even lower. This is yet another indication of Texas' substantial job creation, which contributed to a lower unemployment rate compared with a large number of people dropping out of the labor force elsewhere.

As noted by Mulligan (72-73), the expansion of social safety-net programs (e.g., Patient Protection and Affordable Care Act, unemployment insurance, and food stamps), which were implemented during and subsequent to the Great Recession, contributed to the severity of the downturn and poor job creation and weak economic expansion. Specifically, many recipients of these programs chose to not work because of the increase in the marginal labor income tax rate. He defines this "implicit marginal income tax rate" as "the extra taxes paid, and subsidies forgone, as the result of working, expressed as a ratio to the income from working" (Mulligan, 4). The higher the implicit tax rate, the less incentive there is for recipients to work, contributing to a smaller labor force.

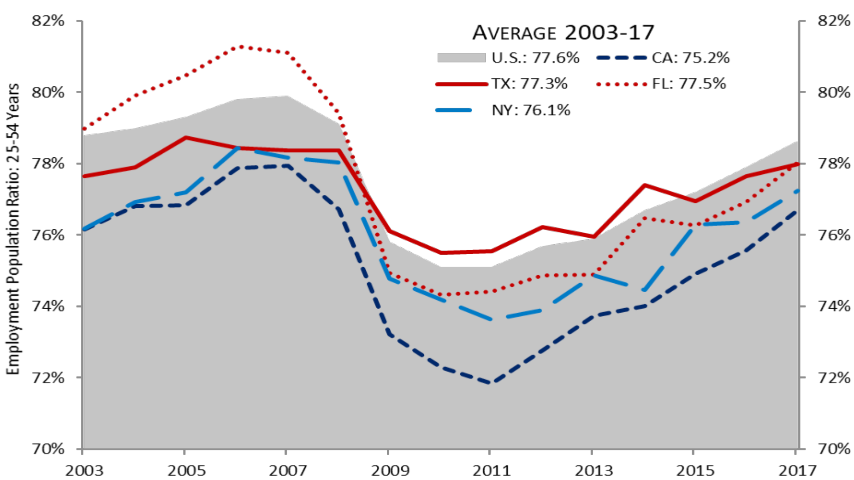
The unemployment rate may not be the best measure to assess these labor markets because of labor force volatility.

Figure 6. Share of the population employed, 2000-17



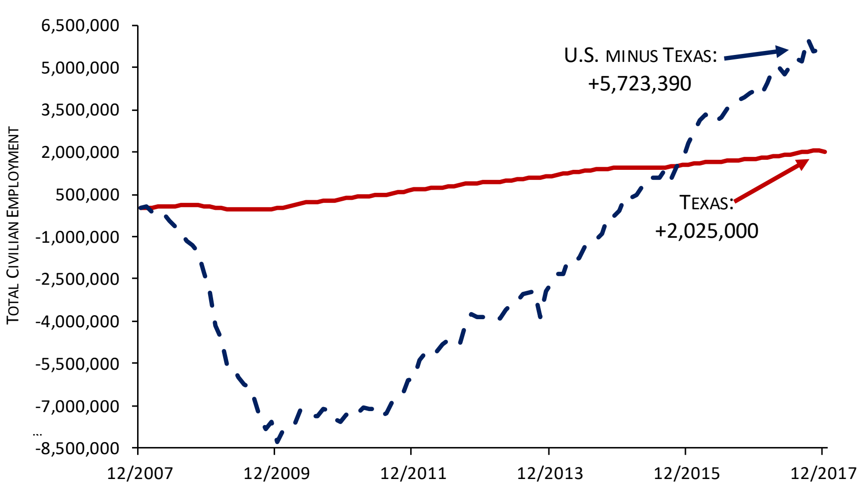
Source: Bureau of Labor Statistics

Figure 7. Share of the 25-54 years old prime working-age population employed, 2003-17



Source: Bureau of Labor Statistics

Figure 8. Cumulative total civilian jobs created since start of Great Recession



Source: Bureau of Labor Statistics

Figure 6 provides a potentially better indicator by presenting a comparison of the share of the population employed.

Compared with the other large states and the U.S. average, which have an employment-population ratio far below their pre–Great Recession levels, Texas' ratio barely budged lower and had a higher average during the last 17 years. Combined with the labor force participation rate, this ratio suggests that the lower unemployment rate in Texas is driven primarily by robust job creation and not so much by people dropping out of the labor force. Although a common argument is that the decline in the labor force participation rate and employment-population rate derive from baby boomers retiring, which is partially true, potentially the greatest threat to the prosperity of the U.S. and these states is the declining share of employment of the 25 to 54 prime working-age group.

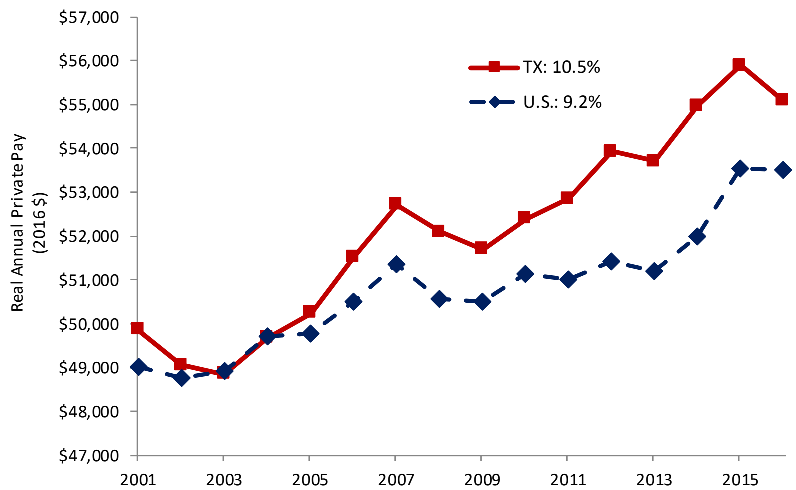
Figure 7 shows that since 2003—the earliest data available—Florida slightly edged out Texas as having the highest average employment ratio for the prime working-age group, but Texas has led the way since 2009. On the other hand, California and New York have average employment ratios for this group during the last 15 years that are considerably below those in Texas and Florida, as well as the U.S. average, yet another indication of progressive policies contributing to slower economic activity and job creation.

The steep decline in this key age group's employment ratio for the U.S. average and many large states is troubling because these people are especially likely to raise children, take care of elders, and make productive investments. Fewer job opportunities force many of them on government assistance, making it difficult for them to improve their life. While some rationally choose to stay home or go to college after unsuccessful job searches, loss of lifetime earnings and increasing student loans could have adverse long-term consequences for many. Others, particularly young men, are choosing to stay home instead of participating in the labor force (Krueger, 15-17). Unlike women, who often derive meaning from their non-employment activities, these young men are watching more television and playing video games, relying on government aid and family members to survive (Dotsey et al., 21). Less of a decline in young men's share of employment in Texas from more job opportunities contributes to more sustainable family budgets and an overall more stable economy compared with other large states.

Job Creation Since the Great Recession
To expand on the Texas Model's success and the recovery since the Great Recession, **Figure 8** shows that Texas employers created more than 2 million total civilian jobs since December 2007, according to the Bureau of Labor Statistics' (BLS) household survey, which is 26 percent of all U.S. civilian jobs in the last decade. Civilian job creation by the rest of the U.S. was not positive until January 2015 and did not exceed Texas' job creation until November 2015—almost eight years after the Great Recession started.

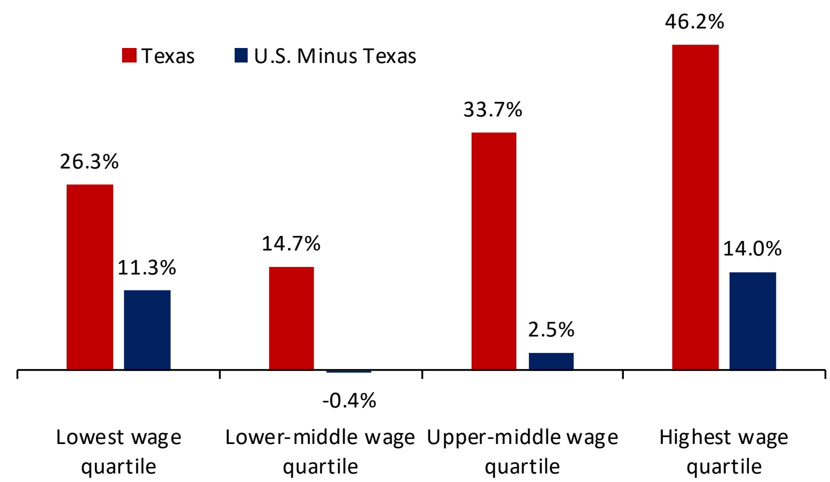
Texas also led the rest of the U.S. in total nonfarm job creation since the Great Recession started, according to the BLS establishment survey of businesses, with 19 percent of all U.S. jobs created. The rest of the U.S. did not have positive nonfarm employment until September 2014 and did not surpass Texas until March 2015. The Great Recession ended in June 2009.

Figure 9. Real average annual private pay, 2001-16



Source: Bureau of Labor Statistics

Figure 10. Job growth across all wage quartiles in Texas, 2000–14



Source: Federal Reserve Bank of Dallas

Wage Growth, Income Distribution, and Poverty
Although the Texas Model has supported more opportunities to find a job than the policies of other large states and the U.S., critics attempt to discredit these gains by arguing that these are primarily low-paying jobs. The data tell a different story.

Figure 9 shows that consumer price inflation-adjusted (real) average annual private pay for Texans is higher than in 2001 (the earliest year of available BLS data). During the last 16 years, the Consumer Price Index (CPI) increased by 35.5 percent. Adjusted for price inflation, the 10.5 percent increase in Texans' real private pay is greater than the U.S. average increase of 9.2 percent.

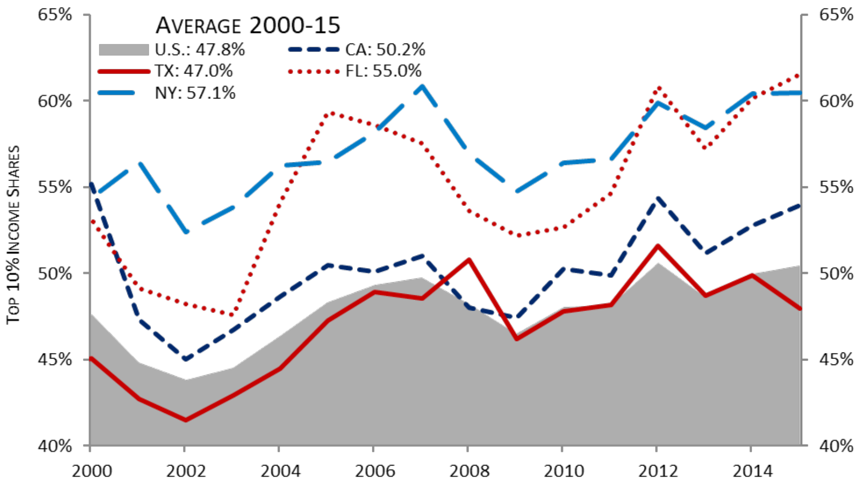
These real-wage data suggest Texas has created well-paying jobs. **Figure 10**, by former Federal Reserve Bank of Dallas President Richard Fisher (7), shows this is the case, with substantially larger percentage increases in high-paying jobs since 2000 in Texas than the rest of the nation.

The increases in job creation in the highest and lowest wage quartiles may contribute to rising income inequality—a widening income gap between the top and bottom earners.

Although it is beyond the scope of this paper to discuss the economic significance of this gap, as this is an empirical question that could be addressed, some economists, such as Piketty, claim that widening income inequality may be detrimental to economic prosperity. To examine how Texas' distribution of income ranks against other states' distribution, **Figure 11** presents the U.S. and state-level data from 2000 to 2015 (latest data available) provided by Frank (2018) for total income shares of the top 10 percent of income earners.

Texas was the only state of these four large states without an average income share above the U.S. average for this 16-year period. California, New York, and Florida had a larger income gap throughout much of the period. During the post–Great Recession period since 2009, both shares grew at a slower rate in Texas than the other large states at

Figure 11. Total income shares held by the top 10 percent of income earners, 2000-15



Source: [Mark Frank, Sam Houston State University]

the same time as the Lone Star State created the most jobs. Texas' top 10 percent income share was more concentrated since 2000, but compared with Texas' closest counterparts, these income inequality statistics show that the pro-growth, conservative policies in Texas, along with a more international trade, have contributed to a relatively more equal income distribution. While this is counter to the extractive institutions in California and New York, there is no consensus that a more equal distribution of income is preferable in a free society.

These data tell us little about the level of poverty in the Lone Star State compared with others. Fox (26-27) notes the Official Poverty Measure for the average of the 2015 to 2017 period shows that the shares of the population under the federal poverty level are 12.9 percent for the U.S., 14 percent for Texas, 14.3 percent for Florida, 13.4 percent for California, and 13.2 percent for New York. However, as noted by DeVore (4-8) these data neglect to include key metrics such as after-tax income, the variable cost of housing among states, smoothed consumer expenditures, and noncash government assistance, such as food stamps and Section 8 housing subsidies.

To account for these key metrics, Fox (26-27) constructed a relatively new measure of poverty for state-level data for the average of the 2015 to 2017 period known as the Supplemental Poverty Measure. These data paint a much different picture, as the U.S. rate is 14.1 percent, Texas' is 14.7 percent, Florida's is 18.1 percent, California's—the highest state rate in the nation—is 19 percent, and New York's is 15.5 percent. Texas' supplemental poverty measure is slightly above the U.S. average, with the cost of housing and many other living expenses being much lower in Texas than in other large states thanks to fewer barriers to competition resulting in less regulation and higher levels of economic freedom.

Conclusion

These data provide overwhelming evidence that the Texas Model of inclusive institutions with a relatively low tax-and-spend burden, no individual income tax, and sensible regulation provides an institutional framework supporting more job growth, higher wages, lower income inequality, and less poverty than in comparable states and the U.S., in most cases.

Texas is doing something right. Other states and D.C. would be wise to consider adopting Texas' inclusive economic and political institutions that champion individual liberty, free enterprise, and personal responsibility. This is a path to providing an economic environment that allows entrepreneurs the greatest opportunity to thrive and for prosperity to be generated for the greatest number of people.

Despite this success, improvements are needed to keep the Texas Model competitive and create even more opportunities for all to flourish. These improvements to Texas' institutional framework include—

- limiting the growth in government spending,
- eliminating the state's onerous business franchise tax,
- reducing barriers to international trade,
- reducing the escalating burden of property taxes, and
- relieving Texans from burdensome occupational licenses.

Even with these improvements, the data overwhelmingly show it was not a miracle in Texas, but rather abundant prosperity generated by Texans from a proven institutional framework called the Texas Model.

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About the Author

Vance Ginn, Ph.D., is the director of the Center for Economic Prosperity and senior economist at the Texas Public Policy Foundation, one of the nation's premier free-market think tanks.

Dr. Ginn is a leading free-market economist and former university lecturer who was honored with the "Champion of Freedom" award from Grassroots America—We The People. He is passionate about finding ways to let people prosper in Texas and beyond through sound research on the benefits of restraining government spending, cutting and ending taxes, and eliminating government barriers to competition.

He is a first-generation college graduate and earned his doctorate in economics from Texas Tech University. He gives keynote speeches, appears in major media outlets, publishes papers in top-ranked academic journals, writes policy research on critical issues, and works to turn papers into policy.

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