

# LEGAL ORIGINS AND STATE ECONOMIC FREEDOM

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## ABSTRACT

*Problems associated with economic development have recently focused on the role of institutions. Arguably, the most important institutional structure is the rule of law. Previous research has drawn attention to the relationship between a country's legal origins and its current economic, legal, and political institutions. In this paper we extend this literature to the U.S. states. We find evidence that state legal origins help to explain its current economic institutions as measured by the Economic Freedom of North America index. States originally settled by civil law countries have lower levels of economic freedom as a result.*

## INTRODUCTION

The subject of economic development has transformed significantly in the past century. Historically, economic development fixated upon factors of production like capital and labor and less on the role of institutional quality in determining economic outcomes (Hall et al. 2010). As a result of the work of Nobel Laureate Douglass North (1990) and others, institutions have increasingly been considered an important force characterizing economic progress. North's work in particular, both in his earlier work (North, 1994) and in his later work (North et al., 2009) has helped to reshaped the way economists analyze the issue of economic development and turned attention toward looking at the effect of institutions – “the humanly devised constraints that shape human interaction” (North, 1990, 3) – on economic performance. In recent years, a growing body of research has used the Economic Freedom of the World (EFW) index (Gwartney et al., 2010) to measure institutional quality and has found a strong, positive relationship between quality institutions and economic growth (see, for example, Dawson, 1998; Gwartney et al., 1999; Cole, 2003; Gwartney et al., 2004; Gwartney et al., 2006; Hall et al., 2010).

If institutions are important to economic growth, then it is necessary to understand what factors are associated with institutional quality. Recently, the empirical literature discussing the relationship between institutions and economic growth has grown substantially. However, little focus been given to examining the sources of institutional quality across countries, with a few notable exceptions such as such as Crampton (2002), De Haan and Sturm (2003), Boockmann and Dreher (2003), Heckelman and Knack (2008), and Lawson and Clark (2010). While these studies are valuable, they limit their focus to recent causes of institutional change. As a result, they potentially overlook historical determinants of institutional quality. Countries with poor

institutions in the past tend to have poor institutions today. Thus, we need to look to history – at least in part – for a better understanding of the sources of institutional diversity. A series of influential studies begun by La Porta et al. (1997; 1998) examine the relationship between a country's current economic condition and the origin of their legal system. Essentially, contemporary market conditions are potentially explained by past and present legal conditions, with present legal conditions represented as a function of past legal conditions.

In this paper we build off these important studies by taking a first look at the impact of colonial origins of U.S. states on current state economic freedom, with a particular focus on the role that the legal system of the settling country has on current institutional quality. As is recent convention in the empirical institutional literature, we measure a state's current institutional quality using the Economic Freedom of North America (EFNA) index, published annually by the Fraser Institute. We begin our analysis with further discussion of how the legal origins of state settlers might influence current institutional quality. We then proceed to describe our data and empirical approach, present our results, and then summarize our findings with a few concluding remarks.

### **LEGAL ORIGINS: CIVIL VS. COMMON LAW**

Discovering the relationship between institutional quality and economic growth has motivated a well-defined body of research focusing on how good institutions are formed. Arguably, high-quality institutions are formed when the rule of law is in place because the rule of law facilitates the formation of other good institutions by creating certainty and protection from expropriation (North et al., 2009). Recently, economists have produced empirical evidence that financial markets contribute to economic growth and strong legal institutions contribute to the growth of financial markets (Mahoney, 2001). The question is which legal institutions are best for economic development?

The reason this inquiry is important is because over time, multiple structures of legal institutions have formed representing different traditional legal systems (Mahoney, 2001). The two most common legal systems are civil and common law. The common legal tradition is primarily associated with England and the civil legal tradition with France (although its origins are Roman). Hayek (1960) argues that English and French concepts of law originated from their respective notions of liberty. English models of liberty are derived from Locke and Hume, who emphasized individual freedom, while the French model of liberty is derived from Hobbes and Rousseau who emphasized government's freedom to pursue the public's interest. In this way, common law became a law of property. Civil law, on the other hand, continually faces the risk of the legislature altering existing rights for political purposes or in the public interest (Mahoney 2001). According to Merryman (1985), common law developed to protect the property rights of citizens from the monarch. Because of the ever present risk of government expropriation of

property under civil law, Hayek (1960) argued that the British common legal tradition was superior to the French civil legal tradition.

In recent years, empirical research in law and economics has gone beyond a discussion of the differences between the two legal traditions and instead focused on possible differences in economic outcomes between the two types of legal traditions. Common and civil legal traditions have spread throughout the world by conquest and imitation and thus many countries legal systems have their roots in either British common law or French civil law. The ability of common law countries to provide investors greater protection from expropriation by corporate insiders led La Porta et al. (1997) to look at differences in investor protections between common law and civil law countries. From their initial research comes a large body of work suggesting the “economic consequences of legal origins are pervasive” (La Porta et al., 1998, 298). They find that, when compared to countries employing some version of the French civil legal system, common law countries have more developed financial markets, lighter government ownership, less regulation, less corruption, and more independent judiciaries. These economic consequences tend to be related to improved resource allocation; thus, it is not surprising that Mahoney (2001) finds that British common law countries grew 0.6 percentage points faster than French civil law countries from 1960 to 2000.

In three papers, Berkowitz and Clay (2004; 2005; 2006) utilize the fact that ten of the U.S. states were settled by France, Spain, or Mexico and thus had civil law systems prior to the American Revolution. While all ten states, except for Louisiana, eventually transitioned to the common law, their work finds that these states civil law origins explain several important institutional features of these states today, the most important of which is the impact of legal origins on the quality of state courts today. Berkowitz and Clay (2005) find that civil law states have had a higher degree of constitutional instability over time, which is negatively related to the quality of state courts. Berkowitz and Clay (2006) investigate the relationship between legal origins and state court quality more in-depth and find a negative relationship between the number of years a state was a civil law state and state court quality in the early 2000s. Given the pervasiveness of economic outcomes related to legal origins from an international perspective, Berkowitz and Clay’s research is important because it points toward the significance of legal origins in understanding current economic institutions as well as legal institutions.

## **DATA AND EMPIRICAL APPROACH**

In order to test the hypothesis that legal origins are related to current economic institutions, we need data on both legal origins and economic institutions. Our data on the legal origins of states was obtained from Berkowitz and Clay (2004; 2005; 2006). They note that there are ten current states that initially had civil law origins because they were initially settled by France, Mexico, or Spain. These states are Alabama, Arizona, Arkansas, California, Florida, Louisiana, Mississippi, Missouri, New Mexico, and Texas. Eventually all of these states, except

for Louisiana, adopted common law. The adoption of common law by most of these states occurred after the American Revolution in 1776. Arguably, those states that shifted from civil to common legal structures retained some of the elements of the civil legal system.

The remaining states were settled with common legal structures, either through British settlement or American expansion. For the purpose of this analysis these two will be grouped into common law states. There are mild variations in these two forms of common law, but they are extremely similar and are also distinctly different from the civil legal tradition. American states are denoted as settler states and British states were colonized states (Berkowitz and Clay, 2006).

The dependent variable for this analysis is the North American Economic Freedom Index (EFNA) published annually by the Fraser Institute, a Canadian think tank (Karabegović and McMahon, 2008). The EFNA measures the extent to which a state's economic institutions are consistent with resource allocation being guided by personal choice in markets, rather than by collective decision-making. The authors of the EFNA gather third-party data on ten variables in three policy areas to measure the economic freedom of each state (and Canadian province). Since we are measuring the effect of legal origins on economic institutions, it is important to note that there are zero variables in the EFNA that directly measure legal institutions such as the rule of law. Each variable, such as total tax revenue as a percentage of GDP, is placed onto a zero-to-ten scale and then aggregated into a zero-to-ten overall freedom score. Thus, higher scores represent higher levels of economic freedom. Since the data used in the EFNA are published with a lag, the fact that we employ the 2008 edition of the report means that we are using index scores representing state economic freedom in the year 2005. In that year the most free state at the all-government level was Delaware with a score of 8.5 and the least free was West Virginia with a score of 5.3.

Variable	Mean	Std. Dev.	Min	Max
North American Freedom Index (2005)	6.688	0.58	5.3	8.5
Ln Per Capita Income (2005)	10.405	0.145	10.123	10.778
Ln Initial Population	-0.369	2.377	-3.912	1
Civil Legal Origin	0.2292	0.4247	0	3.797
Climate	13.13	7.5	1.99	39.79
% Slave Population in State	10.29	17.74	0	57.2
Southern States	0.229	0.424	0	1

Summary statistics for all the variables can be found in Table 1. Our control variables that might be related to long-run institutional quality were also obtained from Berkowitz and Clay (2004; 2005). These control variables are the initial population of the state, its climate, percentage slave population, and the southern states. For further documentation on each variable

see Table 1 of Berkowitz and Clay (2005). The intuition for each of these control variables is straightforward. For example, the size of a state's initial population is positively related to vote cycling and thus negatively related to the stability of a state's constitution over time, thus it might be positively related to current state institutional quality. Similarly, climate, slave population, and the a binary variable for a Southern Confederacy state are attempting to control for the influence of slavery and the extractive institutions often associated with hotter climates.

## EMPIRICAL RESULTS

In this section we estimate the effect legal origins have on contemporary economic performance using the North American Economic Freedom Index of 2005. The independent variable of interest is the binary variable that represent if a state is a descendent of a civil legal tradition (1=civil, 0=common). Table 2 depicts the model's results, estimated using ordinary least squares (OLS). The coefficient on the legal origins variable is negative and significant at the 10 percent level, suggesting a negative relationship between a state being founded by a civil law country and its current economic institutions as measure by the Economic Freedom of North America index. This result holds while controlling for other important historical variables such as being a member of the Confederacy, a state's climate, and its slave population.

Variable	Coefficient	T-Score
Constant	<b>7.08</b>	36.6
Civil Legal Origin	<b>-0.4314</b>	-1.98
Ln Initial Population	0.009	0.27
Climate	-0.0154	-0.91
% Slave Population in State	-0.017	-1.19
Southern States	<b>1.231</b>	2.26
N	48	
R-sq	0.1	

Note: Variables statistically significant at least at the 10% level are in bold.

It is interesting to note that states that were members of the Confederacy have higher economic freedom today, *ceteris paribus*, contrary to what a priori theorizing would suggest. Perhaps this occurs the EFNA measures primarily areas like taxation and spending policy - areas where the legacy of slavery indirectly leads to less economic freedom because of reduced provision of publicly-provided goods – then areas like property rights and the rule of law where's slavery's legacy has been to inhibit economic freedom. Further research is needed to

reconcile this finding with the work of Carden (2009) and others on the impact of slavery and the Confederacy on institutions.

## CONCLUSION

In this paper we analyzed the role of legal origins in explaining current institutional quality at the U.S. state level using the Economic Freedom of North America index. Building on previous work by Berkowitz and Clay (2004; 2005; 2006), we exploit the fact that ten states were settled by the civil law countries of France, Spain, and Mexico. After controlling for initial conditions, including climate and membership in the Confederacy, a state that descended from a civil law legal tradition has lower economic freedom today, *ceteris paribus*, when compared to a state that was initially settled by a common law country. This finding creates further support for the importance of legal origins to current economic institutions as well as getting towards a better understanding of the historical origins of present-day institutions.

Further research is needed, however, to further explore the role of other factors in explaining current economic institutions. In particular, it would be interesting to note if this result holds up after controlling for other factors that might be related to a state's legal origins. For example, common law states tended to have industrial economies and civil law states were more agricultural. If civil law states are more likely to have extractive economic and political institutions (Acemoglu et al., 2001) in a manner not controlled for with the percentage of slave population and the South binary variable, then our results might overstate the relationship between legal origins and current levels of economic freedom. It is also possible that rather than directly influencing economic institutions, legal origins could work indirectly through these and other factors, such as culture. Following from Tollison (2007), we would urge future researchers to explore the rich data on political and economic institutions available in the Book of the States (Council of State Governments, 2010).

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