

# INSTITUTIONS MATTER: ECONOMIC FREEDOM AND INCOME MOBILITY

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## INTRODUCTION

Upward income mobility is the ability of children to achieve a higher economic status than their parents, or a key measure of the “equality of opportunity” that is often discussed in the United States. Most attention in this field has focused on social capital (networks and community ties), family engagement, and education. However, the role of market-friendly institutions (economic freedom) has been largely overlooked. Free markets (lax regulations, lower taxes) are consistently associated with higher incomes, employment, and other standards-of-living measures.

Here, we bridge this gap and estimate the impact of local-level economic freedom on absolute and relative mobility. Absolute mobility is the relationship between one’s income with their parents; relative mobility is the relationship between one’s income ranking with their parent’s income ranking. Increases in economic freedom can represent a powerful yet under-utilized policy lever for improving opportunity, particularly as it is one that policymakers at a local level have more direct control over relative to previously studied explanations.

## POLICY RECOMMENDATIONS

- 1 Reduce excessive government spending.
- 2 Prioritize market-opening reforms. Some reforms at the local level include decrease excessive government employment that crowds out private employment, reduce government consumption, and allow for more flexible labor markets.
- 3 Treat economic freedom as a complementary tool to social capital initiatives. Investments in bridging social capital (e.g., programs that connect low- and high-income residents) will be more effective in freer economic environments; the two reinforce each other.
- 4 Focus deregulation efforts on policies that most affect lower-income families, such as occupational licensing, childcare regulations, housing supply restrictions, and small-business barriers.

## KEY FINDINGS

**Using U.S. data from metropolitan statistical areas, our research shows that economic freedom is a strong, independent driver of intergenerational income mobility.** Children growing up in metropolitan areas in the top quartile of economic freedom experience 11.6 percentage points higher absolute upward mobility and 4.6 percentage points higher relative mobility than children in the bottom quartile.

**Even after controlling for economic connectedness—a type of “bridging” social capital characterized by having high or above median income friends—the effect of economic freedom remains large:** 9.5 percentage points higher absolute mobility and 4.5 percentage points higher relative mobility between the top and bottom quartiles.

**Moreover, the effects from economic freedom and bridging social capital are additive;** they act as independent channels that further boost mobility.

**“Bonding” (or “in-group”) social capital** tends to reduce mobility and acts as a substitute for economic freedom; areas with exclusive networks benefit more from market-opening reforms.

**The positive effects** are driven primarily by less government spending and more labor market freedom (lower union density, fewer government employee per capita, and lower minimum wage rates). Notably, economic freedom shows no association with racial gaps in mobility, suggesting broad-based benefits.

## SUMMARY

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Economic freedom is good for growth on average; it is one powerful tool available for expanding opportunity and enabling children to rise above their parents' economic station. The impact from economic freedom is as strong, and sometimes stronger, than that of social capital. Many of the proposals to improve social capital are costly to society, while pro-market reforms (deregulation, for instance) are costless to the government. Markets and opportunity are not at odds; freer markets are a proven pathway to greater upward mobility for all Americans.

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