Welcome to the 20th anniversary edition of the *Index of Economic Freedom*. What began as the brainchild of free-market economists in the 1980s is today a world-renowned landmark measuring economic progress in over 180 countries.

Each year, government officials from around the world tell us they pay close attention to their *Index* scores, using them as a guide for key policy decisions. Companies use the *Index* to guide investments and manage risk, and universities work it into their curricula. Its growing popularity is evident in the fact that the number of visits to its website, launched in 2001, has risen from nearly 700,000 in 2008 to almost 1.9 million in 2012 and is on track to surpass 2.4 million in 2013.

Why such success? The main reason is that the message of the *Index* rings true: More than any other political or policy approach, economic freedom generates more opportunities and greater well-being for more people, no matter where they live. Over the past two decades, the *Index of Economic Freedom* has documented the critical link between economic opportunity and prosperity. It has also demonstrated the power of free-market, limited-government, rules-based capitalism in helping people to prosper.

**CREATING AN INDEX OF ECONOMIC FREEDOM**

The idea of creating an index to measure the impact of economic freedom in the world began percolating in the 1980s. Nobel laureate Milton Friedman talked of producing one, and it was discussed periodically at meetings of free-market economists during that decade.

In the late 1980s, one of the biggest policy interests in Washington was measuring the efficacy of foreign aid. In 1989, U.S. Agency for International Development (USAID) Administrator Alan Woods proposed an “Economic Opportunity Index” to evaluate the U.S. government’s foreign aid programs.¹ That same year, Heritage analyst Ed Hudgins analyzed the “Woods Report” in a *Backgrounder* and called on Congress to consider using such an index to rewrite the decades-old Foreign Assistance Act so as to improve the allocation of U.S. aid to developing countries.²
A few years later, in 1992, the chairman of the President’s Commission on the Management of AID Programs, George M. Ferris, and commission member Jack Kemp urged USAID to adopt a quantitative measure of economic freedom to help decide the allocation of U.S. foreign aid. The chairman of the President’s Commission on the Management of AID Programs, George M. Ferris, and commission member Jack Kemp urged USAID to adopt a quantitative measure of economic freedom to help decide the allocation of U.S. foreign aid.3

Several members of Heritage’s Board of Trustees had expressed early interest in the notion of measuring economic freedom around the world. William E. Simon, former Secretary of the Treasury, and Ambassador J. William Middendorf II both had talked about quantitative measures that would permit comparative analysis on a national basis. The subject was debated in detail at Heritage Board Meetings and Ed Feulner, Heritage’s President, was encouraged to move ahead with the concept to see if it could develop into a usable product.

The decision to launch a formal Heritage project to produce the Index was made in 1993 after a conversation that I, as Vice President for Foreign and Defense Policy Studies, had with then-Heritage President Ed Feulner. We were discussing our plans for the upcoming year when he asked whether I thought an index on economic freedom could be produced. I replied that many economists had talked a great deal about it but so far had been unable to agree on how to go about it.

I took Feulner’s question as a mandate to decide whether Heritage could succeed where others had failed. I went back and discussed the matter with my staff, particularly Jay Kingham Fellow in Regulatory Affairs Thomas Sheehy and a young analyst, Bryan T. Johnson. Then I recommended going forward.

In early 1994, Heritage experts were invited to testify before Congress on the idea of an index of economic freedom. I testified before the House Foreign Affairs Committee, Johnson appeared before the Senate Foreign Relations Committee, and Sheehy testified before the Senate Foreign Relations Committee on foreign aid. In his testimony, Sheehy discussed the need for creating an index of economic freedom to help the U.S. government determine the best candidates for U.S. aid. A few months later, he went into more detail in a Heritage Backgrounder.4

The main question was how to create a methodology for an index. Throughout the early 1990s, the Fraser Institute, a Canadian-based think tank led by Michael Walker, had held a series of workshops to discuss the prospects for a world economic freedom index. Sometimes attended by Milton Friedman, who later chaired Fraser’s economic freedom project, the sessions examined the question of a methodology. Ed Hudgins, who led Heritage’s international economics center at that time, had attended them and shared the concerns raised and conclusions drawn with his Heritage colleagues. When we made the decision to develop a methodology, the task fell to Johnson. He conferred with Hudgins, who by that time had moved to the Cato Institute, and then devised the 10 factors we ultimately used for the first Index.

The aim from the outset was to make the methodology transparent and simple enough that non-economists, including Members of Congress and their staffs, would find it user-friendly. In practice, this meant using data that were readily available, reliable, and consistent. The Heritage methodology may not have captured all of the theoretical nuances of economic theory, but it did reflect the main economic and institutional factors involved in economic freedom and growth. The methodology was largely an in-house affair, operationalized by Johnson, who with Sheehy undertook the time-consuming task of grading over a hundred countries. By the second half of 1994, they were ready to go.

So, late in 1994, we launched our first Index of Economic Freedom5 in New York City. Feulner, co-authors Johnson and Sheehy, and I, as supervising editor, were there. Also present were former Treasury Secretary William Simon; National Review editor William F. Buckley; and Forbes magazine president and editor in chief Steve Forbes. At a private meeting with some of America’s most important CEOs, such as the president of American Express, the Heritage crew explained how the Index worked and, using a graph called “The Curve of Economic Freedom,” how it showed a statistically significant relationship between economic freedom and long-term growth.
That first Index was an instant success. According to Ed Feulner, “Former Treasury Secretary William Simon told me after reviewing a draft copy of The Index of Economic Freedom that it may well be the single most important publication ever published by The Heritage Foundation...” Milton Friedman told Johnson and me that he was “glad someone finally ended up doing this.” When we traveled to Hong Kong in early 1995 to release it overseas, our press conference attracted a huge number of media, kicking off that city’s long-running interest in keeping its Index ranking as the freest economy in the world. The Index was attracting national and global attention, even in its first edition, not only because of its compelling message on economic freedom, but also because it gave countries an easy way to measure and compare themselves on the world economic stage.

By 1997, the Index was so well known that William Simon advised the Air Force Academy to start a program on economic freedom. Ed Feulner was invited to present the concept to the Academy. That same year, at the request of Dow Jones CEO Peter Kann, the Editorial Page of The Wall Street Journal joined Heritage as the Index’s co-publisher; Melanie Kirkpatrick became a co-editor and, along with editorial page editor Robert Bartley, forged an exciting and constructive partnership with Heritage that lasts to this day.

In Asia, the Index had become so widely known that even average people had heard of it. Upon checking into a hotel in Singapore on one of the promotional tours in those early years, I was greeted by a clerk proclaiming, “We’re number two,” referring to Singapore’s Index score and revealing how much of a household name it had become there. In Croatia, popular evening TV quiz shows like our Jeopardy featured a question about that country’s Index score in 2007; two contestants actually cited Index statistics from memory.

Naturally, with so much attention, the Index also came under heavy scrutiny. Some developmental economists objected to its criticism of government-to-government foreign aid programs. Liberal economists were hostile to the message on economic freedom. Some economists objected to our refusal to weight economic factors. But when the Fraser Institute’s first Economic Freedom in the World report appeared nearly two years after the first Index, its findings were not all that different from those of the Heritage Index even though it employed a more complicated methodology that weighted the relative importance of various factors. A 1997 Cato Institute study that compared the results of the Heritage and Fraser indexes concluded that, “[d]espite underlying differences in purpose, methodology, and philosophy, the various surveys produce rankings that have much in common.”

One of the reasons the Index has fared so well is that its findings conform to economic reality and thus are not merely about theory. In his autobiography, published after he retired as chairman of the Federal Reserve Board, Alan Greenspan summed up this point succinctly:

The ultimate test of the usefulness of such a scoring process [for example, the Index] is whether it correlates with economic performance. And it does. The correlation coefficient of 157 countries between their “Economic Freedom Score” and the log of their per capita incomes is 0.65, impressive for such a motley body of data.

IMPACT OF THE INDEX

Over the years, the impact of the Index has fallen into distinct categories. The most important is its influence on government policies in countries in every region of the world. Topping the list is Hong Kong. Its government adopted the first Index as a key barometer in measuring its economic success. This interest persisted even after the handover of Hong Kong from the British to the People’s Republic of China on July 1, 1997. The government took out full-page advertisements in the press whenever it scored “number one” on the Index. Press conferences there with Heritage analysts are always jam-packed, treated as high-profile and almost official affairs. Indeed, press coverage of the Index release sometimes amounts to hundreds of articles in local and Asian papers.
The story that best demonstrates the impact of the Index on Hong Kong is the reaction to the 1999 edition, known as the “year of the asterisk.”11 Hong Kong had responded to the Asian economic crisis by purchasing large amounts of securities on the stock market. Since it occurred after the June 30 cutoff date for data for the 1999 edition, this action did not affect Hong Kong’s score that year. However, as the editors of the Index explained in an asterisk attached to its still-number one ranking, if this action were not reversed, Hong Kong would lose its number one ranking in the next edition. In a tense meeting between the Heritage delegation, led by Ed Feulner, and then-Hong Kong Financial Secretary Donald Tsang, it was clear that something would have to give for Hong Kong to retain its coveted position.

And something did give. Before the data deadline for the 2000 edition, Hong Kong sold off the securities. As a result, it retained its position as the world’s “freest economy” in the 2000 Index,12 and the asterisk was dropped. It was clear to all that the Index had been the key factor in driving the decision (Hong Kong officials admitted as much to Feulner and other Heritage personnel). Most important, however, was how the rest of the world took note. Seeing the impact on Hong Kong, droves of embassy and foreign government officials began visiting Heritage to provide input, hoping to influence their country’s scores. One government went so far as to present me with a scoring of itself, complete with a perfectly formatted country page that matched the formatting style of the book.

Other areas of impact have involved U.S. law and policy. Following the release of the first edition, Representative Bob Livingston, chairman of the House Appropriations Committee, used findings from the Index to reduce foreign aid by some 40 percent by fiscal year 1996.13 Other legislation was proposed in the 1990s, but none made its way into law because the Clinton Administration and Democrats in Congress opposed placing conditions on foreign aid. Eventually, however, in 2004, with George W. Bush in the White House, the impact of the Index on the way foreign aid would be distributed was recognizable in the work of a newly established U.S. government agency, the Millennium Challenge Corporation. Each year, the MCC requests our annual trade freedom score before the Index’s official release date to help it determine which countries will qualify for performance-based aid compacts.

Recognizing the importance of economic freedom and the usefulness of the Index as a policy tool, other international organizations such as the World Bank14 and the Organisation for Economic Co-operation and Development15 have featured Index results in their database and use our analysis and scoring in their studies on the effectiveness of development assistance. Notably, for the 2012 Index, the World Bank’s vice president for Africa contributed an essay highlighting the urgency of increasing economic freedom to improve development prospects.16

Index findings also have been used in other international indexes, such as the Bertelsmann Stiftung’s Transformation Index17 and the Legatum Institute’s first Prosperity Index (published in 2009).18

Another target of influence for the Index is American corporations. After its release, Washington Post investment columnist James Glassman spoke favorably of that first Index in his Sunday column.19 In 2004, Steve Forbes called the Index “a superb source for business conditions in countless countries.”20 Robert Ulrich, Chairman and CEO of Target Corporations and Target Stores, reiterated that point in 2005, calling the Index an “important reference book for any business that invests overseas and is engaged in today’s global marketplace.”21 In 1996, executives at General Motors invited Tom Sheehy to Michigan to brief them on how the Index could be used to direct overseas investments.22 Bryan Johnson recalls Procter and Gamble integrating Index findings into its long-range investment plans and Franklin Templeton Investments using material from the Index in marketing its own products.23 Samson Capital Advisors has included Index findings in its analysis of currency returns, and in 2013, UBS Investment Research included information on Index country scores in its report to subscribers on global emerging markets.24 There has even been inter-
interest in creating a marketable fund based directly on the Index as a portfolio investment tool.

One of the most surprising uses of the Index is as an educational tool. It has become quite popular as a textbook and research source for high-school teachers and university professors. For example, Mark C. Green, Professor of Marketing at Simpson College, included a chart from the Index in his college textbook Global Marketing, which is used in courses at over 200 colleges and universities. Three widely used textbooks on economics published by McGraw-Hill drew on source materials from the Index. It was often used as well by scholars for their primary research work. Not only the raw data of scores, but the analyses provided in each year’s editions were often cited by scholars both here and abroad. Several Federal Reserve Banks (such as St. Louis, New York, Dallas, and Atlanta) have used Index materials in their educational outreach programs. The bank in St. Louis, for example, made the Index a centerpiece in its online education course called “Which Came First—Democracy or Growth?”

The culmination of the Index’s history in American education, however, came under the tutelage of the current lead editor, Terry Miller. A former senior State Department diplomat who specialized in international economics, Miller undertook a major effort to highlight the Index as an educational tool. It is no surprise that the most enthusiastic response has come from graduate schools of international business, with Index data featured increasingly in scholarly research and exhibited annually at the Academy of International Business. Economic freedom is, after all, the foundation for economic and commercial success. Even more interesting, perhaps, has been the positive reception on undergraduate campuses for the Index’s message of revolutionary economic change and rapid development through individual empowerment.

Over the years, Heritage has partnered with a number of international think tanks and institutes in producing the Index and promoting the cause of economic freedom. Fourteen current partners are listed in the back of this volume. This year, the Index has its first international contributing editor, Sergio Daga of the Fundación Políticas Publicas para la Libertad–POPULI in Bolivia. The Index or its major sections are now translated regularly into Spanish and Portuguese, and excerpts have appeared in French, Italian, Polish, and Bulgarian, among other languages.

POLICY LESSONS

Equally important to the Index’s legacy are its policy lessons. Looking back on its 20 years of tracking economic freedom, certain of these lessons stand out. The Index has documented the linkage between economic freedom and long-term prosperity that had been suspected for some time, but as our editors and analysts have drilled further down into the rich accumulation of data and findings over these two decades, they have discovered other connections as well. We should pause and take a look at them.

The most prominent of these connections is the link between economic freedom and per capita GDP. As noted, the first edition of the Index included a chart called “The Curve of Economic Freedom.” Most of the statistical work for it was done by Heritage economist Bill Beach with the support of Bryan Johnson. Charting their findings showed a sweeping upward curve of economic freedom scores compared with per capita GDP, establishing with statistical certainty the connection between economic freedom and prosperity. In plain language, the more economically free a country is, the wealthier its people are. The linkage is unmistakable, and the data each year confirm it. Economists may argue about whether other factors such as education, roads, and natural resources lead to economic prosperity, but none could dispute that economic freedom is a key ingredient.

The link between prosperity (wealth measured by per capita GDP or income) and freedom was clear, but this did not answer the larger question of whether there was a link between economic freedom and economic growth. Drawing on strides in economic growth theory, Heritage economists Beach and Gareth Davis tackled this question in the 1997 edition. Using data developed by Harvard economists Robert Barro and
Jong-Wha-Lee, they argued that “institutional settings strongly influence the rate of economic growth.” Their analysis showed a “statistically significant relationship,” at a 99 percent confidence level, between economic freedom and economic growth. For the 2000 edition, Barro himself contributed a chapter that extrapolated on this theme, concluding that property rights and the rule of law (but not democratic elections) were key determinants of economic growth. Barro revisited the issue in the 2013 edition of the Index, confirming his results with an updated data set.

The relationship between economic freedom and democracy or political freedom is a long-standing issue. The year before Barro first tackled it, Bryan Johnson had looked at the relationship between economic freedom and political freedom. Conducting a regression analysis of data derived from the Index and Freedom House’s annual survey of political freedom, he concluded that “those countries that are more economically free also are more politically free and have higher levels of civil liberties than those countries with less economic freedom.” This confirmed what many had already expected: Advanced economies tend to be more democratic, while undeveloped ones are more often poor and undemocratic.

One of the most lasting lessons from the Index findings over these two decades is the importance of international trade for economic growth. This was a theme in the 2001 edition, which contained an essay by The Wall Street Journal’s Mary O’Grady titled “First, Open Markets.” O’Grady focused mainly on the benefits of free trade to Latin America, but she and others argued that the general effect of free trade was to encourage liberalization of all areas of the economy. Free trade, for example, makes it easier to protect property rights. Free trade agreements institutionalize market openings and encourage others to follow suit.

Because of the importance of this issue, I directed our Index analysts to pen a chapter for the 2001 edition on the arguments for creating a global free trade area. The idea was to bring together not only existing free trader nations, but also aspiring ones, creating global momentum in favor of open trade (particularly in the wake of the Asian economic crisis and the recent lack of progress in free trade talks). Variations of this idea were later picked up by presidential candidates such as Rudy Giuliani and Mitt Romney.

When Terry Miller took over as lead editor for the 2009 edition, he began to explore the larger universe of economic freedom. He wanted to understand better the broader benefits and how economic freedom related to other aspects of human development.

In the 2010 edition, for example, Miller compared data from the United Nations Human Development Reports’ “Human Poverty Index” with our economic freedom scores. He found that poverty rates dropped faster in economically free countries than in those that were losing economic freedom. He performed a similar comparative analysis of data on social instability and discovered that there was considerably more social unrest in countries that were economically repressed. The social benefits of economic freedom are widespread and palpable. As Miller concluded, “The prosperity that flows from economic freedom results in greater access to education, reduced illiteracy, increased access to higher quality health care and food supplies, and longer life expectancy.” The data from a broad spectrum of global sources made clear that the freer a country was, the greater would be the well-being of its people across the board.

In the 2011 edition, this comparative approach was taken to even higher levels. Using data from the Yale Center for Environmental Law and Policy and other groups, former Heritage Foundation Senior Fellow Ben Lieberman compared the environmental performance of 163 nations with Index scores on economic freedom. He discovered that a nation’s wealth “correlates highly” with the “Environmental Performance Index.” Since the wealthiest nations also happen to be the most economically free, he concluded that free economies do the best job of protecting the environment. The reason is straightforward: “One can think of environmental protection as a good that only prosperous societies can afford.”
People struggling for economic survival do not have the luxury of worrying about or paying for cleaner water or air. The policy implication is obvious: If an environmentalist wants to protect the environment, he or she should advocate policies that promote economic freedom rather than more state-controlled environmental restrictions on the world’s poor and economically repressed countries.

Over the past few years, under the leadership of Miller and his assistant Anthony Kim, the Index has also played an important role in documenting the decline of economic freedom in the United States. The election of President Barack Obama in 2008 ushered in an era of high government spending, regulation, and new taxes. It was not long before these policies began to affect America’s ranking as one of the world’s freest economies. The U.S. dropped out of the top ranks of the freest economies in 2010. Its score dropped another spot in 2011 and ended up in 10th place in both editions preceding this one—and well below the other freest economies. Even Canada, with socialized medicine, scored higher. For over five years, as the Index documents, our nation’s economic freedom has been unambiguously eroded by excessive government spending and growth-stifling regulations, an unreformed tax system, and creeping cronyism that undermines the rule of law.

The last big change under Miller’s leadership has been the push to achieve truly universal coverage of countries around the world. The number of countries included in the Index has grown from 157 in 2007 to 186 in this year’s edition, making the Index by far the most comprehensive study of its type.

20 YEARS OF MAKING A DIFFERENCE

Looking back on the 20 years of research in the Index of Economic Freedom, former Heritage President Ed Feulner explained to me the keys to its success:

It was its timeliness, continuity, and transparency that made the difference. It came out every year at the same time, so people could depend on using it to measure the progress of economic freedom. It built up a huge base of data that policymakers and scholars could use to make comparisons and draw broader conclusions. And it was easy to understand and simple to use.

As one of the founders of the Index, I would add that the research quality and dedication of the Heritage people involved, including all of the country and regional experts, has made a huge difference. Our partnership with The Wall Street Journal, particularly in the early days with Melanie Kirkpatrick and later with Mary O’Grady, obviously has been a key to its success. It helped to bring wider recognition, and input from their editors has contributed to making the Index a world-class product. I have been privileged to work with them and others, both in and outside of Heritage, who are among the best minds in the business. I will always be thankful for the opportunity to have been part of this wonderful enterprise.
Endnotes


7 From discussions with Joel Anand-Samy of the Adriatic Institute, with permission to cite.


15 See, for example, Organisation for Economic Co-operation and Development, Studies on SMEs and Entrepreneurship, Thailand: Key Issues and Policies, 2011, p. 74.


22 Information provided in e-mail correspondence with author, with permission to cite.

23 Information provided in e-mail correspondence with author, with permission to cite.

24 Information provided in e-mail correspondence with current Index staff, with permission to cite.


31 Bryan T. Johnson, “Comparing Economic Freedom and Political Freedom,” in Johnson, Holmes, and Kirkpatrick, 1999 *Index of Economic Freedom*, p. 34. A 1997 Cato Institute study reported similar observations; its authors called results of their regression analyses “quite remarkable” because they showed that, “while both economic freedom and political/civil liberty contribute significantly to prosperity, gains in economic freedom have a ‘prosperity dividend’ that is three to six times greater than that which would be obtained from comparable gains in political/civil liberty.” Hanke and Walters, “Economic Freedom, Prosperity, and Equality: A Survey,” p. 139.


37 Ibid., p. 55.