

Chapter 2

Why Economic Freedom Matters

Ambassador Terry Miller and Anthony B. Kim

Since its inception in 1995, the *Index of Economic Freedom* has chronicled hundreds of examples of government policy changes that have enhanced economic freedom, thereby promoting human progress and greater prosperity. As the *Index* has catalogued, nations with higher degrees of economic freedom prosper because they capitalize more fully on the ability of the free-market system not only to generate, but also to reinforce dynamic growth through efficient resource allocation, value creation, and innovation. Policies that promote freedom, whether through improvements in the rule of law, the promotion of competition and openness, or suitable restraints on the size and economic reach of government, turn out in practice to offer and advance practical solutions to a wide range of economic and social challenges that face the world's societies.

The findings of the 2015 *Index* once again demonstrate the strongly positive linkages between economic freedom and various dimensions of human development. Many of the

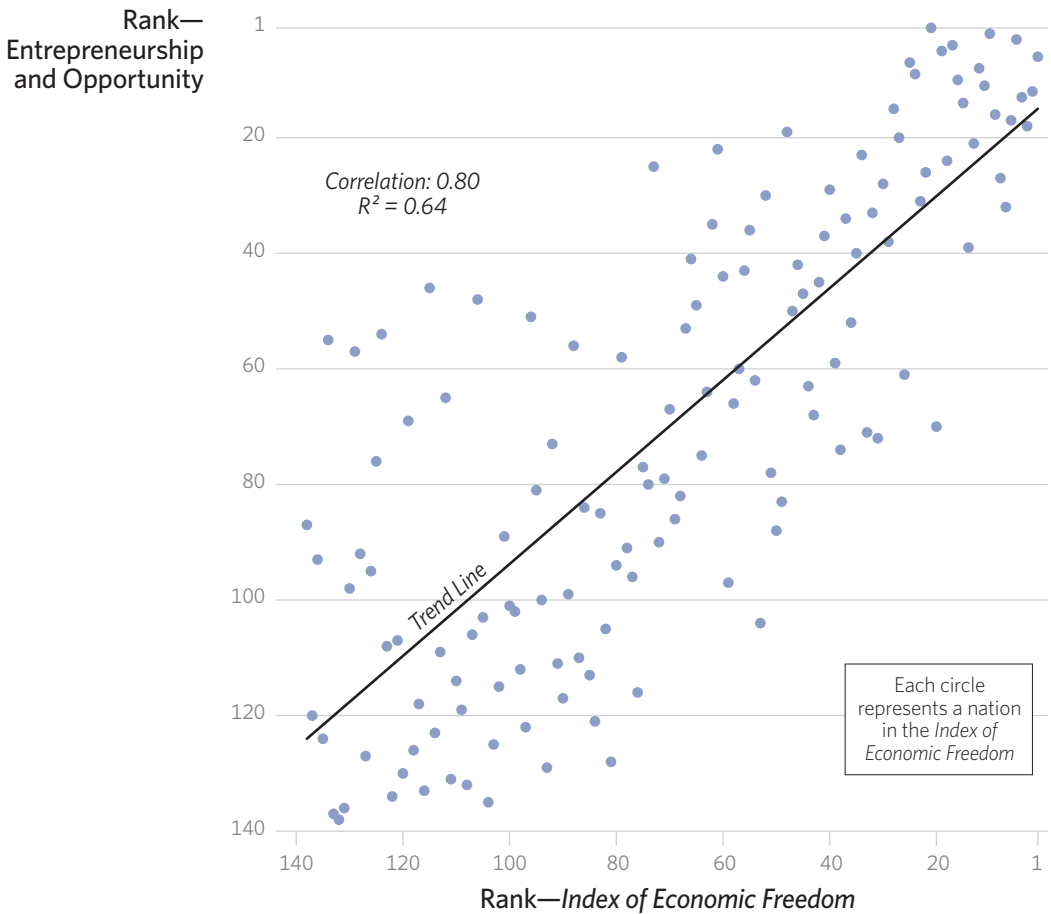
linkages are straightforward: Higher taxes, for example, reduce investment and hurt job growth. Others, such as the impact on economic growth from the promotion of property rights or the maintenance of a stable monetary system, are more intricate, multidimensional, and nonlinear.

Even in these cases, however, the evidence is strong that adherence to the principles of economic freedom is an unmatched strategy for promoting solutions to human problems and advancing overall well-being. No alternative systems—and many have been tried—come close to the record of free-market capitalism in promoting growth and improving the human condition.

ECONOMIC FREEDOM: ADVANCING OPPORTUNITY

Today's successful economies are not necessarily geographically large or richly blessed with natural resources. Many economies have managed to expand opportunities for their citizens by enhancing their economic dynamism. In general, the overarching objective of economic policies

Economic Freedom Promotes Entrepreneurial Dynamism



Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>, and Legatum Institute Foundation, "Legatum Prosperity Index: Entrepreneurship and Opportunity," <http://www.prosperity.com/#!/entrepreneurship-opportunity> (accessed November 20, 2014).

Chart 1  heritage.org

must be to create an environment that provides the most opportunity for the widest range of activities that can lead to increased prosperity.

The *Index* results have shown that sustaining such economic dynamism is achievable only when governments adopt economic policies that empower individuals and firms with more choices, encouraging greater entrepreneurship.

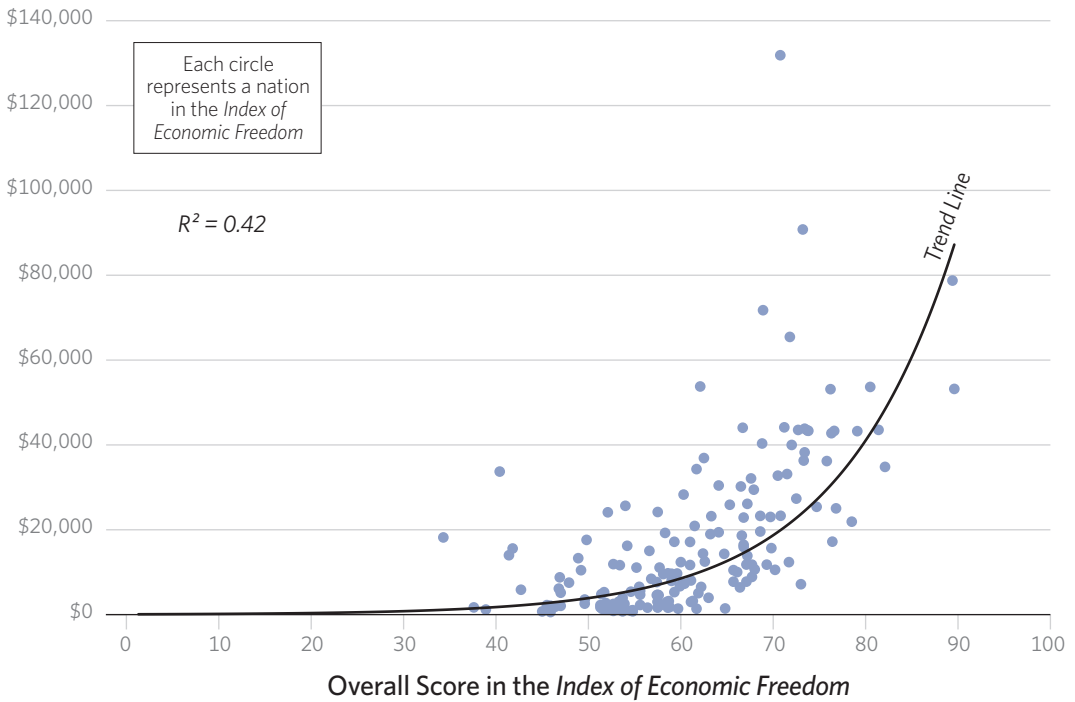
It is noteworthy that despite recent policy missteps by many countries in responding to the global economic slowdown, which amounted to a political assault on capitalism in some places,

the free-market system is not on the verge of breakdown. In fact, as the negative impact of regulatory and spending mistakes has become apparent, a greater number of people around the world seem to be realizing that the economic damage inflicted by the heavy hand of government—subpar growth, deteriorating entrepreneurial environments, and lower employment growth—is not inevitable, but rather the result of bad policy choices.

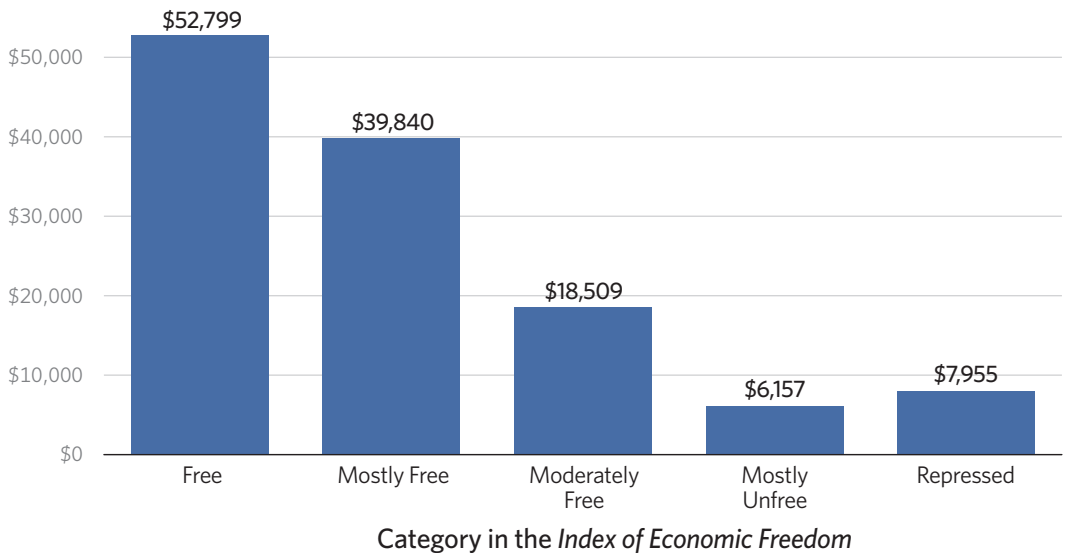
Even as the free market has been under challenge in countries such as Venezuela, Bolivia,

Economic Freedom and Prosperity


GDP per Capita (Purchasing Power Parity)



GDP per Capita (Purchasing Power Parity)

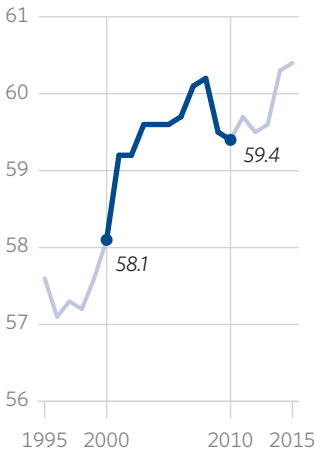


Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>; and International Monetary Fund, World Economic Outlook Databases, <http://www.imf.org/external/ns/cs.aspx?id=28> (accessed November 19, 2014).

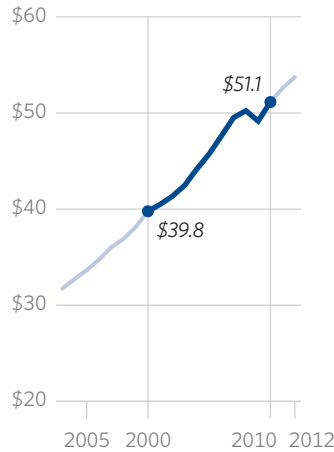
Chart 2  heritage.org

As Economic Freedom Rises, the Global Economy Expands and Poverty Falls

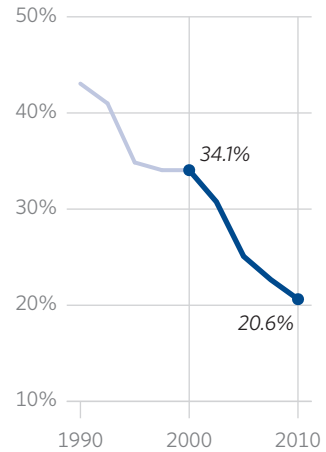
Average Score in the Index of Economic Freedom



Global GDP, in Trillions of 2005 U.S. Dollars



Percent of Global Population in Poverty



Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>; The World Bank, World Development Indicators Online, <http://databank.worldbank.org/data/views/variableSelection/selectvariables.aspx?source=world-development-indicators> (accessed November 20, 2014); and The World Bank, PovcalNet, <http://iresearch.worldbank.org/PovcalNet/index.htm?1> (accessed November 20, 2014). Some figures have been interpolated.

Chart 3  heritage.org

Russia, and even the United States, many other governments around the world have acknowledged its superiority. Decades of evidence, some presented in the pages of this *Index*, are hard for even the most ideological governments to ignore. Not only does the free-market system remain viable, but many of its core features, such as private property rights, openness to trade and investment, and fiscal discipline, have entrenched themselves as the policy standard, any deviation from which requires strong justification.

ECONOMIC FREEDOM: PROMOTING PROSPERITY

In many respects, economic freedom is merely shorthand for an openness to entrepreneurial activity that increases opportunity for individuals to succeed in their endeavors. Chart 1 shows the close correspondence between economic freedom and entrepreneurial opportunity as measured by the Entrepreneurship and Opportunity sub-index of the Legatum Prosperity Index, which “measures a coun-

try’s entrepreneurial environment, its promotion of innovative activity, and the evenness of opportunity.”

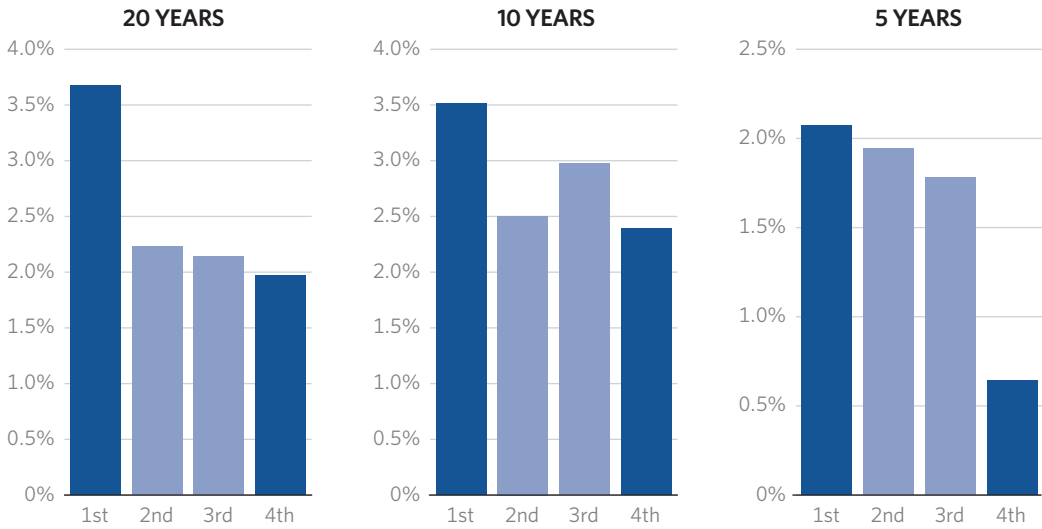
Given such a strong relationship, it should be apparent that a government’s most effective stimulus activity will not be to increase its own spending or increase layers of regulation, both of which reduce economic freedom. The best results are likely to be achieved instead through policy reforms that improve the incentives that drive entrepreneurial activity, creating more opportunities for greater economic dynamism.

Equally notable are the fundamental benefits that stem from the strong positive relationship between economic freedom and levels of per capita income. For countries achieving scores in the *Index* that reflect even moderate levels of economic freedom (60 or above), the relationship between economic freedom and per capita GDP is highly significant.

As indicated in Chart 2, countries moving up the economic freedom scale show increasingly high levels of average income. Economies rated

Advancing Economic Freedom Leads to Higher Economic Growth

Average Annual Growth in Real Per Capita GDP



Change in Economic Freedom Score, by Quartile
(1st—most improvement, 4th—least)

Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>, and The World Bank, World Development Indicators Online, <http://databank.worldbank.org/data/views/variableSelection/selectvariables.aspx?source=world-development-indicators> (accessed November 20, 2014). Changes in economic freedom score have been calculated as the annual compound growth rate.

Chart 4  heritage.org

“free” or “mostly free” in the 2015 *Index* enjoy incomes that are over twice the average levels in all other countries and more than five times higher than the incomes of “repressed” economies.

ECONOMIC FREEDOM: ANTIDOTE TO POVERTY

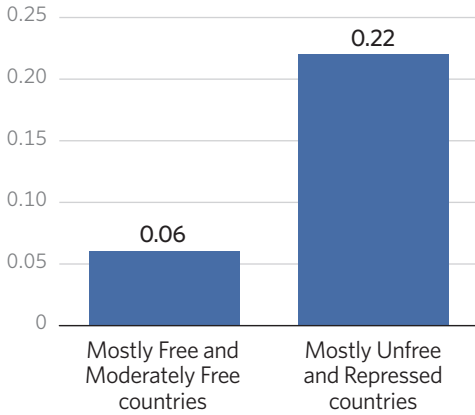
By a great many measures, the past two decades during which the *Index* has been charting the advance of economic freedom have been the most prosperous in the history of humankind. Those countries that have adopted some version of free-market capitalism, with economies supported by efficient regulations and open to the free flow of goods, services, and capital, have participated in an era of globalization and economic integration in which solutions to many of the world’s development problems have taken hold and generated real improvements in living standards.

The free-market system that is rooted in the principles of economic freedom has fueled unprecedented economic growth around the world. As Chart 3 illustrates, as the global economy has moved toward greater economic freedom over the past two decades, real world GDP has increased by about 70 percent, and the global poverty rate has been cut in half, lifting hundreds of millions of people out of poverty.

Greater economic freedom has had a positive impact not just on the number of people in poverty, but also on the intensity of the poverty still experienced by some. Poverty intensity as measured by the United Nations Development Programme’s Multidimensional Poverty Index, which assesses the nature and intensity of deprivation at the individual level in education, health outcomes, and standard of living, is much lower on average in countries with higher levels of eco-

Economic Freedom and Poverty Intensity

Poverty Intensity



Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>, and U.N. Human Development Programme, "Human Development Report 2014," 2014, <http://hdr.undp.org/en/content/human-development-report-2014> (accessed November 20, 2014).

Chart 5  heritage.org

conomic freedom. Chart 5 shows that the intensity of poverty in countries whose economies are considered mostly free or moderately free is only about one-fourth the level in countries that are rated less free.

The key driver of poverty reduction is dynamic and resilient economic growth that creates jobs. Not surprisingly, one of the most important goals of economic policy in almost every country in the world has thus been to increase the rate of economic growth.

As Chart 4 demonstrates, there is a robust relationship between improving economic freedom and achieving higher per capita economic growth. Whether long-term (20 years), medium-term (10 years), or short-term (five years), the relationship between changes in economic freedom and changes in economic growth is consistently positive.

Undeniably, countries moving toward greater economic freedom tend to achieve higher rates of per capita GDP growth over time. Whether in the short term or over the long run, the average annu-

al per capita economic growth rates of countries that have grown economic freedom the most are at least 50 percent higher than those of countries where freedom has stagnated or slowed.

ECONOMIC FREEDOM: SOCIETAL DEVELOPMENT AND DEMOCRATIC PROGRESS

Growing economic freedom is unequivocally about more than financial success. Achieving greater overall prosperity that goes beyond materialistic and monetary dimensions of well-being is equally important. The societal benefits of economic freedom extend far beyond higher incomes or reductions in poverty. Countries with higher levels of economic freedom enjoy higher levels of overall human development as measured by the United Nations Human Development Index, which measures life expectancy, literacy, education, and the standard of living in countries worldwide. As Chart 6 shows, governments that choose policies that increase economic freedom are placing their societies on the pathway to more education opportunities, better health care, and higher standards of living for their citizens.

In some countries, government policies and actions concerning the environment have become more intrusive and economically distortionary. Many governments have pushed programs to tax carbon emissions and increase taxes on gasoline, organized non-transparent and sometimes corrupt exchanges for the buying and selling of carbon emissions, and provided subsidies for "clean" energy to politically favored firms. Such policies impose a huge direct cost on society, and they also retard economic growth—and all for uncertain environmental benefits.

Interestingly, the same free-market principles that have proven to be the key to economic success have also proven to deliver environmental success. Around the world, economic freedom has been shown to increase countries' capacity for innovation and thus to improve overall environmental performance.

The positive link between economic freedom and higher levels of innovation ensures greater economic dynamism in coping with

various developmental challenges, and the most remarkable improvements in clean energy use and energy efficiency over the past decades have occurred not as a result of government regulation, but rather because of advances in technology and trade. A virtuous cycle of investment, innovation (including in greener technologies), and dynamic economic growth has flourished where governments have trusted market forces and competition to spur efficiency. (See Chart 7.)

Greater economic freedom can also provide more fertile ground for effective and democratic governance. Debate over the direction of causality between economic freedom and democracy has become more controversial in recent years because of the multifaceted interaction between the two. Undoubtedly, achieving greater political freedom through well-functioning democracy is a messy and often excruciating process.

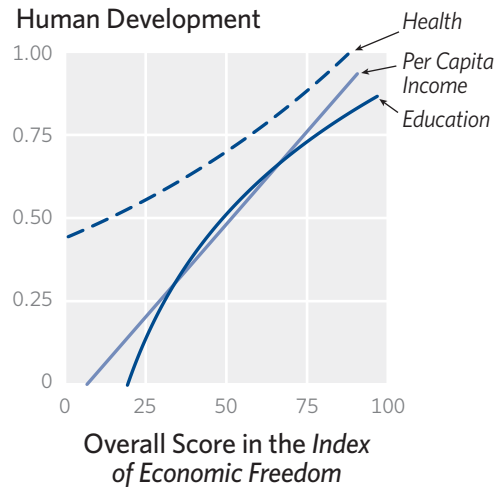
However, the positive relationship between economic freedom and democratic governance is undeniable. (See Chart 8.) By empowering people to exercise greater control of their daily lives, economic freedom ultimately nurtures political reform by making it possible for individuals to gain the economic resources necessary to challenge entrenched interests and compete for political power, thereby encouraging the creation of more pluralistic societies.

Pursuit of greater economic freedom is thus an important stepping-stone to democracy. It empowers the poor and builds the middle class. It is a philosophy that encourages entrepreneurship and disperses economic power and decision-making throughout society.

ECONOMIC FREEDOM: THE KEY TO UPWARD MOBILITY AND GREATER SOCIAL PROGRESS

The massive improvements in global indicators of income and quality of life largely reflect a paradigm shift in the debate over how societies should be structured to achieve the most optimal outcome. Over the past two decades, this debate has largely been won by capitalism. However, fears that the immediate benefits of capitalism are fading has brought to the forefront concerns about economic mobility and economic freedom.

Greater Freedom Means Greater Performance by Several Measures



Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>, and U.N. Human Development Programme, International Human Development Indicators, <http://hdr.undp.org/en/statistics/> (accessed November 20, 2014). Human Development values have been converted to a 0-1 scale.

Chart 6 heritage.org

At the heart of ensuring upward economic mobility is the task of advancing economic freedom so that dynamic and inclusive growth can meaningfully occur for ordinary people in a free society. Milton and Rose Friedman made a keen observation on the critically intertwined relationship between freedom and mobility:

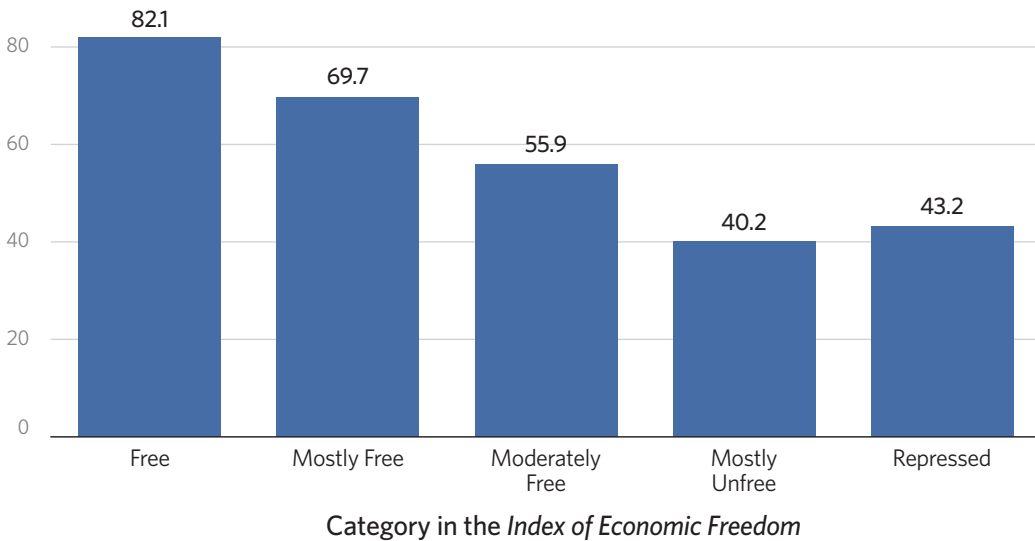
[S]o long as freedom is maintained, it prevents ... positions of privilege from becoming institutionalized. Freedom means diversity, but also mobility. It preserves the opportunity for today's disadvantaged to become tomorrow's privileged and, in the process enables almost everyone, from top to bottom, to enjoy a fuller and richer life.¹

Economic freedom is critical to generating the broader-based economic growth that brings more opportunities for a greater number of people to work, produce, and save. In other words, ensuring greater economic freedom is

Economic Freedom, Innovation, and the Environment



Environmental Performance Index

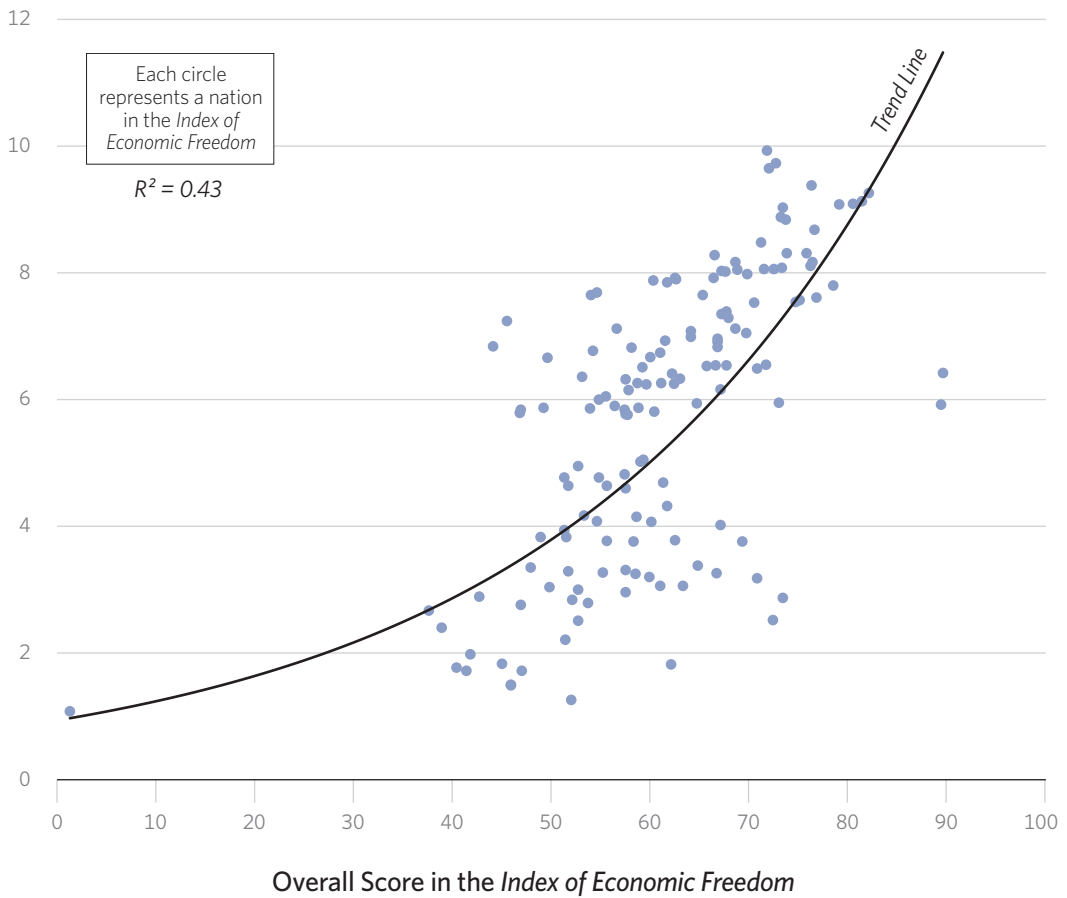


Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>; and Cornell University, INSEAD, and World Intellectual Property Organization, *The Global Innovation Index 2013: The Local Dynamics of Innovation* (Geneva: World Intellectual Property Organization, 2013), <http://www.globalinnovationindex.org/content.aspx?page=gii-full-report-2013> (accessed November 20, 2014); and Yale University, "2014 Environmental Performance Index," <http://epi.yale.edu/epi> (accessed November 20, 2014).

Chart 7  heritage.org

Economic Freedom and Democratic Governance

The Economist Intelligence Unit's Index of Democracy



Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>, and The Economist Intelligence Unit, "Democracy Index 2013," http://www.eiu.com/public/topical_report.aspx?campaignid=Democracy0814 (accessed November 19, 2014).

Chart 8  heritage.org

directly related to preserving and enhancing dynamic upward mobility.

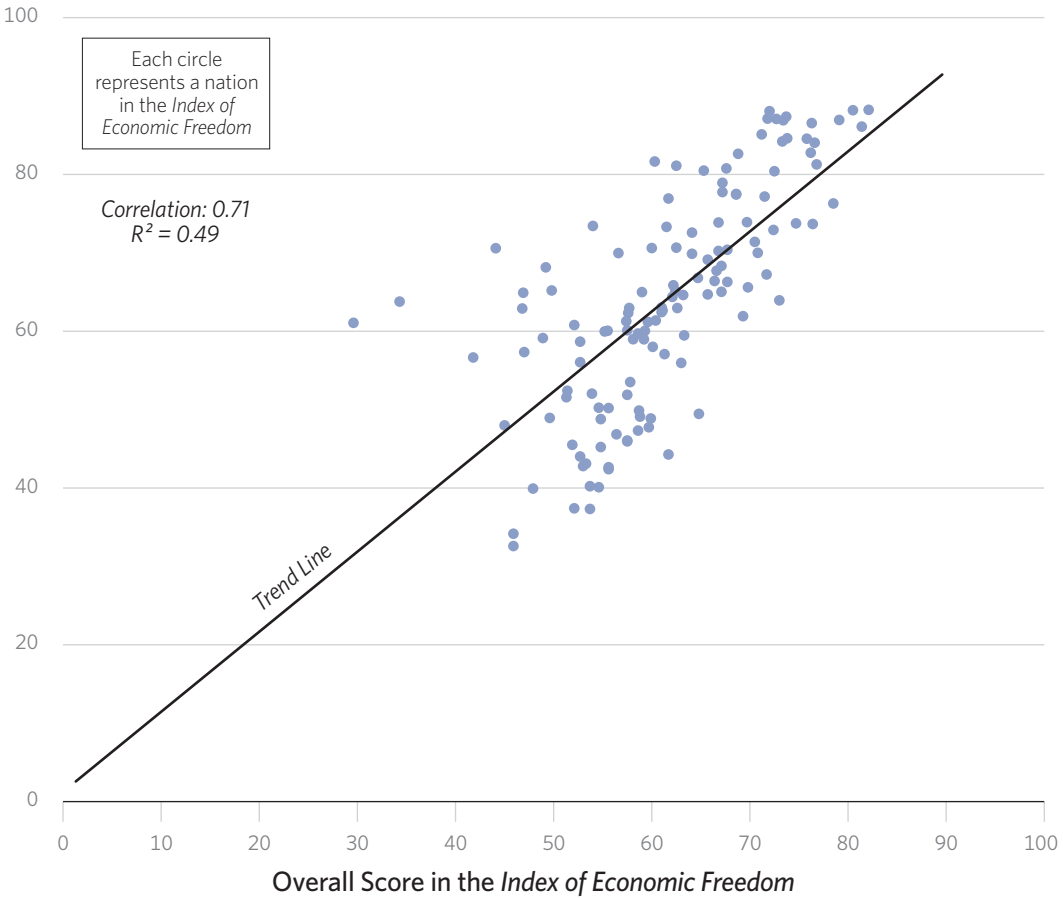
Also notable is that although some naysayers claim that economic and social progress has been limited in recent years as incomes in some countries have become more unequal as a result of economic freedom, the evidence does not support this contention. Instead, societies based on economic freedom are the ones that have demonstrated the strongest social progress.

As shown in Chart 9, countries that largely embrace economic freedom provide the envi-

ronments that are most conducive to social progress.² Countries that improve their competitiveness and open their societies to new ideas, products, and innovations have largely achieved the high levels of social progress that their citizens demand. It is not massive redistributions of wealth or government dictates on income levels that produce the most positive social outcomes. Instead, mobility and progress require lower barriers to entry, freedom to engage with the world, and less government intrusion.

Economic Freedom and Social Progress

Social Progress Index



Sources: Terry Miller and Anthony B. Kim, *2015 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), <http://www.heritage.org/index>, and Social Progress Imperative, "Social Progress Index 2014," April 2014, <http://www.socialprogressimperative.org/data/spi> (accessed November 19, 2014).

Chart 9  heritage.org

STAYING ON COURSE

The 21st edition of the *Index of Economic Freedom* shows economic freedom once again on the rise, reaching the highest point in the *Index's* 21-year history. Behind this record are stories of human progress and the achievements of countries and their citizens—literally billions of people around the world whose lives have measurably improved.

It is no coincidence that the increase of economic liberty over the past decades has coincided with a massive reduction in worldwide poverty,

disease, and hunger. The link between economic freedom and development is clear and strong. People in economically free societies live longer. They have better health. They are able to be better stewards of the environment, and they push forward the frontiers of human achievement in science and technology through greater innovation.

A recurring theme of human history has been resilience and revival. The country profiles in the 2015 *Index of Economic Freedom* include many examples of countries that have accelerated their economic and social progress in the face

of difficult challenges and a sometimes harsh international environment. Their successes can be emulated by others. The *Index of Economic Freedom* charts not just one path to development, but as many as the ingenuity of humans can produce when they are free to experiment and innovate.

The principles of economic freedom are a sure guide, but only a guide. What truly will matter are the creative solutions to pressing world problems that are certain to flow from people who are, in the words of Milton and Rose Friedman, “free to choose.”

ENDNOTES

1. Milton Friedman and Rose D. Friedman, *Free to Choose: A Personal Statement* (New York: Harcourt Brace Jovanovich, 1979).
2. The Social Progress Index defines social progress as the capacity of a society to meet the basic human needs of its citizens, establish the building blocks that allow citizens and communities to enhance and sustain the quality of their lives, and create the conditions for all individuals to reach their full potential.