

## Chapter 2

# Defining Economic Freedom

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**A**ny discussion of economic freedom has at its heart reflection on the critical relationship between individuals and the government. In general, state action or government control that interferes with individual autonomy limits economic freedom.

However, the goal of economic freedom is not simply an absence of government coercion or constraint, but the creation and maintenance of a mutual sense of liberty for all. Some government action is necessary for the citizens of a nation to defend themselves and to promote the peaceful evolution of civil society, but when government action rises beyond the minimal necessary level, it leads inevitably and quickly to the loss of freedom.

Throughout history, governments have imposed a wide array of constraints on economic activity. Such constraints, though sometimes imposed in the name of equality or some other ostensibly noble societal purpose, are in reality imposed most often for the benefit of societal elites or special interests. As Milton and Rose Friedman once observed:

A society that puts equality—in the sense of equality of outcome—ahead of freedom will end up with neither equality nor freedom. The use of force to achieve equality will destroy freedom, and the force, introduced for good purposes, will end up in the hands of people who use it to promote their own interests.<sup>1</sup>

The excessive intrusion of government into wide spheres of economic activity comes with a high cost to society as a whole. By substituting political judgments for those of the marketplace, government diverts entrepreneurial resources and energy from productive activities to rent-seeking, the quest for economically unearned benefits. The result inevitably is lower productivity, economic stagnation, and declining prosperity.

### **MEASURING ECONOMIC FREEDOM**

The *Index of Economic Freedom* takes a comprehensive view of economic freedom. Some of the aspects of economic freedom that are

evaluated are concerned with a country's interactions with the rest of the world—for example, the extent of an economy's openness to global investment or trade. Most, however, focus on policies within a country, assessing the liberty of individuals to use their labor or finances without undue restraint and government interference.

Each of the measured aspects of economic freedom plays a vital role in developing and sustaining personal and national prosperity. All are complementary in their impact, however, and progress in one area is often likely to reinforce or even inspire progress in another. Similarly, repressed economic freedom in one area—respect for property rights, for example—may make it much more difficult to achieve high levels of freedom in other categories.

The 10 aspects of economic freedom measured in the *Index* may be grouped into four broad categories:

- **Rule of law** (property rights, freedom from corruption);
- **Government size** (fiscal freedom, government spending);
- **Regulatory efficiency** (business freedom, labor freedom, monetary freedom); and
- **Market openness** (trade freedom, investment freedom, financial freedom).

## Rule of Law

**Property Rights.** In a market economy, the ability to accumulate private property and wealth is a central motivating force for workers and investors. The recognition of private property rights and an effective rule of law to protect them are vital features of a fully functioning market economy. Secure property rights give citizens the confidence to undertake entrepreneurial activity, save their income, and make long-term plans because they know that their income, savings, and property (both real and intellectual) are safe from unfair expropriation or theft.

The protection of private property requires an autonomous and accountable judicial system that is available to all equally and without discrimination. The independence, transparency, and effectiveness of the judicial system have

proven to be key determinants of a country's prospects for long-term economic growth. An effective and impartial judiciary is also vital to the maintenance of peace and security and the protection of human rights.

A key aspect of property rights protection is the enforcement of contracts. The voluntary undertaking of contractual obligations is the foundation of the market system and the basis for economic specialization, gains from commercial exchange, and trade among nations. Even-handed government enforcement of private contracts is essential to ensuring equity and integrity in the marketplace.

**Freedom from Corruption.** In the context of economic freedom, corruption can be understood best as the failure of integrity in the economic system, a distortion that enables individuals or special-interest groups to gain at the expense of the whole. Often a direct result of the government's concentration of economic or political power, corruption manifests itself in many forms such as bribery, extortion, nepotism, cronyism, patronage, embezzlement, and graft.

Corruption can infect all parts of an economy in systematic ways. There is a direct relationship between the extent of government intervention in economic activity and the prevalence of corruption. In particular, excessive and redundant government regulations provide opportunities for bribery or graft. In addition, government regulations or restrictions in one area may create informal markets in another. For example, by imposing numerous burdensome barriers to conducting business, including regulatory red tape and high transaction costs, a government can incentivize bribery and encourage illegitimate market interactions.

Ensuring transparency is crucial to dealing effectively with corruption. Openness in regulatory procedures and processes can promote equitable treatment and greater efficiency.

## Government Size

**Fiscal Freedom.** Fiscal freedom is a direct measure of the extent to which government permits individuals and businesses to keep and manage their income and wealth for their own

benefit and use. All governments impose fiscal burdens on economic activity through taxation and borrowing.

The higher the government's share of income or wealth, the lower the individual's reward for economic activity and the lower the incentive to undertake work at all. Higher tax rates reduce the ability of individuals and firms to pursue their goals in the marketplace and thereby lower overall private-sector activity.

Individual and corporate income tax rates are an important and direct constraint on an individual's economic freedom and are reflected as such in the *Index*, but they are not a comprehensive measure of the tax burden. Governments impose many other indirect taxes, including payroll, sales, and excise taxes, as well as tariffs and the value-added tax (VAT). In the *Index of Economic Freedom*, the burden of these taxes is captured by measuring the overall tax burden from all forms of taxation as a percentage of total gross domestic product (GDP).

**Government Spending.** The cost of excessive government is a central economic freedom issue, both in terms of generating revenue (see fiscal freedom) and in terms of spending. Government spending comes in many forms. Some government spending—for example, to provide infrastructure, fund research, or improve human capital—may be considered investment. Government also spends on public goods, the benefits of which accrue broadly to society in ways that markets cannot price appropriately.

All government spending, however, must eventually be financed by higher taxation and entails an opportunity cost. This cost is the value of the private consumption or investment that would have occurred had the resources involved been left in the private sector.

Excessive government spending runs a great risk of crowding out private economic activity. Even if an economy achieves faster growth through more government spending, such economic expansion tends to be only temporary, distorting the market allocation of resources and private investment incentives.

Even worse, a government's insulation from market discipline often leads to bureaucracy,

lower productivity, inefficiency, and mounting public debt that imposes an even greater burden on future generations. As many economies have experienced in recent years, high levels of public debt accumulated through irresponsible government spending undermine economic freedom and prevent dynamic entrepreneurial growth.

## Regulatory Efficiency

**Business Freedom.** Business freedom is about an individual's right to establish and run an enterprise without undue interference from the state. Burdensome and redundant regulations are the most common barriers to the free conduct of entrepreneurial activity. By increasing the costs of production, regulations can make it difficult for entrepreneurs to succeed in the marketplace.

Although many regulations hinder business productivity and profitability, the most inhibiting to entrepreneurship are those that are associated with licensing new businesses. In some countries, as well as many states in the United States, the procedure for obtaining a business license can be as simple as mailing in a registration form with a minimal fee. In Hong Kong, for example, obtaining a business license requires filling out a single form, and the process can be completed in a few hours. In other economies, such as India and parts of South America, the process of obtaining a business license can take much longer and involve endless trips to government offices and repeated encounters with officious and sometimes corrupt bureaucrats.

Once a business is open, government regulation may interfere with the normal decision-making or price-setting process. Interestingly, two countries with the same set of regulations can impose different regulatory burdens. If one country applies its regulations evenly and transparently, it can lower the regulatory burden by facilitating long-term business planning. If the other applies regulations inconsistently, it raises the regulatory burden by creating an unpredictable business environment.

**Labor Freedom.** The ability of individuals to find employment opportunities and work is a key component of economic freedom. By the

same token, the ability of businesses to contract freely for labor and dismiss redundant workers when they are no longer needed is essential to enhancing productivity and sustaining overall economic growth.

The core principle of any market is free, voluntary exchange. That is just as true in the labor market as it is in the market for goods.

State intervention generates the same problems in the labor market that it produces in any other market. Government labor regulations take a variety of forms, including wage controls, restrictions on hiring and firing, and other constraints. In many countries, unions play an important role in regulating labor freedom and, depending on the nature of their activity, may be either a force for greater freedom or an impediment to the efficient functioning of labor markets.

Onerous labor laws penalize businesses and workers alike. Rigid labor regulations prevent employers and employees from freely negotiating changes in terms and conditions of work, and the result is often a chronic mismatch of labor supply and demand.

**Monetary Freedom.** Monetary freedom requires a stable currency and market-determined prices. Whether acting as entrepreneurs or as consumers, free people need a steady and reliable currency as a medium of exchange, unit of account, and store of value. Without monetary freedom, it is difficult to create long-term value or amass capital.

The value of a country's currency can be influenced significantly by the monetary policy of its government. With a monetary policy that endeavors to fight inflation, maintain price stability, and preserve the nation's wealth, people can rely on market prices for the foreseeable future. Investments, savings, and other longer-term plans can be made more confidently. An inflationary policy, by contrast, confiscates wealth like an invisible tax and distorts prices, misallocates resources, and raises the cost of doing business.

There is no single accepted theory of the right monetary policy for a free society. At one time, the gold standard enjoyed widespread support.

What characterizes almost all monetary theories today, however, is support for low inflation and an independent central bank. There is also widespread recognition that price controls corrupt market efficiency and lead to shortages or surpluses.

## Market Openness

**Trade Freedom.** Trade freedom reflects an economy's openness to the flow of goods and services from around the world and the citizen's ability to interact freely as buyer or seller in the international marketplace. Trade restrictions can manifest themselves in the form of tariffs, export taxes, trade quotas, or outright trade bans. However, trade restrictions also appear in more subtle ways, particularly in the form of regulatory barriers.

The degree to which government hinders the free flow of foreign commerce has a direct bearing on the ability of individuals to pursue their economic goals and maximize their productivity and well-being. Tariffs, for example, directly increase the prices that local consumers pay for foreign imports, but they also distort production incentives for local producers, causing them to produce either a good in which they lack a comparative advantage or more of a protected good than is economically efficient. This impedes overall economic efficiency and growth.

In many cases, trade limitations also put advanced-technology products and services beyond the reach of local entrepreneurs, limiting their own productive development.

**Investment Freedom.** A free and open investment environment provides maximum entrepreneurial opportunities and incentives for expanded economic activity, greater productivity, and job creation. The benefits of such an environment flow not only to the individual companies that take the entrepreneurial risk in expectation of greater return, but also to society as a whole. An effective investment framework is characterized by transparency and equity, supporting all types of firms rather than just large or strategically important companies, and encourages rather than discourages innovation and competition.

Restrictions on the movement of capital, both domestic and international, undermine the efficient allocation of resources and reduce productivity, distorting economic decision-making. Restrictions on cross-border investment can limit both inflows and outflows of capital, thereby shrinking markets and reducing opportunities for growth.

In an environment in which individuals and companies are free to choose where and how to invest, capital can flow to its best use: to the sectors and activities where it is most needed and the returns are greatest. State action to redirect the flow of capital and limit choice is an imposition on the freedom of both the investor and the person seeking capital. The more restrictions a country imposes on investment, the lower its level of entrepreneurial activity.

**Financial Freedom.** An accessible and efficiently functioning formal financial system ensures the availability of diversified savings, credit, payment, and investment services to individuals. By expanding financing opportunities and promoting entrepreneurship, an open banking environment encourages competition in order to provide the most efficient financial intermediation between households and firms as well as between investors and entrepreneurs.

Through a process driven by supply and demand, markets provide real-time information on prices and immediate discipline for those who have made bad decisions. This process depends on transparency in the market and the integrity of the information being made available. A prudent and effective regulatory system, through

disclosure requirements and independent auditing, ensures both.

Increasingly, the central role played by banks is being complemented by other financial services that offer alternative means for raising capital or diversifying risk. As with the banking system, the useful role for government in regulating these institutions lies in ensuring transparency and integrity and promoting disclosure of assets, liabilities, and risks.

Banking and financial regulation by the state that goes beyond the assurance of transparency and honesty in financial markets can impede efficiency, increase the costs of financing entrepreneurial activity, and limit competition. If the government intervenes in the stock market, for instance, it contravenes the choices of millions of individuals by interfering with the pricing of capital—the most critical function of a market economy.

## **ECONOMIC FREEDOM: AN END IN ITSELF, A MEANS FOR PROGRESS**

As a vital element of human dignity, autonomy, and personal empowerment, economic freedom is valuable as an end itself. Just as important, however, is the fact that economic freedom is the key to achieving the broad-based economic dynamism that ensures lasting inclusive growth and increased prosperity for society as a whole. As Friedrich Hayek foresaw decades ago, “the guiding principle in any attempt to create a world of free men must be this: a policy of freedom for the individual is the only truly progressive policy.”<sup>2</sup>

## ENDNOTES

1. Milton Friedman and Rose D. Friedman, *Free to Choose: A Personal Statement* (New York: Harcourt Brace Jovanovich, 1979).
2. Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944).