

CHAPTER 2

DEFINING ECONOMIC FREEDOM

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Economic freedom is at its heart about individual autonomy, concerned chiefly with the freedom of choice enjoyed by individuals in acquiring and using economic goods and resources. The underlying assumption of those who favor economic freedom is that individuals know their needs and desires best and that a self-directed life, guided by one's own philosophies and priorities rather than those of a government or technocratic elite, is the foundation of a fulfilling existence. Independence and self-respect flow from the ability and responsibility to take care of oneself and one's family and are invaluable contributors to human dignity and equality.

Living in societies as we do, individual autonomy can never be considered absolute. Many individuals regard the well-being of their families and communities as equal in importance to their own, and the personal rights enjoyed by one person may well end at his neighbor's doorstep. Decisions and activities that have an impact or potential impact on others are rightly constrained by societal norms and, in the most critical areas, by government laws or regulations.

In a market-oriented economy, societal norms, not government laws and regulations, are the primary regulator of behavior. Such norms grow organically out of society itself, reflecting its history, its culture, and the

experience of generations learning how to live with one another. They guide our understanding of ethics, the etiquette of personal and professional relationships, and consumer tastes. Democratic political systems, at their best, reflect societal norms in their laws and regulations, but even democratic governments, if unconstrained by constitutional or other traditional limits, may pose substantial threats to economic freedom. A constraint imposed on economic freedom by majority rule is no less a constraint than one imposed by an absolute ruler or oligarch. It is thus not so much the type of government that determines the degree of economic freedom as it is the extent to which government has limits beyond which it may not, or at least does not, go.

Inevitably, any discussion of economic freedom will focus 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 the absence of government coercion or constraint, but rather 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 is likely infringing on someone's economic or personal 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 fact 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.¹

Government's excessive intrusion 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 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 promoting 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 (for example, a lack of respect for property rights) may make it much more difficult to achieve high levels of freedom in other categories.

The 12 aspects of economic freedom measured in the *Index* may be grouped into four broad categories:

- **Rule of law** (property rights, judicial effectiveness, and government integrity);
- **Government size** (tax burden, government spending, and fiscal health);
- **Regulatory efficiency** (business freedom, labor freedom, and monetary freedom); and
- **Market openness** (trade freedom, investment freedom, and 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.

Property rights are a primary factor in the accumulation of capital for production and investment. Secure titling is key to unlocking the wealth embodied in real estate, making natural resources available for economic use, and providing collateral for investment financing. It is also through the extension and protection of property rights that societies avoid the "tragedy of the commons," the phenomenon that leads to the degradation and

exploitation of property that is held communally and for which no one is accountable. 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.

Judicial Effectiveness. Well-functioning legal frameworks protect the rights of all citizens against infringement of the law by others, including by governments and powerful parties. As an essential component of the rule of law, judicial effectiveness requires efficient and fair judicial systems to ensure that laws are fully respected, with appropriate legal actions taken against violations.

Judicial effectiveness, especially for developing countries, may be the area of economic freedom that is most important in laying the foundations for economic growth, and in advanced economies, deviations from judicial effectiveness may be the first signs of serious problems that will lead to economic decline.

There is plenty of evidence from around the world that judicial effectiveness is a critical factor in empowering individuals, ending discrimination, and enhancing competition. In the never-ending struggle to improve the human condition and achieve greater prosperity, an institutional commitment to the preservation and advancement of judicial effectiveness is critical.

Government Integrity. In a world characterized by social and cultural diversity, practices regarded as corrupt in one place may simply reflect traditional interactions in another. For example, small informal payments to service providers or even government officials may be regarded variously as a normal means of compensation, a “tip” for unusually good service, or a corrupt form of extortion.

While such practices may indeed constrain an individual’s economic freedom, their

impact on the economic system as a whole is likely to be modest. Of far greater concern is the systemic corruption of government institutions by practices such as bribery, nepotism, cronyism, patronage, embezzlement, and graft. Though not all are crimes in every society or circumstance, these practices erode the integrity of government wherever they are practiced. By allowing some individuals or special interests to gain government benefits at the expense of others, they are grossly incompatible with the principles of fair and equal treatment that are essential ingredients of an economically free society.

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 and 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 and secret interactions that compromise the transparency that is essential for the efficient functioning of a free market.

GOVERNMENT SIZE

Tax Burden. All governments impose fiscal burdens on economic activity through taxation and borrowing. Governments that permit individuals and businesses to keep and manage a larger share of their income and wealth for their own benefit and use, however, maximize economic freedom.

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 the level of 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 value-added taxes (VATs). 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, size, and intrusiveness of government taken together are a central economic freedom issue that is measured in the *Index* in a variety of ways (see, for example, Tax Burden and Regulatory Efficiency). Government spending comes in many forms, not all of which are equally harmful to economic freedom. 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 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.

Fiscal Health. A government's budget is one of the clearest indicators of the extent to

which it respects the principle of limited government. By delineating priorities and allocating resources, a budget signals clearly the areas in which government will intervene in economic activity and the extent of that intervention. Beyond that, however, a budget reflects a government's commitment (or lack thereof) to sound financial management of resources, which is both essential for dynamic long-term economic expansion and critical to the advancement of economic freedom.

Widening deficits and a growing debt burden, both of which are direct consequences of poor government budget management, lead to the erosion of a country's overall fiscal health. Deviations from sound fiscal positions often disturb macroeconomic stability, induce economic uncertainty, and thus limit economic freedom.

Debt is an accumulation of budget deficits over time. In theory, debt financing of public spending could make a positive contribution to productive investment and ultimately to economic growth. Debt could also be a mechanism for positive macroeconomic countercyclical interventions or even long-term growth policies. On the other hand, high levels of public debt may have numerous negative impacts such as raising interest rates, crowding out private investment, and limiting government's flexibility in responding to economic crises. Mounting public debt driven by persistent budget deficits, particularly spending that merely boosts government consumption or transfer payments, often undermines overall productivity growth and leads ultimately to economic stagnation rather than growth.

REGULATORY EFFICIENCY

Business Freedom. An individual's ability to establish and run an enterprise without undue interference from the state is one of the most fundamental indicators of economic freedom. 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 ones that most inhibit entrepreneurship are often 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 economically free market is 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 minimum wages or other wage controls, limits on hours worked or other workplace conditions, 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, economically 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. Many governments place restrictions on their citizens' ability to interact freely as buyers or sellers 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 related to health or safety.

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 ideal. 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 uses: 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: A FORMULA FOR SUCCESS

As a vital component 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 provides a formula for economic success.

We know from the data we collect to build the *Index* that each measured aspect of economic freedom has a significant effect on economic growth and prosperity. Policies that allow greater freedom in any of the areas measured tend to spur growth. Growth, in turn, is an essential element in building lasting prosperity.

Economic freedom is not a single system, however. In many respects, it is the absence of a single dominating system. As previous editions of the *Index* have elaborated, economic freedom is not a dogmatic ideology. It represents instead a philosophy that rejects dogma and embraces diverse and even competing strategies for economic advancement. The *Index* also reveals that it is not the policies we fail to implement that hold back economic growth. Rather, it is the dreadful policies that, all too often, we put in place.

In other words, those who believe in economic freedom believe in the right of individuals to decide for themselves how to direct their lives. The added benefit from society's point of view is the proven power of self-directed individuals, whether working alone or working together in associations or corporations, to create the goods and services that best respond to the needs and desires of their fellow citizens.

No country provides perfect freedom to its citizens, and those that do permit high levels of freedom differ with respect to which aspects they believe are most important. That is consistent with the nature of liberty, which allows individuals and societies to craft their own unique paths to prosperity.

Throughout the *Index of Economic Freedom*, we explore many aspects of the relationships between individuals and governments. In measuring economic freedom, we have focused on a comprehensive yet far from exhaustive range of policy areas in which governments typically act, for good or ill. However, the concept of freedom, by its very nature, resists a narrow definition, and each year seems to bring new challenges from those who seek to impose their own views or control the economic actions of others. As new threats to economic freedom arise around the world, our definitions and methodologies will continue to evolve so that we can provide as true a picture as possible of the state of economic freedom around the world.

ENDNOTE:

1. Milton Friedman and Rose D. Friedman, *Free to Choose: A Personal Statement* (New York: Harcourt Brace Jovanovich, 1979).