

Chapter 3

The *Index* at Fifteen: Standing Firm for First Principles

The publication of the 2009 *Index of Economic Freedom*—the 15th anniversary edition—is a good point at which to step back and reflect on the principles and themes that have been highlighted and emphasized in the *Index* over the years. These have been articulated not only in the methodology of the rankings, but also through many outstanding contributions, both by experts from within The Heritage Foundation and *The Wall Street Journal* and by guest authors. Excerpts from some of these contributions appear below.

With the perspective of 15 years, it is obvious that some of the principles and themes of economic freedom have been widely understood, accepted, and implemented by many countries. Their progress is seen in the rankings. The poorer performing countries, by contrast, have tried only some of the ideas, adulterated others, or even, in a few cases, rejected them outright. The negative consequences are also apparent in the rankings. Especially during times of global financial uncertainty, it is important to remember these first principles and stick with them.

THE 1995 INDEX

[When the Index of Economic Freedom debuted in 1995, Dr. Edwin J. Feulner, President of The Heritage Foundation, described in his foreword the policy context and economic environment in which the first edition was produced. He noted in particular the hesitancy of many countries to embrace fully the basic tenets of capitalism. Feulner also highlighted one of the key areas of focus in early editions of the Index—the failure of donor governments’ foreign aid programs to achieve the sought-after impact in developing countries. The reality of this failure has been confirmed by a significant body of peer-reviewed research in the ensuing years and remains a subject of interest today.]

Much has been made of the collapse of state socialism and the post-Cold War global march toward free markets. In reality, however, progress has been slow—and in some parts of the

world nonexistent. Even today, as the authors show in the study that follows, only a relative handful of countries—and we [in the United States] are blessed to be among them—have truly free economies. And some of them, our own included, are backsliding.

U.S. development assistance should have one priority, and one priority only: to promote the kind of free market growth that will enable the recipient country to prosper *without* foreign aid. If U.S. aid does not promote free market capitalism and self-sufficiency, we need to ask the question: Why are we giving it?

The Heritage Foundation's *Index of Economic Freedom* provides compelling evidence that economic prosperity and economic freedom go hand in hand. Lasting prosperity cannot exist in the absence of economic freedom; and a free economy inevitably results in economic growth and rising living standards. Well-intentioned programs that fail to accomplish their goals—and in some cases make matters worse—can no longer be tolerated. The U.S. foreign aid program is a classic example of this: good intentions gone awry.

THE 1996 INDEX

[In a chapter on "Foreign Aid and Economic Development," Bryan T. Johnson and Thomas P. Sheehy of The Heritage Foundation looked at U.S. foreign aid in even greater depth, and the results were not pretty.]

The facts show that poverty is largely a condition imposed on people by ill-conceived and repressive economic policies. Other factors such as history, culture, war, and climate influence a country's development, but none is as important as economic freedom. The facts also show that no amount of foreign aid can make up for the conditions that result from economically "unfree" economies. Some countries have received U.S. foreign aid for over 50 years and still are no better off than they were before such aid. A close look at recipients of U.S. foreign aid and their economic performance over the last several decades proves the point:

- Of the 76 countries ranked as "mostly unfree" or "repressed" on the *Index*, 34 have

received U.S. foreign aid for over 35 years, many for as long as 51 years.

- Of these 34 countries, 14 are poorer today than they were in 1965.

- Twelve more have essentially the same amount of wealth as they did some 30 years ago.

- Of the 34 long-term recipients of U.S. foreign aid ranked by the *Index* as lacking economic freedom, 26 are no better off than they were over three decades ago.

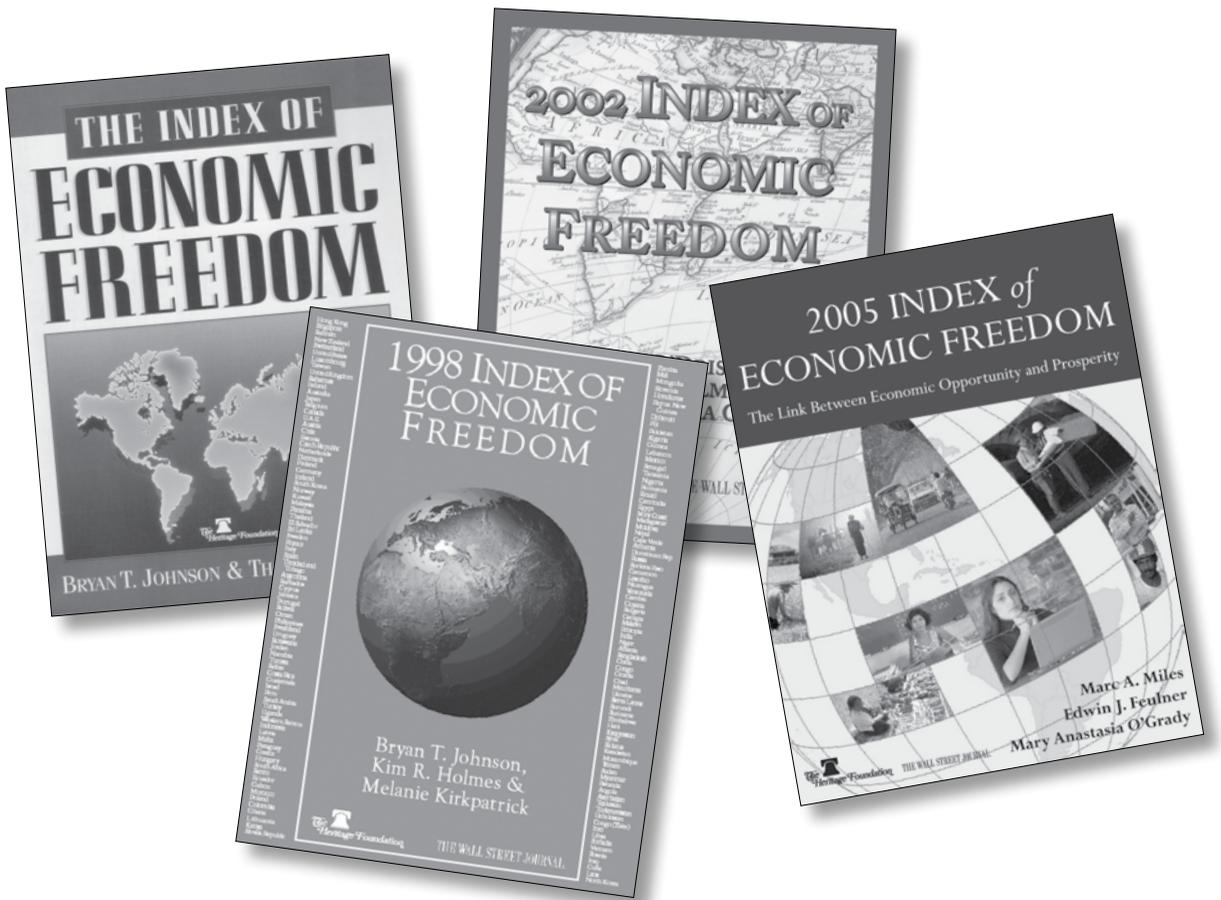
While many countries dependent on foreign aid have remained poor, the few that have eschewed foreign aid have achieved impressive levels of economic growth and wealth. They have done so because they have maximized economic freedom. The key to economic growth is a set of policies that minimize government control of the economy.

THE 1997 INDEX

[Sticking with the subject of development assistance, in 1997, William W. Beach, Director of The Heritage Foundation's Center for Data Analysis, and Gareth Davis, also of Heritage, discussed competing academic theories in "The Index of Economic Freedom and Economic Growth."]

Why do some countries prosper while others do not? For Adam Smith, the answer was obvious: All economic growth flourishes from the single root of creatively dividing labor in the production of desirable goods and blossoms in a political environment that protects private property and the justly deserved fruits of labor. Nations will experience opulence and peace, Smith argued, once they create the institutions that encourage entrepreneurship and savings (the stock of capital upon which all production takes place). On the other hand, nations reap only poverty and despair when they discourage business and thrift.

From the 1960s to the mid-1980s, the dominant academic theory of what causes economic growth was named after Nobel Laureate Robert Solow. From a factual or a policy viewpoint, this theory has performed poorly. First, the theory offered meager advice to



policymakers on to how to generate economic growth. Solow argued that the only way a nation could boost its level of growth was to save more and therefore accumulate physical capital. Even an increase in the rate of capital accumulation, however, would bring only a one-time boost in income and have only a short-term or medium-term increase in economic growth rates.

The long-run rate of economic growth (the “steady state” level) was determined by “technological innovation.” This technological innovation was a mysterious force within Solow’s model that neither could be analyzed by economists nor influenced by government policy. In the Solow model, to paraphrase the famous Cambridge economist Joan Robinson, technology and growth fall like manna from heaven. Second, the major factual prediction of traditional growth theory (that poorer countries generally would grow faster and “converge” to the economic status of richer countries) clearly is not coming true in the real world.

In 1983, Professor Paul Romer, then at the University of Rochester, published a paper entitled “Increasing Returns and Long Run Growth.” Romer argued that an initial increase in a society’s productive capacity can feed on itself (because of what are known technically as *increasing returns*) to produce permanently higher rates of growth. This feedback effect stands in sharp contrast to the *decreasing returns* contained in the old theory, under which the growth effects of an increase in a society’s capacity are only temporary.

In other words, under the old theory of decreasing returns, policy changes would produce only a one-time boost to economic activity, after which the economy would return to its long-term growth path. Under the new theory of increasing returns, however, it is possible to affect the long-term growth path itself.

The old growth theory predicted that establishing sound policies would lead only to a one-time boost in income (and therefore

only a transitory increase in economic growth rates). The theory of increasing returns implies that instituting sensible policies can result in a GDP growth rate that is permanently higher.

[Also in 1997, Bryan T. Johnson of The Heritage Foundation wrote about the USAID bureaucracy's efforts to resist market-based reforms in "Economic Freedom, Foreign Aid, and Economic Development."]

U.S. foreign aid bureaucrats have argued for years that foreign assistance is vital to the economic well-being of less developed countries. J. Brian Atwood, administrator of the U.S. Agency for International Development (USAID), the agency responsible for handing out most of America's \$12 billion foreign aid budget, has further stretched such claims by suggesting that the overall economic prosperity of the post-World War II era can be attributed largely to the Marshall Plan and successive foreign aid efforts. This grossly exaggerates the benefits of development aid while ignoring its many harmful effects. Not only has the U.S. foreign aid program failed to promote economic growth in less developed countries, but many recipient countries are worse off because of it.

The *Index of Economic Freedom* demonstrates that economic freedom is the single most important factor in creating the conditions for economic growth and prosperity. The data in this chapter further demonstrate that instead of helping poor countries lift themselves out of poverty, development aid often impedes their economic growth while damaging their fragile economies. Economic freedom, not aid, is what matters most in achieving economic development.

The *Index* also shows that many long-term U.S. foreign aid recipients have unfree or repressed economies. No matter how much money the United States and other donors spend on foreign aid recipients like Tanzania, Sudan, and Ethiopia, economic development and wealth will not be forthcoming.

THE 1998 INDEX

[In 1998, William W. Beach and Gareth Davis of The Heritage Foundation continued to explore the academic debate in "The Institutional Setting of Economic Growth."]

From Alfred Marshall and Karl Marx to John Maynard Keynes and Friedrich Hayek—all have emphasized the critical relationship between economic activity and its institutional setting when explaining the phenomenon of economic growth. Perhaps more important, much of the policymaking community and intellectually active public already recognizes that sustainable, long-term growth stems in some fashion from the synergy between free-wheeling capitalism and the institutions that sustain the civil society.

The *Index*, of course, speaks for those who understand that free markets produce steadier and fairer economic progress than markets shaped by government edict. Not only does history show the central role of economic freedom in producing superior economic well-being and growing economies, [but] it also shows that state intervention in private economic decision making nearly always reduces long-term well-being. [It is simply wrong to argue] that the *Index* ignores the state. The *Index* does recognize government's role in protecting free markets, principally through its judicial, monetary, and international functions. In fact, the *Index* may be viewed correctly as singularly devoted to examining government's role in economic affairs.

THE 1999 INDEX

[Long before her tenacious investigative reporting uncovered the massive "Oil-for-Food" scandal at the United Nations, journalist Claudia Rosett put a human face on the theory of economic freedom in "Mapping the New World Markets."]

One of the most poignant questions I have heard about economic development came from a North Korean refugee I interviewed in Moscow for *The Wall Street Journal* back in 1994. This

man had come to Russia under official auspices from North Korea to work in a lumber camp in the Far East. From there, he had defected into post-communist Russia. When I met him, he was staying in a dingy Moscow apartment, hiding out from North Korean agents and hoping for asylum. To him, after the repression and hopeless poverty of North Korea, newly liberalizing Russia seemed a land of promise and opportunity—worth risking his life for a chance to stay. But he had a question: “Is it true,” he asked, “that America is even better than this?”

THE 2000 INDEX

[Harvard University Professor of Economics Robert J. Barro found a surprisingly weak link between democracy and the promotion of development in “Rule of Law, Democracy, and Economic Performance.”]

The problem in having the United States recommend democracy to a country such as Zaire (now the Democratic Republic of Congo) is not that democracy would harm economic performance but, rather, that it would have little impact. If there is a limited amount of energy that can be used to accomplish institutional reforms, then it is much better spent in a poor country by attempting to implement the rule of law—or, more generally, property rights and free markets. These are the institutional features that matter most for economic growth, and these features are not the same thing as democracy. Moreover, in the long run, the rule of law tends to generate sustainable democracy by first promoting economic development. Thus, even if democracy is the principal objective in the end, the best way to proceed is to encourage the rule of law in the short run. U.S. advice to poor countries should focus more on the rule of law, property rights, and free markets, and less on the romance of democracy.

[Guest contributors Alejandro A. Chafuen of the Atlas Economic Research Foundation and Eugenio Guzmán of the Heritage-affiliated Institute for Liberty and Development in Santiago, Chile, wrote about the

greatest threat to the rule of law in “Economic Freedom and Corruption.”]

True economic freedom is possible only under a system of limited government with a strong rule of law. Economic freedom has little value if corruption in government means that only a few will enjoy it. Therefore, the rule of law, under limited government, is the essence of a just society—one in which the rights of persons are respected and individuals are free to improve their personal and social lives through their own efforts and according to just laws, unencumbered by corrupt government actions.

The fewer resources (including assets and regulatory power) a government controls, the fewer the opportunities for corruption. Both the number and amount of resources controlled by a government and the ability of its officials to grant privileges can influence the level of corruption.

THE 2001 INDEX

[Mary Anastasia O’Grady, Editor of The Wall Street Journal’s weekly “Americas” column (and now a member of the Journal’s Editorial Board), explored the link between economic freedom and political change in “First, Open Markets.”]

The North American Free Trade Agreement’s (NAFTA’s) most important effect on Mexico was not more choice for consumers or a larger market for producers—although these are certainly significant—but rather a change in the ownership and control of the political economy. In a very real sense, it was NAFTA that brought Vicente Fox to power because it weakened the grip of the Institutional Revolutionary Party (PRI).

Recognizing the connection between Mexico’s opening to trade and its gains in political and economic rights is key to understanding what is going on in the rest of Latin America, where (Chile excepted) economic modernization is lagging.

Along with price stability, the highest reform priority for the region ought to be trade liberalization. The competition engendered by free

trade not only provides direct gains in productivity and lowers prices for consumers, but also produces less tangible but perhaps more powerful side effects. As NAFTA proved in Mexico, foreign competition and contact with the outside world weaken the very pillars of statism.

THE 2002 INDEX

[Lee Hoskins, former President of the Federal Reserve Bank of Cleveland, and Ana I. Eiras of The Heritage Foundation touched upon another crucial ingredient of economic freedom in "Property Rights: The Key to Economic Growth."]

The more government policy facilitates the use of private property, the more prosperity it helps bring. In contrast, when governments infringe on citizens' property rights, implementing policies that restrict access to markets and interfere with the use of private property, they bring poverty to their countries. Accordingly, the extent to which governments carry out their responsibility to respect and protect property rights does much to determine the extent to which economic growth is possible and individuals can use freely what is theirs and enjoy the things that science, technology, and innovation can deliver to improve their lives.

When government policy interferes with economic activity, the economy suffers and people's living standards decrease. Governments can infringe on property rights directly by enabling a weak judiciary or indirectly by raising taxes, enacting burdensome regulations, consuming scarce resources, and mandating that business implement social programs. Government infringement of property rights subtly confiscates wealth, decreases the value of economic activity, and prevents resources from flowing to their most valuable use. At the same time, it helps to concentrate wealth in the hands of the few at the expense of the poorest.

THE 2003 INDEX

[Mart Laar, who served as Prime Minister of newly independent Estonia from 1992 through 1994 and then again from 1999

until January 2002, delivered a lecture entitled "How Estonia Did It" during the 25th Annual Meeting of The Heritage Foundation's Resource Bank in Philadelphia, Pennsylvania, on April 11–12, 2002. The text of the lecture was adapted as a guest chapter in the next edition of the Index.]

After 50 years of Soviet occupation, Estonia was in ruins. Our economy was a shambles, the spirit of our people spoiled by the socialist heritage. Within 10 years, Estonia has changed beyond recognition. Sometimes it is hard even for us to remember how this country looked under the socialist system. Estonia is now a modern and vibrant young country, integrating with Western structures like the European Union and NATO with astonishing speed.

In planning our "jump to nowhere," we tried to learn from the experiences of other countries that had undertaken a transition from left-wing socialist utopia to free-market economy. Some key lessons emerged. One is to take care of politics first and then to proceed with economic reform. Don't underestimate the importance of a new, modern constitution and democratic legislature with free elections.

There can be no market economy and democracy without laws, clear property rights, and a functioning justice system.

The flat-rate tax has been an important part of the Estonian success story. It is easy to collect and easy to control. The only losers...were the tax lawyers.

We realized quickly the danger of extensive reliance on aid. Shipments of outdated computers to any transition country can secure them a permanent seat in the Third World.

THE 2004 INDEX

[Daniel J. Mitchell of The Heritage Foundation discussed desirable models for tax reform in "The Economics of Tax Competition: Harmonization vs. Liberalization."]

Like other forms of competition, fiscal rivalry generates positive results. People get to keep more of the money they earn, and economic performance is enhanced because of lower tax

rates on work, saving, and investment.

The thought of losing sources of tax revenue scares government officials from high-tax nations, who vociferously condemn tax competition and would like to see it reduced or eliminated. Working through international bureaucracies like the European Union, the United Nations, and the Organisation for Economic Co-operation and Development, high-tax governments are promoting various tax harmonization schemes to inhibit the flow of jobs and capital from high-tax jurisdictions to low-tax jurisdictions.

Tax competition should be celebrated, not persecuted. It is a powerful force for economic liberalization that has helped promote good tax policy in countries around the world.

[The same year, The Wall Street Journal's Brian M. Carney attacked a roadblock to successful completion of the Doha trade round in "The Common Agricultural Policy: How the European Union Distorts Trade with Non-EU Nations."]

The European Union (EU)—or, more precisely, its predecessor, the European Economic Community (EEC)—was founded on the idea that war in Europe could be stopped through free trade and open borders. It is a cruel irony, therefore, that the EU in its various forms has spent most of its 46-year history waging economic war on others, and most particularly on the world's developing nations.

The predominant form that this warfare has taken is known as the Common Agricultural Policy, an anti-competitive combination of subsidies designed to give the European farmer an edge. Written into the EEC's founding documents in 1957, CAP was the price French President Charles de Gaulle exacted for France's membership. It has grown inexorably ever since and now eats up approximately half of the EU's 90 billion euro annual budget.

It may be surprising to learn that fully half of the funds spent each year by Brussels takes the form of handouts to farmers—that is, sup-

ports the CAP. Yet, apart from the direct costs of the EU subsidies, there is another cost that exacts a terrible toll on world economic prosperity and development. That is the cycle of global protectionism that EU agricultural policy perpetuates. CAP is harming European consumers and taxpayers, Europe's manufacturers and service providers, and—just as important—consumers in the developing world because it is a major stumbling block to further world trade liberalization, as was vividly demonstrated at the [World Trade Organization] ministerial meeting in Cancun in September 2003.

THE 2005 INDEX

[James Jay Carafano of The Heritage Foundation found a role for free trade in combating terrorism in "Global Terrorism and the Global Economy: Unpeaceful Coexistence."]

In the long term, the best way to engage emerging economies in the battle against terrorism is to promote free trade. Free trade is the handmaiden of security. It makes more inhabitants stakeholders in their national economy and the international economy. Economic growth also provides the capacity to implement effective security regimes. In short, there are few better weapons in the war against terrorism than free trade.

Developed nations can help speed the process in two ways.

First, they can negotiate and implement free trade agreements with emerging economies.

Second, they can promote policies that combat corruption; encourage good governance, the rule of law, and transparency; aim to establish strong institutions; and advance economic and political freedom.

Developed nations can start by rethinking their foreign assistance programs. Traditional aid programs are just not getting the job done, either in promoting economic growth or in enhancing security.

[With the Doha round continuing to founder, John C. Hulsman, Brett D. Schaefer, and Anthony B. Kim of The Heritage Founda-

tion examined "The Benefits of a Global Free Trade Alliance."¹]

Liberal trade policy is a key component of economic freedom and contributes to long-term, stable economic growth by increasing efficiency and reducing costs for producers and consumers. Yet resistance to trade liberalization remains strong in both developed and developing countries. The struggle in the World Trade Organization during the current Doha round of trade negotiations clearly demonstrates that many governments continue to see trade as a zero-sum game in which their goal is to lower barriers in other countries while seeking to keep their own barriers as high as possible. The slow pace of WTO negotiations does not mean that they are without merit, but countries that grasp the value of free trade should not hold themselves hostage to glacial progress in that body.

Instead, countries eager to take advantage of free trade should consider forming a Global Free Trade Alliance (GFTA). Because the GFTA would be a free trade coalition of the willing, membership would be based on existing policies, not negotiated concessions. It would secure the benefits of increased trade and investment without forcing members to undergo any new major policy reforms. With the potential to encompass every nation—provided only that they meet the criteria and wish to open their markets to goods and services from other GFTA members—the GFTA offers an intriguing alternative means for advancing global free trade that does not force unwilling countries to liberalize more quickly than they desire.

[Mary Anastasia O'Grady, a member of the Editorial Board of The Wall Street Journal and Editor of the Journal's weekly "Americas" column, looked at another problem in the WTO in "Antidumping Abuses Threaten the Gains in Global Free Trade."]

World trade expansion is critical to finding new markets for U.S. agriculture, manufactures, and information technology. It is also critical to the war on terrorism because economic engagement is among the best tools available to America in its efforts to combat the isolationism that breeds radical Islamic militancy.

The World Trade Organization's limits on tariff hikes and restrictive quotas have brought about tremendous gains in trade liberalization in the past 25 years. Because rising global competition is challenging the status quo, however, antidumping law has picked up where tariffs and quotas left off as a favored tool for winning protection.

Envisioned in theory as a legitimate mechanism for combating "predatory" pricing, antidumping action gains its potency from broad interpretations by trade authorities of what constitutes "predatory." Its widening use is a modern-day example of Adam Smith's classic warning about business and government getting together and conspiring to cheat the people. Domestic producers use it as their last bastion for survival; politicians, despite knowing full well that protection is bad for the majority of their constituents, are using it as a political safety valve to release pressure from special interests.

THE 2006 INDEX

[Three chapters in the 2006 Index were devoted to microeconomic conditions in developing countries. In "The Failures of State Schooling in Developing Countries and the People's Response," Professors James Tooley and Pauline Dixon from the University of Newcastle in the United Kingdom painted a vivid example of the benefits of competition in education in the Third World.]

Drive across the low highway viaduct toward Victoria Island in the bustling city of Lagos, Nigeria, and you see the shantytown of Makoko, home to an estimated 50,000 people, sprawling out into the black waters below. Wooden huts on stilts stretch out into the lagoon; young men punt and women paddle dug-out canoes down into narrow canals weaving between the raised

1. For a more updated discussion of this concept, see Kim R. Holmes, *Liberty's Best Hope: American Leadership for the 21st Century* (Washington, D.C.: The Heritage Foundation, 2008).

homes; teenage boys stand on rocks in the water and cast their fishing nets; large wooden boats, some with noisy outboard motors, carry fishermen out to below the highway and into the ocean beyond. Across the top of the shantytown, there is a veneer of drifting smog created by the open fires used for cooking.

It is possibly the last place where you would expect to witness an educational revolution taking place, but that is precisely what is happening. In Makoko—as in other poor communities around the developing world—parents are abandoning public education *en masse*, disturbed by its low quality, and educational entrepreneurs are setting up private schools to cater to this demand. These private schools, it turns out, whatever their appearances might suggest, are of higher quality than the public alternative, achieving higher standards at a fraction of the cost of public education. Their existence provides a neat grassroots solution to the problem that so perplexes development experts: how to achieve universal basic education—the United Nations Millennium Development Goal of “education for all”—by 2015.

[Barun S. Mitra, Director of the Liberty Institute in New Delhi, extolled the revolutionary potential of the informal economy in the Third World in “Grassroots Capitalism Thrives in India.”]

India remains a poor country, with a per capita income of around USD\$550 (around USD\$3,100 in purchasing power parity). At the same time, however, it is rich in potential—a potential that is fueled by the real stars of the Indian economy, the ordinary Indians who have survived the heavy hand of government that has sought to control almost every aspect of economic activity since the 1950s.

Notwithstanding the ideological fervor of the intelligentsia and the rhetoric of the political class, there is a point beyond which the government cannot impose rigid economic regulations. Where such regulations are indeed laid down, there is a point beyond which enforcement agencies cannot implement laws on the ground.

That is the way it has always been. While the dominant political party adopted the doctrine of a “socialist pattern of development” in the mid-1950s and sought to implement Soviet-style five-year plans, a large part of the Indian economy continued to function virtually outside the scope of the law. Today, 15 years after economic liberalization, experts estimate that 30 percent–40 percent of the Indian economy continues to be in the informal sector. This informal economy reflects India’s true economic potential.

[Michael Gonzalez of The Asian Wall Street Journal, in “Informal Finance: Encouraging the Entrepreneurial Spirit in Post-Mao China,” explained how economic freedom can triumph even in Third World countries still under the heavy hand of the state.]

In China, back-alley banks do most of the intermediation between savers and private businesses. In 2000, only 0.5 percent of loans extended by the state banks went to the private sector. It is estimated that, even today, this number is not much larger than 1 percent.

Economists such as Hernando de Soto have rightly put an emphasis on the need to legalize underground activity. And in a sense, the important role that informal finance plays in China shows how dysfunctional the place remains. I prefer to think the glass is half full, however, and see the informal phenomenon as proof of how the entrepreneurial spirit of the Chinese people shines through any crack in the great wall of repressive government.

The dead hand of the state continues to restrain people’s economic freedom in China more than it does in France or Germany—countries that are commonly thought of as socialist infernos. The reason China seems to have a more exciting future is perhaps that the government and its writ suffer from a deficit of legitimacy unknown in democracies and that the people are used to bypassing the law.

As the growing phenomenon of informal finance reveals, the Chinese are quick to open shop in any nook or cranny abandoned by the state. China is a fascinating study in the eco-

conomic truths advanced by Adam Smith, Frederick Hayek, and Hernando de Soto, illustrating that its recent communist past continues to feed many serious policy distortions.

THE 2007 INDEX

[Xavier Sala-i-Martin, Professor of Economics at Columbia University and a renowned expert on economic growth, in "Global Inequality Fades as the Global Economy Grows," rebutted criticisms from the left that market-based policies do not benefit the poor. He noted that the confusion about growing global inequality among individuals is based on a logical misunderstanding. Comparing countries and comparing individuals within those countries is akin to the classic problem of mixing apples and oranges. Professor Sala-i-Martin corrected that analysis by integrating the apples with the apple trees.]

Looking at the planet as a whole, never in history has poverty been eradicated as rapidly as it has been during our lifetimes. Moreover, individual income inequalities have been falling, and this is the first time they have fallen since the eve of the Industrial Revolution. The aggregate numbers have never looked better. Looking at the world distribution of income, the world is a better place.

Using the original World Bank definition (\$495 annual income), the poverty rate declined from 15.4 percent of the world population in 1970 to 5.7 percent in 2000, a decline of a factor of almost three. This is especially impressive given that, during the same period, world population increased by almost 50 percent, from 3.5 billion to 5.5 billion. The implication is that the total number of poor citizens went from 534 million to 322 million, a decline of 50 percent.

Our analysis shows that, after having stagnated during the 1970s, global income inequality started a two-decades-long process of decline. The main reason is that incomes of some of the world's poorest and most populated countries (most notably China and India, but also many other countries in Asia) converged rapidly with the incomes of OECD citizens. This force has been larger than the divergence effect caused by the dismal performance of African countries.

THE 2008 INDEX

[Last year, Dr. Carl J. Schramm of the Ewing Marion Kauffman Foundation stressed the importance of entrepreneurship in "Economic Fluidity: A Crucial Dimension of Economic Freedom."]

Without entrepreneurship—what Joseph Schumpeter called the "fundamental impulse" of a free-market system—an economy will stagnate, and without the requisite labor mobility, a society's workers will not feel secure enough to launch an entrepreneurial venture. Economist William Baumol has helped to bring the entrepreneur back into economic analysis, and some economic historians have highlighted the role of entrepreneurs in continuously renewing economic growth and freedom.

The degree of economic freedom (and, thus, of economic growth) in any society will reflect the amount of fluidity in the institutional, organizational, and individual elements of the economy. Every economy evolves based on the interactions within and between these elements, but the *rate* of evolution is determined by the level of fluidity and corresponding degree of interaction, which allows the mixing of ideas and generation of innovation.