

## Chapter 1

# The Limits of Government

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**A** critical battle has been raging between friends and foes of economic liberty. The global economic and financial turmoil of the past two years emboldened critics of the capitalist, free enterprise system and raised questions about the best policy framework for supporting economic growth, employment, and overall prosperity. Questions relating to the role and size of government have been front and center, both in national debates and in international discussions:

- With countries from Europe to China facing the demographic challenges of aging populations, problems of funding pensions on a sustainable basis are becoming acute.
- Health costs are rising rapidly around the world, with many countries facing hard choices about the allocation of care and rationing.
- The recession has strained social safety nets almost everywhere; increased spending in some countries has turned what was previously a debate about long-term funding

solutions into an acute crisis demanding immediate decisions about austerity measures to restrain national debt.

With battle lines drawn more starkly than at any time since the fall of the Soviet Union, the advocates of free enterprise and economic freedom have faced new challengers from some unexpected quarters, particularly the governments of the United States and, until May of 2010, the United Kingdom. These governments, championing state intervention and government control for the first time since the *Index of Economic Freedom* began ranking countries in 1995, have led the calls for greater international regulation of business, backed away from the cause of free trade, and shed economic freedom at home, stifling their own growth and, in effect, turning off two of the most important engines that had driven world growth for half a century or more.

When dealing with democracies, of course, battles are fought not just among countries, but also within them through the political sys-

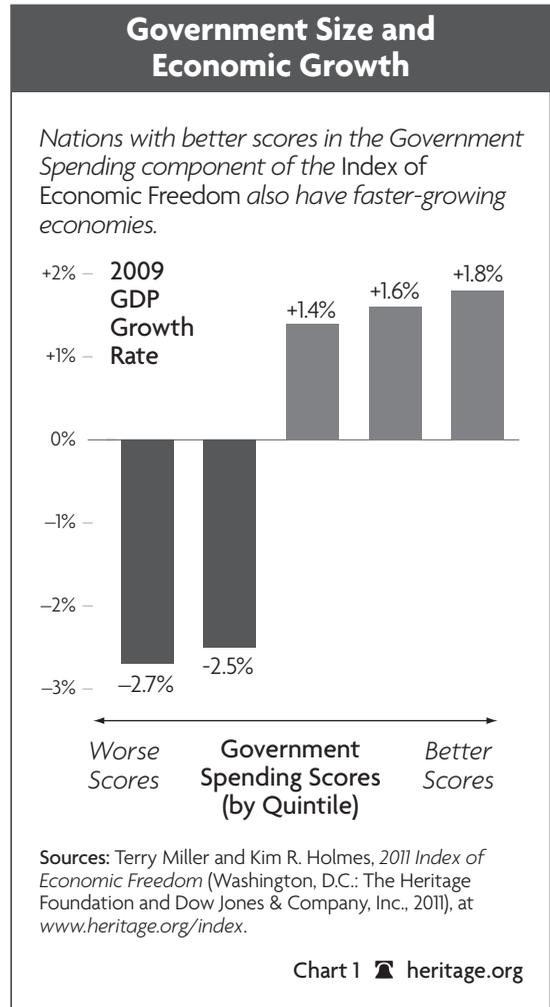
tem and the electoral process. A great debate emerged, particularly in the United States, between those who claimed that economic freedom caused, or at least exacerbated, the first global economic crisis of the new century and those who blamed past government interventions that inflated unsustainable bubbles in housing and financial markets.

U.S. voters, apparently more interested in practical solutions than ideology, responded pragmatically. As the first shock wave of the global financial troubles washed over them in late 2008, they elected President Barack Obama and installed a Congress with large left-leaning majorities that massively increased government spending and regulation. Then, only two years later, voters just as massively rejected the President's failed statist solutions, as well as many of the politicians who had championed them.

In Europe, decades of high social welfare spending and stifling regulation have combined to reduce economic and social dynamism and flexibility. As electorates were clamoring for action during the financial crisis and recession, governments' scope for effective response proved surprisingly small. For governments increasingly constrained by budget deficits and rising debt, the disconnect between their past promises and their capability to fulfill them, and between their financial assets and liabilities, became difficult to ignore. A fundamental rethinking of the social contract, the basic relationship between government and citizen, became, for some countries like Greece or France, not just an academic exercise but a political debate that spilled into the streets.

## RIGHT-SIZING GOVERNMENT

The *Index of Economic Freedom* has never, in its methodology, claimed that there was an appropriate or ideal level of government spending against which countries' economic performance should be measured. Factors as diverse as culture and geography have an impact on the need for government. Demands on government vary widely between developed and developing countries. It is undeniable, however, that there is an opportunity cost



to government spending: resources used by government are unavailable for private-sector consumption or investment. In addition, governments, because they operate outside of market constraints and competition, are typically susceptible to excessive bureaucracy, corruption, and waste.

Whatever the ideal level of government may be, the political and economic developments of the past year have made clear that in many societies, particularly among the more developed countries, the limits of appropriate or tolerable government spending may have been reached or even surpassed. Debates are underway in many of these countries that may fundamentally alter the relationship between citizen and state and provide new insights into our understanding of government spending as a constraint on economic freedom.

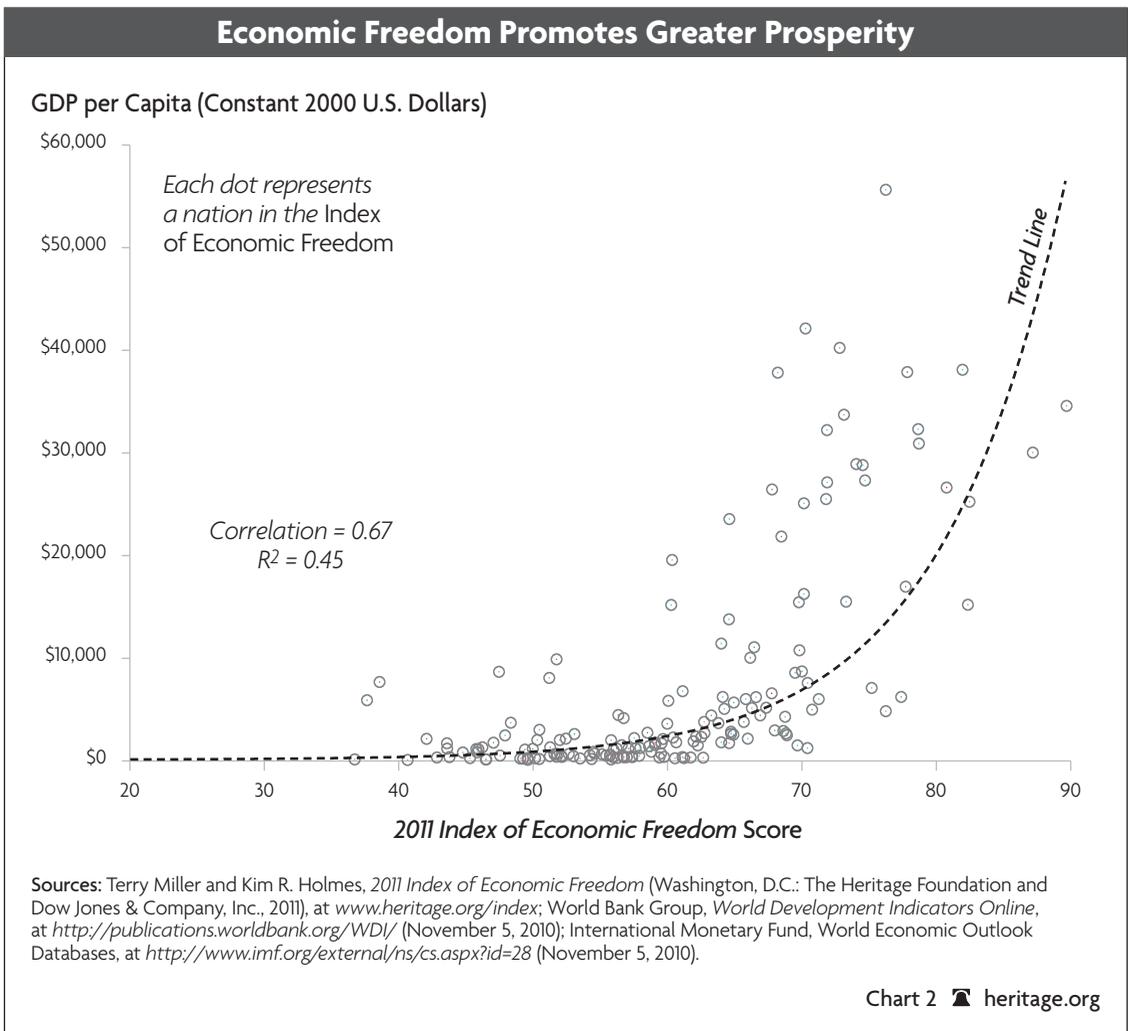
With global economic recovery far from secure, many countries are at a critical juncture and face decisive policy choices. Leaders will either acknowledge the limits of government and make necessary policy adjustments, or they will carry on with ill-guided policies that empower governments but not people. The alternatives are clear: openness or protectionism; austerity or fiscal collapse; entrepreneurial dynamism or economic stagnation.

The 2011 *Index* results demonstrate clearly that for many of the countries of the world, particularly those that experienced the inevitable results of state economic control under Communist systems in the past, policy solutions that would re-regulate economic activity or undo the integration of economies in a globalized trade and investment market hold little attraction.

Their skepticism is justified. Countries that reduced government spending had economic growth rates almost two percentage points higher in 2009 than countries whose government spending scores worsened, and countries with the highest rates of government spending had gross domestic product (GDP) growth rates 4.5 percentage points lower on average than countries where government spending was best contained. (See Chart 1.)

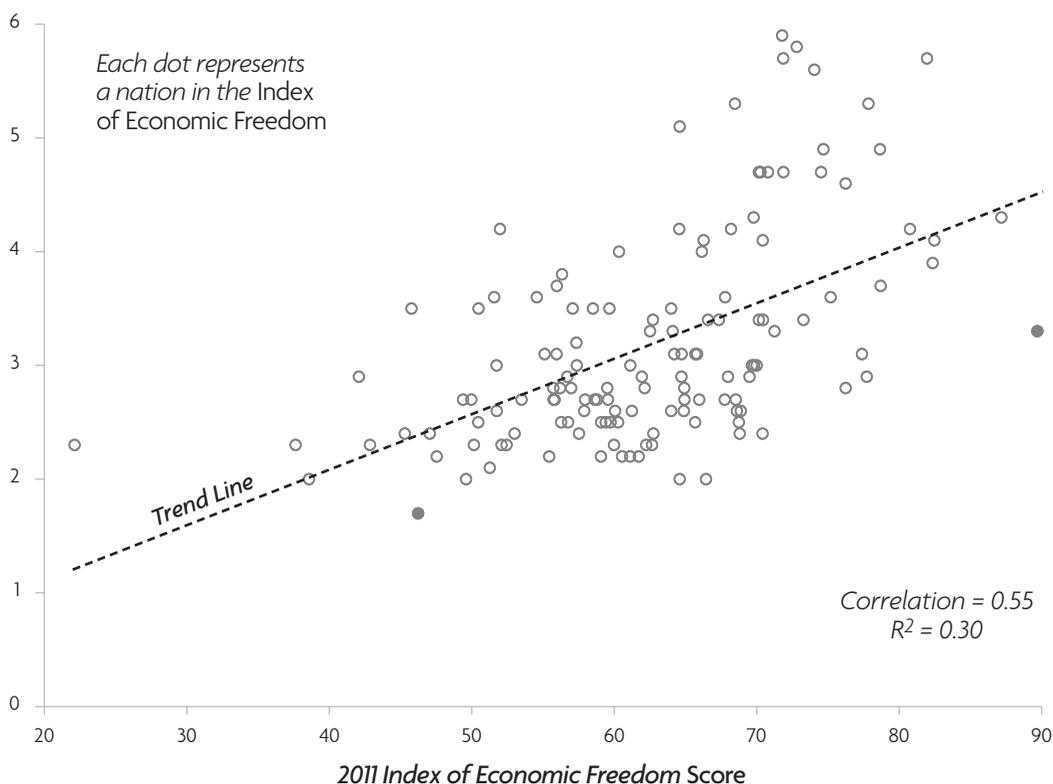
### ECONOMIC FREEDOM: THE FOUNDATION FOR RESILIENCE, INNOVATION, AND GROWTH

While the global economic crisis has tested confidence in economic freedom, the *Index* results, when compared with real data about changes in economic and social conditions in



## Economic Freedom Propels Innovation

### Innovation Capacity



Sources: Terry Miller and Kim R. Holmes, *2011 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2011), at [www.heritage.org/index](http://www.heritage.org/index); *Global Competitiveness Report 2010–2011*, World Economic Forum, at <http://www.weforum.org/en/initiatives/gcp/Global%20Competitiveness%20Report/index.htm> (November 4, 2010).

Chart 3  [heritage.org](http://heritage.org)

societies around the world, provide strong evidence that the free-market system remains not only viable—with such core features as private property rights, openness, and flexibility almost uncontested—but uniquely able to promote long-term prosperity.

Over the past decades, the globalized economic and trading system that is based on economic freedom has fueled unprecedented economic growth around the world. From 1980 to 2008, the world economy achieved real GDP expansion of around 145 percent, lifting hundreds of millions of people out of poverty. Globally, poverty has fallen by 40 percent since 1990. Economic freedom has helped economies to become more flexible and resil-

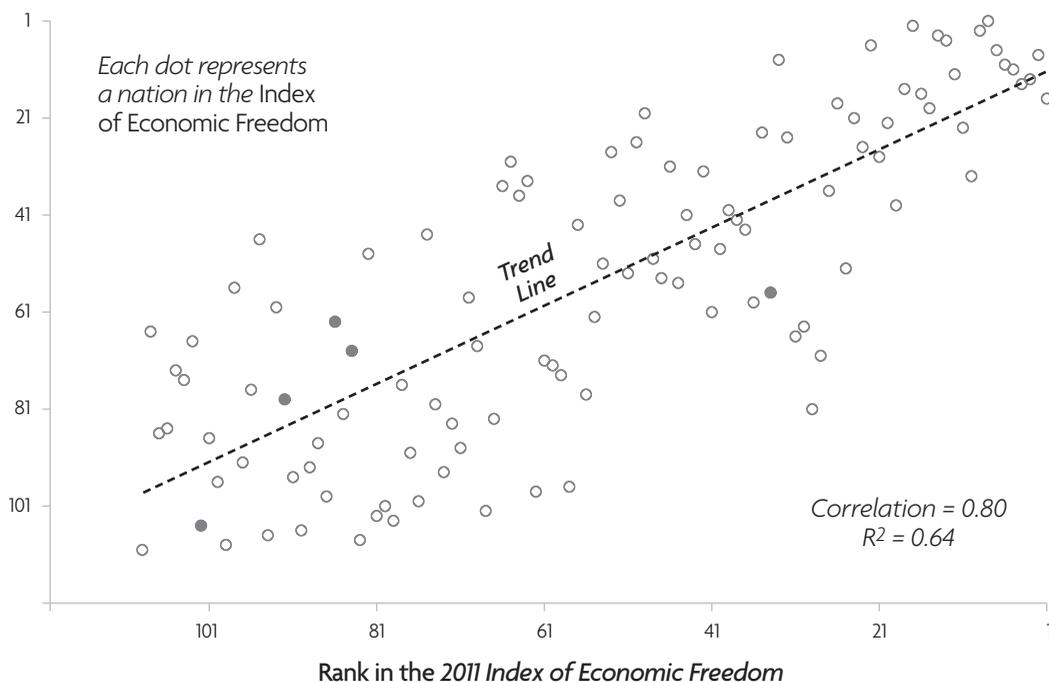
ient and has promoted increased productivity and higher wages.

The positive relationship between economic freedom and prosperity has been confirmed yet again in the 2011 *Index*. GDP per capita is much higher in countries with greater economic freedom. Chart 2 shows a strong positive relationship between the level of economic freedom and GDP per capita.

Given this 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

## Economic Freedom Promotes Entrepreneurial Dynamism

Rank in the Entrepreneurship and Opportunity Sub-Index



Sources: Terry Miller and Kim R. Holmes, *2011 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2011), at [www.heritage.org/index](http://www.heritage.org/index); 2010 Legatum Prosperity Index at <http://www.prosperity.com/downloads/2010LegatumProsperityIndexBrochure.pdf> (November 4, 2010).

Chart 4  heritage.org

incentives that drive entrepreneurial activity, creating greater opportunities for investment and job growth.

One proven path to stimulating economic growth is to advance economic freedom by promoting policies that generate a virtuous cycle of innovation, job creation, productivity growth, and higher living standards that help create the social and economic resilience to sustain and empower individuals in a rapidly evolving economic environment. As shown in Chart 3, economic freedom is positively linked to innovation.

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 and vitality. Economic freedom is highly correlated with societies' openness to entrepreneurial activity that creates new jobs and increases opportunity and choice for individuals in advancing their own well-being. (See Chart 4.)

For countries in which the economic crisis lingers, and particularly for those in which job creation is a priority, it is imperative to pick up the pace of economic reform. The political will to resist elite and special interests that support the status quo, whether through tariffs and other protectionist measures or through domestic regulations so complex that only the largest and most well-entrenched companies can afford to implement them, is critical. Reforms to facilitate business startups are essential, and those countries that lighten the

regulatory and financial burden for the private sector will be on the fast track to economic success in the future.

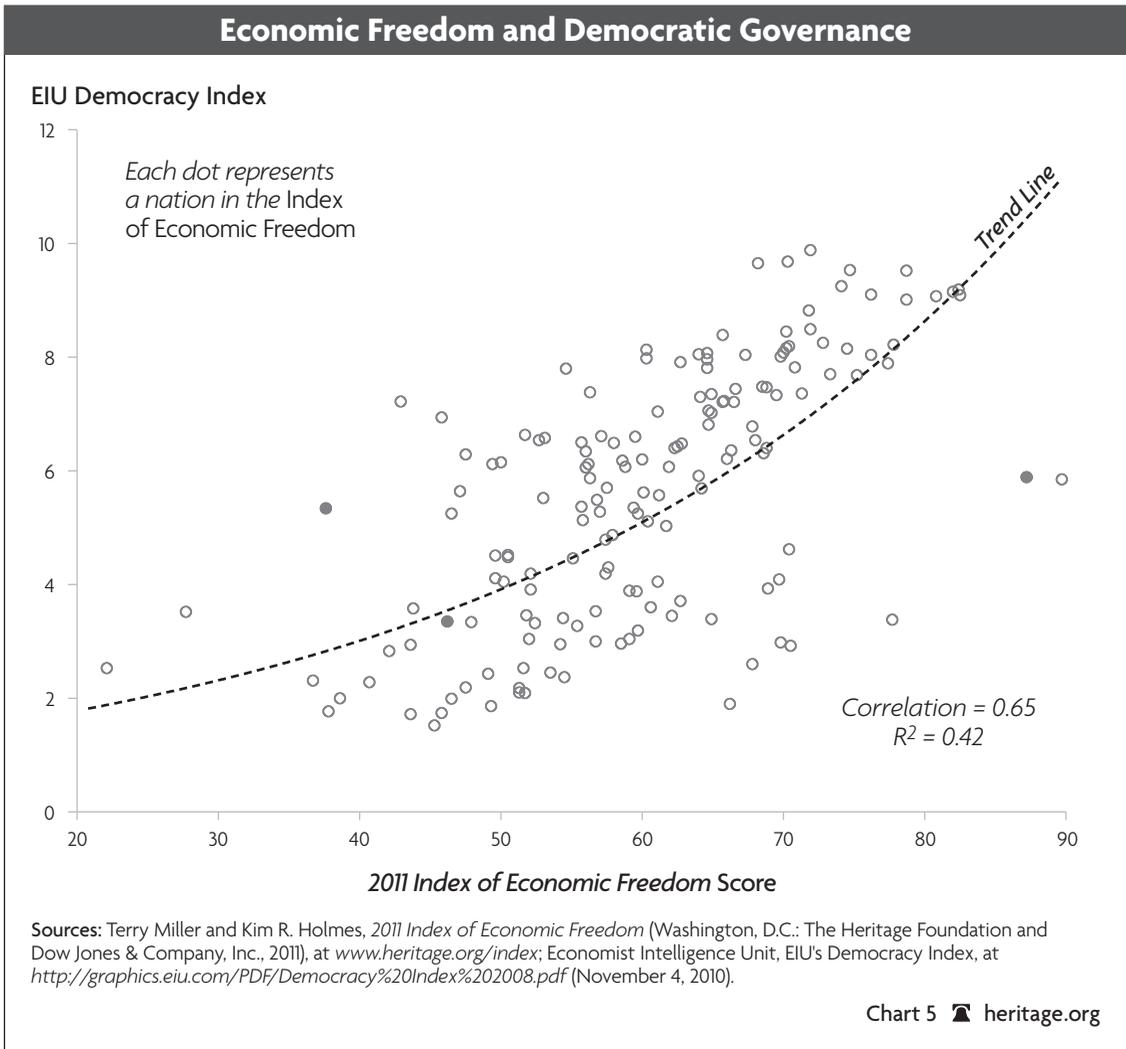
### THE FREE MARKET: A DEMOCRATIC CHALLENGE TO GOVERNMENT POWER

The *Index of Economic Freedom* has often explored the relationship between economic freedom and political freedom or democracy. There is a strong correlation between the two and little doubt that higher levels in either can have a positive impact on the other. (See Chart 5.)

What has been ignored too often is the democratic nature of the free market itself. In a market that is truly free, consumers, producers, and investors exercise sovereignty over their own

individual lives. In making the best decisions for themselves, whether by seeking the lowest cost for goods or the maximum opportunities for profit, they are helping to identify their society's true priorities. Through their individual decisions, they help determine the nature and characteristics of the society in which they live. This is the essence of democracy.

In a political democracy, government decisions about economic matters may, of course, reflect the will of the people, or at least 51 percent of the people. Unfortunately, a minority may have their freedom constrained or even repressed by one-size-fits-all government solutions. A system that provides for economic freedom allows for greater diversity, promoting creativity and innovation. In addition, a



free society requires the dispersal of power to prevent monopoly or abuse. Competition for power will always occur within governments; free markets provide an additional channel in which individuals may challenge entrenched interests.

## **RENEWING CONFIDENCE IN ECONOMIC FREEDOM**

Perhaps the largest lesson of the past years is that the fundamental superiority and value of economic liberty must be retaught to a new generation of political leaders, either by their peers who have lived in less free systems and less free times or by their own citizens, who understand instinctively that when individuals are allowed to decide for themselves how best to pursue their dreams and aspirations, their collective achievements can add up to a better society for all.

Some world leaders have seemed shocked and disoriented by the global financial crisis and recession. Those with a greater knowledge of history, or perhaps just longer memories, have maintained their confidence in the free enterprise system as the most rapid means to increase prosperity. They understand that there

will be interruptions from time to time as bubbles burst, or pauses to retool and restructure, but they know that over decades and even centuries, the trend will be dependably upwards.

By contrast, those who in a time of crisis turn to increased government power and control for answers are repeating a fundamental error exposed many times in the past. No other systems that have been tried have come close to free-market capitalism in terms of providing broad-based economic expansion. In no case have even the best efforts of central planners and bureaucrats led to dependable growth over an extended period. Such efforts are certain to be futile. Indeed, the only real question is how much damage they will do.

The certain path to prosperity and a greater society is the path of renewal and recommitment to the fundamental principles of economic freedom. That is the course charted and evaluated in the *Index of Economic Freedom*. The evidence is strong that individual liberty leads to more sustainable development and to collective happiness. Countries that embrace freedom are sure to achieve a better future for their people.