Chapter 1

The 10 Economic Freedoms

The existence of a free market does not of course eliminate the need for government. On the contrary, government is essential both as a forum for determining the "rules of the game" and as an umpire to interpret and enforce the rules decided on. What the market does is to reduce greatly the range of issues that must be decided through political means, and thereby to minimize the extent to which government need participate directly in the game.

Milton Friedman, *Capitalism and Freedom*

Economic freedom is that aspect of human liberty that is concerned with the material autonomy of the individual in relation to the state and other organized groups. Individuals are economically free if they can fully control their own labor and property. Economic freedom is related to—and is perhaps a necessary condition for—political freedom, but it is also valuable as an end in itself.[1]

DEFINING ECONOMIC FREEDOM

The authors of the *Index of Economic Freedom* perceive economic freedom as a positive concept, recognizing that its traditional definition as an absence of government coercion or constraint must also include a sense of liberty as distinct from anarchy. Governments are instituted to create basic protections against the ravages of nature or the predations of one citizen over another so that positive economic rights such as property and contract are given social as well as individual defense against the destructive tendencies of others.

A comprehensive definition of economic freedom should *encompass all liberties and rights of production, distribution, or consumption of goods and services. The highest form of economic freedom should provide an absolute right of property ownership; fully realized freedoms of movement for labor, capital, and goods; and an absolute absence of coercion or constraint of economic liberty beyond the extent necessary for citizens to protect and maintain liberty itself*. In other words, individuals in an economically free society would be free and entitled to work, produce, consume, and invest in any way they please under a rule of law, with their freedom at once both protected and respected by the state.

All government action involves coercion. Some minimal coercion is necessary for the citizens of a community or nation to defend them-

1. Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), esp. Chapter 1, "The Relation Between Economic Freedom and Political Freedom," pp. 7–17.

selves, promote the evolution of civil society, and enjoy the fruits of their labor. This Lockean idea is embodied in the U.S. Constitution. For example, citizens are taxed to provide revenue for the protection of person and property as well as for the common defense. Most political theorists also accept that certain goods—what economists call "public goods"—can be supplied more efficiently by government than through private means. Of particular interest are those economic freedoms that are also public goods, such as the maintenance of a police force to protect property rights, a monetary authority to maintain a sound currency, and an impartial judiciary to enforce contracts among parties.

When government coercion rises beyond the minimal level, however, it becomes corrosive to freedom—and the first freedom affected is economic freedom. Logically, an expansion of state power requires enforcement and therefore funding, which is extracted from the people. Exactly where that line is crossed is open to reasoned debate.

Throughout history, governments have imposed a wide array of constraints on economic activity. Constraining economic choice distorts and diminishes the production, distribution, and consumption of goods and services (including, of course, labor services).[2] The establishment of price controls is perhaps the clearest example of the distortionary effect of state coercion because of its well-known disruption of the equilibrium of supply and demand.

MEASURING ECONOMIC FREEDOM

As the first comprehensive study of economic freedom ever published, the 1995 *Index of Economic Freedom* defined a method of measuring and ranking freedom in such vastly different places as Hong Kong and North Korea.

The *Index* looks at economic freedom from 10 different viewpoints. Some aspects of economic freedom are external in nature, measuring the extent of an economy's openness to investment or trade. Most are internal in nature, assessing the liberty of individuals to use their labor or finances without restraint and government interference. Each is vital to the development of personal and national prosperity. The fundamental right of property, for example, has been recognized for centuries by the great philosophers of liberty, such as Locke and Montesquieu, as a bulwark of free people. Over time, scholars and practitioners have recognized many other pillars of economic liberty, including free trade, stable money, the right to work, control of government spending, and lower taxation. Over the past 15 years, the *Index* has grown and improved its measurement of countries' capacity to create environments that allow economic opportunity to flourish.

The 10 specific economic freedoms measured in the *Index of Economic Freedom* are discussed below. Each of the freedoms is individually scored. A country's overall economic freedom score is a simple average of its scores on the 10 individual freedoms. Detailed information about the methodology used to score each component is contained in the appendix.

Freedom #1: Business Freedom

Business freedom is about an individual's right to create, operate, and close an enterprise without interference from the state. Burdensome, redundant regulatory rules are the most common barriers to the free conduct of entrepreneurial activities.

Regulations are a form of taxation that makes it difficult for entrepreneurs to create value. Although many regulations hinder businesses, the most important are associated with licensing new companies and 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 countries, such as India and countries in parts of South America, the process involved

2. "The property which every man has in his own labour, as it is the original foundation of all other property, so it is the most sacred and inviolable." Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: The Modern Library, 1937), pp. 121–122; first published in 1776.

in obtaining a business license requires endless trips to government offices and can take a year or more.

Once a business is open, government regulation does not always subside; in some cases, it increases. Interestingly, two countries with the same set of regulations can impose different regulatory burdens. If one country, for instance, applies its regulations evenly and transparently, it lowers the regulatory burden by enabling businesses to make long-term plans more easily. If the other applies regulations inconsistently, it raises the regulatory burden by creating an unpredictable business environment. Finally, regulations that make it difficult and expensive to close business are disincentives for entrepreneurs to start them in the first place.

Freedom #2: Trade Freedom

Trade freedom reflects the openness of an economy to imports of goods and services from around the world and the ability of citizens to interact freely as buyers and sellers in the international marketplace.

Trade restrictions can take the form of taxes on imports and exports, quotas or outright bans on trade, and 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.

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

Freedom #3: Fiscal Freedom

Fiscal freedom is the freedom of individuals and businesses to keep and control their income and wealth for their own benefit and use. A government can impose fiscal burdens on economic activity by generating revenue for itself, primarily through taxation but also from debt that ultimately must be paid off through taxation.

The marginal tax rate confronting an individual is, in effect, the government's cut of the profit from his or her next unit of work or engagement in a new entrepreneurial venture; whatever remains after the tax is subtracted is the individual's actual reward for this effort. The higher the government's cut, the lower the individual's reward—and the lower the incentive to undertake the work at all. Higher tax rates both interfere with the ability of individuals and firms to pursue their goals in the marketplace and reduce, on average, their willingness to work or invest.

While individual and corporate income tax rates are important to economic freedom, they are not a comprehensive measure of the tax burden. Governments impose many other taxes, including payroll, sales, and excise taxes, tariffs, and the value-added tax (VAT). One way to capture all taxation is to measure total government revenues from all forms of taxation as a percentage of total GDP.

Freedom #4: Government Size

The burden of excessive government is a central issue in economic freedom, both in terms of generating revenue (see fiscal freedom) and in terms of expenditure.

Government expenditures are often justified in terms of "public goods" that are provided efficiently by the state rather than by the market. There is also a justification for correcting market failures through government action. Unfortunately, a government's insulation from market discipline leads to inefficiency, bureaucracy, and lowered productivity. Government expenditures necessarily compete with private agents and interfere in market prices by overstimulating demand and potentially diverting resources through a crowding-out effect. In extreme cases, governments can coerce goods and capital out of markets altogether, driving up interest rates and inflation.

The government's appetite for private resources affects both economic freedom and economic growth. Even if a state-managed economy achieves fast growth through heavy expenditure, it diminishes freedom in the process and can create long-term damage to a country's growth potential.

Freedom #5: Monetary Freedom

Monetary freedom, reflected in a stable currency and market-determined prices, is to an economy what free speech is to democracy. Free people need a steady and reliable currency as a medium of exchange and store of value. Without monetary freedom, it is difficult to create long-term value.

The value of a country's currency is controlled largely by the monetary policy of its government. With a monetary policy that endeavors to maintain stability, people can rely on market prices for the foreseeable future. Investment, savings, and other longer-term plans are easier to make, and individuals enjoy greater economic freedom. Inflation not only confiscates wealth like an invisible tax, but also distorts pricing, misallocates resources, raises the cost of doing business, and undermines a free society.

There is no singularly accepted theory of the right monetary institutions for a free society. At one time, the gold standard enjoyed widespread support, but this is no longer the case. What characterizes almost all monetary theories today, however, is support for low inflation and an independent central bank. There is also now widespread recognition that price controls corrupt market efficiency and lead to shortages or surpluses.

Freedom #6: Investment Freedom

Restrictions on foreign investment can limit both inflows and outflows of capital. In a free environment, capital will flow to its best use where it is most needed and the returns are greatest. State action to redirect the flow of capital is an imposition on both the freedom of the investor and the freedom of the people seeking capital. The more restrictions a country imposes on investment, the lower its level of entrepreneurial activity and economic growth.

Freedom #7: Financial Freedom

Virtually all countries provide some type of prudential supervision of banks and other financial services. This supervision serves two major purposes: ensuring the safety and soundness of the financial system and ensuring that financial services firms meet basic fiduciary responsibilities.

Excessive banking and financial regulation by the state, however, limits competition, impedes efficiency, and increases the costs of financing entrepreneurial activity. In a free banking environment, the marketplace should be the primary source of protection through such institutions as independent auditors and information services. Such oversight is distinguished from burdensome or intrusive government regulation or government ownership of banks, both of which interfere with market provision of financial services to consumers.

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, aside from basic provisions to enforce contractual obligations and prevent fraud, increased government intervention in these areas undermines economic freedom and inhibits the ability of non-banking financial services to contribute to economic growth. If the government intervenes in the stock market, it contravenes the choices of millions of individuals by interfering with the pricing of capital—the most critical function of a market economy. Equity markets measure, on a continual basis, the expected profits and losses in publicly held companies. This measurement is essential in allocating capital resources to their highest-valued uses and thereby satisfying consumers' most urgent requirements. Similarly, government ownership or intervention in the insurance sector undermines the ability of providers to make available those services at prices that are based on risk and market conditions.

Freedom #8: Property Rights

The ability to accumulate private property is the main motivating force in a market economy, and the rule of law is vital to a fully functioning free-market economy. Secure property rights give citizens the confidence to undertake commercial activities, save their income, and make long-term plans because they know that their income and savings are safe from expropriation or theft. The protection of private property requires an effective and honest judicial system that is available to all, equally and without discrimination.

Freedom #9: Freedom from Corruption

Corruption is defined as dishonesty or decay. In the context of governance, it can be defined as the failure of integrity in the system, a distortion by which individuals are able to gain personally at the expense of the whole. Political corruption is a sad part of human history and manifests itself in many forms such as bribery, extortion, nepotism, cronyism, patronage, embezzlement, and (most commonly) graft, whereby public officials steal or profit illegitimately from public funds.

Many societies, of course, outlaw such activities as the traffic in illicit drugs, but others frequently limit individual liberty by outlawing such activities as private transportation and construction services. Corruption infects all parts of an economy unless the market is allowed to develop transparency and effective policing. A government regulation or restriction in one area may create an informal market in another. For example, a country with high barriers to trade may have laws that protect its domestic market and prevent the import of foreign goods, but these barriers create incentives for smuggling and an informal market for the barred products.

Freedom #10: Labor Freedom

The ability of individuals to work as much as they want and wherever they want is a key component of economic freedom. By the same token, the ability of businesses to contract freely for labor and to fire workers when they are no longer needed is a vital mechanism for increasing productivity and sustaining economic growth. The core principle of any market is free, voluntary exchange. That principle has several components such as voluntary choice and free competition. The labor market is no exception.

The free market is also an efficient institution for labor, yielding the best results for society and workers, just as the free market has proven superior for virtually all other fields. Furthermore, state intervention generates the same problems in the labor market that it produces in any other markets.

Government regulations take a variety of forms, including wage controls, hiring and firing restrictions, and health and safety restrictions. 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. In general, the greater the degree of labor freedom, the lower the rate of unemployment in an economy.

Equal Weight. In the *Index of Economic Freedom*, the 10 components of economic freedom are equally weighted so that the overall score will not be biased toward any one component or policy direction. It is clear that the 10 economic freedoms interact, but the exact mechanisms of this interaction are not easily definable. Is a minimum threshold for each one essential? Is it possible for one to maximize if others are minimized? Are they dependent or exclusive, complements or supplements?

These are valid questions, but they are beyond the scope of our fundamental mission. The purpose of the *Index* is to reflect the economic environment in every country surveyed in as balanced a way as possible. The *Index* has never been designed specifically to explain economic growth or any other dependent variable; that is ably done by empirical econometricians elsewhere. The raw data for each component are provided so that others can study and weight and integrate as they see fit.

The Grading Scale. Each one of the 10 economic freedoms is graded using a scale from 0 to 100, with 100 representing the maximum freedom. A score of 100 signifies an economic environment or set of policies that is most conducive to economic freedom. The grading scale is continuous, meaning that scores with decimals are possible. For example, a country could have a trade freedom score of

50.3. Many of the 10 freedoms are based on quantitative data that are converted directly into a score. In the case of trade, a country with zero tariffs and zero non-tariff barriers will have a trade freedom score of 100.[3]

Period of Study. For the current *Index of Economic Freedom*, the authors generally examined data for the period covering the second half of 2007 through the first half of 2008. To the extent possible, the information considered for each factor was current as of June 30, 2008. It is important to understand, however, that some component scores are based on historical information. For example, the monetary freedom component is a three-year weighted average rate of inflation from January 1, 2005, to December 31, 2007.

Sources. In evaluating the criteria for each component, the authors have used a range of authoritative sources that are internationally recognized. All sources are indicated in the narrative where appropriate. Because it would be unnecessarily cumbersome to cite all of the sources used in scoring every single variable of each factor, unless otherwise noted, the major sources used in preparing the country summaries may be found in the appendix.

3. For detailed guidance on how the data in the *Index* can be used in statistical research, see *http://www.heritage.org/research/features/index/downloads.cfm#methodology*.