Chapter 5

Defining Economic Freedom

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Fundamentally, there are only two ways of co-ordinating the economic activities of millions. One is central direction involving the use of coercion—the technique of the army and of the modern totalitarian state. The other is voluntary co-operation of individuals—the technique of the market place.

—Milton Friedman[1]

In an economically free society, each person controls the fruits of his or her own labor and initiative. Individuals are empowered—indeed, entitled—to decide for themselves where to live and work. They have the right to own property and dispose of it as they choose.

In an economically free society, individuals succeed or fail based on their individual effort and ability. The institutions of society do not discriminate against—or in favor of—individuals based on their race, ethnic background, gender, class, family connections, or any other factor unrelated to individual merit. Government decision-making is characterized by transparency and openness, and the light of opportunity replaces the shadows where discrimination can be most insidious.

In an economically free society, the power of economic decision-making is widely dispersed, and the allocation of resources for production and consumption is on the basis of free and open competition so that every individual or firm has a fair chance to succeed.

These three fundamental principles of economic freedom—empowerment of the individual, non-discrimination, and open competition—underpin and inform every measurement in the *Index of Economic Freedom*.

ECONOMIC FREEDOM: AUTONOMY, NOT ANARCHY

The discussion of economic freedom has at its heart consideration of the relationship between the individual and the state. In general, state action or control that interferes with individual autonomy limits economic freedom.

1. Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1982), p. 13.

The *Index of Economic Freedom* is not, however, a call for anarchy. The goal of economic freedom is not simply an absence of government coercion or constraint, but the creation and maintenance of a sense of liberty for all. As individuals enjoy the blessings of economic freedom, they in turn have a responsibility to respect the economic rights and freedoms of others. 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 contracts are given societal 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 choose under a rule of law, with their freedom at once both protected and respected by the state.

Some government action is necessary for the citizens of a community or nation to defend themselves, promote the peaceful 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. Some 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, are themselves vital ingredients of an economically free society. When government action rises beyond the minimal level, however, it can become corrosive to freedom—and the first freedom affected is often economic freedom.

Throughout history, governments have imposed a wide array of constraints on economic activity. Though often imposed in the name of equality or some other noble societal purpose, such constraints are most often imposed for the benefit of societal elites or special interests, and they come with a high cost to society as a whole. Constraining economic choice distorts and diminishes the production, distribution, and consumption of goods and services (including, of course, labor services).[2] The overall result, inevitably, is reduced growth, declining prosperity, and economic stagnation.

MEASURING ECONOMIC FREEDOM

The measurement of economic freedom in countries as different as Hong Kong and North Korea, Zimbabwe and Singapore, or Australia and Cuba presents formidable challenges. As the number and variety of countries included in the *Index* have increased, it has become ever more difficult to find consistent and reliable data. We are indebted to the various international organizations, both governmental and non-governmental, that have undertaken the arduous task of data collection in their various areas of focus and have shared their data with us.

The *Index of Economic Freedom* is comprehensive in its view of economic freedom as well as in its worldwide coverage of countries. 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 global 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

2. "The property which every man has in his own labor, 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.

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. Each one illuminates some aspect of the relationship between the individual and the state, and all should be viewed in light of the fundamental principles of economic liberty—individual empowerment, non-discrimination, and open competition—outlined above.

The 10 specific economic freedoms measured in the *Index of Economic Freedom* are discussed below. Each of the freedoms is individually scored on a 0 to 100 scale. 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 establish and run an enterprise without interference from the state. Burdensome and redundant regulatory rules are the most common barriers to the free conduct of entrepreneurial activities.

By increasing the costs of production, regulations can make it difficult for entrepreneurs to succeed in the marketplace. Although many regulations hinder business productivity and profitability, the most inhibiting to entrepreneurship are those 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, involving 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, 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 bankruptcy procedures onerous are also distortionary, providing disincentives for entrepreneurs to start businesses 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 manifest themselves in the form of taxes on imports and exports and quotas or outright bans on trade. However, trade restrictions also appear in more subtle ways, particularly in the form of regulatory barriers. The degree to which government hinders the free flow of foreign commerce has a direct bearing on the ability of individuals to pursue their economic goals and to maximize their productivity and well-being.

Tariffs, for example, directly increase the prices that local consumers pay for foreign imports, but they also distort production incentives for local producers, causing them to produce either a good in which they lack a comparative advantage or more of a protected good than is economically efficient. This impedes overall economic efficiency and growth. In many cases, trade limitations also put advanced-technology products and services beyond the reach of local entrepreneurs, limiting their own productive development.

FREEDOM #3: FISCAL FREEDOM

Fiscal freedom is a direct measure of the extent to which individuals and businesses are permitted by government to keep and control their income and wealth for their own benefit and use. A government can impose fiscal burdens on economic activity through taxation, but it also does so when it incurs 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 the 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 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 indirect taxes, including payroll, sales, and excise taxes, tariffs, and the value-added tax (VAT). In the *Index of Economic Freedom*, the burden of these taxes is captured by measuring total government revenues from all forms of taxation as a percentage of total GDP.

FREEDOM #4: GOVERNMENT SPENDING

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 spending. Some government spending, such as providing infrastructure or funding research or even improvements in human capital, may be thought of as investments. There are public goods whose benefits accrue broadly to society in ways that markets cannot appropriately price. All government spending, however, entails an opportunity cost equal to the value of the private consumption or investment that would have occurred had the resources involved been left in the private sector.

In other words, excessive government spending runs a great risk of crowding out private consumption, thereby thwarting the choices of individuals. Even worse, a government's insulation from market discipline often leads to inefficiency, bureaucracy, lower productivity, and waste.

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 economic 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, 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 is controlled largely 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 also 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 now widespread recognition that price controls corrupt market efficiency and lead to shortages or surpluses.

FREEDOM #6: INVESTMENT FREEDOM

A free and open investment environment provides maximum entrepreneurial opportunities and incentives for expanded economic activity, productivity increases, 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 will be characterized by transparency and equity, supporting all types of firms rather than just large or strategically important companies, and will encourage rather than discourage 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, 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 will flow to its best use: to the sectors and activities where it is most needed and the returns are greatest. State action to redirect the flow of capital and limit choice is an imposition on the freedom of both the investor and the person seeking capital. The more restrictions a country imposes on investment, the lower its level of entrepreneurial activity.

FREEDOM #7: FINANCIAL FREEDOM

A transparent and open financial system ensures fairness in access to financing and promotes entrepreneurship. An open and free banking environment encourages competition to provide the most efficient financial intermediation between households and firms and between investors and entrepreneurs.

In an efficient banking environment that facilitates open and transparent access to financing, the marketplace is the primary source of protection for all parties involved in a financial transaction. 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. An 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; disclosure of assets, liabilities, and risks; and ensuring integrity.

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. 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 that service available at prices that are based on risk and market conditions.

FREEDOM #8: PROPERTY RIGHTS

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

The protection of private property requires an effective and honest judicial system that is available to all, equally and without discrimination. The independence, transparency, and effectiveness of the judicial system have proven to be key determinants of a country's prospects for long-term economic growth. Such a system is also vital to the maintenance of peace and security and the protection of human rights.

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

FREEDOM #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 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.

Corruption can infect all parts of an economy; there is a direct relationship between the extent of government regulation or other government intervention in economic activity and the amount of corruption. Almost any government regulation can provide an opportunity for bribery or graft. In addition, 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 a black market for the restricted products.

Transparency is the best weapon against corruption. Openness in regulatory procedures and processes can promote equitable treatment and greater regulatory efficiency and speed.

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 dismiss redundant workers when they are no longer needed is a vital mechanism for enhancing productivity and sustaining overall economic growth. The core principle of any market is free, voluntary exchange. That is 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 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.

THE *INDEX*: AN EVOLVING MEASURE OF DURABLE VALUES

Taken together, these 10 economic freedoms provide a comprehensive, albeit imperfect, picture of economic freedom, both in individual countries and in the world as a whole. At present, our understanding of economic freedom has outpaced the availability of data on a worldwide basis.[3] As data become more readily available, we will continue to refine the measures to provide the most complete picture possible.

It may well be also that our understanding of various facets of economic freedom will improve or evolve over time. There is no question, for example, that our understanding of discrimination has broadened in recent decades. Similar advances may occur in our understanding of the ideal relationship between individuals and society and—critically—of the role that government may play in bolstering equitable competition.

What will not change is our commitment to freedom, and particularly economic freedom, as a fundamental and inalienable human right.

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3. See, for example, Chapter 3 for an augmented view of economic freedom in Asia during the recent crisis.