

## Chapter 2

**The Rule of Law**

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**E**conomic freedom rests on the empowerment of the individual, nondiscrimination, and open competition. None of these requirements can exist in a society that lacks effective rule of law. This special section of the 2013 *Index of Economic Freedom* offers some diverse perspectives on the rule of law and its relationship to economic freedom and prosperity.

**THE RULE OF LAW AND DEVELOPMENT**

The *Index of Economic Freedom* provides unambiguous confirmation of the importance of the rule of law to economic growth and prosperity. Both of the rule-of-law indicators in the *Index* demonstrate a high degree of predictive power with respect to per capita incomes. The coefficient of correlation between the property rights indicator and per capita incomes is 0.76 (1.00 equals perfect correlation). For freedom from corruption, the coefficient is 0.80. Taken together, the rule-of-law indicators are highly predictive of per capita GDP, irrespective of other factors or the overall level of economic freedom. (See Chart 1.)

The rule of law is a critically important factor in determining which countries attract dynamic flows of global investment capital. Countries with rule-of-law scores in the top quarter have recorded levels of inward foreign direct investment that exceed levels in the lower three quarters combined. (See Chart 2.)

There is also evidence of a strong relationship between rule of law and employment. Available data from the Organisation for Economic Co-operation and Development (OECD) allow a comparison between unemployment rates and *Index* rule-of-law scores for OECD members. The top quartile of OECD members in terms of rule of law had unemployment rates averaging about 6 percent in 2011. Members that scored in the bottom half on rule of law averaged about 10 percent unemployment. (See Chart 2.)

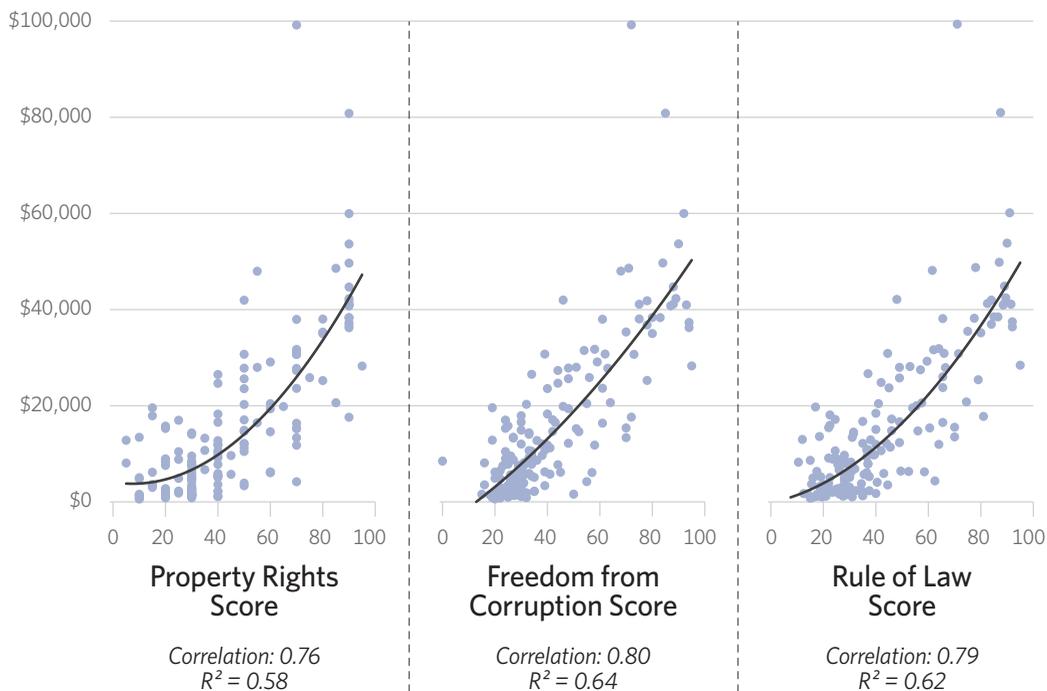
Given the obvious importance of property rights and freedom from corruption in underpinning high levels of economic performance, it is vital that we sharpen our overall understanding of the rule of law, its various manifestations, and the ways in which it affects economic achievement.

## The Effective Rule of Law Propels Prosperity

GDP per Capita  
(Purchasing Power Parity)

Each circle represents a  
nation in the Index of  
Economic Freedom

— Trend Lines



Sources: Terry Miller, Kim R. Holmes, and Edwin J. Feulner, 2013 *Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2013), <http://www.heritage.org/index>, and International Monetary Fund, World Economic Outlook Databases, <http://www.imf.org/external/ns/cs.aspx?id=28> (accessed November 6, 2012).

Chart 1  heritage.org

### THE RULE OF LAW AND DEMOCRACY

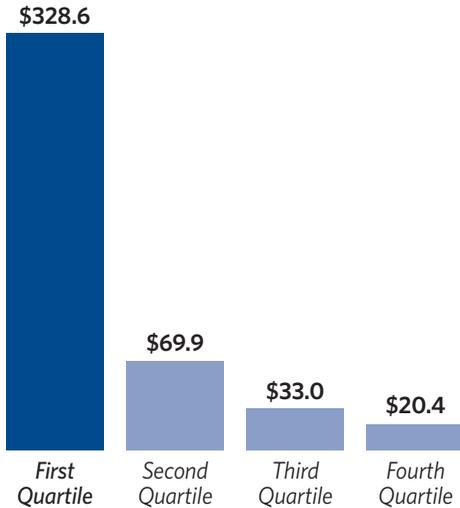
The relationship between the rule of law and economic development was explored in depth in research by Dr. Robert J. Barro that was published in the 2000 *Index of Economic Freedom*.<sup>1</sup> In a groundbreaking chapter, Dr. Barro was among the first to question the relationship between the promotion of democracy and development, highlighting the practical differences between democracy and the more general concept of rule of law and concluding that rule of law, by empowering individuals within a stable and predictable environment, is the more reliable factor in promoting development.

Dr. Barro returns to the *Index* this year with an updated version of that study based on improved data and new research. His conclusion, however, is the same: Efforts to promote the rule of law can bear substantial fruit in promoting development; promotion of democracy, by contrast, is uncertain at best in spurring economic growth or laying a solid foundation for economic freedom.

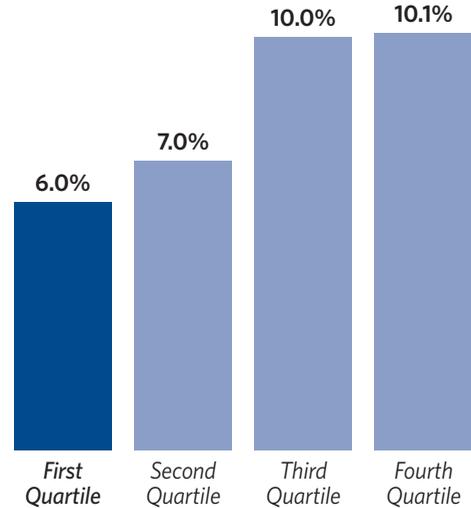
At a time when the Middle East is in turmoil, with political systems in rapid evolution or even revolution, Barro's study provides a solid basis on which to evaluate the likely success of attempts by aid donors to support greater levels of freedom and broad-based economic development throughout the region.

## Stronger Rule of Law Boosts Foreign Investment, Lowers Unemployment

Inflow of Foreign Direct Investment,  
in Billions of U.S. Dollars



Unemployment Rate  
for OECD Countries



Rule of Law Scores

**Sources:** Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2013 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2013), <http://www.heritage.org/index>; United Nations Conference on Trade and Development, *World Investment Report 2012*, [http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/WIR2012\\_WebFlyer.aspx](http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/WIR2012_WebFlyer.aspx) (accessed November 6, 2012); and Organisation for Economic Cooperation and Development, "Statistics from A to Z," <http://www.oecd.org/statistics/> (accessed November 6, 2012).

Chart 2  heritage.org

### EQUITABLE TREATMENT UNDER THE LAW

In developing countries, advances in the rule of law often involve such basics as the implementation of constitutional legal frameworks, land titling procedures, and the struggle against petty corruption. In advanced economies, corruption often takes more subtle forms, involving special subsidies or tax privileges for elites, abuses of government contracting, cronyism, and selective bailouts. These, of course, exist also in developing countries. Indeed, such government-granted special privileges tend to exist any time the government claims a significant economic role, either as property holder, business operator or regulator, or through programs aimed at redistributing wealth.

Such policies and practices violate one of the

three principles of economic freedom: equitable treatment for all. As emphasized in the *Index*, in free societies, individuals succeed or fail based on their effort and ability, not on their connections or class. Openness and transparency are the greatest antidotes to discrimination, but they are among the most difficult goals to achieve in government, where secrecy and bureaucracy enable corruption and graft.

In the second study in this section, Dr. Matthew Mitchell surveys the range of corrupt government practices involving special privileges for government-favored individuals or groups and highlights the economic costs they impose on society.

Next, James M. Roberts and John A. Robinson weigh in with a contribution analyzing the specific vulnerabilities of societies endowed

with significant natural resources, especially minerals such as oil or diamonds. Through a comparison of countries that have handled the so-called resource curse either especially well or especially poorly, they identify the policies and legal systems most conducive to successful management and exploitation of natural resources. It turns out that strong property rights are the best cure for the “curse.”

## **THE RULE OF LAW: GOOD FOR BUSINESS**

The free-market economy depends on an open competitive environment with a level playing field. Government’s proper role is to referee the competition. When it abandons its neutrality, either through outright corruption or through misguided efforts at social engineering that involve picking an economy’s winners and losers, the predictable results are a loss of efficiency, a reduction in productivity, and eventual economic stagnation. Entrepreneurs have little chance of success if government is tipping the scales against them in favor of vested interests. It is a fact of life that already established firms, not tomorrow’s innovators, are first in line at the government trough.

To close out this special section, the *Index* presents an essay by Myron Brilliant of the U.S. Chamber of Commerce, who argues that sustainable business success is impossible without the rule of law, which provides market predictability and due process. For Brilliant, good governance is good business, and he urges greater efforts to develop new and better indicators to measure the effectiveness of the rule of law and guide firms’ investment decisions.

Indeed, the effort to identify better measures of the rule of law is a critical concern for everyone engaged in comparative studies of economic freedom. Of the four pillars of economic freedom

evaluated in the *Index of Economic Freedom*,<sup>2</sup> the rule of law is by far the most difficult to measure. There are few standard metrics, and most published attempts to quantify and compare the rule of law in various countries rely on opinion surveys that can be subjective and unreliable.

To mitigate such deficiencies, the *Index* draws on an unusually wide variety of sources in evaluating respect for property rights, including information from international organizations, government sources, businesses, research organizations, and the media. Undoubtedly, better metrics would enable even better understanding and analysis.

## **THE FOUNDATION OF ECONOMIC FREEDOM AND GROWTH**

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

There is plenty of evidence from around the world that rule of law is a critical factor in empowering individuals, ending discrimination, and enhancing competition. In the never-ending struggle to improve the human condition and achieve greater prosperity, policies that promote the rule of law may well deserve a claim of precedence over other desirable objectives.

The first and most important role of governments is to preserve the peace while simultaneously respecting human rights, dignity, and freedom. It is the rule of law that enables peaceful resolution of conflict and ensures integrity in government’s interactions with individuals. The studies in this special section represent an effort to better understand, measure, and promote this key aspect of economic freedom.

## Endnotes

- 1 Gerald P. O'Driscoll Jr., Kim R. Holmes, and Melanie Kirkpatrick, *2000 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2000).
- 2 Rule of law, limited government, regulatory efficiency, and open markets.