Chapter 7

Defining Economic Freedom

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> The economic freedom which is the prerequisite of any other freedom cannot be the freedom from economic care which the socialists promise us and which can be obtained only by relieving the individual at the same time of the necessity and of the power of choice: it must be the freedom of economic activity which, with the right of choice, inevitably also carries the risk and the responsibility of that right.
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> —Friedrich A. Hayek[1]

Economic freedom is the condition in which individuals can act with autonomy while in the pursuit of their economic livelihood and greater prosperity. Any discussion of economic freedom has at its heart reflection on the critical relationship between individuals and the government.

Economic freedom is an essential aspect of human liberty, without which a person's rights to life, liberty, and the pursuit of happiness may be fundamentally compromised. As Friedrich Hayek once observed, "To be controlled in our economic pursuits means to be controlled in everything."[2] Hayek's keen insights on economic freedom are based on the moral truth that each person is, as a matter of natural right, a free and responsible being with inalienable dignity and fundamental liberties that righteous and effective political systems should regard as unassailable.

GUIDING PRINCIPLES OF ECONOMIC FREEDOM

In an economically free society, each person controls the fruits of his or her own labor and initiative. Individuals are empowered—indeed, entitled—to pursue their dreams by means of their own free choice.

In an economically free society, individuals succeed or fail based on their individual effort and ability. The institutions of a free and open society do not discriminate either 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 openness, and the bright light of transparency, illuminating the shadows where discrimination might flourish, guarantees equal opportunity for all.

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 gets a fair chance to succeed.

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

ECONOMIC FREEDOM: AUTONOMY, NOT ANARCHY

In general, state action or government control that interferes with individual autonomy limits economic freedom. 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 mutual 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 within the rule of law. Governments are instituted to ensure 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 view of economic freedom encompasses all liberties and rights of production, distribution, or consumption of goods and services. The highest forms of economic freedom should provide an absolute right of property ownership; full freedom of movement for labor, capital, and goods; and an absolute absence of coercion or constraint of economic liberty beyond that which is necessary for the protection and maintenance of liberty itself. An economically free society encourages handling of economic decisions in a decentralized fashion. Individuals are free to work, produce, consume, and invest in any way they choose under the even-handed application of laws, with their economic freedoms at once both protected and respected by the state.

Some government action is necessary for the citizens of a nation to defend themselves, promote the peaceful evolution of civil society, and enjoy the fruits of their labor. For example, citizens are taxed to provide revenue for public safety, the protection of property, and for the common defense. There can also be other goods—what economists call "public goods"—that may 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 necessary level, however, it leads inevitably and quickly to the loss of freedom—and the first freedom affected is often economic freedom.[3]

Throughout history, governments have imposed a wide array of constraints on economic activity. Though sometimes imposed in the name of equality or some other noble societal purpose, such constraints are in reality most often imposed for the benefit of societal elites or special interests, and they come with a high cost to society as a whole. By substituting political judgments for those of the marketplace, government diverts entrepreneurial resources and energy from productive activities to rent-seeking, the quest for economically unearned benefits. The result is lower productivity, economic stagnation, and declining prosperity.

Government provision of goods and services beyond those that are clearly considered public goods imposes a separate constraint on economic activity as well, crowding out private-sector activity and usurping resources that might otherwise have been available for private investment or consumption. Constraining economic choice distorts and diminishes the production, distribution, and consumption of goods and services (including, of course, labor services). The wealth of a nation declines as a result.

MEASURING ECONOMIC FREEDOM

Assessing economic freedom in countries as diverse as Hong Kong and North Korea, Zimbabwe and Singapore, or Australia and Cuba is not an easy task. 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 covering them all. Our research is indebted to various governmental and non-governmental international organizations 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* takes a broad and comprehensive view of country performance, measuring 10 separate areas of economic freedom. Some of the aspects of economic freedom that are evaluated are concerned with a country's interactions with the rest of the world—for example, the extent of an economy's openness to global investment or trade. Most, however, focus on policies within a country, assessing the liberty of individuals to use their labor or finances without undue restraint and government interference.

Each of the economic freedoms plays a vital role in developing and sustaining personal and national prosperity. All are complementary in their impact, however, and progress in one area is often likely to reinforce or even inspire progress in another. Similarly, repressed economic freedom in one area—respect for property rights, for example—may make it much more difficult to achieve high levels of freedom in other categories.

Each economic freedom is individually scored on a scale of 0 to 100. 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.

For analytical ease and presentational clarity, the 10 economic freedoms are grouped into four broad categories or pillars of economic freedom:

- **Rule of Law** (property rights, freedom from corruption);
- **Limited government** (fiscal freedom, government spending);
- **Regulatory efficiency** (business freedom, labor freedom, monetary freedom); and
- **Open markets** (trade freedom, investment freedom, financial freedom).

RULE OF LAW

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 and an effective rule of law to protect them are vital features of a fully functioning market economy. Secure property rights give citizens the confidence to undertake entrepreneurial activity, 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 autonomous and accountable 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 from Corruption. In the context of economic freedom, corruption can best be understood as the failure of integrity in the economic system, a distortion by which individuals or special-interest groups are able to gain at the expense of the whole. Often a direct result of the government's concentration of economic or political power, corruption manifests itself in many forms such as bribery, extortion, nepotism, cronyism, patronage, embezzlement, and graft.

Corruption can infect all parts of an economy in systematic ways. There is a direct relationship between the extent of government intervention in economic activity and the amount of corruption. In particular, excessive and redundant government regulations provide opportunities for bribery or graft. In addition, government regulations or restrictions in one area may create informal markets in another. For example, a country with high barriers to trade may have laws that protect its domestic manufacturers and prevent the import of foreign goods, but these barriers create incentives for smuggling and a black market for the restricted products, thereby increasing corruption.

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

LIMITED GOVERNMENT

Fiscal Freedom. Fiscal freedom is a direct measure of the extent to which government permits individuals and businesses to keep and manage 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 thereby reduce overall private-sector activity.

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 the overall tax burden from all forms of taxation as a percentage of total GDP.

Government Spending. The cost 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, the benefits of which accrue broadly to society in ways that markets cannot price appropriately. All government spending that must eventually be financed by higher taxation, 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.

Excessive government spending runs a great risk of crowding out private economic activity. Even if an economy achieves faster growth through more government spending, such economic expansion tends to be only temporary, distorting the allocation of resources and private investment incentives. Even worse, a government's insulation from market discipline often leads to bureaucracy, lower productivity, inefficiency, and mounting debt that imposes an even greater burden on future generations.

As many economies have experienced in recent years, high levels of public debt accumulated through irresponsible government spending undermine economic freedom and prevent dynamic entrepreneurial growth.

REGULATORY EFFICIENCY

Business Freedom. Business freedom is about an individual's right to establish and run an enterprise without undue interference from the state. Burdensome and redundant regulations are the most common barriers to the free conduct of entrepreneurial activity.

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 that are 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 applies its regulations evenly and transparently, this can lower the regulatory burden by facilitating long-term business planning. If the other applies regulations inconsistently, it raises the regulatory burden by creating an unpredictable business environment. Rigid and onerous bankruptcy procedures are also distortionary, providing a disincentive for entrepreneurs to start businesses in the first place.

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, restrictions on hiring and firing, and other constraints. 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.

Onerous labor laws penalize businesses and workers alike. Rigid labor regulations prevent employers and employees from freely negotiating changes in terms and conditions of work, resulting often in a chronic mismatch of labor supply and demand. In general, the greater the degree of labor freedom, the lower the rate of unemployment in an economy.

Monetary Freedom. Monetary freedom requires a stable currency and market-determined prices. Whether acting as entrepreneurs or as consumers, 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 can be influenced significantly 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 widespread recognition that price controls corrupt market efficiency and lead to shortages or surpluses.

OPEN MARKETS

Trade Freedom. Trade freedom reflects an economy's openness to the flow of goods and services from around the world and the citizen's ability to interact freely as buyer or seller in the international marketplace. Trade restrictions can manifest themselves in the form of tariffs, export taxes, trade quotas, or outright trade bans. 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 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.

Investment Freedom. A free and open investment environment provides maximum entrepreneurial opportunities and incentives for expanded economic activity, greater productivity, 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, thereby 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.

Financial Freedom. An accessible and well-functioning formal financial system ensures the availability of diversified savings, credit, payment, and investment services to individuals. By expanding financing opportunities and promoting entrepreneurship, an open banking environment encourages competition in order to provide the most efficient financial intermediation between households and firms as well as between investors and entrepreneurs.

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. A prudent and 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; promoting 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.

ECONOMIC FREEDOM: AN END IN ITSELF, A MEANS FOR PROGRESS

Economic freedom, enhanced and secured by the rule of law, limited government, regulatory efficiency, and open markets, is a vital element of human dignity, providing individuals the ability to plan and direct their lives in ways that maximize their happiness as they see fit. In addition, economic freedom is the key to achieving the broad-based economic dynamism that ensures lasting growth and increased prosperity for society as a whole.

In other words, economic freedom is valuable as an end itself. But equally important is that, with its 10 freedoms interacting with and complementing each other, economic freedom is also about a multidimensional process of achieving economic progress.

Nineteen years of data in the *Index of Economic Freedom* have documented the clear association between higher levels of economic freedom and greater levels of overall prosperity. Equally important, improvements in economic freedom, from whatever level, have been shown to enhance economic dynamism and social progress. Governments that choose policies that increase economic freedom are placing their societies on the pathway to more meaningful and productive work, higher incomes, and better standards of living for all.

Endnotes

1 Friedrich A. Hayek, *The Road to Serfdom* (Chicago, Ill.: University of Chicago Press, 1944).

2 Ibid.

3 "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.