Economic Freedom and the Wealth and Well-Being of Nations

Robert A. Lawson *1

When you can measure what you are speaking about, and can express it in numbers, you know something about it; but when you cannot measure it, when you cannot express it in numbers, then your knowledge is of a meager and unsatisfactory kind.

– Lord Kelvin

If it matters, measure it. If it can't be measured, measure it anyway.

– Milton Friedman

1. Introduction

The idea that institutions are important in determining the degree of economic productivity in a nation is hardly new. Long ago Adam Smith ([1776] 1937), speaking of China, wrote,

> China seems to have been long stationary, and had probably long ago acquired that full complement of riches which is consistent with the nature of its laws and institutions. But this complement may be much inferior to what, with other laws and institutions, the nature of its soil, climate, and situation might admit of (Book I, Chapter IX, Paragraph 15, 95).

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* Robert A. Lawson is associate professor in the department of finance, codirector of the Center for International Finance and Global Competitiveness, and director of the Economic Freedom Initiative at Auburn University.

1 This paper is based on talks given as a part of the 2009 Upton Forum at Beloit College and draws heavily on various editions of the *Economic Freedom of the World* annual report (Gwatney and Lawson 2009) and Lawson (2008).

Of course the notion that "institutions matter" is hardly unique to advocates of laissez-faire. Karl Marx ([1867] 1906) himself acknowledged the productive capacity of the capitalist system, even while disparaging its impact on the relative standing of workers, and argued for economic institutions based on socialized planning.

The debate that ensued between Marxists (and other socialists) on the one hand and Smithian free-market advocates on the other was to rage for the better part of the next century. While the political debate between totalitarian communism and liberal democracy was to continue throughout most of the twentieth century, lasting at least until the fall of the Soviet Union in 1991, the intellectual debate had receded into the background by around mid-century.

A mathematical and formalization revolution took over the economics profession in the mid-twentieth century, and untidy concepts like institutional arrangements and entrepreneurship gave way to the new "science" of development economics. Development and growth economists (e.g., Solow 1956) modeled entire economies as if they were production functions: output is a function of inputs. It is certainly true that increasing inputs should increase output *ceteris paribus*, but there was little discussion about what was being held constant. While the model was eventually extended to include technological progress, the implicit assumption was that labor and capital would always be combined in the most efficient way possible; that is, the models assumed that countries were always functioning on their production possibilities frontier.

Another line of reasoning, mostly associated with Jeffrey Sachs (2001), is that geographic/locational factors such as a temperate climate and ease of access to markets are critically important for the achievement of high-income levels and growth rates. In contrast, tropical climatic conditions both erode the energy level of workers and increase the risk of disabling and life-threatening diseases such as malaria. As a result, worker productivity and the general level of development are retarded in tropical areas.

But even a casual look at the real world revealed problems with these theoretical perspectives. Countries that appeared to have high levels of inputs in terms of natural resources, such as Argentina, did not necessarily perform very well. High investment rates in the centrally planned economies likewise did not generate rapid economic development. On the other hand, the strong economic performance of resource-poor and tropical Hong Kong and Singapore appear anomalous. It seemed obvious to anyone who cared to look that the real world pattern of economic development was based on more than just the available quantities of resources and technology or location. Nevertheless, development economics continued to recommend building roads, schools, bridges, airports, factories, etc. without regard to whether those input investments were likely to be productive in the context of the institutions in place.

Recent researchers, however, have rediscovered the role of institutions as a cause of economic development. Acemoglu, Johnson, and Robinson (2001; 2005) argue that differences in institutions have been important in determining the pattern of economic development and that, after controlling for these institutional differences, geographical location loses much of its explanatory power. Rodrick, Subramanian, and Trebbi (2004) also strongly reinforce this view.

One problem for the early theorists and empirical researchers alike is that institutional quality is quite difficult to measure quantitatively. Fortunately, today we have many measures of these institutional factors at our disposal.

2. Why Measure Economic Freedom?

As anyone who has taught macroeconomics knows, students sometimes have difficulty grasping the enormity of the concept of GDP. We give them a definition, "the market value of all final goods and services produced in a nation in a year," and some insanely large number like "$14 trillion." But what does it mean? To most of my students, it is just a number. To make it seem more concrete, I ask my students to imagine a long printout with everything produced in the United States this year: 10 million cars, 1.2 billion haircuts, 2,430 major league baseball games … Then I ask them to imagine the same printout but with dollar values instead of quantities: $200 billion worth of cars, $12 billion in haircuts, $2 billion in ticket sales at major league games … Finally I ask them to imagine adding up all the numbers. Slowly it dawns on them what we are talking about. Clearly, the total production of the United States is a big, multidimensional thing, and GDP boils it down to a single, mind-bogglingly huge number.

Why do we go to so much trouble to measure GDP? The simple answer is that we want to know how much we have produced this year relative to last year. We also want to know how much we've produced (per person) relative to Japan or other countries.

Despite the fact that GDP is a single number, we know that it represents a multidimensional thing, and we worry about the ability of the number to tell us anything useful. We wonder, for instance, whether today's number is comparable with yesterday's or if the United States's number is comparable with Japan's. Because these questions and others are important to us, we persevere, doing our best to adjust for price changes over time and purchasing power parity difference among countries. The bottom line is that unless we take the time to measure GDP, we simply cannot address many of the questions that we economists are interested in.

Now consider the concept of economic freedom. It is not too difficult to come up with a quick, working definition such as "the ability of individuals to consume, produce, and voluntarily trade with others without interference" that would satisfy most.[2] Economists would probably agree that freedom is an economic good in the sense that people prefer more of it to less, all things being equal. We may be interested in a number of questions about this economic freedom thing: How much freedom do we have? Are we more or less free than we used to be? Are the Japanese more free than we are? Do societies with more economic freedom perform differently than those with less?

More than anyone else, Milton Friedman (1962) was responsible for elevating the concept of economic freedom to our minds. Milton and Rose Friedman (1980, 148–49) wrote:

> [A] society that puts freedom first will, as a happy by-product, end up with both greater freedom and greater equality. Though a by-product of freedom, greater equality is not an accident. A free society releases the energies and abilities of people to pursue their own objectives. It prevents some people from arbitrarily suppressing others. It does not prevent some people from achieving positions of privilege, but so long as freedom is maintained, it prevents those positions of privilege from becoming institutionalized; they are subject to continued attack by other able, ambitious people. Freedom means diversity, but also mobility. It preserves the opportunity for today's disadvantaged to become tomorrow's privileged and, in the process enables almost everyone, from top to bottom, to enjoy a fuller and richer life.

Free market advocates like the Friedmans like to paint a rosy picture of economic freedom leading to higher growth and incomes, less poverty, more equality, more civil rights, etc.

Meanwhile many other scholars of the same period argued that economic freedom would lead to ruin. Harrington (1962), Galbraith (1967), and Thurow (1980) all argued forcefully that the United States should reject economic freedom in favor of greater government taxation, regulation, and industrial planning to solve various social problems like poverty, inequality, slow growth, and business cycles. The free market, in their eyes, is the source of much misery, and thus, aggressive government action is required to rein in the destructive forces of the market.

All sides to the debate appear to agree on the ends (higher incomes and growth are good; poverty, inequality, and business cycles are bad), but they disagreed on the means for achieving those ends. But the debate was mostly unscientific and loaded with heated rhetoric. It was as though two chemists who disagreed about a particular chemical reaction decided to argue about it in the hallway rather than go to the lab to run the necessary experiments to decide who was correct. The problem for the great debate between free market advocates and central planners was the inability to empirically test their competing hypotheses. Either economic freedom results in

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[2] Sen (1999) would probably not be one to agree with this definition as he prefers a definition of freedom based on positive rights.

higher incomes, faster growth, more equality, less poverty, etc., as the free market advocates claim, or it does not. It is as simple as that, but to test these hypotheses, we first need to measure economic freedom.

3. The Economic Freedom of the World Index

The Economic Freedom of the World (EFW) index is designed to measure the consistency of a nation's institutions and policies with economic freedom. The key ingredients of economic freedom are: personal choice, voluntary exchange coordinated by markets, freedom to enter and compete in markets, and protection of persons and their property from aggression by others.

These cornerstones underpin the design of the EFW index. Put simply, institutions and policies are consistent with economic freedom when they provide an infrastructure for voluntary exchange and protect individuals and their property from aggressors. In order to achieve a high EFW rating, a country must provide secure protection of privately owned property, evenhanded enforcement of contracts, and a stable monetary environment. It also must keep taxes low, refrain from creating barriers to both domestic and international trade, and rely more fully on markets rather than on the political process to allocate goods and resources.

Since 1980, there has been a gradual but steady movement toward economic freedom. Monetary policy has been more stable, trade barriers have declined, high marginal tax rates have been reduced, and exchange rate controls have been virtually eliminated. Consider the following: The median inflation rate was 4 percent in 2007, down from 14 percent in 1980. Among the ninety-three countries with data from both periods, only seventeen had a double-digit average annual rate of inflation during 2003–07, compared to sixty-one for the five years ending in 1980. The mean tariff rate fell from 26.2 percent in 1980 to 9.0 percent in 2007. The number of countries imposing marginal tax rates of 50 percent or more fell from sixty-two in 1980 to nine in 2007. Fifty countries imposed exchange rate controls that generated a black market premium of 10 percent or more in 1980 but only 3 percent in 2007.

Economic growth is primarily the result of gains from trade, capital investment, the discovery of improved products, lower-cost production methods, and better ways of doing things. Numerous studies have shown that countries with more economic freedom grow more rapidly and achieve higher levels of per-capita income than those that are less free. Similarly, there is a positive relationship between changes in economic freedom and the growth of per-capita income. Given the sources of growth and prosperity, it is not surprising that increases in economic freedom and improvements in quality of life have gone hand in hand during the past quarter of a century.

The construction of the Economic Freedom of the World Index is based on three important methodological principles. First, objective components are always preferred to those that involve surveys or value judgments. Given the multidimensional nature of economic freedom and the importance of legal and regulatory elements, it is sometimes necessary to use data based on surveys, expert panels, and generic case studies. To the fullest extent possible, however, the index utilizes objective components. Second, the data used to construct the index ratings are from external sources such as the IMF, World Bank, and World Economic Forum that provide data for a large number of countries. Data provided directly from a source within a country are rarely used, and only when the data are unavailable from international sources. Importantly, the value judgments of the authors or others in the EFW network are never used to alter the raw data or the rating of any country. Third, transparency is present throughout. The report provides information about the data sources, the methodology used to transform raw data into component ratings, and how the component ratings are used to construct both the area and summary ratings

Exhibit 1 indicates the structure of the EFW index. The index measures the degree of economic freedom present in five major areas: (1) Size of Government: Expenditures, Taxes, and Enterprises, (2) Legal Structure and Security of Property Rights, (3) Access to Sound Money, (4) Freedom to Trade Internationally, and (5) Regulation of Credit, Labor, and Business.

Within the five major areas, there are twenty-three components in the index. Many of those components are themselves made up of several subcomponents. In total, the index is comprised of forty-two distinct variables. Each component and subcomponent is placed on a scale from 0 to 10 that reflects the distribution of the underlying data. The subcomponent ratings are averaged to determine each component. The component ratings within each area are then averaged to derive ratings for each of the five areas. In turn, the five area ratings are averaged to derive the summary rating for each country. The following section provides an overview of the five major areas.

3.1 Area 1: Size of Government: Expenditures, Taxes and Enterprises

The four components of Area 1 indicate the extent to which countries rely on the political process to allocate resources and goods and services. When government spending increases relative to spending by individuals, households, and businesses, government decision making is substituted for personal choice, and economic freedom is reduced. The first two components address this issue. Government consumption as a share of total consumption (1A) and transfers and subsidies as a share of GDP (1B) are indicators of the size of government. When government consumption is a larger share of the total, political choice is substituted for personal choice. Similarly, when governments tax some people in order to provide transfers to others, they

Exhibit 1: The Areas and Components of the EFW Index

Area 1: Size of Government: Expenditures, Taxes, and Enterprises

A	General government consumption spending	
B	Transfers and subsidies as a percentage of GDP	
C	Government enterprises and investment	
D	Top marginal tax rate	
i		Top marginal income tax rate
ii		Top marginal income and payroll tax rates

Area 2: Legal Structure and Security of Property Rights

A	Judicial independence (GCR)
B	Impartial courts (GCR)
C	Protection of property rights (GCR)
D	Military interference in rule of law and the political process (CRG)
E	Integrity of the legal system (CRG)
F	Legal enforcement of contracts (DB)
G	Regulatory restrictions on the sale of real property (DB)

Area 3: Access to Sound Money

A	Money Growth
B	Standard deviation of inflation
C	Inflation: Most recent year
D	Freedom to own foreign currency bank accounts

Area 4: Freedom to Trade Internationally

A	Taxes on international trade	
i		International trade tax revenues (% of trade sector)
ii		Mean tariff rate
iii		Standard deviation of tariff rates
B	Regulatory Trade Barriers	
i		Nontariff trade barriers (GCR)
ii		Compliance cost of importing and exporting (DB)
C	Size of the trade sector relative to expected	
D	Black-market exchange rates	
E	International capital market controls	
i		Foreign ownership/investment restrictions (GCR)
ii		Capital controls

Area 5: Regulation of Credit, Labor, and Business

A	Credit market regulations	
i		Ownership of banks
ii		Foreign bank competition
iii		Private sector credit
iv		Interest rate controls/Negative real interest rates
B	Labor market regulations	
i		Minimum wage (DB)
ii		Foreign bank competition
iii		Private sector credit
iv		Interest rate controls/Negative real interest rates
C	Business Regulations	
i		Price controls
ii		Administrative requirements (GCR)
iii		Bureaucracy costs (GCR)
iv		Starting a business (DB)
v		Extra payments/Bribes (GCR)
vi		Licensing restrictions (DB)
vii		Cost of tax compliance (DB)

reduce the freedom of individuals to keep what they earn.

The third component (1C) in this area measures the extent to which countries use private rather than government enterprises to produce goods and services. Government firms play by rules that are different from those to which private enterprises are subject. They are not dependent on consumers for their revenue or on investors for capital. They often operate in protected markets. Thus, economic freedom is reduced as government enterprises produce a larger share of total output.

The fourth component (1D) is based on (Di) the top marginal income-tax rate and (Dii) the top marginal income- and payroll-tax rate and the income threshold at which these rates begin to apply. These two subcomponents are averaged to calculate 1D. High marginal tax rates that apply at relatively low-income levels are also indicative of reliance upon government. Such rates deny individuals the fruits of their labor. Thus, countries with high marginal tax rates and low-income thresholds are rated lower.

Taken together, the four components of Area 1 measure the degree to which a country relies on personal choice and markets rather than on government budgets and political decision making. Therefore, countries with low levels of government spending as a share of the total, a smaller government enterprise sector, and lower marginal tax rates earn the highest ratings in this area.

3.2 Area 2: Legal Structure and Security of Property Rights

Protection of persons and their rightfully acquired property is a central element of economic freedom and a civil society. Indeed, it is the most important function of government. Area 2 focuses on this issue. The key ingredients of a legal system consistent with economic freedom are rule of law, security of property rights, an independent judiciary, and an impartial court system. Components indicating how well the protective function of government is performed were assembled from three primary sources: the International Country Risk Guide, the Global Competitiveness Report, and the World Bank's Doing Business project.

Security of property rights, protected by the rule of law, provides the foundation for both economic freedom and the efficient operation of markets. Freedom to exchange, for example, is meaningless if individuals do not have secure rights to property, including the fruits of their labor. When individuals and businesses lack confidence that contracts will be enforced and the fruits of their productive efforts protected, their incentive to engage in productive activity is eroded. Perhaps more than any other area, this area is essential for the efficient allocation of resources. Countries with major deficiencies in this area are unlikely to prosper regardless of their policies in the other four areas.

3.3 Area 3: Access to Sound Money

Money oils the wheels of exchange. An absence of sound money undermines gains from trade. As Milton Friedman informed us long ago, inflation is a monetary phenomenon, caused by too much money chasing too few goods. High rates of monetary growth invariably lead to inflation. Similarly, when the rate of inflation increases, it also tends to become more volatile. High and volatile rates of inflation distort relative prices, alter the fundamental terms of long-term contracts, and make it virtually impossible for individuals and businesses to plan sensibly for the future. Sound money is essential to protect property rights and, thus, economic freedom. Inflation erodes the value of property held in monetary instruments. When governments use money creation to finance their expenditures, in effect, they are expropriating the property and violating the economic freedom of their citizens.

The important thing is that individuals have access to sound money; it makes little difference who provides it. Thus, in addition to data on a country's inflation and its government's monetary policy, it is important to consider how difficult it is to use alternative, more credible currencies. If bankers can offer saving and checking accounts in other currencies, or if citizens can open foreign bank accounts, then access to sound money is increased and economic freedom expanded.

There are four components to the EFW index in Area 3. All of them are objective and relatively easy to obtain, and all have been included in the earlier editions of the index. The first three are designed to measure the consistency of monetary policy (or institutions) with long-term price stability. Component 3D is designed to measure the ease with which other currencies can be used via domestic and foreign bank accounts. In order to earn a high rating in this area, a country must follow policies and adopt institutions that lead to low (and stable) rates of inflation and avoid regulations that limit the ability to use alternative currencies.

3.4 Area 4: Freedom to Trade Internationally

In our modern world of high technology and low costs for communication and transportation, freedom of exchange across national boundaries is a key ingredient of economic freedom. Many goods and services are now either produced abroad or contain resources supplied from abroad. Voluntary exchange is a positive-sum activity: both trading partners gain, and the pursuit of the gain provides the motivation for the exchange. Thus, freedom to trade internationally also contributes substantially to our modern living standards.

Responding to protectionist critics and special-interest politics, virtually all countries adopt trade restrictions of various types. Tariffs and quotas are obvious examples of roadblocks that limit international trade. Because they reduce the convertibility of currencies, controls on the exchange rate also hinder international trade. The volume of trade is also reduced if the passage of goods through customs is onerous and time consuming. Sometimes these delays are the result of administrative inefficiency while in other instances they reflect the actions of corrupt officials seeking to extract bribes. In both cases, economic freedom is reduced.

The components in this area are designed to measure a wide variety of restraints that affect international exchange: tariffs, quotas, hidden administrative restraints, and exchange rate and capital controls. In order to get a high rating in this area, a country must have low tariffs, a trade sector larger than expected, easy clearance and efficient administration of customs, a freely convertible currency, and few controls on the movement of capital.

3.5 Area 5: Regulation of Credit, Labor, and Business

When regulations restrict entry into markets and interfere with the freedom to engage in voluntary exchange, they reduce economic freedom. The fifth area of the index focuses on regulatory restraints that limit the freedom of exchange in credit, labor, and product markets. The first component (5A) reflects conditions in the domestic credit market. The first two subcomponents provide evidence on the extent to which the banking industry is dominated by private firms and whether foreign banks are permitted to compete in the market. The final two subcomponents indicate the extent to which credit is supplied to the private sector and whether controls on interest rates interfere with the market in credit. Countries that use a private banking system to allocate credit to private parties and refrain from controlling interest rates receive higher ratings for this regulatory component.

Many types of labor-market regulations infringe on the economic freedom of employees and employers. Among the more prominent are minimum wages, dismissal regulations, centralized wage setting, extension of union contracts to nonparticipating parties, and conscription. The labor-market component (5B) is designed to measure the extent to which these restraints upon economic freedom are present. In order to earn high marks in the component rating regulation of the labor market, a country must allow market forces to determine wages and establish the conditions of hiring and firing, and refrain from the use of conscription.

Like the regulation of credit and labor markets, the regulation of business activities (component 5C) inhibits economic freedom. The subcomponents of 5C are designed to identify the extent to which regulations and bureaucratic procedures restrain entry and reduce competition. In order to score high in this portion of the index, countries must allow markets to determine prices and refrain from regulatory activities that retard entry into business and increase the cost of producing products. They also must refrain from "playing favorites," that is, from using their power to extract financial payments and reward some businesses at the expense of others.

3.6 Summary Economic Freedom Ratings, 2007

Exhibit 2 presents summary economic freedom ratings, sorted from highest to lowest. These ratings are for the year 2007, the most recent year for which comprehensive data are available. Hong Kong and Singapore once again occupy the top two positions. The other nations in the top 10 are New Zealand, Switzerland, Chile, United States, Ireland, Canada, Australia, and the United Kingdom. The rankings of other major countries include Germany (27th), Japan (30th), Korea (32nd), France (33rd), Spain (39th), Italy (61st), Mexico (68th), China (82nd), Russia (83rd), India (86th), and Brazil (111th). The ten lowest-rated countries are Niger, Chad, Democratic Republic of Congo, Guinea-Bissau, Central African Republic, Republic of Congo, Venezuela, Angola, Myanmar, and again in last place, Zimbabwe.

The EFW index is calculated back to 1970 as the availability of data allows; see the Web site <http://www.freetheworld.com> for information from past years.

Exhibit 2. Economic Freedom Ratings, 2007

Rank	Countries	EFW Index	Rank	Countries	EFW Index
1	Hong Kong	8.97	71	Ghana	6.80
2	Singapore	8.66	71	Kyrgyz Republic	6.80
3	New Zealand	8.30	73	Romania	6.79
4	Switzerland	8.19	74	Poland	6.78
5	Chile	8.14	75	Barbados	6.75
6	United States	8.06	76	Bulgaria	6.74
7	Ireland	7.98	77	Pap. New Guinea	6.71
8	Canada	7.91	78	Israel	6.69
9	Australia	7.89	79	Egypt	6.68
9	United Kingdom	7.89	80	Fiji	6.64
11	Estonia	7.81	81	Montenegro	6.58
12	Denmark	7.74	82	China	6.54
13	Austria	7.67	83	Russia	6.50
14	Luxembourg	7.65	84	Serbia	6.47

Rank	Countries	EFW Index	Rank	Countries	EFW Index
14	Panama	7.65	85	Azerbaijan	6.46
16	Finland	7.62	86	India	6.45
16	Mauritius	7.62	87	Haiti	6.44
16	Taiwan	7.62	88	Turkey	6.42
19	Unit. Arab Em.	7.58	89	Macedonia	6.40
20	Bahrain	7.56	90	Tunisia	6.39
20	Costa Rica	7.56	91	Paraguay	6.38
20	Netherlands	7.56	92	Lesotho	6.36
23	Malta	7.54	93	Indonesia	6.35
24	Iceland	7.53	94	Moldova	6.34
24	Norway	7.53	95	Croatia	6.33
26	Slovak Rep	7.52	96	Tanzania	6.32
27	Germany	7.50	97	Nigeria	6.31
28	El Salvador	7.48	98	Madagascar	6.29
28	Honduras	7.48	99	Mali	6.28
30	Japan	7.46	100	Dominican Rep.	6.27
30	Kuwait	7.46	101	Vietnam	6.22
32	Korea, South	7.45	102	Rwanda	6.20
33	France	7.43	103	Bolivia	6.18
34	Jordan	7.40	104	Morocco	6.16
35	Lithuania	7.38	105	Argentina	6.10
36	Cyprus	7.36	105	Bosnia and Herzegovina	6.10
36	Oman	7.36	105	Sri Lanka	6.10
38	Hungary	7.33	108	Cote d'Ivoire	6.09
39	Spain	7.32	109	Mauritania	6.05
40	Sweden	7.28	110	Pakistan	6.01
41	Peru	7.26	111	Brazil	6.00
42	Georgia	7.25	112	Iran	5.99
42	Guatemala	7.25	113	Guyana	5.98
44	Latvia	7.22	114	Sierra Leone	5.97
45	Jamaica	7.19	115	Bangladesh	5.93
45	Portugal	7.19	115	Malawi	5.93
47	Belgium	7.18	117	Togo	5.90
48	Armenia	7.17	118	Benin	5.89
49	Zambia	7.13	119	Burkina Faso	5.87
50	Botswana	7.12	120	Ecuador	5.83
50	Kazakhstan	7.12	121	Colombia	5.81
52	Greece	7.11	122	Gabon	5.80
53	Bahamas	7.10	123	Cameroon	5.79

Rank	Countries	EFW Index	Rank	Countries	EFW Index
54	Czech Rep.	7.09	124	Syria	5.76
54	Kenya	7.09	125	Mozambique	5.74
56	Trinidad & Tobago	7.07	126	Senegal	5.72
57	Albania	7.06	127	Ethiopia	5.71
57	South Africa	7.06	128	Ukraine	5.68
59	Thailand	7.04	129	Nepal	5.58
60	Nicaragua	6.96	130	Burundi	5.54
61	Italy	6.95	131	Algeria	5.34
61	Uruguay	6.95	132	Niger	5.11
63	Mongolia	6.91	133	Chad	5.09
64	Slovenia	6.90	134	Congo, Dem. R.	5.00
64	Uganda	6.90	135	Guinea-Bissau	4.84
66	Malaysia	6.88	136	Central Afr. Rep.	4.79
67	Belize	6.87	137	Congo, Rep. Of	4.44
68	Mexico	6.85	138	Venezuela	4.33
69	Namibia	6.83	139	Angola	4.04
69	Philippines	6.83	140	Myanmar	3.69
			141	Zimbabwe	2.89

4. Economic Freedom and Democracy: Friends or Foes?

It is important to recognize the difference between economic freedom and democracy. Democracy has to do with how political choices are made, while economic freedom is about the consistency of those choices with voluntary exchange and the protection of people and their property from aggressors.

For our purposes, we can say that liberal democracy is present when all adult citizens are free to participate in the formal political process (vote, run for office, lobby, etc.) and larger societal debates (freedom of press, speech, and assembly). While democracy in some narrow sense can occur without political freedom (as in the case of the former Soviet Union), and likewise much political freedom can occur without much democracy (as in the case of Hong Kong today), it is reasonably acceptable for our purposes to equate democracy with political freedom.

The key thing to note is that restrictions that inhibit personal choice, voluntary exchange, the opportunity to compete, and the right of individuals to keep what they earn are in conflict with economic freedom. This is true regardless of whether they are adopted by democratic or nondemocratic procedures.

Clearly, democratic political decision making will not guarantee economic freedom. Voters may elect political leaders who substantially restrict economic freedom. In recent years, this has been the case in both Venezuela and Zimbabwe. The experiences of India and Israel during 1960–90 also illustrate the potential conflict between political democracy and economic freedom. Interestingly, it is also possible for a country with very little democracy to nonetheless have a substantial amount of economic freedom. Hong Kong during the last several decades provides an example.

Despite possible conflicts between economic freedom and political freedom/ democracy, many scholars have speculated that they may be positively linked in practice. In *The Road to Serfdom*, Friedrich A. Hayek sounded the alarm bell among intellectuals worried about the prospects for political liberalism in Europe. Hayek speculated that the centralized planning embraced by the United Kingdom during the war would continue and spread after the war, and this would ultimately threaten the liberal democratic values of Western Europe. Hayek (1944, 69–70) wrote,

> If "capitalism" means here a competitive system based on free disposal over private property, it is far more important to realize that only within this system is democracy possible. When it becomes dominated by a collectivist creed, democracy will inevitably destroy itself.

Writing eighteen years later in the United States, Milton Friedman (1962, 9) echoed Hayek in *Capitalism and Freedom*,

> Historical evidence speaks with a single voice on the relation between political freedom and a free market. I know of no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organize the bulk of economic activity.

Lawson and Clark (forthcoming) examine empirically these views of Hayek and Friedman that economic freedom is a necessary though not sufficient condition for political freedom, and conclude,

> As both Milton Friedman and F. A. Hayek suggested, there are relatively few instances of societies combining high political freedom without high levels of economic freedom. It appears that at least some reasonable amount of economic freedom is a precondition, necessary but not sufficient, if a nation is to have high political freedom. The number of cases where countries have tried to combine high political freedom and low economic freedom appears to be diminishing over time with almost all of them moving in the direction of freer markets.

5. Economic Freedom and Economic Outcomes

The relative contribution of economic freedom and political freedom on prosperity has also been the subject of considerable scholarly attention. With respect to economic growth, which over time leads to greater average incomes, the evidence is solid that economic freedom is highly important (de Haan et al. 2006), and that in turn, economic freedom is more potent than democracy (Wu and Davis 1999) in fostering growth.

Related to this evidence, Clark and Lawson (2008) found that progressive taxation, as measured by high top marginal tax rates, appears to foster increased income equality. However, they note that broader measures of economic freedom (private property rights, sound money, trade openness and government size) correlate very strongly with increased income equality. Scully (2002) also found that economic freedom promotes both economic growth and income equality.

The Economic Freedom of the World index has allowed scholars to examine the impact of market liberalism in many areas. Of particular interest has been the relationship between economic freedom and political freedom/democracy and the relative importance of each in various societal outcomes. While there may be conflicts on some margins between economic and political freedom, the two concepts can go hand in hand. The evidence suggests that while political democracy may yield many good things for society, economic freedom is at least as important if not more so.

A final lesson is also emerging. As Easterly (2006) notes: Top-down or imposed efforts to foster more economic freedom are not likely to succeed. Bottom-up, home-grown approaches toward more economic freedom that are supported with local education and consistent with local cultural norms are more likely to work in the long run.

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