Institutions, Economic Freedom, and the Wealth of Nations\textsuperscript{1}

James D. Gwartney\textsuperscript{2}

I have enjoyed my week at Beloit College and found the students to be bright, inquisitive, and committed to making the world a better place to live. The students reflect a faculty heavily involved in their studies and that challenges them to think seriously about important issues and topics. From my viewpoint, we have had a wonderful time focusing on and wrestling with complex issues that will shape the future of our nation, and indeed the entire world.

The Economic Freedom of the World Index

During the past quarter of a century, I have been involved with the Economic Freedom of the World project. The origins of this project go back to a panel session of the 1984 Mount Pelerin Society meeting on “Was George Orwell right?” Michael Walker of the Fraser Institute and the historian Paul Johnson were on the panel and a heated discussion on the differences between economic and political freedom ensued. Over lunch following the session, Walker asked Milton and Rose Freidman to join with him and host a series of conferences with a single objective: define and measure economic freedom for a large set of countries. The Liberty Fund of Indianapolis, Indiana agreed to fund the conferences. This resulted in a series of six conferences during 1986-1994. In addition to Walker and the Fried- man’s, the conferences involved approximately 60 scholars, including luminaries such as Douglass North, Gary Becker, and Peter Bauer.

\textsuperscript{1} This essay is an edited version of Professor Gwartney’s Upton keynote address.
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What is economic freedom? In the early conference sessions, there was considerable debate about the nature and conceptualization of economic freedom. But, a consensus emerged that economic freedom, properly understood, is founded on the idea of self-ownership and freedom of individuals to choose for themselves. Individuals are economically free when they can choose how to use their time, talents, and resources as long as their actions do not harm the person or property of another party. Use of violence, theft, fraud, and physical invasions are not permissible; but otherwise, individuals are free to choose for themselves, trade with others, and compete as they see fit.

This view implies that there are four cornerstones of economic freedom:

- personal choice rather than collective choice,
- voluntary exchange coordinated by markets rather than allocation via the political process,
- open entry and freedom to compete in markets, and
- protection of persons and their property from aggression by others.

These cornerstones imply that governments should do some things but refrain from others. A country’s legal and monetary arrangements provide the infrastructure for voluntary exchange and the operation of markets. Governments promote economic freedom when they establish a legal structure that provides for the even-handed enforcement of contracts and the protection of individuals and their property from aggressors seeking to use violence, coercion, and fraud to seize things that do not belong to them. Governments also enhance economic freedom when they facilitate access to sound money. But the cornerstones of economic freedom also require governments to refrain from many activities. They must refrain from actions that interfere with personal choice, voluntary exchange, and the freedom to enter and compete in labor and product markets. Similarly, economic freedom is reduced when taxes, government expenditures, and regulations are substituted for personal choice and voluntary exchange and when they restrict entry into occupations and business activities.

There is a tendency to confuse democracy with economic freedom. Thus, it is important to distinguish between the two. Democracy has to do with the procedures used to make political choices, while economic freedom is about the consistency of political institutions and policies with voluntary exchange and the protection of people and their property from aggressors. Political democracy is present when all adult citizens are free to participate in the political process (e.g., to vote, lobby, and choose among candidates), and when political outcomes
are determined through fair and open elections. However, political choices conflict with economic freedom when they impose restrictions that inhibit personal choice, voluntary exchange, the opportunity to compete, and the right of individuals to keep what they earn. This is true whether the restrictions are adopted by democratic or non-democratic procedures. Clearly, democratic political procedures do not guarantee economic freedom. Moreover, the differences between economic freedom and democracy underscore the importance of possessing a valid and reliable measure of economic freedom—one that can help us avoid the confusion that often results from a failure to distinguish between these two decidedly different concepts.

Using the four cornerstones of economic freedom as a compass, the participants in the Economic Freedom of the World (EFW) project set out to develop a measure of economic freedom across both space and time. From the very beginning, objectivity and transparency were central elements of the EFW project. Milton Friedman constantly reminded participants that we were developing a scientific instrument. Thus, it was vitally important that the derivation of each component was carefully specified and the methods used to assign component values for each country clearly outlined.

The data incorporated into the EFW index are from external sources such as the World Bank, International Monetary Fund, and Price-Waterhouse-Cooper accounting firm. As the availability of data has expanded through the years, the EFW index has become more comprehensive. The index now contains 42 separate components. The foundational data for each of the components are transformed to a zero-to-ten scale, where higher scores represent more economic freedom. The 42 components are then grouped into five areas and used to derive both area and summary ratings for each country.

The five areas of the EFW index are: (1) size of government, (2) legal structure and protection of property rights, (3) access to sound money, (4) international exchange, and (5) regulation of capital, labor, and business. Transparency is present throughout. The report provides information on the source of the data for each component, the methodology used to transform the raw data into component ratings, and how the component ratings are used to construct both the area and summary ratings. Moreover, the entire data set used in the construction of the index is freely available to researchers.

One hundred fifty two countries are now included in the index. Data are available for 102 of these countries for 1980, 1985, 1990, 1995, and annually for 2000 through 2011.
Economic Freedom Ratings

What are the world’s freest economies? Exhibit 1 provides the answer for 2011, the most recent year for which the data are available. The list of the ten freest economies is headed by Hong Kong, Singapore, New Zealand, Switzerland, and the United Arab Emirates. Mauritius, Finland, Bahrain, Canada, and Australia round out the top ten.

Exhibit 1: The Ten Freest Economies, 2011

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Name</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Hong Kong</td>
<td>8.97</td>
</tr>
<tr>
<td>2</td>
<td>Singapore</td>
<td>8.73</td>
</tr>
<tr>
<td>3</td>
<td>New Zealand</td>
<td>8.49</td>
</tr>
<tr>
<td>4</td>
<td>Switzerland</td>
<td>8.30</td>
</tr>
<tr>
<td>5</td>
<td>United Arab Emirates</td>
<td>8.07</td>
</tr>
<tr>
<td>6</td>
<td>Mauritius</td>
<td>8.01</td>
</tr>
<tr>
<td>7</td>
<td>Finland</td>
<td>7.98</td>
</tr>
<tr>
<td>8</td>
<td>Bahrain</td>
<td>7.93</td>
</tr>
<tr>
<td>9</td>
<td>Canada</td>
<td>7.93</td>
</tr>
<tr>
<td>10</td>
<td>Australia</td>
<td>7.88</td>
</tr>
</tbody>
</table>

Source: Economic Freedom of the World: 2013 Annual Report, Exhibit 1.2

Exhibit 2 indicates the rankings of other large economies including the United Kingdom (12th), United States (17th), Germany (19th), Japan (33rd), France (40th), Italy (83rd), Mexico (94th), Russia (101st), India (111th), and China (123rd). The 10 lowest-rated countries are: Algeria, Democratic Republic of Congo, Burundi, Central African Republic, Angola, Chad, Zimbabwe, Republic of Congo, Myanmar, and—in last place—Venezuela.
**Exhibit 2:** 2011 Economic Freedom Rating and Ranking of Other Major Economies

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Name</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>United Kingdom</td>
<td>7.85</td>
</tr>
<tr>
<td>17</td>
<td>United States</td>
<td>7.73</td>
</tr>
<tr>
<td>19</td>
<td>Germany</td>
<td>7.68</td>
</tr>
<tr>
<td>33</td>
<td>Japan</td>
<td>7.50</td>
</tr>
<tr>
<td>40</td>
<td>France</td>
<td>7.38</td>
</tr>
<tr>
<td>83</td>
<td>Italy</td>
<td>6.85</td>
</tr>
<tr>
<td>94</td>
<td>Mexico</td>
<td>6.64</td>
</tr>
<tr>
<td>101</td>
<td>Russia</td>
<td>6.55</td>
</tr>
<tr>
<td>102</td>
<td>Brazil</td>
<td>6.51</td>
</tr>
<tr>
<td>111</td>
<td>India</td>
<td>6.34</td>
</tr>
<tr>
<td>123</td>
<td>China</td>
<td>6.22</td>
</tr>
<tr>
<td>152</td>
<td>Venezuela</td>
<td>3.93</td>
</tr>
</tbody>
</table>

Source: Economic Freedom of the World: 2013 Annual Report, Exhibit 1.2

**Importance of EFW Project**

Why was the Economic Freedom of the World Project important? Prior to the 1990s, the growth and development literature was dominated by the production function models patterned after the work of Robert Solow. These models indicated that economic growth was the result of the growth of inputs plus improvements in technology. Inputs grew because of investment in physical and human capital. Technological improvement was merely the residual of the growth of output that was unexplained by the growth of inputs.

While the Solow input-output models were quite sophisticated and highly mathematical, there were several things they were unable to explain. First, the centrally planned economies all had high rates of investment in both physical and human capital. According to the Solow models, rapid growth was the expected result. By the late 1980s, it was clear this was not the case. Second, the production function models did not provide a credible explanation for the variation of capital formation and its productivity across countries and time periods. Even if capital formation is a highly important source of growth, this information is not very valuable if you do not understand the factors that contribute to its varia-
tion. Similarly, why did the productivity of capital grow more rapidly in some countries than others? Again, if you cannot explain this variation, the production function approach is not very enlightening. Finally, the ineffectiveness of foreign aid programs added to the dissatisfaction with the production function approach. The input-output models imply that countries are poor because they lack physical capital and education. If this is true, then foreign aid should help poor countries overcome this handicap. During 1960-1990, foreign aid programs were expanded and billions of dollars were “invested” in both the physical infrastructure and education in less developed countries. The results, however, were disappointing. Most of the countries receiving the largest amounts of aid continued to stagnate.

By the mid-1990s, the shortcomings of the input-output growth models were increasingly obvious. Further, interest in the institutional approach was growing. Douglass North and Peter Bauer argued persuasively that institutions were vitally important as a source of growth and development. The public choice research of James Buchanan, Gordon Tullock, and others also highlighted the potential importance of economic and political institutions. Professor North won the Nobel Prize in 1993 for his work on institutions as a determinant of growth and development. In the mid-1990s Mancur Olson and two of his students, Steve Knack and Robert Keefer, used data from the International Country Risk Guide to examine the impact of institutional factors on the growth and development process. But there was still no comprehensive measure of the degree to which different countries used markets relative to the political process to allocate resources. The Economic Freedom of the World measure filled this vacuum.

The EFW index provided a comprehensive measure of the degree to which the institutions and policies of various countries were consistent with economic freedom. This made it possible for researchers to examine the contribution of economic institutions as a source of capital formation, growth, and development. This is why the measure is important.

What Have We Learned from the EFW Research?

During the past 15 years, more than 200 scholarly articles have used the EFW data to examine a highly diverse set of topics. This research has yielded a number of important findings. I would like to consider five of them with you.

1. Economic Freedom has Increased Since 1980. Exhibit 3 presents the average economic freedom rating for the 101 countries with data since 1980. The
average economic freedom rating increased from 5.34 in 1980 to 5.82 in 1990 to 6.74 in 2000 and finally to 6.87 in 2011. Thus, the average EFW rating increased worldwide by approximately 1.5 points on the ten point scale. Most of the increase occurred between 1980 and 2000. The world is more economically free today than it was three decades ago. The major contributing factors to this long-term increase in economic freedom were reductions in marginal income-tax rates, more stable monetary policy, a decline in the use of military conscription, and liberalization of trade policies.

Exhibit 3: Average EFW Rating for the 102 Countries Rated Since 1980

While the economic freedom of the world has been increasing, the United States has been moving in the opposite direction. The EFW rating of the United States was the third highest in the world, behind only Hong Kong and Singapore throughout the 1980s and 1990s. But the EFW rating of the U.S. fell by nearly a full point between 2000 and 2011 and its ranking plunged to 8th in 2005 and 17th in 2011. Many Americans used to refer to Canada as our socialist neighbor to the north, but this is certainly not true now. Canada is now more economically free than the United States.

2. Institutions Matter: Economic Freedom Enhances Economic Growth. Since the time of Adam Smith, most economists have argued that freer economies will grow more rapidly and achieve higher income levels. Is this really true?
With the economic freedom data, it is possible to provide an empirical answer to this question. The average EFW rating during 2000-2011 was derived and the countries grouped by quartiles ranging from the least free to most free. The average growth rate of per capita income for the two decades between 1991 and 2011 was then derived for each of the four groups. Exhibit 4 provides the data on these growth rates. Clearly, there is a strong positive relationship between economic freedom and growth of per capita income.

The freest economies grew at an annual rate of 3.69, more than three times the 1.09 growth rate of the least free economies. While the figures of Exhibit 4 adjust for only initial income level, more detailed analysis indicates that the linkage between economic freedom and growth persists after adjusting for political institutions, location, climate, and other factors that might influence growth. Moreover, econometric analysis indicates that countries that move toward more economic freedom subsequently grow more rapidly and this relationship also holds even after adjustment for differences in factors such as political institutions, education, location, climate, and culture.

*Exhibit 4: Economic Freedom and Economic Growth, 1991-2011 by Quartile*


3. **Countries with Persistently High Levels of Economic Freedom have Higher Income Levels than those that are Less Free.** Exhibit 5 indicates the per capita income level in 2011 for each of the four quartile groups. The 2011 per capita incomes of countries in the freest quartile averaged $36,466, more than
twice the $17,869 of the second freest quartile. In turn, the income level of the second freest group was more than twice that of the third quartile, which was approximately twice the $4,382 of the least free quartile. The per capita income of the freest group of economies was nearly nine times that of the least free group. While the figures of Exhibit 5 do not adjust for other factors that might influence per capita income, more detailed statistical analysis indicates that the strong positive relation between persistently high levels of economic freedom and income remains after adjustment for other major factors that might influence income levels.

Exhibit 5: Economic Freedom and 2011 Income per Capita by Quartile

4. A Sound Legal System Provides the Foundation for Growth and Prosperity. Our modern living standards are almost entirely the result of investment, entrepreneurial discovery, and gains from depersonalized trade, i.e., trade between people who do not know each other and often never meet. But the realization of gains from these sources is critically dependent on the presence of a legal system that provides for rule of law, protection of property rights, and unbiased enforcement of contracts and settlement of disputes.

The EFW data have been used to examine the importance of Area 2, the legal system. Virtually without exception, countries with low Area 2 ratings perform poorly. On the other hand, countries with high Area 2 ratings grow and achieve high income levels. There is also a relation between the legal system (Area 2) and
regulation (Area 5) ratings. Countries with excessive regulation tend to have low legal system ratings. This is not surprising. When the political system is heavily involved with regulation of business, labor, and capital, it tends to undermine rule of law principles and lead to favoritism, cronyism, and corruption. In turn, this repels investment, slows trade, and encourages wasteful rent-seeking. Stagnation is the inevitable result.

5. **Economic Freedom Results in Less Poverty.** Some observers fear that growth propelled by economic freedom will leave the poor behind. This was not the case during 1980-2005. As Exhibit 3 illustrated, economic freedom increased substantially during this quarter of a century. At the same time, the poverty rate fell. As Exhibit 6 shows, the extreme poverty rate – the share of the world’s population living on $1.25 or less per day – plunged from 58.4 percent in 1980 to 25.1 percent in 2005. During this period, more than 2 billion people were lifted out of extreme poverty.

**Exhibit 6:** Extreme Poverty Rate, 1980 - 2005

![Extreme Poverty Rate Graph](source: Derived from data of Economic Freedom of the World 2013 Annual Report)

As Exhibit 7 shows, economies that are more free have substantially lower poverty rates than those that are unfree. In 2005, the extreme poverty rate in the Least Free economies was 41.5 percent, compared to 21.3 percent in the third
freest quartile, 7.7 percent in the second freest group, and only 2.7 percent in the most economically free quartile. Most importantly, the developing countries that moved most markedly toward economic freedom during 1980-2005 achieved the largest reductions in poverty. These relationships provide strong evidence that an institutional and policy environment consistent with economic freedom is a central element for progress against poverty.

**Exhibit 7:** Economic Freedom and the 2005 Extreme Poverty Rate by Quartile

![Graph showing extreme poverty rate by economic freedom quartile](image)


**Two Unresolved Issues**

During the past two decades, we have learned a lot about what works. Institutions and policies supportive of economic freedom create the environment for sustained growth, higher income levels, and lower rates of poverty. The central elements of this environment are limited government, protection of property rights, unbiased enforcement of contracts, sound money, freedom of exchange, and reliance on markets. But, merely because we know what works, it does not follow that sound policies will be adopted.

Economic and legal institutions are the result of political action. There are at least two unresolved issues in this area. First, we do not fully understand why some countries develop institutions and follow policies consistent with economic freedom and prosperity while others do not. Movements toward economic freedom have occurred under political regimes ranging from democratic to authori-
tarian. Similarly, policies inconsistent with economic freedom have been adopted under diverse forms of political organization.

Second, there is uncertainty about the relationship between democracy and economic freedom. During the past several decades, transitions from authoritarian to democratic regimes appear to enhance economic freedom for a time, something like ten years. After that, however, regression often occurs. Public choice theory indicates that, as they mature, unconstrained democratic regimes unleash forces inconsistent with economic freedom. The shortsighted nature of the political process enhances the popularity of debt financing and promises of future benefits that will be difficult, if not impossible to keep. With time, the special interest effect indicates that rent-seeking, political favoritism, subsidies, and transfers will become more widespread. Dependency, cronyism, and even corruption are predictable side effects. Are there irreversible forces in this direction? We do not know the answer to this question, but it is sure to be a topic of considerable research in the years immediately ahead.

**Conclusion**

The EFW index provides a measure of the degree to which economies rely on markets (as compared to various forms of political decision-making and central planning) to allocate resources. Research using the EFW data indicates that countries with institutions and policies more consistent with economic freedom grow more rapidly, attain higher income levels, and achieve lower poverty rates than those that are less free. The positive impact of economic freedom remains even after adjustment for factors such as political structure, educational levels, geographic location, climate, and cultural differences. This research provides powerful evidence that institutions and policies supportive of economic freedom are vitally important for the achievement of economic growth and higher living standards.

However, economic institutions and policies are a reflection of political choices. Just because we know what works, does not guarantee the emergence of sound institutions and policies. Political incentives often conflict with the adoption of sound economic policy. This is true even when decisions are made democratically. The central issue of our age is how to bring political decision-making more consistently into harmony with economic prosperity. The future wealth of nations is dependent on how we meet this challenge.