Chapter 3

The Freedom Path to Economic Growth: A Comparative Analysis of Country Performance

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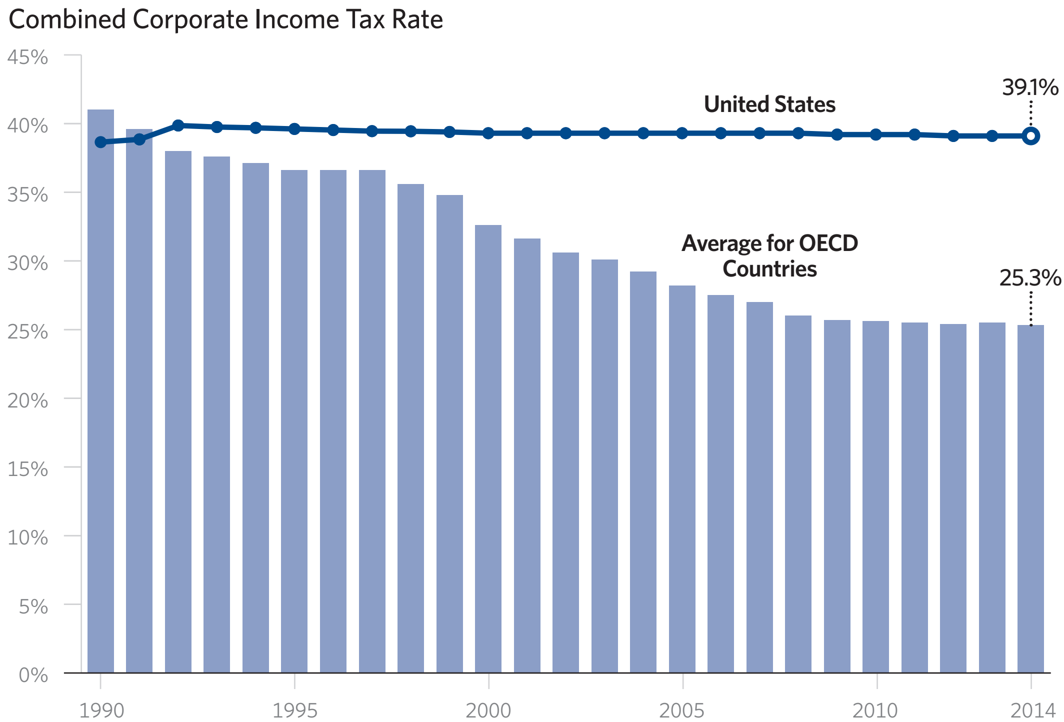
For 21 years, the *Index of Economic Freedom* has provided an indispensable road map for countries that aspire to greater economic dynamism and prosperity. The rules are not complicated. As the *Index* has revealed, lasting prosperity is a result of a persistent commitment to low tax rates, a stable currency, limited government, strong private property rights, openness to global trade and financial flows, and sensible regulation. Together, these factors empower the individual and induce dynamic entrepreneurial activity.

The supply-side economics model, which focuses on ways to increase the production of goods and services rather than on maintaining high levels of demand, was popularized in the United States by President Ronald Reagan more than 30 years ago. It is now a primary operating principle of countries around the world. A key part of the supply-side model is careful attention to the potentially stifling nature of taxes, and tax cuts are often the preferred policy prescription for economic woes. Despite occasional howls of protest over "tax cuts for the rich," much of the world has taken note of the impressive and sustained rates of economic growth that typically follow such cuts, and tax rates have come down worldwide.

One of the taxes that have perhaps the largest impact on a nation's ability to compete in global markets is the corporate tax. The reason, of course, is that tax's large impact on the flow of investment. In this age of information and technology, borders do not matter much anymore for businesses. The world has become one massive shopping market for capital. Nations are in a contest to climb past each other in a race up the ladder of economic growth.

The impact of non-competitive corporate tax rates can be debilitating. For example, the U.S.'s effective statutory rate is now a full 50 percent higher than the average of its international competitors. Businesses are adapting by relocating overseas or through structural changes such as corporate inversion, in which companies legally reincorporate in a foreign country that has lower tax rates.

Corporate Tax Rate: U.S. vs. Average of Developed Countries



Source: Organisation for Economic Co-operation and Development, OECD Tax Database, Corporate and Capital Income Taxes, http://www.oecd.org/tax/tax-policy/tax-database.htm (accessed November 17, 2014).

Chart 1 heritage.org

The *Index of Economic Freedom* has shown that commitment to lower taxation is one of the key components of a country's effort to create a virtuous cycle of entrepreneurship, growth, and lasting prosperity for its citizens. A recent study by the Organisation for Economic Co-operation and Development examines why some countries are becoming more prosperous than others and concludes that "corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes."[1] The OECD study finds, not surprisingly, that investment rates fall when corporate tax rates rise and that the most profitable and most rapidly expanding companies tend to be those that are the most sensitive to corporate tax rates. High corporate tax rates are also self-defeating because they produce little if any revenue.

But taxes are not all that matters. The rule of law, efficient regulatory structures, and open markets are vital to achieving greater prosperity. Over the lifetime of the *Index*, some politicians have evidently been listening and taking action. Others have not. The resulting disparities of living standards among countries are not just happenstance.

This essay provides three types of comparisons:

- We look at some dramatic differences between outcomes in neighboring countries that have pursued vastly different economic policies;
- We compare the economic results since the collapse of the Soviet Union in 1991 between a leading free market–embracing Baltic country and a less liberty-minded nation; and
- We explain that the interrelation between economic policy and outcomes is evidenced by the "laboratories of democracy" in the 50 United States.

NEIGHBORING COUNTRIES: SO CLOSE BUT SO FAR AWAY

In 2014, a book co-authored by one of us, *An Inquiry into the Nature and Causes of the Wealth of States*,[2] explored numerous instances in which individual U.S. states located close to one another achieved vastly different economic outcomes. Many of these disparate outcomes were linked to distinct state policies pursued by the state governments. To summarize, states with higher taxes, more restrictive regulations, and onerous labor restrictions often realized lower rates of job creation and economic growth.

Likewise, nations may share a common border and sometimes even the same language but implement vastly different economic policies. In countries where tax rates have been ratcheted down, sensible monetary policies are pursued by the central bank, and the free flow of capital is encouraged, economies have prospered; but where politicians attempt to seize the wealth of those with capital, co-opt the central banks to meet political ends, and engage in protectionism, citizens—particularly those aspiring to the middle class—are harmed.

The following case studies highlight how nations with similar cultural, geographic, or demographic conditions but different levels of economic freedom often realize far different outcomes.

CHILE VS. ARGENTINA

Chile. Chile's post-war history has been characterized by the struggle for greater freedom, with the right emphasizing economic freedom and the left emphasizing political freedom. In one of the more felicitous outcomes anywhere in the world during this period, both sides have succeeded: Chile now has robust democratic institutions and a strong commitment to human rights as well as one of the freest economies in the world.

Over the decades, Chile has undertaken a series of free-market reforms, including privatizing various government-run entities such as the telecommunications, power, and water sectors.[3] Chile also privatized the bankrupt social security system, granting citizens control of their personal retirement funds.[4] The nation also welcomed foreign trade and investment and abandoned various price-control schemes.[5] Through these reforms, Chile's per capita gross domestic product (GDP) has been growing at an average annual rate of 3.6 percent[6] over the past 38 years, and Chile has moved from being a debtor nation to being a creditor nation.

Today, mining, which is one of the pillars of Chile's economy, accounts for 57.3 percent of its total exports (by value) and 11.1 percent of GDP[7] and absorbs about one-third of foreign direct investment in Chile.[8] But Chile's mining sector was not always this prosperous. Throughout the 1970s, Marxist President Salvador Allende sought and obtained constitutional changes that gave the state "absolute, exclusive, inalienable, and imprescriptible"[9] ownership of production. This effectively paralyzed the entire sector.

Not until approval of the new 1980 constitution and the subsequent Constitutional Mining Law were traditional private property rights restored. The current prosperity is a result of these guarantees.[10] In the words of Jose Pinera, Secretary of Mining in Chile during these reforms, "The positive effects of the law began to show themselves in the form of increased exploration and production activity from the moment its approval was announced."[11] In other words, capital investment is spurred once investors are assured profits and successful projects are safe from state confiscation.

Furthermore, in stark contrast to Argentina (and other Latin American countries), Chile's healthy investment environment attracts foreign investment. According to the World Bank's Business Environment Snapshots, "Chile is one of the most open countries to foreign equity ownership, as measured by the Investing Across Sectors indicators."[12] A foreign limited liability company (LLC) can be established in less than a month.[13]

Minister of the Presidency Cristián Larroulet expressed his pleasure that Chile "has benefited from the presence of large local institutional investors—mainly private pension funds—which are sophisticated investors that continuously invest in the local market. As a result, high-qualified human capital and a solid regulatory framework are already in place."[14]

The decades-long respect for property rights has incentivized investing and fostered trust in financial institutions. With the Socialists currently back in control, all of this could be undone, but Chile has forged a remarkable record under both the left and the right in advancing and protecting hard-won freedoms, both political and economic. With Chile well on its way to becoming the first developed economy in Latin America, one can only hope that such political wisdom continues to prevail.

Argentina. Contrast Chile's remarkable success with the situation in Argentina, once Latin America's richest country. Argentina now ranks 169th out of 178 countries included in the *Index* and 27th out of 29 countries in the South and Central America/Caribbean region. Continuing to be mired in a climate of economic repression, Argentina has recorded its lowest economic freedom score ever in the 2015 *Index*.

The erosion of freedom is creating havoc. Cristina Fernández de Kirchner's government in Buenos Aires "bullies and nationalises businesses, and pressures the central bank to use international reserves for debt payments."[15]

For example, on April 16, 2012, Kirchner introduced a bill, overwhelmingly approved by both houses of Congress, that partially renationalized YPF, the nation's largest energy firm.[16] This followed the discovery by the company just months before of nearly 1 billion barrels of oil in one of its fields.[17] No wonder that the country is on track to remain dependent on foreign suppliers for energy even though the nation possesses the world's third largest deposits of shale gas, and no wonder that investors are hesitant to risk capital in such an environment.

Furthermore, in Argentina, politicians—regional governors—have sway over the operations of private businesses. The authority wielded by elected officials to set prices, mandate production, and engage in other corporate governance is in many ways similar to expropriation. Value is destroyed and profits diminished, although title of the wrangled entity remains in private hands. We have seen this before in Argentina during the socialist Peronist years, and the middle class suffered.

The recent $100 billion national debt default, a wave of nationalizations, and strict capital controls are deterring foreign investment, but Argentina's bureaucrats seem not to mind. Minister of Economy and Production Roberto Lavagna boasted that "Argentina isn't interested in luring speculative investors.... It generates bubbles that when they are reverted can produce a negative impact, especially for the poorest people."[18]

Economic results clearly show the repercussions of these policies. Consider R.R. Donnelly & Sons, a Chicago company that just shuttered the doors of its factory in Argentina. This printing plant employed up to 400 people for more than two decades. Yet, according to the company, "rising labor costs, inflation, materials price increases, devaluation, inability to pay debts as they become due, and other issues" forced the closure.[19]

Despite a population more than twice as large as Chile's, Argentina has barely attracted even a third the level of Chile's net foreign direct investment. Inflation in Argentina has run at more than three times that of Chile. Both taxes and government spending as a fraction of the economy are nearly twice the level of Chile's. In 2012, Argentina's 1.9 percent GDP growth greatly underperformed Chile's 5.5 percent boom.[20]

In fact, after years of Kirchner's steel grip, Argentina's economy is now smaller than Brazil's, Mexico's, and Colombia's.[21] This is quite a fall from grace for the Keynesian experiment considering that just 20 years ago, Argentina's economy was nearly five times that of Colombia's.[22]

This plunge in economic standing worsened as the government officially devalued the peso early in 2014. In combination with the flooding of the markets with newly created currency, future investment is chased away, and prices leap higher.

CHINA VS. HONG KONG AND TAIWAN

China. China ranks a dismal 139th worldwide in economic freedom and 30th out of 42 counties in the Asia–Pacific region. Some have touted China's model of state-guided capitalism as one to be followed.

China has enjoyed annual growth of nearly 9 percent over the past five years, and in the years since liberalization in the late 1970s, per capita income and real GDP have grown exponentially. However, economic freedom in China has advanced only sporadically since then, and problems long unaddressed are becoming impossible to ignore. In particular, the Chinese leadership still maintains inordinate control of the levers of economic power, including finance and investment, and has concentrated its development efforts on seizing market share in existing international markets rather than on developing new products and markets to advance world economic growth.

China's focus on technological imitation rather than innovation may have brought short-term, low-cost prosperity relative to 50 years ago, but unless the economy is freed from such state-imposed self-limitations, the nation will continue to lag behind its free-market competitors. A glance at production levels of state-owned vs. non-state-owned industrial firms illustrates this. Since 2008, non-state-owned industrial firms have enjoyed expansion rates that are twice as high as those of state-owned firms.[23]

Even after modest privatization, state-owned-enterprises (SOEs) still play an enormous role in China. Currently, SOEs exist in a broad range of sectors, including banking, aviation, petroleum, electricity, shipping, and machinery.[24] More than 150,000 enterprises are included in this list.[25] In the past, this has represented an enormous slice of the national economy, at times exceeding 30 percent of nationwide industrial and business revenue.[26] In 2013, these enterprises were worth $5.7 trillion,[27] more than half the size of China's official $9.4 trillion GDP.

Despite this dampening of authentic entrepreneurialism, certain market reforms have enabled robust economic growth. Tax reductions, for example, are an underappreciated part of the decades-long progress. In 1978, then Chinese leader Deng Xiaoping unleashed a series of free market–based economic reforms, including the legalization of privately owned farms (which caused a near doubling of food output above what the Communist state-owned farms produced); the establishment of coastal economic enterprise zones; new opportunities for foreign investment; and the privatization of state-owned enterprises.[28] Although sporadic and limited, these market reforms, enhanced by China's participation in the global trading system, have lifted more than half a billion people out of abject poverty—one of the great economic triumphs in human history.

Yet the errant political idea that bureaucrats are actually capable of centrally planning a large modern economy has held overall development far below potential and kept hundreds of millions of Chinese citizens in poverty. Furthermore, the concentration of power in the hands of central planners and away from local leadership has created environmental mayhem nationally. With growth rates falling, the pressures of unemployment are likely to increase, and with no legitimate democratic outlet for expression of the population's concerns, political and economic stability is a constant concern for the government.

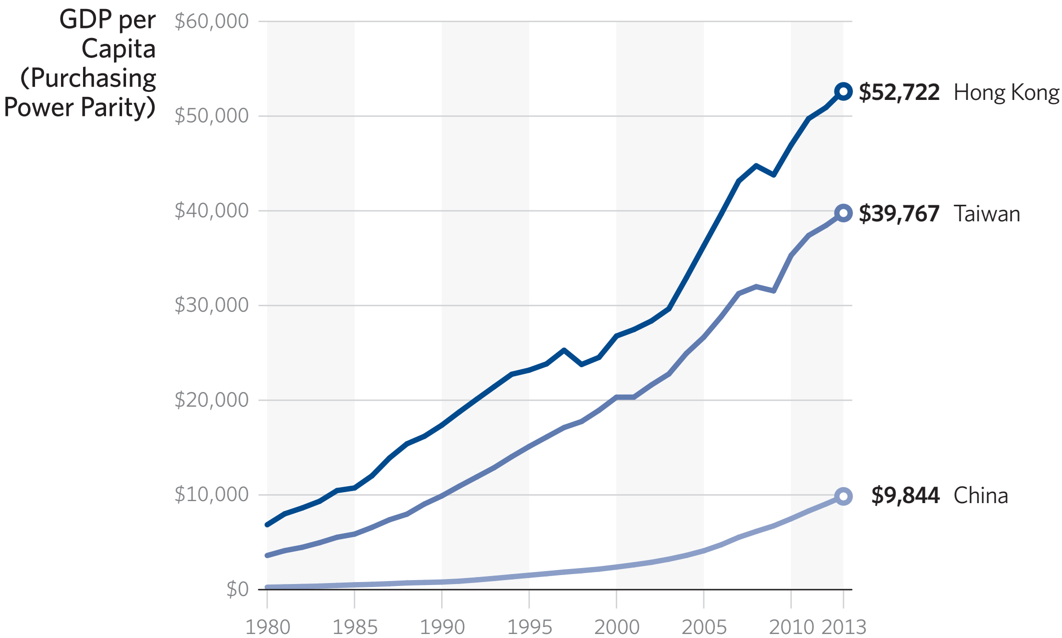
Just think of the prosperity that could have resulted if the mainland Chinese had truly embraced economic and political freedom. But we don't have to imagine it. All we need do is look at Hong Kong and Taiwan.

Hong Kong. Hong Kong follows an ancient common-law tradition handed down from the English that "everything which is not forbidden is allowed." It is no surprise that it is ranked number one globally for economic freedom. Hong Kong also must surely be considered one of the great economic triumphs in human history.

This is a very inconvenient place for mercantilists. How, therefore, does one explain its prosperity? After all, as Milton Friedman reminded us in *Free to Choose*, this is a tiny port island with relatively few natural resources, the highest population density of virtually any nation except for Singapore and tiny Monaco, and no military power.

Hong Kong has never implemented the Maoist one-child policy of Communist China. Given its constricted geographical confines and limited natural resources, a Malthusian would have

GDP per Capita—Hong Kong, Taiwan, and China



Sources: International Monetary Fund, World Economic Outlook Databases, http://www.imf.org/external/ns/cs.aspx?id=28 (accessed December 2, 2014).

Chart 2 heritage.org

predicted more human misery after decades of unchecked population growth than one finds in the poorest province of India or village of Africa. Yet the contrary is true: Hong Kong's per capita GDP exploded by more than $45,000 from 1980 to 2013. The mainland's GDP grew under $300 yearly during that same period, to around $9,800 in 2013. In terms of GDP per capita adjusted for purchasing power parity, the average Hong Kong resident had a standard of living more than five times higher than the average mainlander.

By meeting the demands of individual consumers and companies across the globe rather than the dictates of state bureaucrats, Hong Kong has attained prosperity. Skeptics say, "Well, that's only because Westerners—Brits and Americans—invested so much there." Which begs the question: Why did they invest there? Hong Kong is the most economically free country on the planet. It has long had a 15 percent flat individual income tax; it is a free trade mecca; government spending is low; regulations on small businesses are light; education is largely private; capital moves freely in and out, unhindered.

For many decades after it adopted a flat tax in 1947, Hong Kong enjoyed the benefits of a competitively low tax rate with no tax on dividends or capital gains or money earned outside of the island. Hong Kong has also embraced free trade, which explains why it has evolved into a capitalist paradise brimming with entrepreneurial spirit. The tax code is about 200 pages, compared to over 70,000 pages for the U.S. tax code.[29]

Over several decades, Hong Kong has evolved into one of the richest places on Earth despite its tiny land mass and no natural resources. The only mystery is why it took nearly half a century for the rest of the world to start copying the Hong Kong model.

Taiwan. In the wake of the Chinese Communist revolution, the remnants of the previous Chinese government were confined to the island of Taiwan, which operates for all practical purposes as an independent nation. Although Taiwan shares a common cultural and historic tradition with mainland China just 110 miles away, its economic system is far different from Beijing's.

Prudent macroeconomic policy within a stable legal and monetary environment has been the key to Taiwan's continuing success in achieving rising levels of economic freedom over the past two decades. A sustained commitment to structural reforms and openness to global commerce have enabled the country to advance far into the ranks of the "mostly free." Recording uninterrupted years of growth in economic freedom since 2009, Taiwan has achieved its highest score ever in the 2015 *Index*.

Starting a company in Taiwan takes just three steps, and property rights are generally protected. Business owners know that the judiciary exists to enforce contractual rights.[30]

Taiwan illustrates the benefits of free trade. During the past 40-plus years, foreign trade has been the core driver of Taiwan's economy as total annual trade increased nearly eightyfold from under $4 billion USD in 1971 to $300 billion in 2013.[31] Taiwan also illustrates the dynamism of comparative advantage in conjunction with economic freedom: Export composition has evolved from predominantly agricultural commodities to more than 98 percent industrial goods.[32]

The importance of tax cuts, particularly for businesses and investments, is demonstrated by Taiwan's response to the global economic downturn of 2008–2009. The negative growth of 2009 was Taiwan's first recession in 10 years.[33] In the midst of the turmoil, Taiwan slashed its corporate income tax from 25 percent to 17 percent in 2009.[34] The next year, it enjoyed a GDP boom of more than 10 percent—its most rapid growth in more than 30 years.[35]

BOTSWANA VS. ZIMBABWE

Botswana. Botswana ranks high on the freedom index at 36th globally and 2nd in Sub-Saharan Africa. Several factors enable Botswana to be an oasis of prosperity in a neighborhood of uncertainty and turmoil. These include taxation of individual income at no more than 25 percent, declining government spending, political stability, and the lowest level of judicial corruption on the entire continent.[36]

Botswana also has a relatively high per capita income at over $16,000. This is higher than some European countries and by world standards makes it an upper-middle-class country. The past 10 years have seen an influx of foreign capital and growing privatization of many industries, and with this has followed growth, making Botswana one of the most prosperous countries in Africa. On a continent riddled with poverty, other countries would be wise to take note.[37]

Corporations are selecting Botswana for their international headquarters. The prestigious list includes Laurelton Diamonds (a Tiffany & Co. subsidiary); HJ Heinz; Hewlett-Packard; Barclays Bank; and the South African Development Community (SADC).[38] Certainly, the rejection of corruption in Botswana helps to attract foreign investment and employers. In 2013, Transparency International ranked Botswana the least corrupt African country.[39]

Botswana has also harnessed the power of free markets to conserve endangered species and wildlife areas. Revenue from increased tourism and sustainable hunting expeditions is protecting the nation's natural beauty while also spurring business growth.

Moreover, Botswana has advanced a type of government austerity that works. Unlike Western European "austerity," which fails to reduce government spending significantly and increases taxes, Botswana has cut both spending and taxes as a percentage of GDP.

Zimbabwe. Located due east of Botswana in the southern part of Africa is Zimbabwe. Despite some progress, Zimbabwe remains one of the least free economies in the world. President Robert Mugabe oversees a corrupt and inefficient government that is rife with graft and nepotism. The labor market is one of the most restricted in the world, and business licensing forces most workers to seek employment in the informal sector. The violent seizure of land has upset investor confidence in a once-vibrant agricultural sector.

Robert Mugabe has been in power since 1980, first as prime minister and then as president. For years, the government engaged in monetary mischief, printing such copious amounts of currency that inflation hit 79,600,000,000 percent in November 2008 with an average daily inflation rate of 98 percent a day. This fiscal malpractice, combined with lack of property rights, deters domestic and foreign investment.

Under the guise of racial equality and concern for the poor, the government has seized swaths of land belonging to white farmers. For those who pursue entrepreneurship, opening a business takes three months, during which you will need to go through nine different procedures and spend on average 140 percent of average gross per capita income. Protectionism is rampant, and foreign investment in numerous industries is severely restricted.[40]

Unemployment in Zimbabwe is estimated to be as high as 95 percent, with per capita GDP at only $600 per person. These alarming statistics, combined with the lack of foreign investment and economic growth, make Zimbabwe an economic nightmare.[41] Ironically, the neighboring country of Botswana, with almost identical geographic, demographic, and natural resources, is flourishing.

If Zimbabweans ever wish to lift themselves from poverty, all they need do is look next door to Botswana.

ISRAEL VS. LEBANON

Israel. Israel re-emerged as an independent nation in 1948. Since then, it has become known as the "start-up nation." Israel ranks 33rd for economic freedom globally and 4th in the Middle East/North Africa region. Registering the 10th largest score increase in the 2015 *Index*, Israel has achieved its highest score ever.

This tiny country in the Middle East has absorbed millions of impoverished immigrants from Eastern Europe, the Middle East, and Africa, yet its economy has boomed. Immigrants who fled often-repressive nations have transformed the desert into a start-up nation. Business incubators dot the landscape, and technological output is among the highest in the world. In fact, the number of Israeli companies trading on the Nasdaq totals 40 with more IPOs to come in 2015.[42] Israel has welcomed foreign investment into these start-ups, embraced foreign expertise in governmental development, and sought foreign capital for its burgeoning energy sector.

Established with a socialist bent, Israel has been deregulating industry and allowing privatization and competition to grow in areas once dominated by state monopoly. Israel now has a booming technology sector with start-ups such as Consumer Physics and Reduxio, which raised $4 million and $12 million, respectively, in the past year. As home to between 4,000 and 5,000 start-ups, Israel is second only to Silicon Valley in technology innovation.[43]

Perhaps Israel best exemplifies what the late Julian Simon taught: "The ultimate resource is people—skilled, spirited, and hopeful people who will exert their wills and imaginations for their own benefit as well as in a spirit of faith and social concern. Inevitably they will benefit not only themselves but the rest of us as well."[44]

Despite the constant threat of war with hostile neighbors, terrorist activity, and diplomatic hurdles, Israel continues to advance. The ability of smaller political groups to obtain proportional representation in the Israeli parliament provides a robustness to Israel's democracy; the necessity to build coalitions has allowed economic reform to move forward. The entire world is better off as a result.

Lebanon. Although Israel and Lebanon share similar climate, geography, and cuisine, these two neighbors are far different in matters of economics. Lebanon ranks 94th globally and 10th in the region for economic freedom. In fact, the situation has deteriorated in recent years, and Lebanon's economy is now classified as "mostly unfree." This has come about as a result of a turbulent political situation influenced by radical ideology that is geared toward state control and socialism.

Recent years' decline in economic freedom has weakened an already fragile structural and institutional environment. Entrepreneurs are suffocated by restrictive business and labor regulations that inhibit business formation and the development of a dynamic private sector. Prevalent corruption has undermined the basic political institutions of society. Although the banking sector is relatively well-developed, Lebanon's economy remains more closed to trade and investment than those of many of its regional peers.

With a paramilitary terrorist and political force (Hezbollah) lodged within its borders, government instability is only exacerbated. Conflict with Syria and Israel, along with a rapid succession of leadership, has deterred those with capital from making longer-term investments. Furthermore, confidence that the courts will fairly adjudicate matters is low. Even the judiciary is heavily influenced by political interests. In 2013, per capita income was just half the level of Israel's.

ESTONIA VS. UKRAINE

Estonia. Following the dissolution of the Soviet Union in 1991, some countries chose to cling to centrally planned economic models. The Baltic republics of Estonia, Latvia, and Lithuania, however, threw off the shackles of statism and embraced free-market reform, implementing a dramatic policy turnaround. An economic boom ensued.

While the socialist instinct may be to demand that the rich "pay their fair share," those who are truly dedicated to expansion of the middle class and eradication of poverty understand that resisting the urge to confiscate private wealth results in more jobs and even more government revenue. Even former Communists are grasping this concept.

Mart Laar, former Prime Minister of Estonia, was the first politician to bring the flat tax to Eastern Europe. Mr. Laar told one of the authors in 2007 that when he first pushed the flat tax, the major opponents were not Estonian citizens, "who love the flat tax," but the economists and other wise men of government "both inside and outside of this tiny country. Almost all of the smartest minds told me 'We cannot have a flat tax. It is untested. It will not work. It will cause budget deficits.'"[45]

Mr. Laar, however, remembered the virtues of the flat tax in Milton Friedman's classic book *Free to Choose* and insisted that the plan would work. In 1994, he heroically and wisely ignored the economic pundits and snapped in place one of the world's first flat taxes at 23 percent. Since then, Estonia has had one of the most rapid growth spurts of any nation, and adoption of the flat tax has been widely heralded as a cornerstone of its prosperity. In the 13 years immediately following adoption, GDP dipped below 4.5 percent only once (–0.3 percent in 1999). From 1995–2015, average annual GDP growth was 4.76 percent, and real per capita GDP jumped more than 150 percent.[46]

Estonia has become both a technology and angel investor hub. Technology such as Skype was developed there, and the nation welcomes foreign investment: In 2012, more than 80 percent of venture capital originated from outside investors.[47]

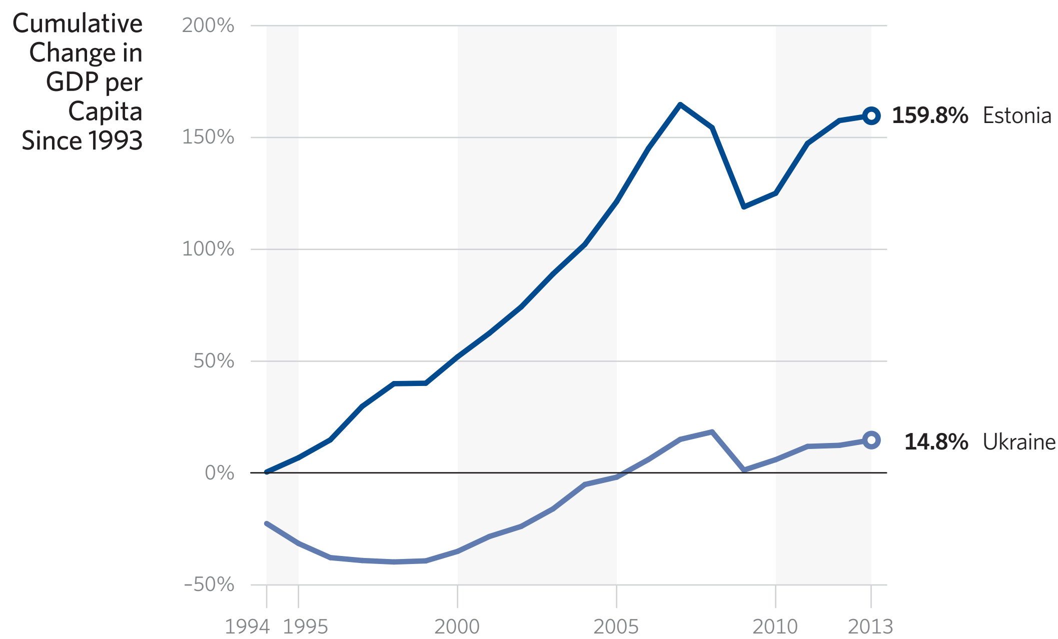
Yet Estonia's pro-market environment, created by a commitment to restrained government spending and low taxes, has not escaped criticism. Paul Krugman, for example, has blasted the nation as "the poster child for austerity defenders."[48]

The facts, however, speak loudly. Since 1993, real per capita GDP in Estonia has jumped more than 150 percent. In dollar terms, this represents an increase in income of more than $7,000 per person.[49]

Ukraine. Contrast Estonia's remarkable income growth with the situation in Ukraine, where income has grown only about 15 percent since 1993, a paltry $700 per person. Why the disparity? More than two decades since the collapse of the Soviet Union, Ukraine remains dedicated to many of the same policies and practices that held back its development during the Communist period.

According to the 2008–2009 Business Environment and Enterprise Performance Survey (BEEPS), almost all companies in Ukraine complain about high tax rates and corruption.[50] Ukraine was ranked 144th out of 177 countries in Transparency International's 2013 Corruption Perceptions Index.[51] The need to escape high taxes and regulation has led to a shadow economy that is equivalent to 44 percent of Ukraine's economic output.[52]

Change in Real GDP per Capita—Estonia and Ukraine



Source: World Bank, "GDP per Capita (Constant 2005 US$)," http://data.worldbank.org/indicator/NY.GDP.PCAP.KD/countries/EE-UA?display=graph (accessed November 20, 2014).

Chart 3 heritage.org

Ukrainian politicians use energy subsidies as a way to curry favor with the public, but by subsidizing up to 75 percent of the actual cost of natural gas, the nation also discourages domestic energy development. In fact, *The Economist* reports that "domestic production has slumped by two-thirds since the 1970s."[53]

In addition, the people that benefit from these subsidies actually are harmed by them. Jobs that would have been created from a booming energy sector fail to materialize. More important, lack of an affordable, abundant supply of energy gas results in Ukraine's not being as competitive in the manufacturing sector. In a European continent becoming ever more integrated, Ukraine places itself at a disadvantage with these policies.

Because of such policy mistakes, Ukraine ranks last in economic freedom in Europe and remains one of the poorest of the former Soviet republics.

U.S. EXPERIENCE UNDERSCORES BIG GOVERNMENT'S THREAT TO GROWTH

Every day in America the 50 states compete against each other for people, jobs, investment capital, and overall prosperity. This interstate competition is economically healthy because it forces governors and legislators to adopt fiscal and regulatory policies that maximize job opportunities and prosperity for their citizens.

State governments have generally divided into two competing camps, which we call "the red state model" and the "blue state model." This has raised the stakes in this interstate competition. The conservative red state model is predicated on low tax rates, right-to-work laws, light regulation, and pro-energy development policies. This policy strategy is now common in most of the southern states and the more rural and mountain states.

The liberal blue state model is found predominantly in the Northeast and in California, Illinois, Minnesota, and (until recently) Michigan and Ohio. The blue states have doubled down on policies that include high levels of government spending, high income tax rates on the rich, generous welfare benefits, forced union requirements, super-minimum wage laws, and restrictions on oil and gas drilling.

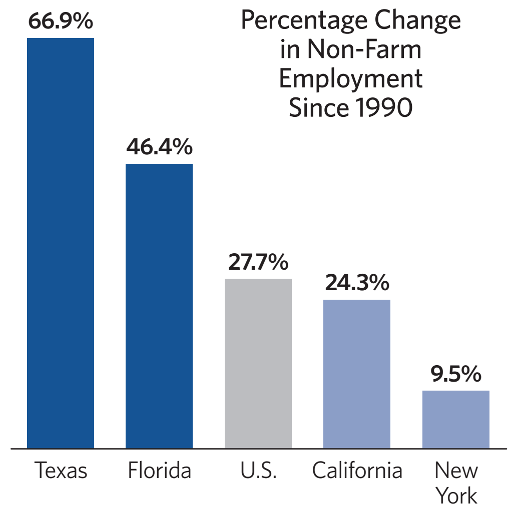
Perhaps the area in which we can see the effect of these competing models most clearly is tax policy. California, Connecticut, Hawaii, Illinois, Minnesota, New York, and Oregon have raised their income tax rates on "the rich" since 2008.[54] In four of these states, the combined state and local income tax rates now exceed 10 percent.[55] Meanwhile, the red states of Arizona, Arkansas,[56] Kansas,[57] Missouri,[58] North Carolina,[59] Oklahoma,[60] and Idaho[61] have cut their tax rates. As a result, the income tax differential between blue and red states has widened for businesses and upper-income families.

Similarly, red states like Oklahoma, Texas, and North Dakota have embraced the oil and gas drilling revolution in America. Blue states like New York, Vermont, Illinois, and California have resisted it. Blue states have raised their minimum wages; red states generally have not.

A thorough examination of interstate migration, economic performance, and job growth shows that these divergent policy choices have a noticeable impact on growth. For example:

- The nine states with zero income tax gained an average of 3.7 percent population from domestic in-migration from 2003–2013, while the highest-income tax states lost an average of 2.0 percent population. Overall, population growth on an equally weighted basis from 2003–2013 was twice as high in the low-income tax states.[62] The flow of families from high-tax to low-tax states is unmistakable.[63]
- The jobs growth rate in the zero income tax states was more than two times higher than that of the high-income tax states on an equally weighted basis.[64] Businesses like Toyota are more likely to set up operations in low-tax states. This kind of business relocation to low-tax states is happening routinely and even accelerating.[65]

Employment Growth in Four Large States



Source: U.S. Department of Labor, Bureau of Labor Statistics, "State and Metro Area Employment, Hours, and Earnings," http://www.bls.gov/sae/ (accessed November 17, 2014).

Chart 4 heritage.org

- Among the four largest states, from 1990–September 2014, the jobs growth rate in red states Florida (46 percent) and Texas (65 percent) was more than double the jobs growth of blue states California (24 percent) and New York (9 percent).
- Personal income has grown about 15 percent faster in the no-income tax states than it has in the highest-income tax states over the past decade.
- The right-to-work states enjoyed a jobs growth rate more than three times that of the forced union states. Jobs growth was 6.8 percent in right-to-work states and only 1.9 percent in non–right-to-work states.[66] With respect to the effect of right-to-work laws, the same picture comes into sharp focus. A right-to-work law does not prohibit a union, but rather empowers individual workers with the right to choose whether to join the union (and pay dues for political purposes) or not. As of January 1, 2013, 23 states were right to work and 27 were forced union.[67]

Interstate competition for jobs, people, and capital is a positive force that helps to discipline politicians to do the right thing. Yet many politicians and pundits pretend that taxes, labor laws, indebtedness, and heavy regulation do not affect economic growth.

Growth is not a zero sum game: More jobs, higher incomes, and expanded opportunity benefit *all* residents without regard to their income or status. And as states get richer, they are able to provide higher-quality public services—and will need fewer services—for things like welfare and crime prevention.

What would happen if every country were to adopt the pro-growth policies embraced by such states as Texas, Florida, and North Dakota? The entire globe would benefit from rising living standards and expanded opportunity. Billions of those who are now mired in poverty would benefit the most.

CONCLUSION

Twenty-one years ago, when the first edition of the *Index of Economic Freedom* was published, the supply-side idea of the Laffer Curve—that high tax rates reduce growth and can even reduce revenues—was still highly controversial and disregarded among the political class and even trained economists. Today, however, more nations around the globe are embracing the idea.

Few had predicted the rapid change with which Eastern Europe would embrace freedom or the notable extent to which many developing countries in other parts of the world would pursue free-market reforms that advance economic freedom. We have seen hundreds of millions of people advance rapidly from poverty and subsistence living to modern comforts. Experiences of individual nations have acted as laboratories to evaluate performance under a myriad of policy conditions.

Over the past 21 years, the *Index of Economic Freedom* has gathered ample evidence to track the performance of countries implementing to varying degrees the precepts of economic freedom and the resulting levels of their economic success. The comparisons presented in this chapter highlight the opportunity for prosperity that is inherent in giving people the freedom to choose.

Much has been accomplished, and much remains to be done. In charting the freedom path to economic growth, the challenge of advancing economic freedom is the challenge of pursuing sustained prosperity. Those countries that have been brave enough to accept the challenge have reaped great rewards and, in doing so, have set a powerful example for others to follow.

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