

THE 12 ECONOMIC FREEDOMS: POLICIES FOR LASTING PROGRESS AND PROSPERITY

Economic freedom is valuable both as an end in itself and because it is a vital component of human dignity, autonomy, and personal empowerment. Just as important, however, is the fact that it provides a proven formula for economic progress and success.

Each measured aspect of economic freedom has a significant effect on economic growth and prosperity. Policies that allow greater freedom in any of the measured areas tend to spur growth, which in turn generates more opportunities for people to advance themselves economically. The result: reduced poverty and lasting prosperity.

Economic freedom is best understood as a philosophy of governance that rejects dogma and embraces a diverse range of strategies for economic advancement. The competitive pressures of a marketplace that is open to new ideas and processes encourage both excellence and innovation.

When governments inject themselves into economic decision-making, their actions, however well-meant, tend toward coercion, standardization, and the restriction of freedom. They cannot possibly account for the individual circumstances and needs of individuals as effectively as a free marketplace can. They also are nearly certain to impede efficiency and thus promote the waste of resources and effort. The *Index of Economic Freedom* provides compelling evidence that it is the counterproductive policies that our governments all too often put in place, not the policies we fail to implement, that hold back economic growth.

Those who believe in economic freedom believe in the right of individuals to decide for themselves

how to direct their lives. The added benefit from society's point of view is the proven power of self-directed individuals, whether working alone or working together in associations or corporations, to create the goods and services that respond most effectively to the needs and desires of their fellow citizens.

Throughout its previous editions, the *Index* has explored many critical aspects of the relationships between individuals and governments. In measuring economic freedom, we have focused on a comprehensive yet far from exhaustive range of policy areas in which governments typically act for good or ill. However, by its very nature, the concept of freedom resists narrow definition, and each year seems to bring new challenges from those who seek to impose their own views or control the economic actions of others.

As new challenges to economic freedom arise, our definitions and methodologies will continue to evolve so that we can provide as true a picture as possible of the state of economic freedom around the world.

DEFINING ECONOMIC FREEDOM

At its heart, economic freedom is about individual autonomy, concerned chiefly with the freedom of choice that individuals enjoy in acquiring and using economic goods and resources. The underlying assumption of those who favor economic freedom is that individuals know their own needs and desires best and that a self-directed life, guided by one's own philosophies and priorities rather than those of a government or technocratic elite, is the foundation

of a fulfilling existence. Independence and self-respect flow from the ability and responsibility to take care of oneself and one's family and are invaluable contributors to human dignity and equality.

Obviously, because we live together with others in societies, individual autonomy can never be considered absolute. Many individuals regard the well-being of their families and communities as equal in importance to their own, and the personal rights enjoyed by one person may well end at his or her neighbor's doorstep. Decisions and activities that have an impact or potential impact on others are rightly constrained by societal norms and, in the most critical areas, by government laws or regulations.

In a market-oriented economy, societal norms, not government laws and regulations, are the primary regulators of behavior. Such norms grow organically out of society itself and reflect its history, its culture, and the experience of generations as they have learned how to live with one another. They guide our understanding of ethics, the etiquette of personal and professional relationships, and consumer tastes.

At their best, democratic political systems reflect societal norms in their laws and regulations, but if they are not constrained by constitutional or other traditional limits, even democratic governments may pose substantial threats to economic freedom. A constraint imposed on economic freedom by majority rule is no less a constraint than one imposed by an absolute ruler or oligarch. It is thus not so much the type of government that determines the degree of economic freedom as it is the extent to which government has limits beyond which it may not (or at least does not) go.

Inevitably, any discussion of economic freedom will focus on the critical relationship between the individual and government. In general, state action or government control that interferes with individual autonomy limits economic freedom.

However, the goal of economic freedom is not simply the absence of government coercion or constraint, but rather the creation and maintenance of a mutual sense of liberty for all. Some government action is necessary for the citizens of a nation to defend themselves and to promote the peaceful evolution of civil society, but government action that rises beyond the minimal necessary level will likely infringe on someone's economic or personal freedom.

Throughout history, governments have imposed a wide array of constraints on economic activity. Sometimes they have imposed these constraints in the name of equality or some other ostensibly noble societal purpose; most often, however, they have imposed them to benefit elites or special interests.

Government's excessive intrusion into wide spheres of economic activity comes at a high cost to society as a whole. By substituting political judgments for those of the marketplace, government diverts entrepreneurial resources and energy from productive activities to rent-seeking: the quest for economically unearned benefits. The result is lower productivity, economic stagnation, and declining prosperity.

ASSESSING ECONOMIC FREEDOM

The *Index of Economic Freedom* takes a comprehensive view of economic freedom. Some of the aspects of economic freedom that are evaluated (for example, the extent of an economy's openness to global investment or trade) are concerned with a country's interactions with the rest of the world. Most, however, focus on policies within a country, assessing the liberty of individuals to use their labor or finances without undue restraint and government interference.

Each of the measured aspects of economic freedom plays a vital role in promoting and sustaining personal and national prosperity. But all are complementary in their impact, and progress in one area is often likely to reinforce or even inspire progress in another. Similarly, repressed economic freedom in one area (for example, a lack of respect for property rights) may make it much more difficult to achieve high levels of freedom in other categories.

The 12 aspects of economic freedom measured in the *Index* are grouped into four broad categories:

- **Rule of law** (property rights, judicial effectiveness, and government integrity);
- **Government size** (tax burden, government spending, and fiscal health);
- **Regulatory efficiency** (business freedom, labor freedom, and monetary freedom); and
- **Market openness** (trade freedom, investment freedom, and financial freedom).

Rule of Law

Property Rights. In a fully functioning market economy, the ability to accumulate private property and wealth is a central motivating force for both workers and investors. Private property rights and an effective rule of law to protect them are vital features of any such economy. Secure property rights give citizens the confidence to undertake entrepreneurial activity, save their income, and make long-term plans because they know that their income, savings, and property (both real and intellectual) are safe from unfair expropriation or theft.

Property rights are a primary factor in the accumulation of capital for production and investment. Secure titling is key to unlocking the wealth embodied in real estate, making natural resources available for economic use, and providing collateral for investment financing. It is also by extending and protecting property rights that societies avoid the “tragedy of the commons”—the phenomenon that leads to the degradation and exploitation of property that is held communally and for which no one is accountable.

A key aspect of the protection of property rights is the enforcement of contracts. The voluntary undertaking of contractual obligations is the foundation of the market system and the basis for economic specialization, gains from commercial exchange, and trade among nations. Evenhanded government enforcement of private contracts is crucial to ensuring equity and integrity in the marketplace.

Judicial Effectiveness. Effectively functioning legal frameworks protect the rights of all citizens against infringement of the law by others, including by governments and powerful parties. As an essential component of the rule of law, judicial effectiveness requires efficient and fair judicial systems to ensure that laws are fully respected and appropriate legal actions are taken against violations.

Especially for developing countries, judicial effectiveness may be the area of economic freedom that is most important in laying the foundations for economic growth. In advanced economies, deviations from judicial effectiveness may be the first signs of serious problems that will lead to economic decline.

There is abundant evidence from countries around the world that an honest, fair, and effective judicial system is a critical factor in empowering individuals, ending discrimination, and enhancing competition. In the never-ending struggle to improve the human condition and achieve greater

prosperity, an institutional commitment to the preservation and advancement of judicial effectiveness is indispensable.

Government Integrity. In a world characterized by social and cultural diversity, practices regarded as corrupt in one place may simply reflect traditional interactions in another. For example, small informal payments to service providers or even government officials may be regarded variously as a normal means of compensation, a “tip” for unusually good service, or a corrupt form of extortion.

While such practices may indeed constrain an individual’s economic freedom, their impact on the economic system as a whole is likely to be modest. Of far greater concern is the systemic corruption of government institutions by such practices as bribery, nepotism, cronyism, patronage, embezzlement, and graft. Though not all are crimes in every society or circumstance, these practices erode the integrity of government wherever they are practiced. By allowing some individuals or special interests to gain government benefits at the expense of others, they are grossly incompatible with the principles of fair and equal treatment that are necessary ingredients of an economically free society.

There is a direct relationship between the extent of government intervention in economic activity and the prevalence of corruption. In particular, excessive and redundant government regulations provide opportunities for bribery and graft, which in turn are detrimental to economic growth and development. In addition, government regulations or restrictions in one area may create informal or black markets in another. For example, by imposing numerous burdensome barriers to the conduct of business, including regulatory red tape and high transaction costs, a government can incentivize bribery and encourage illegitimate and secret interactions that compromise the transparency that is essential to the efficient functioning of a free market.

Government Size

Tax Burden. All governments impose fiscal burdens on economic activity through taxation and borrowing. Governments that permit individuals and businesses to keep and manage a larger share of their income and wealth for their own benefit and their own use maximize economic freedom.

The higher the government’s share of income or wealth, the lower the individual’s reward for his or

her economic activity and the lower the incentive to undertake work at all. Higher tax rates reduce the ability of individuals and firms to pursue their goals in the marketplace and thereby also reduce the overall level of private-sector activity.

Individual and corporate income tax rates are an important and direct constraint on an individual's economic freedom and are reflected as such in the *Index*, but they are not by themselves a comprehensive measure of the tax burden. Governments impose many other indirect taxes, including payroll, sales, and excise taxes, as well as tariffs and value-added taxes (VATs). The *Index of Economic Freedom* captures the burden of these taxes by measuring the overall tax burden from all forms of taxation as a percentage of total gross domestic product (GDP).

Government Spending. The cost, size, and intrusiveness of government taken together are a central economic freedom issue that the *Index* measures in a variety of ways. Government spending takes many forms, not all of which are equally harmful to economic freedom. Some government spending (for example, to provide infrastructure, fund research, or improve human capital) may be considered investment. Government also spends on public goods, the benefits of which accrue broadly to society in ways that markets cannot price appropriately.

All government spending, however, must eventually be financed by higher taxation and entails an opportunity cost—the value of the consumption or investment that would have occurred had the resources involved been left in the private sector.

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

Fiscal Health. One of the clearest indicators of the extent to which a government respects the principle of limited government is its budget. By delineating priorities and allocating resources, a budget signals unmistakably both the areas in which government will intervene in economic activity and the extent of that intervention. A budget also reflects a government's commitment (or lack thereof) to the

sound financial management of resources, which is both imperative for dynamic long-term economic expansion and critical to the advancement of economic freedom.

Widening deficits and a growing debt burden, both of which are direct consequences of poor government budget management, erode a country's overall fiscal health. Deviations from sound fiscal positions often disturb macroeconomic stability, induce economic uncertainty, and thus limit economic freedom.

Debt is an accumulation of budget deficits over time. In theory, debt financing of public spending could contribute to productive investment and economic growth. Debt could also be a mechanism for positive macroeconomic countercyclical interventions or even long-term growth policies. On the other hand, high levels of public debt can lead to higher interest rates, crowd out private investment, and limit government's flexibility in responding to economic crises. Mounting public debt driven by persistent budget deficits—particularly deficits caused by spending that merely boosts government consumption or transfer payments—often undermines overall productivity growth and leads to economic stagnation rather than economic growth.

Regulatory Efficiency

Business Freedom. An individual's ability to establish and run an enterprise without undue interference from the state is one of the most fundamental indicators of economic freedom. Burdensome and redundant regulations are the most common barriers to the free conduct of entrepreneurial activity. By increasing the costs of production, regulations can make it difficult for entrepreneurs to succeed in the marketplace.

Many regulations hinder business productivity and profitability, but the ones that most inhibit entrepreneurship are often those that are associated with the licensing of new businesses. In some countries, as well as many states in the United States, the procedure for obtaining a business license can be as simple as mailing in a registration form with a minimal fee. In Singapore, it takes only a day and a half and two procedures to start a business, and there is no minimum-capital requirement. In other economies, such as India and parts of South America, the process for obtaining a business license can take much longer and involve endless trips to

government offices and repeated encounters with officious and sometimes corrupt bureaucrats.

Once a business is open, government regulation may interfere with the normal decision-making or price-setting process. Significantly, two countries with the same set of regulations can impose different regulatory burdens that have different consequences. A country that applies its regulations evenly and transparently can lower the regulatory burden by facilitating long-term business planning, while a country that applies regulations inconsistently adds to the regulatory burden by creating an unpredictable business environment.

Labor Freedom. The ability of individuals to find employment opportunities and work is a key component of economic freedom. By the same token, the ability of businesses to contract freely for labor and dismiss redundant workers when they are no longer needed is essential to the achievement of enhanced productivity and sustained economic growth.

The core principle of any economically free market is voluntary exchange. This is just as true in the labor market as it is in the market for goods.

State intervention generates the same problems in the labor market that it produces in any other market. Government labor regulations take a variety of forms: minimum wages or other wage controls, limits on hours worked or other workplace conditions, restrictions on hiring and firing, and other constraints. In many countries, unions play an important role in regulating labor freedom and, depending on the nature of their activity, may be either a force for greater freedom or an impediment to the efficient functioning of labor markets.

Onerous labor laws penalize businesses and workers alike. Rigid labor regulations prevent employers and employees from freely negotiating changes in terms and conditions of work, and the result is often a chronic mismatch of labor supply and demand.

Monetary Freedom. Monetary freedom requires a stable currency and market-determined prices. Whether acting as entrepreneurs or as consumers, economically free people need a steady and reliable currency as a medium of exchange, unit of account, and store of value. The lack of monetary freedom seriously limits their ability to create long-term value or amass capital.

The value of a country's currency can be influenced significantly by the monetary policy of its

government. With a monetary policy that endeavors to fight inflation, maintain price stability, and preserve the nation's wealth, people can rely on market prices for the foreseeable future. They can invest, save, and make other longer-term plans more confidently. An inflationary policy, by contrast, confiscates wealth like an invisible tax and distorts prices, misallocates resources, and raises the cost of doing business.

There is no single accepted theory of the right monetary policy for a free society. At one time, the gold standard enjoyed widespread support. What characterizes almost all monetary theories today is support for low inflation and an independent central bank. It is also widely recognized that price controls corrupt market efficiency and lead to shortages or surpluses.

Market Openness

Trade Freedom. Many governments restrict their citizens' ability to interact freely as buyers or sellers in the international marketplace. Impediments to trade include tariffs, export taxes, trade quotas, outright trade bans, and nontariff barriers related to various licensing, standard-setting, and other regulatory actions. Given the development of global supply chains and cross-border production processes, businesses increasingly value stability in trade policy. Government actions that create uncertainty about future trade conditions may thus have a negative impact on trade freedom that goes beyond their immediate economic effect.

The degree to which government hinders the free flow of foreign commerce has a direct bearing on the ability of individuals to pursue their economic goals and maximize their productivity and well-being. Tariffs, for example, increase the prices that local consumers pay for foreign imports, but they also distort production incentives for local producers, causing them to produce either a good in which they lack a comparative advantage or more of a protected good than is economically ideal. This impedes overall economic efficiency and growth.

In many cases, restricting trade also means limiting the productive development of local entrepreneurs by putting advanced-technology products and services beyond their reach.

Investment Freedom. A free and open investment environment provides maximum entrepreneurial opportunities and incentives for expanded

economic activity, greater productivity, and job creation. The benefits of such an environment flow not only to the individual companies that take the entrepreneurial risk in expectation of greater return, but also to society as a whole. An effective investment framework is characterized by transparency and equity, supporting all types of firms rather than just large or strategically important companies, and encourages rather than discourages innovation and competition.

Restrictions on the movement of capital, both domestic and international, undermine the efficient allocation of resources and reduce productivity, thereby distorting economic decision-making. Restrictions on cross-border investment can limit both inflows and outflows of capital, thereby shrinking markets and reducing opportunities for growth.

By contrast, when individuals and companies are free to choose where and how to invest, capital can flow to its best uses: to the sectors and activities where it is most needed and the returns are greatest. State action to redirect the flow of capital and limit choice is an imposition on the freedom of both the investor and the person seeking capital. The more restrictions a country imposes on investment, the lower its level of entrepreneurial activity will be.

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

Through a process driven by supply and demand, markets provide real-time information on prices and immediate discipline for those who have made

bad decisions. This process depends on transparency in the market and the integrity of the information that is made available. A prudent and effective regulatory system, through disclosure requirements and independent auditing, ensures both.

Increasingly, the central role played by banks is being complemented by other financial services that offer alternative ways to raise capital or diversify risk. As with the banking system, the useful role for government in regulating these institutions lies in ensuring transparency and integrity and in promoting disclosure of assets, liabilities, and risks.

State banking and financial regulation that goes beyond assuring transparency and honesty in financial markets can promote inefficiency, increase the costs of financing entrepreneurial activity, and limit competition. If the government intervenes in the stock market, for instance, it contravenes the choices of millions of individuals by interfering with the pricing of capital—the most critical function of a market economy.

ECONOMIC FREEDOM: MORE THAN A GOOD BUSINESS ENVIRONMENT

Economic freedom is about much more than a business environment in which entrepreneurship and prosperity can flourish. With its far-reaching impacts on various aspects of human development, economic freedom empowers people, unleashes powerful forces of choice and opportunity, nourishes other liberties, and improves the overall quality of life.

No other system—and many have been tried—comes close to free-market capitalism in promoting growth and enhancing the human condition. The undeniable link between economic freedom and prosperity is a striking demonstration of what people can do when they have maximum opportunity to pursue their own interests within the rule of law.