CSFE Issue Briefs
Hard Research, Easy Reading

Volume 1, Issue 4
Spring 2019

Economic Freedom, What Is It Good For?

Robert A. Lawson, Ph.D.
Southern Methodist University

Executive Summary

Economists have debated the sources of human prosperity for centuries. This issue brief begins with the ideas of two of history's top economists, Adam Smith and Karl Marx. In Smith's view, prosperity happens when the economy is built on the principle of natural liberty. But according to Marx, capitalism will lead instead to inequality, revolution, and ultimately authoritarianism. Who was right? To help answer, this brief next explains how the annual Economic Freedom of the World (EFW) report measures economic freedom and how it relates to economic measures of human prosperity. In reviewing over 400 studies that use the EFW data, the results are clear. On average, people living in countries with higher economic freedom enjoy much greater levels of income. Other measures of human well-being are also better in countries with more economic freedom, such as poverty rates, political rights, civil rights, gender inequality, live expectancy at birth, infant mortality rates, and life satisfaction surveys. Even with income inequality, the share of total income going to the poorest tenth of the population is about the same in countries with high economic freedom as it is in countries with low economic freedom. While economic inequality is a deep concern, economic freedom is not the likely cause of excessive inequality. What works at the international level also works at the state and local level, and an emerging area of research seeks to measure economic freedom at the subnational level. In the most recent reports, North Carolina ranks 22nd among the U.S. states in overall economic freedom.

About the Author

Robert Lawson is the Jerome M. Fullinwider Centennial Chair in Economic Freedom and Director of the O'Neil Center for Global Markets and Freedom at Southern Methodist University's Cox School of Business. He is the recipient of the Association of Private Enterprise Education's 2019 Adam Smith Award, which recognizes sustained and lasting scholarship that contributes to understanding of the role of free enterprise and the system of entrepreneurship that underlies it. Email: rlawson@smu.edu.

Western Carolina University | Center for the Study of Free Enterprise

Economic Freedom, What Is It Good For?
Robert A. Lawson

The central question in economics, at least since the time of Adam Smith, has been to explain why some people become rich while others don't. Smith's 1776 magnum opus, An Inquiry into the Nature and Causes of the Wealth of Nations, was one of the first attempts to answer this question. In Smith's account, the division of labor is the source of prosperity for the great masses of people. People get rich by specializing in producing those things they are good at and then trading with others who themselves have specialized in that which they are good at. In order for this specialization to take hold, however, Smith understood that we needed an economic and political system that allowed people the freedom to specialize and trade—he called it "a system of natural liberty." Today, we would call it laissez-faire, private enterprise, free trade, economic freedom, or some such term. Smith is rightly considered the father not only of economics but also free-market economics.

It might be surprising for readers to discover that Smith's intellectual enemy, Karl Marx, largely agreed with Smith's assessment, to a point. Marx's great work, *Capital: A Critique of Political Economy*, first published in 1867 nearly a hundred years after Smith's, argued that capitalism was indeed a very productive system that would yield great riches. The Marxian "yeah but" was that most of those riches would accrue to the elite owners of capital, the bourgeoisie, while the working class would merely subsist on low wages. Furthermore, Marx's analysis suggested that capitalism would cycle from profit to loss with each cycle resulting in greater monopoly power, which in turn would squeeze the working class even further. Ultimately, according to Marx, the cycles of capitalism will create such unbearable conditions for the working class that they will rise up and violently overthrow their capitalist overlords, first ushering in the dictatorship of the proletariat and then eventually a communist system characterized by the famous phrase, "From each according to his ability, to each according to his needs."

Who was right? Smith painted a fairly rosy, if not utopic, picture of free markets yielding ever greater prosperity to the masses, while Marx depicted a dystopic Hunger Games future under capitalism. One of these thinkers, if not both, is wrong about how free-market capitalism works. Ultimately, either economic freedom delivers the goods or it doesn't.

This is certainly not the first time people have disagreed about how the world works. To give just one example from the early 20th Century, Einstein's exotic theory of general relativity challenged the long-standing and highly accurate mathematical system of celestial mechanics built by Newton. Scientists eventually came to conclude that Einstein's equations were correct and Newton's incorrect. This was the result of very careful scientific measurements, namely measurements of Mercury's orbit and of the Sun's gravity bending the paths of light coming from distant stars.

It was measurement that settled the dispute between Einstein and Newton. If measurement is to similarly settle the Smith-Marx debate, we will first need a measurement of economic freedom. In 1996, the Fraser Institute in Canada published the first edition of the Economic Freedom of the World (EFW) report. The index in that report attempts to measure the degree of economic freedom in a country on a zero to ten scale. The most recent edition of the index presents data for up to 159 countries as far back as 1970. The index includes data on 41 separate factors in five areas: (1) size of government, (2) private property rights, (3) sound money, (4) free trade, and (5) limited regulations. Basically, countries that are closer to Adam Smith's "system of natural liberty" get higher scores.

In Adam Smith's view, government should be limited in its scope to just a few functions like national defense, police, courts, and some basic infrastructure like roads and bridges. Although, being the good capitalist that he was, Smith argued that they should be *toll* roads and bridges. To accomplish these limited tasks, the government doesn't need to be very large. In fact, today's governments all over the world are vastly larger than what Smith outlined. In the end, countries with lower taxes and lower levels of government spending get higher scores in the first area of the index.

People need to feel secure in their property and believe that contracts will be enforced if the specialization process is going to work. For this basic reason, private property is the bedrock of any system that encourages specialization and trade. The EFW index uses data from several sources to measure the efficiency of the legal system in protecting private property. To give one example, the index uses data from the World Banks's [Doing Business] project on how long it takes to settle a simple contract dispute. Countries where it takes less time get better EFW scores.

The third area deals with the importance of sound money. Inflation can act as a tax on any asset you have that is denominated in currency terms (like dollars). The value of financial assets (bonds, leases, insurance policies, pensions, etc.) can be eroded by inflation. This area of the EFW index measures how severe this problem is in each country and how easily people can cope with monetary instability.

If there is one aspect that Adam Smith is most famous for, it is free trade. Smith was the crazy Scotsman who had the audacity to argue that 18th Century Britain should trade freely with the dastardly French. This was an eccentric argument in his day. After all, Britain and France had been bitter enemies for centuries. Indeed, it is still a crazy argument today as you can find few politicians in favor of free trade between people in the United State and those in Mexico or China. Smith understood however that the powerful force of specialization requires free trade; it makes no sense to specialize if you can't trade away that which you have produced. This area of the EFW index includes measures of tariffs, quotas, financial capital controls, and even the ability of people to travel freely from country to country. Countries that have lower tariffs and fewer controls get higher ratings.

The final area of the index measures the impact of regulations. Smith wrote a lot about how government regulations that prevent people from trading freely limit our ability to specialize. This is clearly seen with regulations that today we call occupational licensing. This area of the EFW index includes ratings on everything from interest rate controls on bank loans, to hiring and firing regulations, to the regulatory cost of starting a new business. All countries have some regulations, and some regulations are undoubtedly beneficial, but in Smith's view, excessive regulation limits our freedom and retards economic progress. Countries that have fewer regulations receive higher scores in the EFW index.

After measuring economic freedom in these five areas, all the data are converted to a zero-to-ten scale and then averaged to get a country's overall economic freedom rating. Table 1 shows the ten countries with the highest scores, and Table 2 shows the ratings (ranks) of some of the larger, more significant countries, including the United States. Hong Kong, which enjoys a high degree of autonomy over its economic affairs, is clearly the world's leader in economic freedom. Its *top* tax rate is 15 percent, the courts are fair and impartial, there are literally no tariffs or other trade restrictions, and regulations are light. For example, the World Bank says it takes just one day to start a business in Hong Kong. Singapore is very similar to Hong Kong, and these two states have been at the top of the index every year since 1970.

The United States, which had been ranked third for most years, began declining in economic freedom after 2000 and currently sits at 11^{th}. What accounts for the US decline? While the US ratings and rankings have fallen in all five areas of the EFW index, the reductions have been largest in the areas related to private property rights, free trade, and regulations. The declines in the property rights area have been the most troubling, and unfortunately it is not always easy to discern the exact causes of these declines with the data at hand. Could the expanded use of secret Foreign Intelligence Surveillance Act (FISA) courts, where judges rubber stamp government requests nearly 100% of the time, be responsible for this? Similarly, how much did the interference of the executive branch of the federal government in the bankruptcy proceedings of GM and Chrysler contribute to the decline? Could the Supreme Court's notorious *Kelo v. City of New London* decision in 2005 that made it easier to condemn private property and transfer that property to politically connected private interests be the cause? And how about the expansion in civil asset forfeitures, in which the government can take your property without any proof of guilt, in prosecuting the war on drugs – was this a contributing factor? Could increasing environmental, safety, and health rules and new acts like Sarbanes-Oxley, Dodd-Frank, and the Affordable Care Act be seen as a threat to property rights? Whatever the exact causes, the data show that to a large degree, the United States has experienced a significant move away from rule of law and toward a highly regulated, more politicized, and more heavily policed state.

While the United States has fallen somewhat, we should acknowledge that it is still a predominantly market economy. In contrast, at the other of the EFW scale, we see countries where almost all aspects of economic life are controlled by government. Venezuela currently, and tragically, occupies the last position in the EFW index. (Cuba and North Korea are not rated for lack of data.)

Now that we have the EFW index in hand, we are in a position to answer the question we started with. Who was right? Smith or Marx? The answer is Smith. Hands down. Table 3 breaks the world into fourths by economic freedom and reports the average GDP per capita, the best measure of standard of living available, for each group. The results are clear. On average, people living in countries with higher economic freedom enjoy much greater levels of income (and thus living standards) than people living in countries with less economic freedom.

Remember that this result would not have surprised even Karl Marx. His complaint though was that all the riches go only to the elites and little trickles down to the poor workers. Table 4 shows however that the share of total income going to the poorest tenth of the population is about the same in highly economically free nations as in nations with greater government control. Marx was simply wrong when he asserted that free-market capitalism engenders high degrees of inequality. To be clear, economic inequality is a real thing in our world, and many people care deeply about it and are working to improve the situation. The EFW index shows, however, that economic freedom is not the likely cause of excessive inequality.

Other measures of human well-being are also better in countries with more economic freedom, such as poverty rates, political rights, civil rights, gender inequality, live expectancy at birth, infant mortality rates, and life satisfaction surveys. There are many detailed and thorough studies that measure economic freedom and they all say more or less the same thing. Economic freedom tends to yield desirable outcomes. In a recent review of over 400 articles published in refereed journals, Hall and Lawson (2014: 1) summarized the research consensus as follows,

> *Over two-thirds of these studies found economic freedom to correspond to a "good" outcome such as faster growth, better living standards, more happiness, etc. Less than 4% of the sample found economic freedom to be associated with a "bad" outcome such as increased income inequality. The balance of evidence is overwhelming that economic freedom corresponds with a wide variety of positive outcomes with almost no negative tradeoffs.*

Science advances when scholars take their ideas about how the world works and test those ideas against real-world evidence. This is how we learn in the natural sciences, and this is how we should learn in the social sciences as well. The EFW index provides one of the best tools we have to evaluate the impact of market liberal policies on our societies, and the best evidence to date shows that economic freedom does a great job of providing an environment that allows people to flourish. In contrast, state control of economic life fails to provide the goods.

What works at the international level also works at the state and local level. The Economic Freedom of North America index, also published by the Fraser Institute, provides a state and provincial level economic freedom index for the United States, Canada, and Mexico. North Carolina scores in the middle of the pack, with a score of 7.2 out of 10 and a rank of 18th among the 50 states. Economist Dean Stansel has also computed economic freedom scores for 384 municipalities in the United States. North Carolina cities range from the most-free Raleigh-Cary (ranked 49th overall) down to the least free Wilmington (273rd); Charlotte comes in at 101st and Asheville was 114th. These sub-national indexes echo the EFW index, and studies are finding that states and cities with lower taxes and fewer regulations perform better than their higher taxed/regulated counterparts.

Further Reading

Gwartney, James, Robert Lawson, and Joshua Hall. 2017. *Economic Freedom of the World: 2017 Annual Report.* Vancouver: Fraser Institute. https://www.fraserinstitute.org/studies/economic-freedom

Hall, Joshua and Robert Lawson. 2014. "Economic Freedom of the World: An Accounting of the Literature." *Contemporary Economic Policy* 32(1): 1-19.

Leeson, Peter. 2010. "Two Cheers for Capitalism?" *Society* 47(3): 227-33.

Shleifer, Andrei. 2009. "The Age of Milton Friedman." *Journal of Economic Literature* 47(1): 123-35.

Stansel, Dean, Jose Torra, and Fred McMahon. 2017. *Economic Freedom of North America: 2017*. Vancouver: Fraser Institute. https://www.fraserinstitute.org/studies/economic-freedom

Stansel, Dean. 2013. "An Economic Freedom Index for U.S. Metropolitan Areas." *Journal of Regional Analysis and Policy* 43(1): 3-20.

About CSFE Issue Briefs

The goal of *CSFE Issue Briefs* is to provide an accessible educational resource on important issues and fundamental concepts. *CSFE Issue Briefs* are well grounded in sound scholarship, yet written in plain language for every day readers. Hence the tagline: "Hard Research, Easy Reading." CSFE distributes the series of issue briefs by email, social media, and its website.

Other CSFE Issue Briefs

Volume 1

Issue 1 – Why is Economic Mobility so (Surprisingly) Low in North Carolina by Craig Richardson
Issue 2- A Case for Free Trade in Labor by Benjamin Powell
Issue 3- Independent and Accountable State Judges: Drawing Lessons from Past Attempts by F. Andrew Hanssen
Issue 4- Economic Freedom, What Is It Good For? by Robert A. Lawson

Western Carolina University | Center for the Study of Free Enterprise

226K Forsyth, 1 University Drive, Cullowhee NC 28723 | 828.227.2362 | csfe@wcu.edu | **enterprise.wcu.edu**