HANDOUT 3.1

What Does Economic Freedom Measure?

WHAT IS ECONOMIC FREEDOM AND HOW IS THE ECONOMIC FREEDOM OF THE WORLD INDEX MEASURED?

The cornerstones of economic freedom are (1) personal choice, (2) voluntary exchange coordinated by markets, (3) freedom to enter and compete in markets, and (4) protection of persons and their property from aggression by others. Individuals have economic freedom when property they acquire without the use of force, fraud, or theft is protected from physical invasions by others and they are free to use, exchange, or give their property as long as their actions do not violate the identical rights of others. Individuals are free to choose, trade, and cooperate with others, and compete as they see fit.

The Economic Freedom of the World index measures the degree of economic freedom present in five major areas: 1) Size of Government; 2) Legal System and Security of Property Rights; 3) Sound Money; 4) Freedom to Trade Internationally; and 5) Regulation.

Within the five major areas, there are 24 components in the index. Many of those components are themselves made up of several sub-components. In total, the index comprises 42 distinct variables. All variables come from third party sources, such as the International Country Risk Guide, the Global Competitiveness Report, and the World Bank's Doing Business project, so that the subjective judgments of the authors do not influence the index. This also creates transparency and allows researchers to replicate the index.

Below is a brief overview of the five major areas of the index.

1. **Size of Government**

- **What Area 1 measures:** government consumption, transfers and subsidies, government enterprises and investment, and the top marginal tax rate.

- **Why Area 1 is included in the EFW index:** When government consumption is a larger share of total spending in an economy, political choice is substituted for personal choice. Therefore, the larger government spending is relative to spending by individuals, businesses, and households, the lower the amount of economic freedom. Government-owned enterprises are not dependent on consumers for their revenue or on investors for capital, and they often play by a different set of rules than that of the private sector. Therefore, a country's economic freedom is lowered the more resources are directed by government investment as opposed to private investment directing the use of those resources. When governments tax some people in order to transfer wealth to others, the freedom of individuals to keep what they earn decreases, which decreases economic freedom. High marginal tax rates that apply at relatively low income levels are also indicative of reliance upon government. Such rates deny individuals the fruits of their labour. Thus, countries with high marginal tax rates and low income thresholds are rated lower.

2. **Legal System and Property Rights**

- **What Area 2 measures:** judicial independence, impartial courts, protection of property rights, military interference in the rule of law and politics, integrity of the legal system, legal enforcement of contracts, regulatory costs of the sale of real property, reliability of police, and business costs of crime

- **Why Area 2 is included in the EFW index:** Security of property rights, protected by the rule of law, provides the foundation for economic freedom and the efficient operation of markets. The key ingredients of a legal system consistent with economic freedom are rule of law, security of property rights, an independent judiciary and unbiased court system, and impartial and effective enforcement of the law. Freedom to exchange, for example, is fatally weakened if individuals do not have secure rights to property, including the fruits of their labour. When individuals and businesses lack confidence that contracts will be enforced and the fruits of their productive efforts protected, their incentive to engage in productive activity is eroded. Perhaps more than any other area, this area is essential for the efficient allocation of resources. Countries with major deficiencies in this area are unlikely to prosper regardless of their policies in the other four areas.

3. **Sound Money**

- **What Area 3 measures:** money growth, standard deviation of inflation, inflation rate of the most recent year, and freedom to own foreign currency bank accounts

- **Why Area 3 is included in the EFW index:** High and volatile rates of inflation distort relative prices, alter the fundamental terms of long-term contracts, and make it virtually impossible for individuals and businesses to plan sensibly for the future. Sound money is essential to protect property rights and, thus, economic freedom. Inflation erodes the value of property held in monetary instruments. When governments finance their expenditures by creating money, they are, in effect, expropriating the property and violating the economic freedom of their citizens. Furthermore, an absence of sound money undermines gains from trade. This area of the index measures the consistency of monetary policy (or institutions) with long-term price stability, as well as the ease with which other currencies can be used via domestic and foreign bank accounts. In order to earn a high rating in this area, a country must follow policies and adopt institutions that lead to low (and stable) rates of inflation and avoid regulations that limit the ability to use alternative currencies.

4. **Freedom to Trade Internationally**

- **What Area 4 measures:** tariffs, regulatory trade barriers, black-market exchange rates, and controls of the movement of capital and people

- **Why Area 4 is included in the EFW index:** Voluntary exchange is mutually beneficial for both trading partners; hence, trade creates wealth. However, the lobbying of special-interest groups often leads countries to adopt protectionist policies that limit international trade, which decreases a country's economic freedom. The components in this area are designed to measure a wide variety of restraints that affect international exchange: tariffs, quotas, hidden administrative restraints, and controls on exchange rates and the movement of capital. In order to get a high rating in this area, a country must have low tariffs, easy clearance and efficient administration of customs, a freely convertible currency, and few controls on the movement of physical and human capital.

5. Regulation

- **What Area 5 measures:** credit market regulations, labour market regulations, and business regulations

- **Why Area 5 is included in the EFW index:** When regulations restrict entry into markets and interfere with the freedom to engage in voluntary exchange, they reduce economic freedom. The fifth area of the index focuses on regulatory restraints that limit the freedom of exchange in credit, labour, and product markets. Countries that use a private banking system to allocate credit to private parties and refrain from controlling interest rates receive a higher rating in the credit market regulations component of Area 5. Many types of labour-market regulation infringe on the economic freedom of employees and employers. Among the more prominent are minimum wages, dismissal regulations, centralized wage setting, extension of union contracts to nonparticipating parties, and conscription. In order to earn high marks in the component rating regulation of the labour market, a country must allow market forces to determine wages and establish the conditions of hiring and firing, and refrain from the use of conscription. Like the regulation of credit and labour markets, the regulation of business activities inhibits economic freedom. Regulations and bureaucratic procedures that restrain entry and reduce competition will lower a country's economic freedom. A government that uses its power to extract financial payments and reward some businesses at the expense of others will also lower a country's economic freedom.