Discussion

WHAT DO RECENT TRENDS IN *ECONOMIC FREEDOM OF THE WORLD* REALLY TELL US?

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Introduction

The Fraser Institute's *Economic Freedom of the World* index (EFW) quantifies the economic freedom of 152 countries and territories. The index relates closely to the vitality of economic growth (De Haan, Lundström and Sturm 2006) and has been applied to a very broad number of academic topics (Hall and Lawson 2014). It is composed of five areas – Size of Government, Legal System and Property Rights, Sound Money, Freedom to Trade Internationally, and Regulation – which are in turn made up of several components. The decline in economic freedom since 2000, as measured by the index, especially in the United States, is well known to proponents of free markets.

However, close scrutiny of the data demonstrates that the reasons for this fall are not what the standard narratives imply. The United States is not alone in its fall, as the Group of 7 (G7) matches its exact qualitative pattern, and to some extent so do the member countries of the Organisation for Economic Co-operation and Development (OECD). The fall is *not* driven by increases in government spending (except in the first few years of the Great Recession) or by the behaviour of central banks. Size of Government has, if anything, improved in recent years as measured by EFW. Additionally, Regulation has been essentially a random walk since 2000, with the most recent score almost identical to the score in 2000 for the G7. Rather, these falls have been driven by declines in the two areas of Legal System and Property Rights and Freedom to Trade Internationally. The components of these two areas that have fallen are almost entirely driven by declines in various survey data the index employs. In other words, the declines overall in the index do not reflect any hard 'objective' measure. We must explore why these survey numbers have declined so rapidly in order to explain how and why economic freedom has declined in the United States (and elsewhere) since 2000.

EFW in the US and the G7

The United States declined in its (chain-linked)[1] EFW ranking from second in the world in 2000 to 16th as of 2011, with a 'dead cat bounce' back up to 14th in 2014 (Gwartney, Lawson and Hall 2014). This was interpreted by, among others, the authors of the report as a decline specific to the United States (Gwartney, Lawson and Hall 2013, p. 15; for other examples, see Cox and Alm 2012; Vasquez 2014). However, although the United States has declined the most

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Table 1: Areas of Economic Freedom of the World (chain linked), 2000 and 2012

Areas	Global average, 2000	Global average, 2012
Area 1: Size of Government	6.04	6.46
Area 2: Legal System and Property Rights	5.97	5.82
Area 3: Sound Money	7.59	8.17
Area 4: Freedom to Trade Internationally	7.06	6.89
Area 5: Regulation	6.32	6.86
Overall EFW	6.59	6.87

Note: The EFW scale runs from 0 to 10; a higher score signifies more freedom.
Sources: Gwartney, Lawson and Hall (2014); author's calculations.

rapidly, there has been a decline in *all* G7 countries since 2000 (see Table 2). This suggests not simply that the cause of the decline in the United States is creeping statism but that there is a common cause of the decline in the major economies. Despite that, the global average of EFW has improved since 2000 (see Table 1), although it dipped in conjunction with the Great Recession. This is not a global trend; it is a trend affecting the major economies at or near the economic frontier.

The United States is merely the clearest example of a disease afflicting advanced economies, whether one considers it from the point of view of the G7 or even the OECD.[2]

There are apparent long-run trends making the First World less free, regardless of whether one uses a broad or a narrow definition of the term.

Table 2: EFW (chain linked) in the G7, 2000–2012

Country	EFW, 2000	EFW, 2012	Change
Canada	8.36	8.11	–0.25
France	7.31	7.27	–0.04
Germany	7.67	7.57	–0.10
Italy	7.36	6.88	–0.48
Japan	7.90	7.58	–0.32
United Kingdom	8.50	7.92	–0.58
United States	8.65	7.81	–0.84

Sources: As for Table 1.

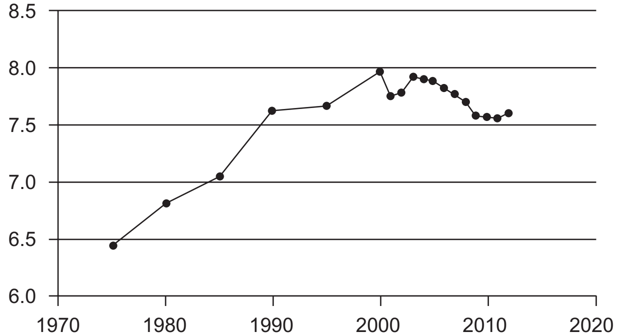


Figure 1: Average G7 EFW.
Note: Figures 1–12 are chain linked.

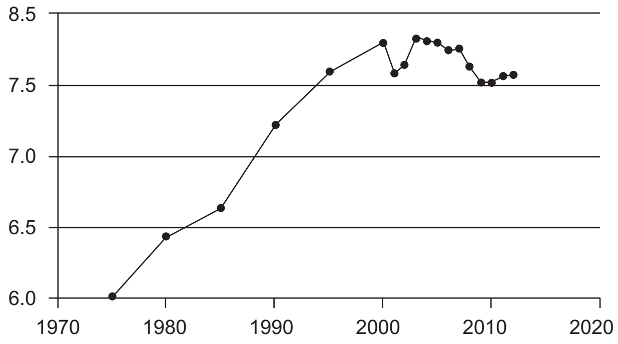


Figure 2: Average OECD EFW.

However, it should be noted that none of these patterns is apparent in an alternative measure of economic freedom, namely the Heritage Foundation's *Index of Economic Freedom* (Miller, Holmes and Kim 2014). The United States has gone backwards in recent years, but that is in conjunction with the Great Recession, not in a long-run trend going back to 2000. No long-run negative trends are apparent among G7 countries in general over this period either.

The sources of the decline

Since the beginning of the Great Recession, the popular narrative would suggest that economic freedom is perhaps most 'obviously' in decline in Areas 1 and 3, Size of Government and Sound Money (see, for example, Murdock 2011; Ferguson 2011). The G7 score in Size of Government declined sharply in conjunction with the Great Recession (as is typical in any recession) and remains significantly below its peak. However, for both the G7 and OECD the average remains above where it was as of 2000.

Moreover, the Area 1 score *is* recovering following the official end of the recession. The average G7 score in the golden era of small government (such as it was) in 2003–7 was 5.94. At its lowest point in 2010, it was 5.26. As of 2012, Area 1 recovered 32.3 per cent of its way to its

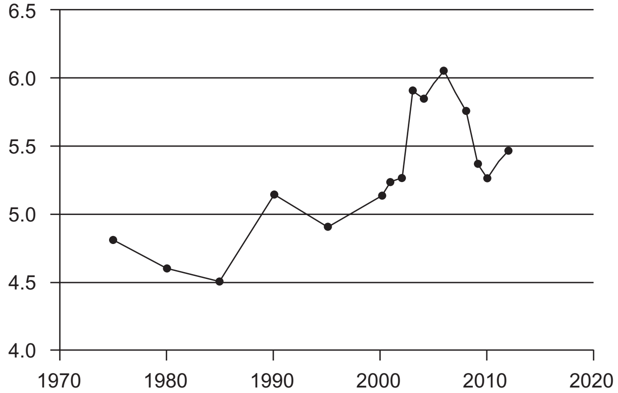


Figure 3: Average G7 Size of Government.

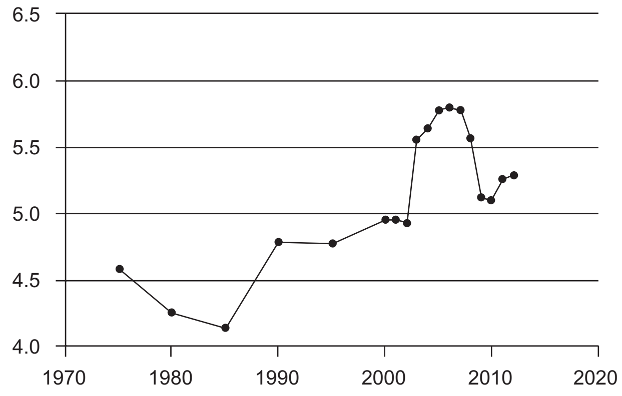


Figure 4: Average OECD Size of Government.

2003–7 average, up to 5.48. While one would wish governments had not expanded at all relative to the size of the economy during the Great Recession, and perhaps improved on previous record highs, the rate at which Area 1 has recovered is certainly reasonable given the constraints of politics and ideology. Concerns regarding Area 1 are best viewed as beating back further attempts to, say, raise the top marginal tax rate, or raising red flags about long-run issues with entitlements. Changes in Size of Government do not in any way explain the decline in economic freedom in the G7 since 2000.

Area 3 (Sound Money) has even less relevance in explaining the decline in economic freedom, as the average score for advanced economies has remained essentially unchanged since 1990. Note that the index has picked up the increases in the money supply associated with quantitative easing (QE). Component 3.A (Money Growth) actually punished the US score early in the century for not growing the supply fast enough, but as of 2012 it has declined to 7.95 following the third round of QE announced on 13 September 2012. It's simply the case that the other orthodox measures of sound money have not budged.

The United States, Japan, or other countries engaging in aggressive monetary policies may see their scores decline more greatly in future editions of *Economic Freedom of the World*, but Area 3 in no way explains the measured decline in economic freedom.

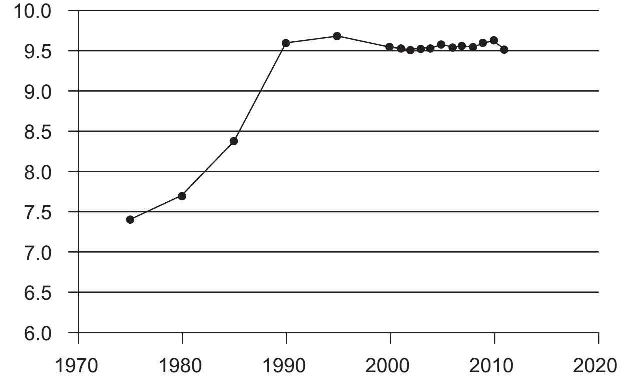


Figure 5: Average G7 Sound Money.

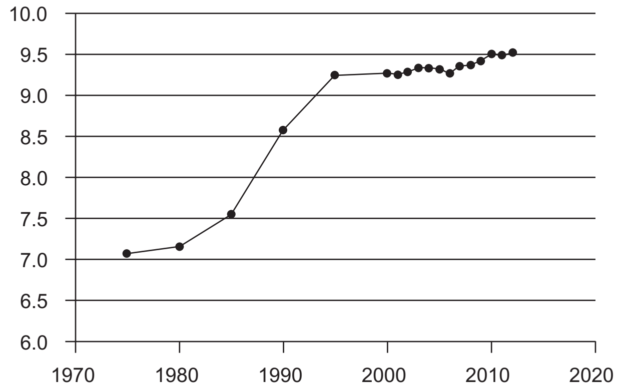


Figure 6: Average OECD Sound Money.

Another possible cause of the decline in economic freedom is the regulatory environment of the G7 in conjunction with the US Dodd–Frank Wall Street Reform and Consumer Protection Act 2010, and other new piles of paperwork propagating throughout developed nations. Area 5 (Regulation) has had its peaks and troughs, but it does not closely align with the general decline in economic freedom since 2000. The average Area 5 score for G7 countries has declined from 7.42 to 7.40; in the OECD overall it has improved from 7.22 to 7.24. The index is not nearly precise enough to allow us to argue that these changes are in any way meaningful.

The major drivers of the decline in EFW have been Area 2 (Legal System and Property Rights) and Area 4 (Freedom to Trade Internationally). The authors of *Economic Freedom of the World* have noted this in the 2014 report regarding the US but not the rest of the G7 (Gwartney, Lawson and Hall 2014, p. 15). Every member of the G7 has seen its score decline in both areas since 2000 (see Table 3). In addition, 20 out of 23 members of the OECD have seen their scores decline in Area 2[3] and *every member of the OECD has seen its score decline in Area 4*. This emergent pattern forcefully suggests we are observing the same phenomenon across all countries.

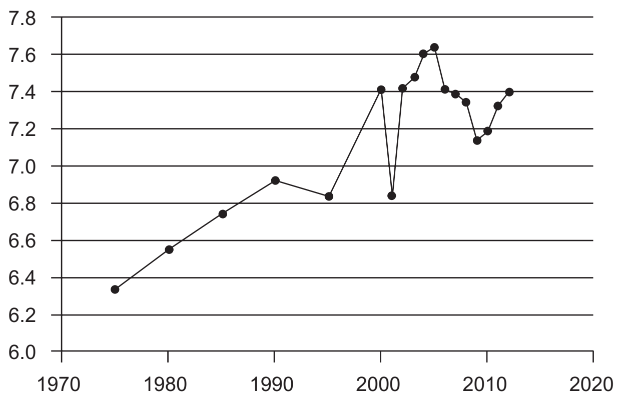


Figure 7: Average G7 Regulation.

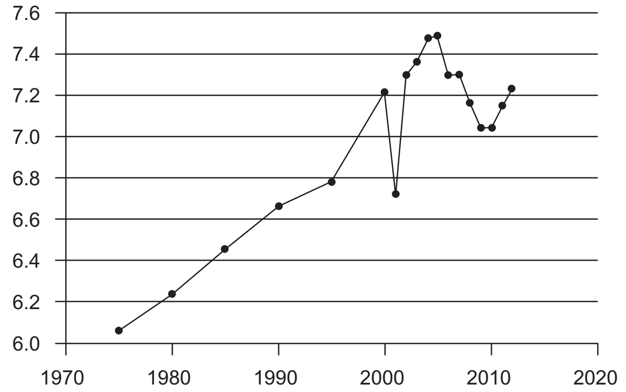


Figure 8: Average OECD Regulation.

Ironically, these two areas are those on which policy experts are most agreed. Economists do not widely agree on the optimal size of the public sector, on whether more inflation would lead to more employment, or on whether governments should deregulate.[4] But very few are willing to dispute the bedrock principles of the rule of law and free trade. Yet it is here that the most developed nations of the world are backsliding.

Table 3: Economic freedom in Area 2 and Area 4 of the G7 (chain linked), 2000 and 2012

Country	Area 2, 2000	Area 2, 2012	Area 4, 2000	Area 4, 2012
Canada	9.27	8.56	8.12	7.79
France	8.09	7.67	8.99	7.96
Germany	9.14	8.25	9.39	7.76
Italy	7.66	5.93	9.01	7.63
Japan	8.18	7.44	8.55	7.44
United Kingdom	9.29	8.59	9.40	8.52
United States	9.23	6.99	8.78	7.91

Sources: As for Table 1.

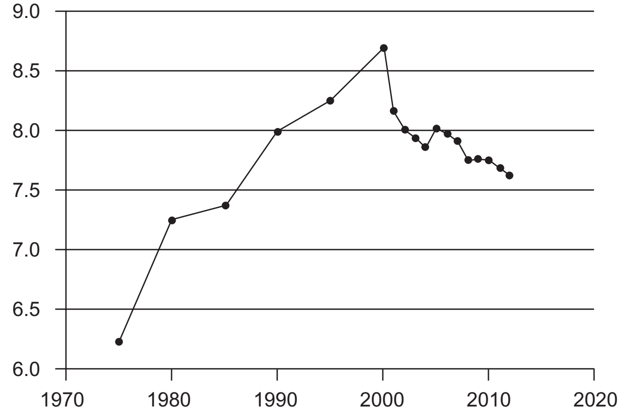


Figure 9: Average G7 Legal System and Property Rights.

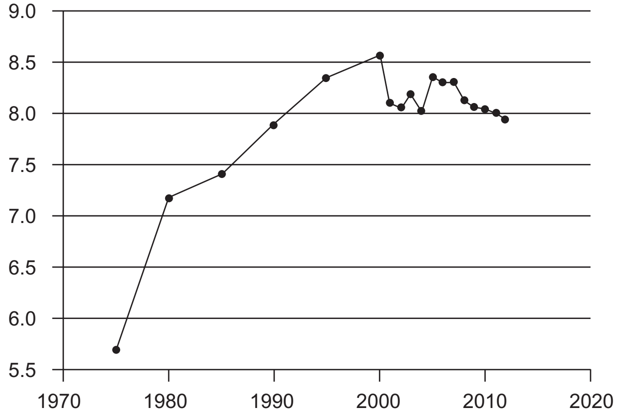


Figure 10: Average OECD Legal System and Property Rights.

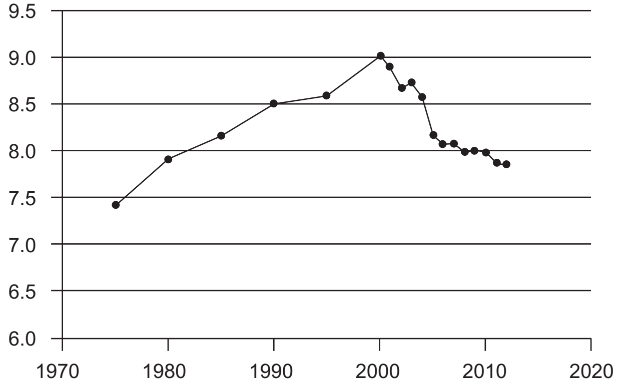


Figure 11: Average G7 Freedom to Trade Internationally.

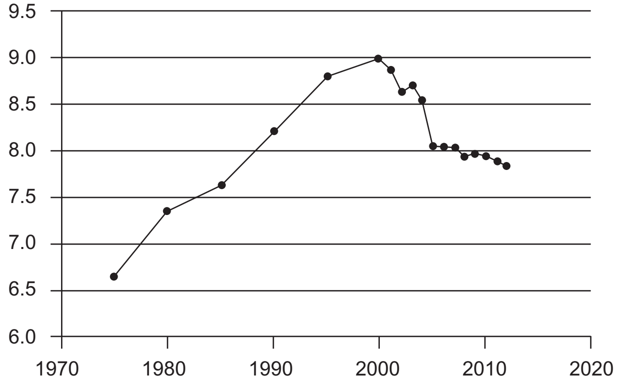


Figure 12: Average OECD Freedom to Trade Internationally.

Again, these trends do not match what is found in the Heritage Foundation's *Index of Economic Freedom*. The equivalent variable for Area 2 (property rights) is approximately stagnant (or even constant) in the G7; and the equivalent variable for Area 4 (trade freedom) is if anything trending upwards. Unfortunately the calculations of these index values are much more opaque than the calculations of EFW, making closer comparisons impossible.

What is leading to the decline in Area 2 and Area 4?

Area 2 and Area 4 (coincidentally) each consist of nine different components. The nine components of Area 2 are all compiled from surveys: the World Economic Forum's *Global Competitiveness Report*, the PRS Group's *International Country Risk Guide*, and the World Bank's *Doing Business* report. Area 4 consists in part of six 'objective' measures: Revenue from Trade Taxes (% of trade sector), Mean Tariff Rate, Standard Deviation of Tariff Rates, Black-market Exchange Rates, Capital Controls, and Freedom of Foreigners to Visit. It also employs three pieces of survey data, one from the World Bank's *Doing Business Report* and two from the World Economic Forum's *Global Competitiveness Report*.

Graphing the various components and sub-components of Areas 2 and 4 immediately reveals that *all* of the survey variables in Areas 2 and 4 have exhibited, to varying degrees, a pattern of EFW decline since 2000. For some (Judicial Independence, Integrity of the Legal System, Non-tariff Trade Barriers, and Foreign Ownership/Investment Restrictions) the relationship is particularly striking, almost monotonic over 12 years. In others (Protection of Property Rights, Regulatory Restrictions on the Sale of Real Property, and Compliance Costs of Importing and Exporting) it is less so but still arguably present. The aggregate of these surveys from Area 2 and Area 4 is shown in Figure 13, and the graphs of the sub-components in these areas are shown in the Appendix. The aggregate of Area 4 excluding its survey data is shown in Figure 14.

The survey data match the story of EFW declines since 2000 perfectly, while the other components of Area 4 do so imperfectly. The precipitate drop between 2004 and 2005 in Figure 14 appears to be driven by an utter collapse in the Area 4 sub-component, Standard Deviation of Tariff Rates, in Canada and Japan, which has been steady otherwise. The score for the sub-component Capital Controls does take on the general pattern of decline.

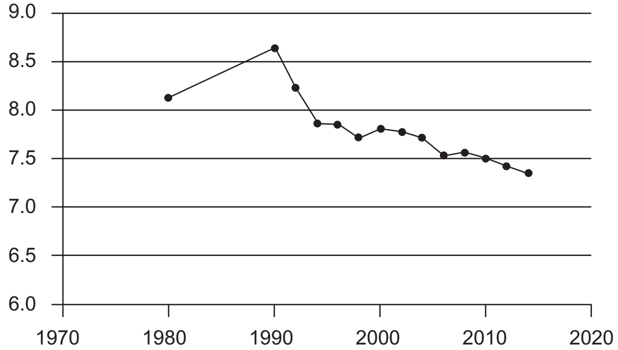


Figure 13: Area 2 and Area 4 survey data, aggregated, G7.

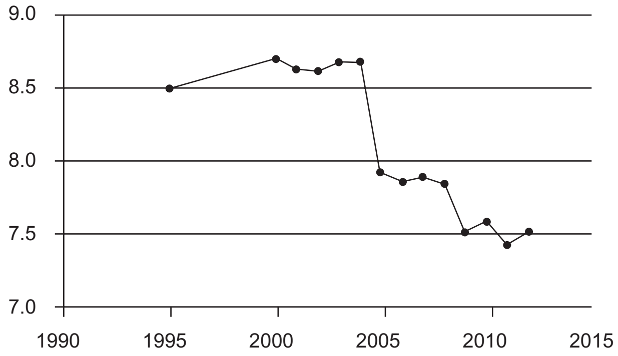


Figure 14: Area 4 excluding survey data, aggregated, G7.

Taken together, what this suggests is that the survey data from Area 2 and Area 4 are driving the underlying result, with correlations in Capital Controls and possibly Standard Deviation of Tariff Rates.

Conjectural analysis

One may look at these results in two ways. The surveys and the two 'objective' variables (Standard Deviation of Tariff Rates and Capital Controls) may reflect something going on in advanced economies, or the survey data should simply not be trusted. If the survey data from Areas 2 and 4 are dropped and the index recalculated, economic freedom has continued marching forward with only a blip associated with the Great Recession similar to a blip associated with the early 2000s recession, as demonstrated in Figures 15 and 16.

One can imagine reasons why the survey data may be so systematically biased. Businesspeople may simply not wish to give positive evaluations of economic institutions

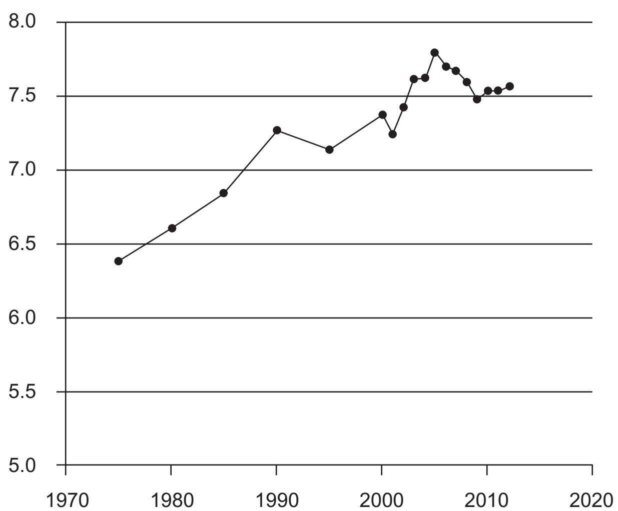


Figure 15: EFW, G7, survey variables omitted.

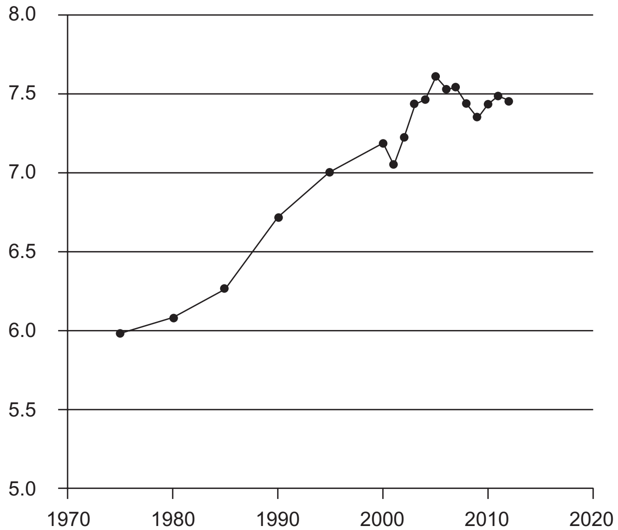


Figure 16: EFW, OECD, survey variables omitted.

following the dotcom crash, the years of the US Bush presidency (2001–9), and the Great Recession.

Alternatively, the G7 may appear to be no longer performing well relative to emerging economies, which have greatly improved their economic institutions. It is worth noting that these patterns do not persist if we look at the developed city states instead of the developed major economies (see Table 4).

While it appears some of the forces afflicting the major world economies may be in play here, these city states do not tightly follow the patterns found in the G7 and, to a slightly lesser extent, the OECD. It should be noted that the major exception to OECD countries with falling Area 2 scores was Luxembourg, which is perhaps better grouped with these city states. Possibly, businesspeople trust these dynamic city states, but are wary of the economic malaise of 'real' countries.

This scenario – that economic freedom isn't actually declining in the developed world – is sanguine regarding the state of the world but not for the accurate measurement of economic freedom. Survey data comprise the entirety of Area 2. And what Area 2 intends to measure is undoubtedly significant. There are limits to what 'objective' variables could either substitute for the survey data or at least to how they might perform in a reality check. Homicide rates, which

Table 4: Area 2 and Area 4 of developed city states of the world (chain linked), 2000 and 2012

City state	Area 2, 2000	Area 2, 2012	Area 4, 2000	Area 4, 2012
Bahrain	6.54	6.25	8.71	8.60
Hong Kong	7.23	7.76	9.72	9.26
Luxembourg	8.62	8.87	9.46	8.17
Singapore	8.53	8.07	9.15	8.67
UAE	7.52	7.56	8.58	8.66

Sources: As for Table 1.

should at least be somewhat reliable in evaluations of G7 countries, should intuitively be correlated negatively with Area 2, but it certainly appears that they continue to improve even within advanced economies (Pinker 2011). So there is a case that *all* of our narratives regarding the backwards trajectory of economic freedom are misguided, but it is not especially clear what we can do about measuring it in the future.

Alternatively, we may take the data at face value. If we do, the simplest (best) explanations are those which can explain the EFW falls in both Area 2 and Area 4. The two following explanations are purely conjectural, and, realistically speaking, simply fit narratives to facts.

1. *9/11 changed everything*. America and her allies became much more careless regarding the rule of law. The US Patriot Act 2001 and similar measures undermined basic civil liberties. Simple international transactions now require excessively burdensome paperwork and oversight. The fall in EFW is the empirical counterpart to the sacrifice of liberty to 'security' throughout the developed world since 2001.
2. *The growth of an insider-serving regulatory structure*. What makes the headlines is cuts in overall tariff rates, but certain countries have better targeted the protection of key, politically connected industries. All countries have sought to raise the fixed costs of exporting and importing, and in doing so keep their protectionism off the books. Meanwhile, courts are increasingly tilted towards businesses that have kept up with their contributions to political campaigns. The fall in EFW is the empirical counterpart to the growth of crony capitalism.

While I would prefer to follow the 'rule of three' and provide a third option, little else presents itself. Recent inequality-driven sabre-rattling for higher marginal tax rates notwithstanding, what EFW has measured has not been the traditional fears of market-oriented economists, such as about the growth in the size of government. What we have measured is the simultaneous collapse of the basic institutions of law and trade, but only when measured by soft data. Few narratives fit such facts.

Conclusion

The apparent decline in economic freedom as measured by *Economic Freedom of the World* is not specific to the United States. It has occurred throughout the world's most advanced economies. This phenomenon has not, so far, been driven by the increasing size of government, inflation, or the growing regulatory state. It has been driven by the decline of the basic institutions of law and trade.

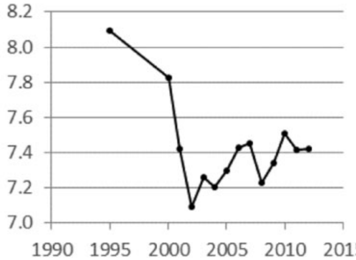
Both of these declines almost entirely reflect significant trends revealed in survey data. If these surveys were excluded from the index, there would be no overall decline in EFW to speak of. It is entirely possible that these surveys are capturing other factors unrelated to Area 2 and Area 4, such as the attitudes of businesspeople towards the most advanced economies. If these surveys do reflect reality, they do not cohere well with many standard narratives regarding America's decline. The narratives that best fit the facts are the West's response to terrorism following 9/11 and a rise in crony capitalism. Whether the truth lies in either narrative, misleading data, or something else entirely, the trend is unsettling.

Appendix

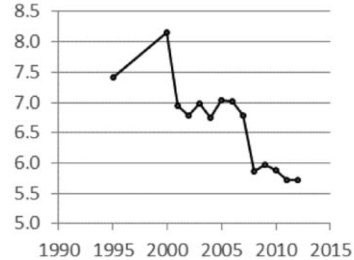
Components of Area 2 and Area 4 for EFW in G7

I do not provide graphs of component 4.C (Black-market Exchange Rates) or sub-component 4.D.(iii) (Freedom of Foreigners to Visit). During the relevant periods these were constant, with the values of 10 and 6.53, respectively.

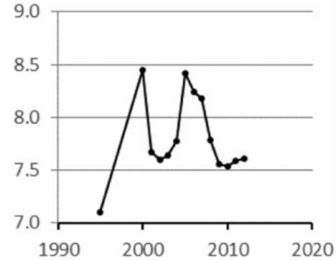
When aggregating the sub-components, I chain linked them as the index does to the areas so that the results would not be misleading as new data came online.



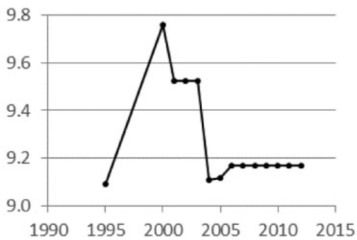
2.A, Judicial Independence.



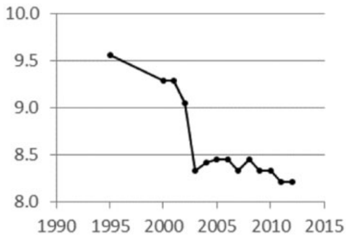
2.B, Impartial Courts.



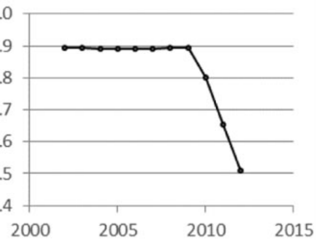
2.C, Protection of Property Rights.



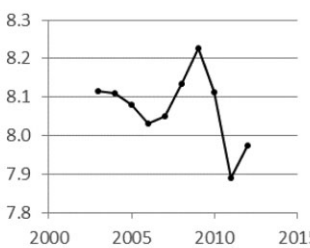
2.D, Military Interference.



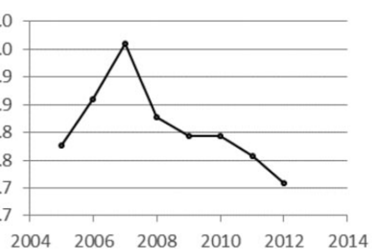
2.E, Integrity of the Legal System.



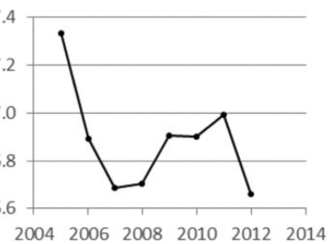
2.F, Legal Enforcement of Contracts.



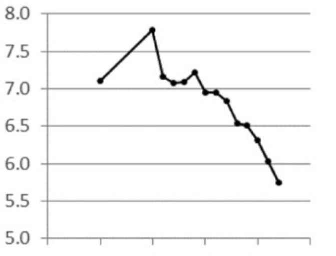
2.G, Regulatory Restrictions on the Sale of Real Property.



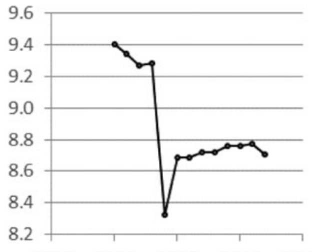
2.H, Reliability of Police.



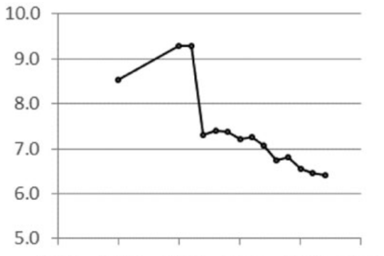
2.I, Business Cost of Crime.



4.B.(i), Non-tariff Trade Barriers.



4.B.(ii), Compliance Costs of Importing and Exporting.



4.D.(i), Foreign Ownership/ Investment Restrictions.

Notes

1. Under 'chain linking', new data are not included the first year they are available. In subsequent years, the change in the value of the new data is taken into account. This addresses the problem of the index behaving chaotically when new data are introduced. It is preferable to the unadjusted index when making comparisons across time, as is done here.
2. 'OECD' here refers to nations that were part of the OECD as of 1990, so as to exclude countries that were not at the 'frontier' as of 2000. Even this definition has issues, as Turkey, for example, is included, whose patterns of institutional change are very distant from much of the rest of the OECD.
3. Ireland has improved by 0.02 and New Zealand has improved by an invisibly small amount. Luxembourg has improved by 0.25 points by apparently improving its crime-related scores (the Area 2 components Reliability of Police and Business Costs of Crime).
4. If anything, there is widespread agreement on the need for increasing inflation, thereby 'hurting' Area 3.

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