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How the Scope of Government Shapes the Wealth of Nations

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A wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government...

—Thomas Jefferson

There are two nearly universally accepted broad principles on the scope of government and its impact on economic growth.

First, some level of government spending is necessary to ensure that the basic structures of society function smoothly enough to facilitate economic activity.

Second, excessive government spending shifts resources from the private sector and impedes economic growth.

Between these two principles lies an ocean of possibilities encompassing the small-government tendencies of Hong Kong, Ireland, New Zealand, Singapore, and the United States; the decidedly robust government philosophies of the countries of Western Europe; and the many developing countries that hope to use government spending to meet their development goals.

Change in the perception of the beneficial role of government in facilitating economic growth has been jarring in the post–World War II era, swinging from advocacy of extensive government involvement in the decades following the war to a general acknowledgement today, with the demise of the communist exper-

Talking Points

- For development to occur, governments must remove obstacles that prevent their people from seizing opportunities to benefit them, their families, and their communities. A key element of this process is reducing the excessive size and scope of government.
- Developed countries can assist development by encouraging good policy and opening their markets to developing country products, but success in development ultimately depends on developing countries adopting and implementing policies that promote economic freedom, good governance, and the rule of law.
- The *Index of Economic Freedom* is useful in pursuit of these improvements because it provides an objective measure of progress in areas that may otherwise seem overwhelming. The *Index* can show where a government lags behind its peers and provide guidance on how to improve through specific policy changes.

This paper, in its entirety, can be found at: *www.heritage.org/research/tradeandforeignaid/hl925.cfm*

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iment in the former Soviet Union, that too much government expenditure and intervention unduly impedes the private-sector activity that is the key to long-term economic growth. This swing from a leading role for government to a supporting role has profound implications for developing countries that spent the early post-independence years pursuing development based on heavy government intervention only to discover in the past couple of decades the detrimental effects of such a strategy.

Until about 1980, development theory was dominated by a government-led model based on the premise that government action was necessary to elevate developing economies from a low-income, low-growth path onto a high-income, high-growth path. The key to this elevation was government-subsidized and direct investment, extensive state involvement in the economy, and policies designed to shelter and foster domestic industrialization. Foreign aid was used to augment government resources in this effort, which only encouraged the expansion of government.

Growing realization that this development model had failed to deliver economic growth led to re-evaluation of the approach and ushered in the early years of the "Washington Consensus" that emphasized smaller government, economic liberalization, and trade.[1] Over the subsequent two decades, some developing countries have made tentative steps toward reducing the scope of government and adopting policies consistent with economic freedom—lower trade barriers, stable money, privatization, and elimination of price controls. Few have followed through and reduced the size of government, however. On the contrary, many have moved in the opposite direction.

This poses a big problem. As anyone familiar with government can assert with certainty, few things are as permanent as a temporary government agency, and government is far more difficult to shrink than to grow. Yet this is the task facing most of sub-Saharan Africa, where many countries continue to have large governments that exert a drag on economic growth, which undermines what should be the primary objective of those governments.

Sub-Saharan Africa is the world's poorest continent, with nearly half of its 719 million people subsisting on less than $1 per day.[2] Worse, the continent on average has grown poorer over the past two decades despite enormous aid disbursements and substantial gains in technology and trade that have helped boost growth in other regions. Even Africans seek investment opportunities outside the continent: The *Economist* magazine estimates that 40 percent of the region's privately held wealth is held outside the region.[3]

No other region of the world more urgently needs economic growth. The stakes are enormous. The difference in real growth in gross domestic product (GDP) of 3 percent annually and 1 percent is nearly 50 percent over 20 years and well over 150 percent over 40 years. To close the gap with wealthy nations, the countries of sub-Saharan Africa must achieve sustained high rates of real growth in GDP for decades. Yet, instead of desperately needed economic growth, sub-Saharan Africa as a region saw a decline in per capita GDP from $575 in 1980 to $524 in 2003 (in 2000 dollars).[4]

1. The fallacy of this model was perceived far earlier by Lord Bauer, who reiterated his rejection of the notion that developing countries were trapped in their poverty unless external assistance were provided in his essay "The Disregard of Reality," noting that "it is in obvious conflict with simple reality. Throughout history innumerable individuals, families, groups, societies, and countries—both in the West and the Third World—have moved from poverty to prosperity without external donations. All developed countries began as underdeveloped. If the notion of the vicious circle were valid, mankind would still be in the Stone Age at best." See Peter Bauer, "The Disregard of Reality," *Cato Journal*, Vol. 7, No. 1 (Spring/Summer 1987), pp. 29–42, at *www.cato.org/pubs/journal/cj7n1/cj7n1-3.pdf*.
2. Population data from World Bank, *World Development Indicators 2005*, at *www.worldbank.org/data/onlinedatabases/onlinedatabases.html* (September 14, 2005; subscription required). Estimate of the number living on a dollar a day from World Bank, Regional Brief for Sub-Saharan Africa, at *http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/0,,menuPK:258652~pagePK:146732~piPK:146828~theSitePK:258644,00.html*.
3. "First Get the Basics Right," *The Economist*, January 15, 2004.

The solution to this lack of growth is not more government. On the contrary, the evidence indicates that the solution is less government, administered better. I therefore thought that the sponsors of this conference were on target in asking me to speak on "How the Scope of Government Shapes the Wealth of Nations."

Government Expenditures and Economic Growth

What is the optimal level of government to maximize economic growth? It is an old question dating back to the birth of modern economics and Adam Smith's *Wealth of Nations*, which in part discussed the proper role or scope of government in facilitating wealth. Smith advocated a free market under which rational self-interest contributed to general economic well-being—the famous invisible hand.

However, Smith did not reject government as altogether unnecessary or detrimental to economic prosperity. On the contrary, he believed that government had an important role to play through enforcement of contracts; provision of patents and copyrights to encourage innovation; construction of public works like roads and bridges unlikely to tempt private investment; and, of course, providing for national security both internally through law enforcement and externally to protect the nation from foreign threats.

The basic premise set forth by Adam Smith—i.e., that there are certain key functions of government that facilitate economic activity and thereby contribute to increased economic growth—is nearly universally accepted by economists. Indeed, almost everyone can identify circumstances in which government spending enhances economic growth. As noted by Heritage Foundation economist Daniel Mitchell, "Economic activity is very low or nonexistent in the absence of government, but it jumps dramatically as core functions of government are financed."[5] Even in this beneficial role, however, government is not costless; it simply means that the benefits outweigh the costs. All of this is related to a concept, called "dead weight loss," used by economists to reflect economic loss caused by government inefficiencies.

Therein lies a problem. The notion of the beneficial impact of government spending has been used to justify expansion of government beyond the point where benefits outweigh costs. Indeed, growth in government expenditures in modern times has been in areas well outside of the core areas generally acknowledged as advantageous by Smith and his modern colleagues: secure property rights, contracts enforcement, an independent and impartial court system to resolve disputes, a stable monetary regime, investment in physical and human infrastructure, and providing for the national defense against external threats.

In developed economies, the public good argument has been used to justify extensive welfare states requiring government spending equivalent to well over half of GDP. Developing country governments identify the many shortcomings in their countries' development as justifications for a more robust role for government. This reasoning may sound attractive, but it is important to note that economic theory indicates that such an expansion of government should negatively affect economic growth through inefficiencies created by government expenditures and the means for financing those expenditures. There are many reasons for this to occur.[6]

1. **Government expenditure often involves unforeseen costs.** Government expenditures to protect people and property can facilitate economic growth by helping the smooth operation of a market economy. However, government expenditures also are used in ways that retard growth, such as supporting regulatory policies that exert compliance costs far exceeding their budgets or the benefits resulting from

4. World Bank, *World Development Indicators 2005*.
5. Daniel J. Mitchell, Ph.D., "The Impact of Government Spending on Economic Growth," Heritage Foundation *Backgrounder* No. 1831, March 15, 2005, p. 4, at *www.heritage.org/Research/Budget/bg1831.cfm*.
6. *Ibid.*

their activities. Similarly, government may be less efficient than the private sector in providing services. An historical example that was pervasive in sub-Saharan Africa is the government telephony monopolies that provided poor service until forced to improve by private-sector competition from cellular networks.

2. **Government expenditures distort markets.** Government spending often distorts allocation of resources. Competitive markets ensure that resources are allocated efficiently through numerous private transactions under which prices and value for those resources is established. Government spending can interfere with competitive markets by establishing a "third-party payer" problem that disconnects end users from costs. This creates a lack of concern about prices that undermines competitive markets and increases inefficiency.
3. **Government expenditures require taxes and/or borrowing that burdens the economy.** The government cannot spend money without taking it from someone. Taxes discourage productive activities by imposing a cost on work, savings, and investment. Borrowing must be paid eventually, implying a future tax burden, and diverts investment resources from the private sector.
4. **Government expenditures lack key elements of entrepreneurship that contribute to economic growth.** Risk associated with investment, research, and innovation in technology and production is critical to economic growth. Markets provide swift rewards and punishment for good versus bad decisions. The process of reward and punishment for adjusting to changing circumstances, economic incentives, information, and technologies is slower for governments.
5. **Growth in government expenditures to non-core activities often involves redistribution of income or protectionism.** Government spending may subsidize economically undesirable activities, such as agricultural subsidies in developed nations that depress commodity prices in world markets. These activities encourage individuals to focus resources on influencing government decisions and rent seeking rather than on production: "away from wealth-creating activities toward the pursuit of wealth transfers."[7]

All of this suggests that increasing government expenditure boosts growth only at relatively low levels. Eventually, the benefits of public outlays no longer exceed the distortion effects of government activities and the taxation and/or borrowing necessary to finance those activities.

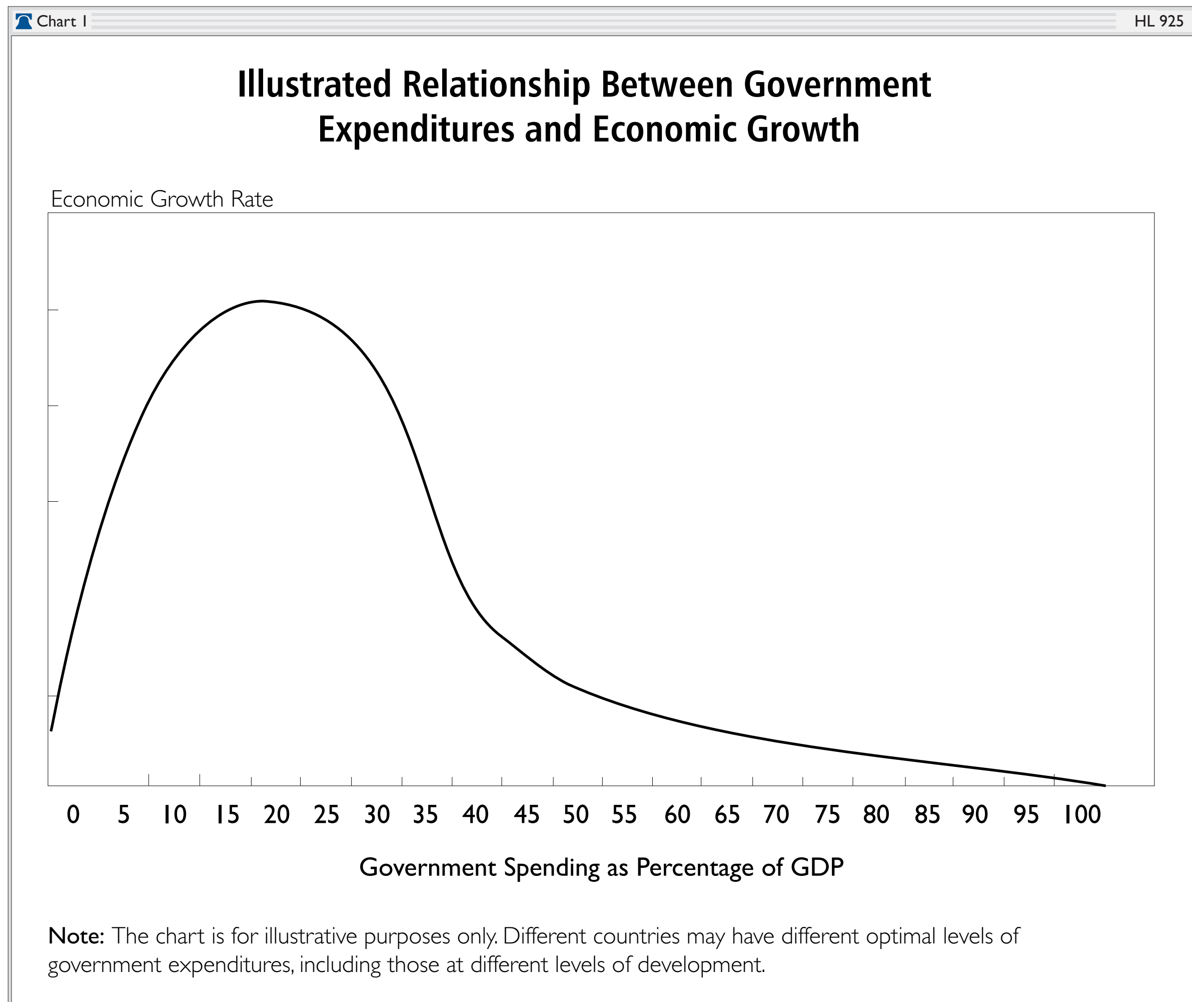
At zero government expenditures or anarchy, economic growth is low because of risk, and uncertainty is heightened by the absence of security, contract enforcement, and other public goods that enhance economic activity. Growth improves until an indeterminate point at which the dead weight loss of government exceeds the benefits of that expenditure. Growth declines as the government share of the economy increases toward a totalitarian system. At the extreme, government takes all that is produced, removing incentives to work, innovate, and produce, resulting in minimal economic growth.

Several researchers have published curves similar to that in Chart 1, which illustrates this relationship of government expenditure to economic growth. The chart should not be taken as absolute. Different countries may have different optimal levels of government expenditures, including those at different levels of development.

Evidence on Government Expenditures and Growth

As observed by Mitchell, "Economic theory is important in providing a framework for understanding how the world works, but evidence helps to determine which economic theory is most accurate."[8] As he and others have concluded in a multitude of economic studies, the evidence of a negative relationship between higher government

7. James Gwartney, Randall Holcombe, and Robert Lawson, "The Scope of Government and the Wealth of Nations," *Cato Journal*, Vol. 18, No. 2 (Fall 1998), p. 169.
8. Mitchell, "The Impact of Government Spending on Economic Growth."



Note: The chart is for illustrative purposes only. Different countries may have different optimal levels of government expenditures, including those at different levels of development.

expenditures and economic growth is strong.[9] Mitchell compared the United States and the original 15 members of the European Union. Compared to the U.S., the EU-15 had substantially higher levels of government spending with correspondingly high levels of taxation and debt. The U.S. performed substantially better in terms of economic growth, unemployment, and living standards.[10]

James Gwartney, Randall Holcombe, and Robert Lawson tested the impact of increased government expenditures on economic growth in 23 Organisation for Economic Co-operation and Development (OECD) member countries between 1960 and 1996. These countries share many characteristics that might otherwise influence growth. All were stable democracies over the period considered and had a well-founded rule of law, a history of sound money in that they avoided hyperinflation, relatively open trade regimes, and educated populations. Despite their similarities, differences in government expenditure among those countries resulted in substantial differences in growth. According to the authors, "As the size of government increased, the average growth rate persistently fell…. The data clearly illustrate an inverse relationship between the year-to-year growth of real GDP and the size of government in OECD countries during the 1960–96 period."[11] Their research concluded that a 10 percentage point increase in government expenditures led to a reduction in economic growth of approximately 1 percentage point.

A 2001 study by Bernhard Heitger of the Kiel Institute of World Economics examined the

impact of government expenditures in 21 OECD countries from 1960 to 2000. He noted a substantial growth in average government expenditures over that period and a corresponding decline in average economic growth. After controlling for physical capital formation, growth rate in the labor force, human capital formation, and relative per capita income, he concluded that "the relationship between government expenditures and economic growth is negative and highly significant: The larger the scope of government in OECD countries was the more pronounced was the decline in economic growth."[12] He estimated that a 10 percentage point reduction in government expenditures by OECD countries would boost economic growth by about 0.5 percentage point on average.

Other studies have found a similar negative relationship. The well-known study by Robert Barro found that "the ratio of real government consumption expenditure to real GDP had a negative association with growth and investment."[13] A New Zealand Business Roundtable study found that "An increase of 6 percentage points in government consumption expenditure as a percentage of GDP, (from, say 10 percent to 16 percent) would tend to reduce the annual rate of growth of GDP by about 0.8 percent."[14] A National Bureau of Economic Research study concluded that "An increase in government spending by 1 percentage point of trend GDP decreases profits as a share of the capital stock by about 1/10 of a percentage point."[15]

Although examples of OECD countries reducing government expenditures are few and far between, Gwartney, Holcombe, and Lawson examined the three instances of substantially reduced government expenditures among the OECD countries between 1960 and 1996: Ireland from 1986 to 1996, New Zealand from 1992 to 1996, and the United Kingdom from 1982 to 1989. In each case,

9. European Commission, Directorate-General for Economic and Financial Affairs, "Public Finances in EMU, 2003," *European Economy*, No. 3 (2003), at *europa.eu.int/comm/economy_finance/publications/european_economy/2003/ee303en.pdf*; Vito Tanzi and Howell H. Zee, "Fiscal Policy and Long-Run Growth," International Monetary Fund *Staff Papers*, Vol. 44, No. 2 (June 1997); Dong Fu, Lori L. Taylor, and Mine K. Yücel, "Fiscal Policy and Growth," Federal Reserve Bank of Dallas *Working Paper* No. 0301, January 2003; Stefan Fölster and Magnus Henrekson, "Growth and the Public Sector: A Critique of the Critics," *European Journal of Political Economy*, Vol. 15, No. 2 (June 1999); S. M. Miller and F. S. Russek, "Fiscal Structures and Economic Growth at the State and Local Level," *Public Finance Review*, Vol. 25, No. 2 (March 1997); Robert J. Barro, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics*, Vol. 106, No. 2 (May 1991); Stefan Fölster and Magnus Henrekson, "Growth Effects of Government Expenditure and Taxation in Rich Countries," *European Economic Review*, Vol. 45, No. 8 (August 2001); P. Hansson and M. Henrekson, "A New Framework for Testing the Effect of Government Spending on Growth and Productivity," *Public Choice*, Vol. 81 (1994); James S. Guseh, "Government Size and Economic Growth in Developing Countries: A Political-Economy Framework," *Journal of Macroeconomics*, Vol. 19, No. 1 (Winter 1997); Kevin B. Grier and Gordon Tullock, "An Empirical Analysis of Cross-National Economic Growth, 1951–80," *Journal of Monetary Economics*, Vol. 24, No. 2 (September 1989); Andrea Bassanini and Stefano Scarpetta, "The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries," Organisation for Economic Co-operation and Development *Economic Studies* No. 33, February 2002, at *www.oecd.org/dataoecd/26/2/18450995.pdf* (February 2, 2005); Alberto Alesina, Silvia Ardagna, Roberto Perotti, and Fabio Schiantarelli, "Fiscal Policy, Profits, and Investment," National Bureau of Economic Research *Working Paper* No. 7207, July 1999; Vito Tanzi and Ludger Schuknecht, "Reforming Government in Industrial Countries," International Monetary Fund *Finance & Development*, September 1996, at *www.imf.org/external/pubs/ft/fandd/1996/09/pdf/tanzi.pdf*.
10. Mitchell, Ph.D., "The Impact of Government Spending on Economic Growth."
11. Gwartney, Holcombe, and Lawson, "The Scope of Government and the Wealth of Nations," p. 172.
12. Bernhard Heitger, "The Scope of Government and Its Impact on Economic Growth in OECD Countries," Kiel Institute of World Economics *Working Paper* No. 1034, April 2001, p. 15, at *www.uni-kiel.de/ifw/pub/kap/2001/kap1034.pdf*.
13. Barro, "Economic Growth in a Cross Section of Countries," p. 407.
14. Winton Bates, "How Much Government? The Effects of High Government Spending on Economic Performance," New Zealand Business Roundtable, July 2001, p. 33.
15. Alberto Alesina, Silvia Ardagna, Roberto Perotti, and Fabio Schiantarelli, "Fiscal Policy, Profits, and Investment," National Bureau of Economic Research *Working Paper* No. 7207, July 1999, p. 4.

the reduction in government expenditures led to periods of substantially improved growth.[16]

What about developing countries? The lack of data makes duplicating the work done by others on OECD nations difficult for sub-Saharan Africa. Results on most efforts that I and my colleagues conducted were not statistically significant, and results suffered from problems of limited data on control variables.

However, some cross-country studies that incorporated developing countries have been conducted. When Gwartney, Holcombe, and Lawson expanded their study to include 60 countries, they reached conclusions similar to those of their OECD analysis, finding that a 10 percentage point increase in government expenditure as a percent of GDP from 1980 was associated with "approximately a six-tenths of a percentage point reduction in growth during the entire 15-year period."[17] Even after controlling for protection of property rights, inflation, education, and investment, the data suggest a strong, independent effect by size of government on growth of real GDP.

An article in the *Journal of Monetary Economics* looked at region breakdowns, finding that:

> In Africa and the Americas, government growth is significantly negatively correlated with GDP growth, and though the coefficients are smaller than what we observe for the OECD, government growth is more variable in these countries so that a one standard deviation increase in government growth reduces GDP growth by 0.58 points in Africa and 0.25 points in the Americas.[18]

So what is the optimal size of government? Some have made stabs at answering this question, but in most cases the answer seems best characterized as "it depends on the country, but less than is the case in most countries." On the assumption that government expenditures on public order and safety, national defense, education, and transportation and communication comprised "core" functions of government, Heitger notes:

> The empirical analysis of national accounts of the main OECD countries revealed that the supply of public goods in the 90s only accounted for about 14 percentage points of gross domestic product. Given the observation that the scope of government in European OECD countries, as measured by government shares, on average accounted for about 50 per cent of gross domestic product one may suggest that these countries have significantly surpassed the "optimum" of government activities….[19]

Milton Friedman observed that "Government has an essential role to play in a free and open society. Its average contribution is positive; but I believe that the marginal contribution of going from 15% of the national income to 50% has been negative."[20] A 1996 article by Georgios Karras noted that "the optimal government size is 23 percent for the average country but ranges from 14 percent for the average OECD country to 33 percent in South America; and the marginal productivity of government services is negatively related to government size."[21]

An interesting observation from Vito Tanzi and Ludger Schuknecht undermines the arguments of those who use social improvements to justify increased government expenditure. In their 1997 study, they found that:

16. Gwartney, Holcombe, and Lawson, "The Scope of Government and the Wealth of Nations," pp. 184–186.

17. *Ibid.*, p. 182.

18. Kevin B. Grier and Gordon Tullock, "An Empirical Analysis of Cross-National Economic Growth, 1951–80," pp. 259–276.

19. Heitger, "The Scope of Government and Its Impact on Economic Growth in OECD Countries," p. 20.

20. Milton Friedman, "If Only the U.S. Were as Free as Hong Kong," *The Wall Street Journal*, July 8, 1997, p. A14.

21. Georgios Karras, "The Optimal Government Size: Further International Evidence on the Productivity of Government Services," *Economic Inquiry*, Vol. 34 (April 1996), and E. A. Peden , "Productivity in the United States and Its Relationship to Government Activity: An Analysis of 57 Years, 1929–1986," *Public Choice*, Vol. 69 (1991).

> [H]igher spending on social programs has not commensurately improved critical social indicators such as life expectancy, infant mortality, or school enrollment, suggesting that increases in public spending are not necessarily productive beyond a certain level…. [G]overnment spending needs to be no higher than 30 percent of GDP to achieve socially desirable goals.[22]

They conclude that large governments do not outperform small governments in achieving these goals.

While it is impossible to provide unassailable evidence on the exact impact of government on economic growth, given the difficulty of isolating the impact of a single element of government on overall economic performance, the research and historical examples strongly imply that excessive government expenditures retard economic growth in developed and developing counties alike. What exactly is the ideal scope of government is open to question and probably differs from country to country, but the evidence indicates that government expenditures in many countries are well beyond optimal—particularly if the overarching priority is to maximize economic growth.

The Broader Scope of Government

The above discussion indicates that excessive government spending inhibits economic growth, but is simply shrinking the size of government sufficient to catalyze economic growth in developing countries? The role of government in modern societies is profound, ranging from setting and enforcing laws to securing domestic security and stability, defending against external threats, providing public goods and services, building and maintaining infrastructure, providing the means for impartial arbitration and justice, and undertaking policies to facilitate domestic tranquility. As with most power, the power of government has two edges and possesses the potential to stimulate general welfare or erode it.

Research in development indicates that the effects of government spending are likely interrelated to any number of other government policies that either mitigate or exacerbate the consequences of government spending. Simply reducing government spending may be enough for OECD countries that share sound institutions and adherence to the rule of law, but such is not the case for most developing countries where those institutions are weak.

If it were, the ample provision of economic assistance over the past decades—the investment equivalent of manna from heaven in that the tax and borrowing implications of government spending are minimal—should have resulted in growth. Former World Bank economist William Easterly specifically analyzed the evidence on whether increased aid or investment can spur growth:

> The classic narrative—poor countries caught in poverty traps, out of which they need a Big Push involving increased aid and investment, leading to a takeoff in per capita income—has been very influential in development economics. This was the original justification for foreign aid…. *Evidence to support the narrative is scarce*…. Takeoffs are rare in the data, most plausibly limited to the Asian success stories. Even then, the takeoffs do not seem strongly associated with aid or investment in the way the standard Big Push narrative would imply.[23]

The predominance of economic research in development over the past decade indicates that bad governance (which encompasses the notion of excessive as well as inept or corrupt governance), anti-market economic policies, and a weak rule of law jointly contribute to development failures and substandard growth. They create, in effect, a per-

22. Summary of findings in Sanjeev Gupta, Luc Leruth, Luiz de Mello, and Shamit Chakravarti, "Transition Economies: How Appropriate Is the Size and Scope of Government?" International Monetary Fund *Working Paper* No. WP/01/55, May 2001, at *www.imf.org/external/pubs/ft/wp/2001/wp0155.pdf*.

23. William Easterly, "Reliving the 50s: The Big Push, Poverty Traps, and Takeoffs in Economic Development," Northwestern University, Kellogg School of Management seminar, June 1, 2005, at *www.kellogg.northwestern.edu/finance/faculty/seminars/easterly_william.pdf* (September 21, 2005). Emphasis added.

fect storm in which economic growth and development are prevented.

So how should developing countries navigate this storm? Economic studies agree on the critical importance of economic freedom, good governance, and the rule of law in promoting economic growth and reducing poverty. A World Bank study found that increased integration into the world economy from the late 1970s to the late 1990s led to higher growth in income. The more integrated countries achieved 5 percent average annual growth in per capita income during the 1990s.[24] In contrast, the non-globalizing nations experienced average growth of only 1.4 percent during the 1990s, and many experienced negative growth rates.

Gwartney, Holcombe, and Lawson found a strong positive correlation between secure property rights and economic growth: "This relationship highlights the importance of a legal structure that protects property rights, helps with the enforcement of contracts, and provides a fair mechanism—rule of law—for the settlement of disputes between parties."[25] Easterly concurs in his 2005 study, finding "support for democratic institutions and economic freedom as determinants of growth that explain the occasions under which poor countries grow more slowly than rich countries."[26]

While it may be the case that simply reducing government spending in OECD countries would be enough to spur substantial growth, the situation is more complex for developing countries. Certainly developing countries should avoid excessive government spending. Developing countries are not immune to the negative impact of excessive government spending. But developing countries face an additional aspect of the scope of government beyond spending—the effectiveness of government in providing the basic services and institutions necessary for economic activity to prosper. Thus, these countries face the dual challenge of reducing government spending while simultaneously improving government effectiveness in the core areas widely recognized as necessary for the smooth operation of the economy.

The *Index of Economic Freedom*

Providing assistance to developing countries in addressing this complex issue is one of the main purposes of the *Index of Economic Freedom*, co-published annually by The Heritage Foundation and *The Wall Street Journal*. The *Index* analyzes 50 economic indicators in 10 independent factors: trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, and informal market activity. Those 10 factors are graded from 1 to 5, with 1 being the best score and 5 being the worst score. Those scores are then averaged to give an overall score for economic freedom. Countries are designated "free," "mostly free," "mostly unfree," and "repressed" based on these overall scores. In essence, the *Index* provides a score card on where a country stands against its peers in terms of economic liberalization and, in some aspects, on good governance and the rule of law.

Our work at Heritage indicates that improvement in each of these 10 factors contributes to a country's prospects for growth. Rigid labor policies, high regulation and bureaucratic red tape, high official taxation, corruption, and trade barriers are obstacles that create a drag on economic growth. The greater the level of government intervention in the economy, the lower the probability that individuals, investors, and businesses will be able to prosper because costs on private economic activity become higher. This leads talented people to leave the country for more advantageous opportunities or to engage in activities that do not contribute to GDP (such as government service) and enrich themselves through rent seeking and corruption. The practical result is that countries with anti-market economic policies and bad governance are more likely to be poor, to be isolated from

24. Paul Collier and David Dollar, *Globalization, Growth, and Poverty: Building an Inclusive World Economy* (Washington, D.C.: World Bank and Oxford University Press, 2001), p. 5.
25. Gwartney, Holcombe, and Lawson, "The Scope of Government and the Wealth of Nations," p. 183.
26. Easterly, "Reliving the 50s," p. 29.

the international economy, and to find it more difficult to escape that poverty.

This is not to say that the *Index* sees no role for government in development or that all government intervention is counterproductive. On the contrary, the *Index* holds with the prevailing view of economics discussed above and defines economic freedom as "*the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself*." Thus, the *Index* clearly recognizes that without some government, economic growth and development is repressed. For instance, the *Index* rewards government intervention and policies that enforce an impartial and reliable rule of law through the property rights factor in the *Index*.

The rule of law serves as the supporting structure of an economy, without which it cannot operate profitably. It ensures entrepreneurs that (1) policies will have lasting power and can be changed only through transparent, widely recognized procedures, permitting an environment conducive to long-term investment; (2) the rules will apply equally to all rather than exempting some or being subject to change at the behest of the powerful; and (3) they will have legal recourse if policies unlawfully affect their activities, thereby reducing the risk of investments.

On the other hand, an arbitrary, overly onerous, or poorly enforced rule of law can prove a very strong deterrent to growth by creating opportunities for corruption or increasing the costs of complying with the law to the point where economic activity is discouraged or leaves the formal sector. In other words, governments must strike the balance between creating a secure environment for economic activity and impeding such activity. The *Index* offers an objective means for weighing the economic policies of a government in pursuit of this goal.

One inescapable conclusion from this research is that economically free countries as measured by the *Index* are associated with higher per capita incomes than countries with less free economies. Chart 2 illustrates this relationship. As shown in Chart 3, "free" countries on average have a per capita income (in purchasing power parity) twice that of "mostly free" countries; "mostly free" countries have a per capita income more than three times that of "mostly unfree" and "repressed" countries.

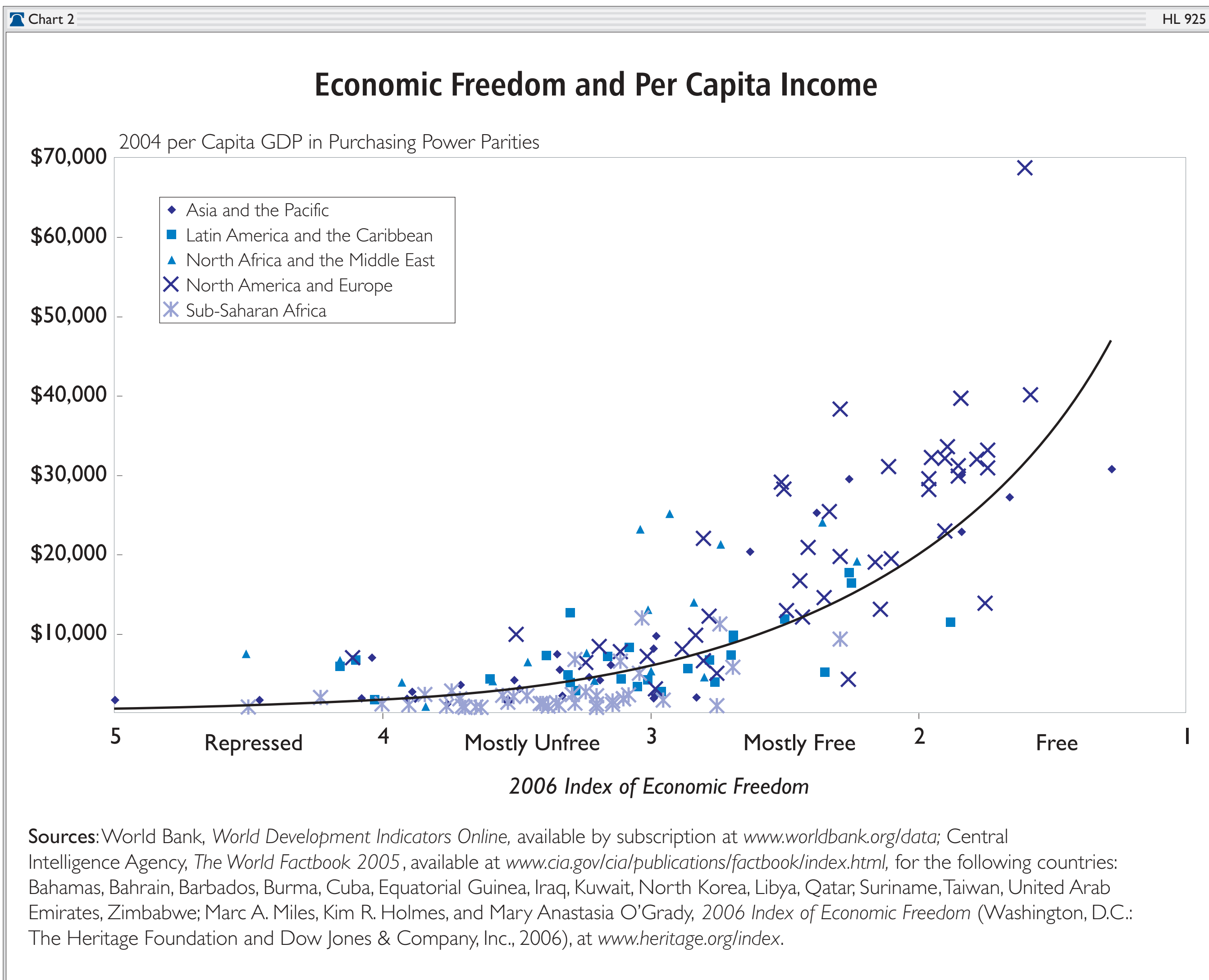
Chart 4 ranks the graded countries according to their improvement in economic freedom between 1997 and 2006.[27] Not only is a higher level of economic freedom clearly associated with a higher level of per capita GDP, but GDP growth rates increase as a country's economic freedom score improves.[28] The countries represented in the left-hand bar were most improved, and those in the right-hand bar were the least improved. Average growth rates across the nine years of changes were then computed for the countries in each bar or group. In general, the more countries improved their economic freedom, the higher average economic growth they achieved. In other words, over the past decade, countries that have consistently marched toward greater economic freedom have enjoyed the most progress toward prosperity.

Table 1 lists the sub-Saharan African countries graded by the *Index* along with their current scores and the net change in scores since they were first graded. Although average levels of economic freedom in sub-Saharan Africa remain poor and the region remains the world's least free economically, no other region has made greater strides in economic freedom than sub-Saharan Africa. The average and median economic freedom scores for sub-Saharan Africa have improved by 0.34 point and 0.37 point respectively from the 1997 *Index*—more than any other region.[29] In the 2006 *Index*, economic freedom improved in 25 sub-Saharan Africa countries and declined in 12 countries. Regrettably, these gains have been from relatively low levels of economic freedom undermining the impact of

27. The analysis does not extend to the 1996 and 1995 editions of the *Index* because they involved significantly fewer countries.

28. Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, "Executive Summary" in *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), pp. 2–3.

29. *Ibid.*, pp. 4 and 8.



Sources: World Bank, *World Development Indicators Online,* available by subscription at *www.worldbank.org/data;* Central Intelligence Agency, *The World Factbook 2005*, available at *www.cia.gov/cia/publications/factbook/index.html,* for the following countries: Bahamas, Bahrain, Barbados, Burma, Cuba, Equatorial Guinea, Iraq, Kuwait, North Korea, Libya, Qatar, Suriname, Taiwan, United Arab Emirates, Zimbabwe; Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), at *www.heritage.org/index*.

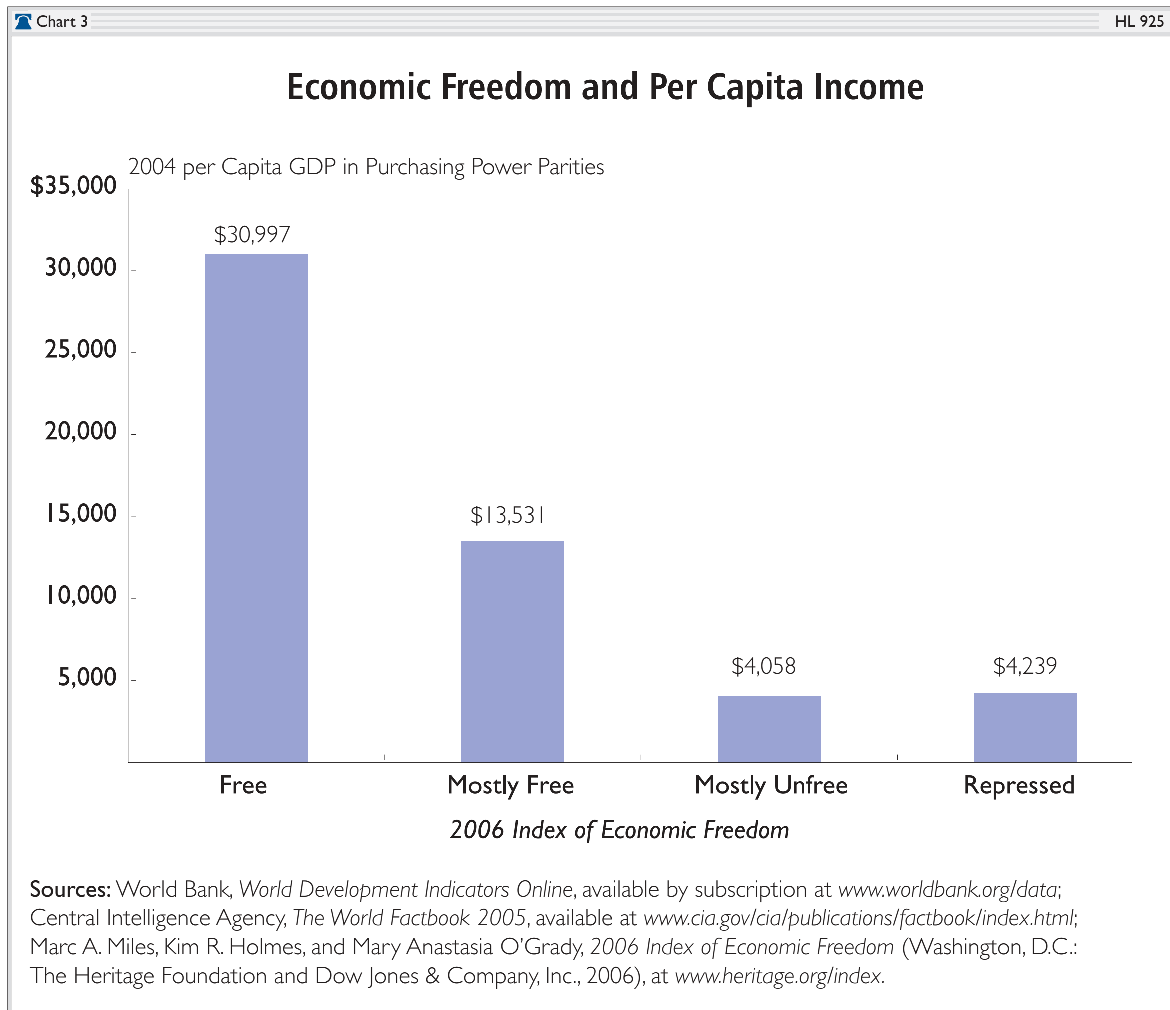
these improvements. While short-term trends are always suspect, increased growth rates in sub-Saharan Africa in recent years may indicate returns on improved economic freedom.[30]

As illustrated in Chart 5, "mostly free" economies in sub-Saharan Africa graded in the 2006 *Index* averaged a per capita GDP (in purchasing power parity) more than two times that of "mostly unfree" economies, which in turn averaged a per capita GDP about $700 greater than "repressed" economies.[31]

Similar to the trend for all countries, Chart 6 illustrates that those sub-Saharan African countries that

30. According to the U.S. Trade Representative, "In 2004, economic growth increased to an eight-year high of 5.0 percent up from 4.1 percent in 2003…. Economic growth was strongest in the oil producing states at 7.0 percent. Non-oil producing countries experienced fairly strong growth at 4.4 percent." See Office of the U.S. Trade Representative, *2005 Comprehensive Report on U.S. Trade and Investment Policy Toward Sub-Saharan Africa and Implementation of the African Growth and Opportunity Act*, May 2005, p. 16, at *www.ustr.gov/assets/Trade_Development/Preference_Programs/AGOA/asset_upload_file215_7746.pdf*.

31. There are no "free" economies in sub-Saharan Africa, although Botswana ranks among the 40 freest economies and continues to improve steadily.



improved their economic freedom score experienced higher GDP growth rates. The relationship is not as linear among the sub-Saharan African countries as it is among all countries, but in general, the countries improving most saw the greatest improvement in GDP growth rates, and the countries improving the least experienced the worst GDP growth.

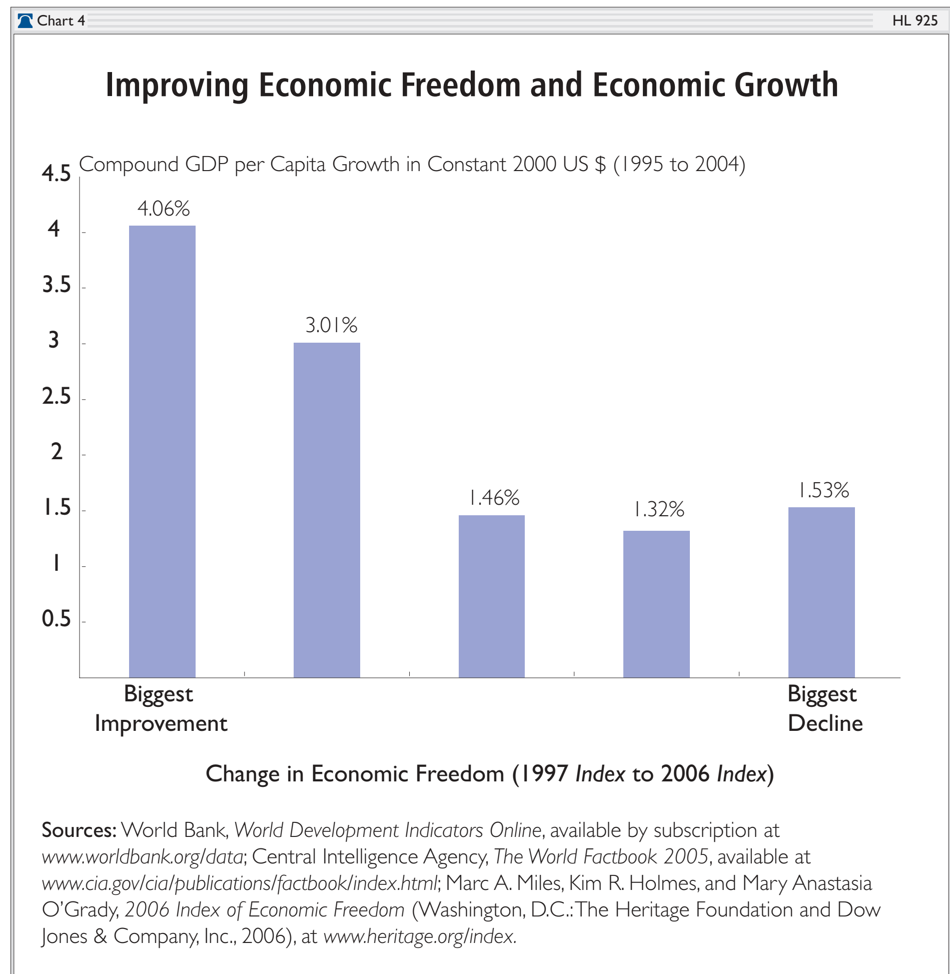
Botswana and Mauritius are good examples of these trends. Both countries have been among the world's fastest growing nations economically since 1980. Both nations have been rated "mostly free" economies for most of the time that the *Index* has graded them. Botswana is currently the freest economy in sub-Saharan Africa, and Mauritius is fifth in the region. Not surprisingly, these countries adopted economic freedom early and reaped the rewards: Compound average growth in per capita GDP for these countries during their time graded by the *Index* has averaged 3.32 percent and 3.86 percent, respectively.

The lesson is that there are no shortcuts: Policy change is necessary for economic growth and development.

Implications for Development

Among his many famous writings, Thomas Jefferson noted: "My reading of history convinces me that most bad government results from too much government." His reading has the support of economic analysis and historical examples that strongly imply that excessive government expenditures retard economic growth.

Experience with development success stories, ranging from the Asian Tigers to Africa's own Botswana, indicates that the path to development through open markets, trade, and the rule of law first blazed in Western Europe and the United States continues to be valid today. For development to occur, governments must remove obstacles preventing their people from seizing opportunities to benefit them, their families, and their communities. The evidence indicates that a key element of this process is reducing the size and scope of government.



Sources: World Bank, *World Development Indicators Online*, available by subscription at *www.worldbank.org/data*; Central Intelligence Agency, *The World Factbook 2005*, available at *www.cia.gov/cia/publications/factbook/index.html*; Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), at *www.heritage.org/index*.

While this goal may be sufficient in OECD countries, it is only a partial solution in developing countries. Certainly developing countries should avoid excessive government spending. Developing countries are not immune to the negative impact of excessive government spending. But developing countries also face problems of ineffective government, weak rule of law, and the accretion of interventionist state policies over decades. Developing countries must address all of these issues simultaneously by adopting the policies that bolster economic freedom, good governance, and the rule of law.

The *Index* is useful in pursuit of these improvements because it provides an objective measure of progress in areas that may otherwise seem overwhelming. Where do you start improving economic freedom or the rule of law? The *Index* can show where a government lags behind its peers and provide guidance on how to improve through specific policy changes.

An often overlooked advantage of developing counties is that they have the benefit of history. Nothing says that development must proceed linearly. The possibility of leapfrogging is well understood in technology—as sub-Saharan Africans should immediately appreciate as beneficiaries of the cell phone revolution.

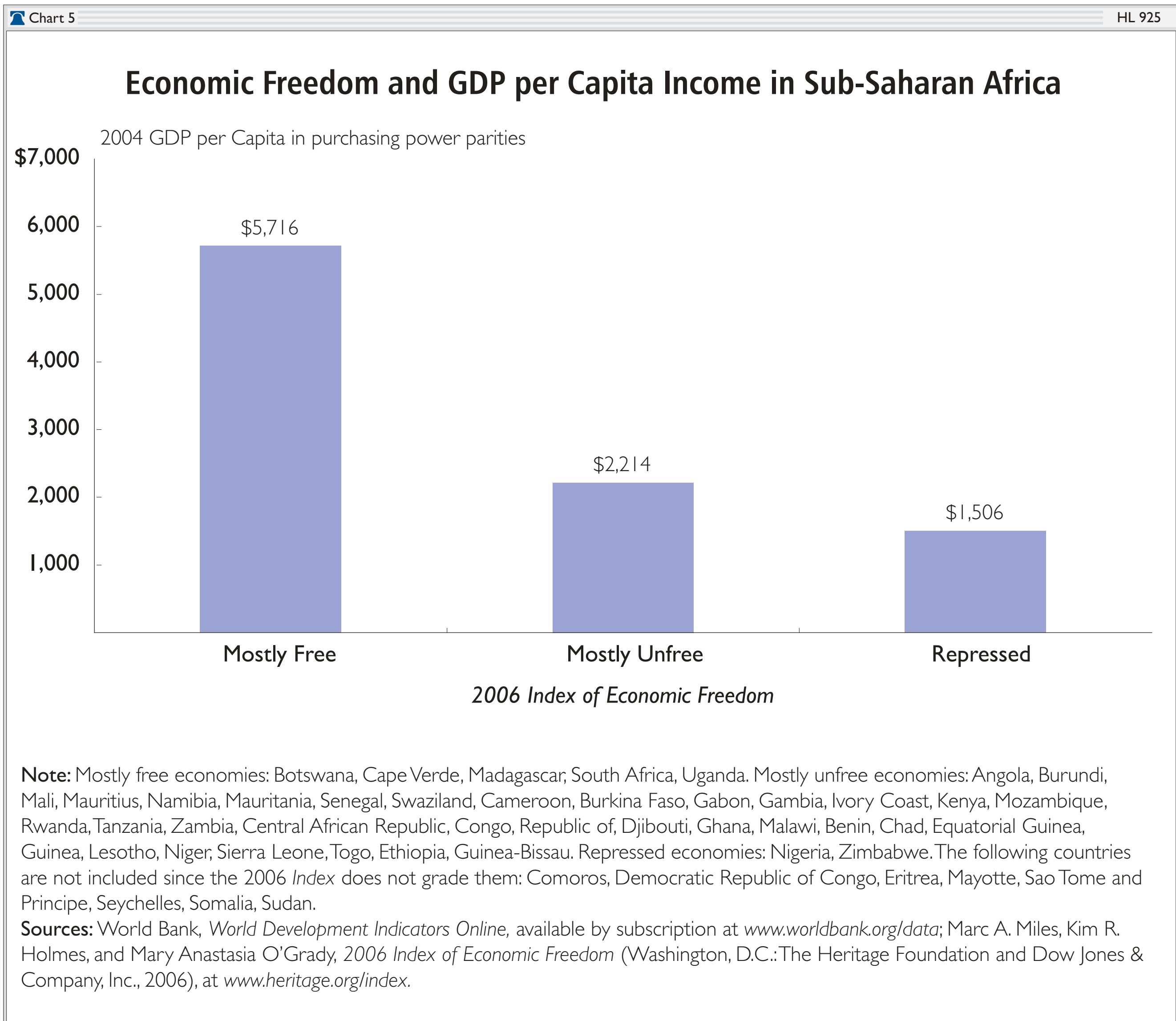
Perhaps the governments and people of sub-Saharan Africa should consider how to avoid the problems of developed countries. For instance, one of the biggest challenges facing developed countries is the financing of their welfare programs, particularly retirement and health benefit programs. Resolution of these problems is politically difficult, and developing countries would be wise to explore alternatives to the government-led welfare efforts that characterize most developed countries. The former Soviet countries are demonstrating another facet of learning from the experi-

Table 1 — HL 925

Economic Freedom in Sub-Saharan Africa

Mostly Free			Mostly Unfree						Repressed		
	2006 *Index* Score	Change in Score Since First Graded in the *Index*		2006 *Index* Score	Change in Score Since First Graded in the *Index*		2006 *Index* Score	Change in Score Since First Graded in the *Index*		2006 *Index* Score	Change in Score Since First Graded in the *Index*
Botswana	2.29	1.04	Mauritius	3.03	(0.30)	Zambia	3.34	(0.19)	Zimbabwe	4.23	0.14
Madagascar	2.75	0.99	Mauritania	3.08	0.80	Tanzania	3.20	0.59	Nigeria	4.00	(0.62)
South Africa	2.74	0.49	Senegal	3.10	0.66	Central African Republic	3.41	(0.10)			
Cape Verde	2.69	0.86	Swaziland	3.04	0.31	Equatorial Guinea	3.74	0.62			
Uganda	2.95	0.20	Namibia	3.11	(0.31)	Niger	3.38	0.82			
			Mali	3.14	0.34	Rwanda	3.53	1.07			
			Ivory Coast	3.14	0.29	Cameroon	3.46	0.05			
			Burkina Faso	3.28	0.63	Benin	3.40	0.13			
			Guinea	3.55	(0.26)	Malawi	3.63	0.11			
			Kenya	3.20	0.25	Togo	3.71	0.43			
			Djibouti	3.20	(0.02)	Ethiopia	3.70	0.20			
			Ghana	3.29	0.25	Sierra Leone	3.76	0.09			
			Mozambique	3.35	0.99	Congo, Republic of	3.90	0.10			
			Lesotho	3.24	0.49	Guinea-Bissau	3.65	0.85			
			Chad	3.29	0.95						
			Gabon	3.28	(0.09)						
			The Gambia	3.51	0.09						

Note: Suspended from grading in the 2006 *Index of Economic Freedom:* Democratic Republic of the Congo and Sudan.
Not Graded by the *Index:* Comoros, Eritrea, Liberia, Somalia, Seychelles, and Sao Tome and Principe.



Note: Mostly free economies: Botswana, Cape Verde, Madagascar, South Africa, Uganda. Mostly unfree economies: Angola, Burundi, Mali, Mauritius, Namibia, Mauritania, Senegal, Swaziland, Cameroon, Burkina Faso, Gabon, Gambia, Ivory Coast, Kenya, Mozambique, Rwanda, Tanzania, Zambia, Central African Republic, Congo, Republic of, Djibouti, Ghana, Malawi, Benin, Chad, Equatorial Guinea, Guinea, Lesotho, Niger, Sierra Leone, Togo, Ethiopia, Guinea-Bissau. Repressed economies: Nigeria, Zimbabwe. The following countries are not included since the 2006 *Index* does not grade them: Comoros, Democratic Republic of Congo, Eritrea, Mayotte, Sao Tome and Principe, Seychelles, Somalia, Sudan.

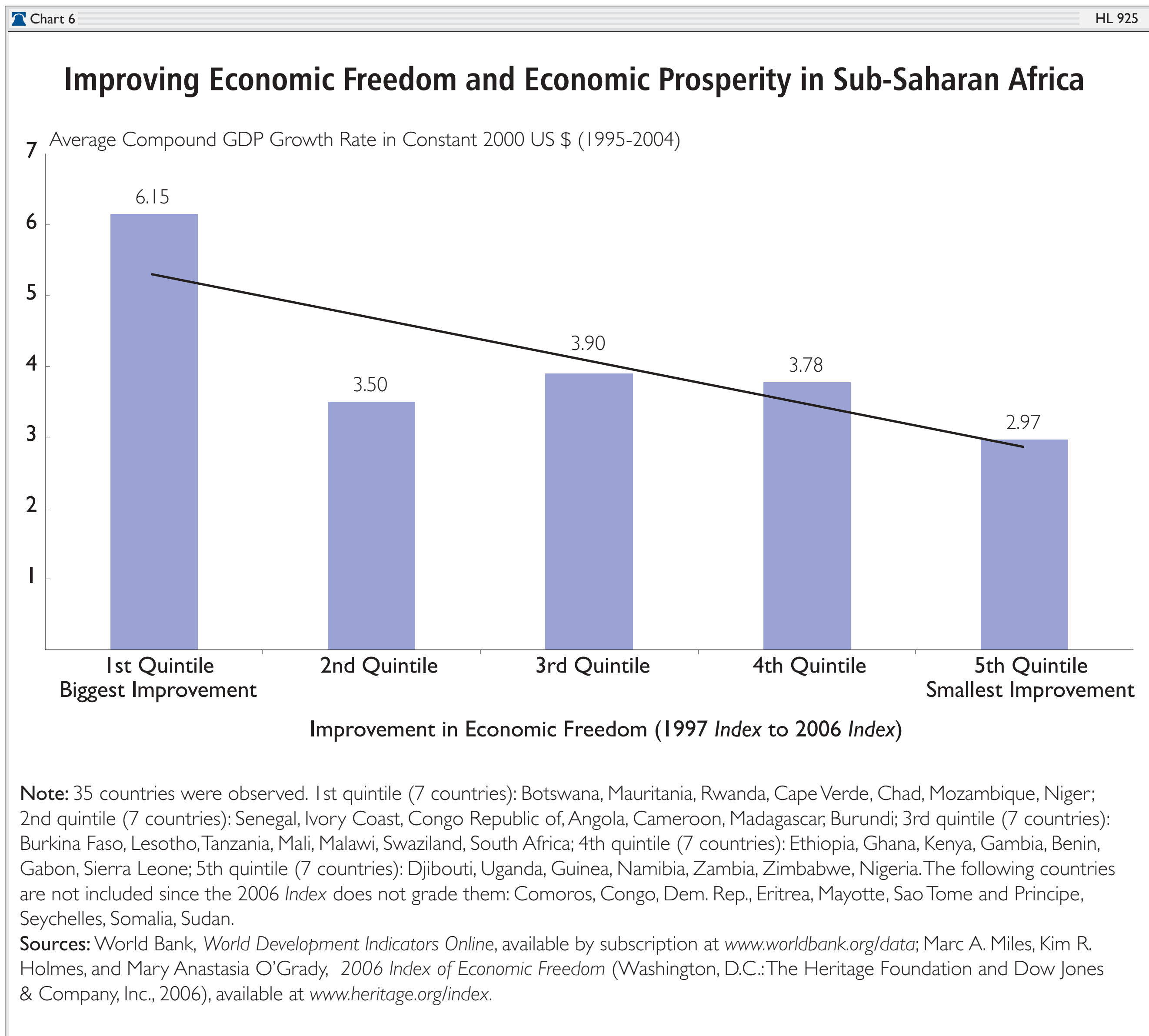
Sources: World Bank, *World Development Indicators Online,* available by subscription at *www.worldbank.org/data*; Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), at *www.heritage.org/index.*

ence of others by adopting flat taxes instead of progressive income taxes.

Many concerns have been raised about the pursuit of economic freedom and the rule of law instead of other priorities. Claims have been made that economic freedom leads to a race to the bottom in wages, environment, and living standards. The evidence contradicts these claims.

- A World Bank study found that "In the long run workers gain from integration [with the world economy]. Wages have grown twice as fast in globalized developing countries than in less globalized ones…."[32]
- And the environmental damage caused by trade? "Despite widespread fears," the study continued, "there is no evidence of a decline in environmental standards. In fact, a recent study of air quality in major industrial centers of the new globalizers found that it had improved significantly in all of them."[33]
- Same story on poverty: Economic freedom is good for the poor. A related World Bank study

32. Collier and Dollar, *Globalization, Growth, and Poverty*, p. 13.



Note: 35 countries were observed. 1st quintile (7 countries): Botswana, Mauritania, Rwanda, Cape Verde, Chad, Mozambique, Niger; 2nd quintile (7 countries): Senegal, Ivory Coast, Congo Republic of, Angola, Cameroon, Madagascar, Burundi; 3rd quintile (7 countries): Burkina Faso, Lesotho, Tanzania, Mali, Malawi, Swaziland, South Africa; 4th quintile (7 countries): Ethiopia, Ghana, Kenya, Gambia, Benin, Gabon, Sierra Leone; 5th quintile (7 countries): Djibouti, Uganda, Guinea, Namibia, Zambia, Zimbabwe, Nigeria. The following countries are not included since the 2006 *Index* does not grade them: Comoros, Congo, Dem. Rep., Eritrea, Mayotte, Sao Tome and Principe, Seychelles, Somalia, Sudan.

Sources: World Bank, *World Development Indicators Online*, available by subscription at *www.worldbank.org/data*; Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), available at *www.heritage.org/index.*

> found that increased growth resulting from expanded trade "leads to proportionate increases in incomes of the poor.... [G]lobalization leads to faster growth and poverty reduction in poor countries."[34]

The evidence indicates that, to the extent that these concerns are used to delay policy change, they are actually hurting the very people that are allegedly the justification for concern.

Neither can sub-Saharan Africa rely on outsiders to cure their problems. There are no shortcuts—not even increased aid transfers can replace good governance, economic freedom, and the rule of law. Numerous studies conclude that countries beset by

33. *Ibid.*, p. 16.

34. David Dollar and Aart Kraay, "Trade, Growth, and Poverty," World Bank, Development Research Group, draft of March 2001, abstract.

a weak rule of law, corruption, heavy state intervention, and other policies that retard growth will not experience increased economic growth even with greater amounts of economic assistance.[35] Subsequent studies question whether aid could spur growth even in good policy environments.[36]

Achieving these objectives requires political will to implement policy change to expand opportunities and remove barriers to growth. Developed countries can assist development by encouraging good policy and opening their markets to developing country products, but success in development ultimately depends on developing countries adopting and implementing policies that promote economic freedom, good governance and the rule of law.

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35. For example, economists Richard Roll and John Talbott support this conclusion with evidence that the economic, legal, and political institutions of a country explain more than 80 percent of the international variation in real per capita income between 1995 and 1999 in more than 130 countries. Richard Roll and John Talbott, "Developing Countries That Aren't," unpublished manuscript, University of California at Los Angeles, November 13, 2001, p. 3 at *www.cipe.org/pdf/whatsnew/events/talbot.pdf*. Other comparable studies include Paul Collier and Jan Willem Gunning, "Why Has Africa Grown Slowly?" *Journal of Economic Perspectives*, Vol. 13, No. 3 (September 1999), pp. 3–22; Robert J. Barro and Xavier Sala-i-Martin, *Economic Growth* (New York: McGraw-Hill, 1995); Jeffrey D. Sachs and Andrew Warner, "Economic Reform and the Process of Global Integration," in William C. Brainard and George L. Perry, *Brookings Papers on Economic Activity, 1995* (Washington, D.C.: Brookings Institution Press, 1995), pp. 1–118; and David Dollar, "Outward-Oriented Developing Economies Really Do Grow More Rapidly: Evidence from 95 LDCs, 1976–1985," *Economic Development and Cultural Change*, Vol. 40, No. 3 (April 1992), pp. 523–544.

36. William Easterly, "Can Foreign Aid Buy Growth?" *Journal of Economic Perspectives*, Vol. 17, No. 3 (Summer 2003), pp. 23–48, at *www.nyu.edu/fas/institute/dri/Easterly/File/EasterlyJEP03.pdf* (September 21, 2005).