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Private Property Rights, Economic Freedom, and Well Being

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The question of why some countries are rich, and others are poor, is a question that has plagued economists at least since 1776, when Adam Smith wrote *An Inquiry into the Nature and Causes of the Wealth of Nations*. Some countries that have a wealth of human and natural resources remain in poverty (in Sub-Saharan Africa for example) while other countries with few natural resources (like Hong Kong) flourish.

An understanding of how private property and economic freedom allow people to coordinate their activities while engaging in trades that make them both people better off, gives us an indication of the institutional environment that is necessary for prosperity. Observation of the countries around the world also indicates that those countries with an institutional environment of secure property rights and high degrees of economic freedom have achieved higher levels of the various measures of human well being.

Property Rights and Voluntary Interaction

The freedom to exchange allows individuals to make trades that both parties believe will make them better off. Private property provides the incentives for individuals to economize on resource use because the user bears the costs of their actions. When private property is combined with market exchange, the price system that results provides the information and incentives for the many anonymous individuals in society to coordinate their activities to channel available resources to the people with the most urgent demand for them.

Private property forces individuals to bear the costs of their actions. Without private ownership, when a person uses resources, they impose a cost on everyone else in society. Economists call this the "tragedy of the commons." Communal property leads to over use, and depletion of resources. Once property is privatized and individually held, the owner may use the property for his own benefit but he also directly incurs the cost of using it. Private property provides an incentive to conserve resources and maintain capital for future production. Although this is important, the full benefit of private property is not realized unless owners have the ability to exchange it with others.

The freedom to enter into voluntary exchanges should obviously increase the subjective well being of individuals in a society. If two people agree to exchange something, they both demonstrate that they desire what the other had more than what they gave up. Both parties expect to benefit from the trade, so both expect their well being to increase. Any regulations that prohibit or interfere with certain types of voluntary transactions necessarily must limit the economic well being people are able to achieve. The regulations prevent people from doing things that people deem will make them happier than if they unable to do them. The less voluntary interaction is interfered with, the more people will exchange resources to increase their subjective wealth.

When private property is combined with the right to exchange it, a price system develops. The price system provides a common denominator that serves as a relative scarcity indicator. People are able to observe prices and determine whether they value the property they have more than the money they could receive for it. Price changes signal changes in the demand and supply for different goods and services. These price changes provide the information to entrepreneurs as to what products are most urgently demanded and what inputs can be combined to most cheaply produce them. Without free exchange and the price system, this information is not generated. Since entrepreneurs have a property right in their profits, they also have every incentive to use resources to satisfy these most highly valued demands.

The decentralized price system and private property provide the incentives and the information for millions of people to coordinate their activities and direct resources to those who value them most. A higher level of well being can be generated for all when individual activities are coordinated. The institutional environment of private property rights and freedom to exchange are necessary in order to achieve coordination.

The classic notion of private property rights, from John Locke, includes the individual's ownership of himself and the land (resources) he mixed his labor with or traded for.[1] Self-ownership, private property in resources, and the ability to do anything that does not infringe on someone else's right of ownership and property can all be broadly described as a system of private property rights. The various measures of "economic freedom" that exist roughly measure the degree to which countries respect this broader notion of property rights. The indexes seek to measure the extent that voluntary cooperation between individuals is not interfered with, by coercion, from either governments or private criminals.

Measuring Economic Freedom

With the failure of communism and Keynesian macro economic management programs in the late 20th century, a rough observation of the world tends to confirm the importance of private property and economic freedom. There is no one absolute precise measure of economic freedom that can differentiate levels of freedom in the various "mixed" economies. There is no completely objective way to weight one category of freedom against another. For example, is a country with low tax rates but with no international trade allowed more or less free than a country with the policies reversed? This weighting becomes more complex as all the different ways in which the government

[1] For a History of the origins and theories of property rights see AIER's May 2002 Economic Education Bulletin "Property Rights: Origins and Theories" by Walker Todd.

interferes with the economy are added. There are two major publications that have constructed overall measures of economic freedom and rank the countries that they have data from.[2]

The Heritage Foundation and the Wall Street Journal co-publish the *Index of Economic Freedom*. This index has been published annually since 1995. The 2002 index ranks 156 countries, using fifty variables in ten broad categories. Each category receives a separate score between 1 (more free) and 5 (less free) and then the categories are averaged together (weighted equally) to obtain a score for each country. The ten broad categories are: 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 black market activity. Each of the ten categories has a separate grading scale that looks at a few different variables and determines the category's score. In the 2002 Index, Hong Kong was ranked the most free country with an overall score of 1.35. Singapore was ranked second and New Zealand was ranked third. Estonia, Ireland, Luxembourg, Netherlands, and the United States were all tied for fourth freest country in the world, while Iraq and North Korea were the most repressed countries in the world with the worst possible overall score of 5.00 (see Table 1 for other scores).

[2] There is a third measure done by Freedom House. This measure focuses more on political freedom and civil liberties than it does on property rights protection, so it will not be considered here.

Table 1
Heritage 2002 *Index of Economic Freedom* Rankings

Rank	Country	Score
1	Hong Kong	1.35
2	Singapore	1.55
3	New Zealand	1.70
4	Estonia	1.80
4	Ireland	1.80
4	Luxembourg	1.80
4	Netherlands	1.80
4	United States	1.80
9	Australia	1.85
9	Chile	1.85
9	United Kingdom	1.85
15	Canada	2.00
20	Germany	2.10
35	Japan	2.45
38	Argentina	2.50
38	South Korea	2.50
45	France	2.70
60	Botswana	2.90
60	Mexico	2.90
79	Brazil	3.10
121	China	3.55
121	India	3.55
131	Russia	3.70

In 1996 the Fraser institute began publishing its economic freedom measure, *Economic Freedom of the World*. The first publication, written by Block, Gwartney, and Lawson, scored and ranked counties in five-year intervals from 1975 to1995. The second edition of the *Economic Freedom of the World* was published in 1997 and there was an interim report for 98/99. The Fraser institute's measure has been updated and published annually since 2000. The current 2002 edition ranks countries in five-year intervals back to 1970.

The 2002 Fraser Institute measure ranks 123 countries using 37 variables that fall into five broad categories. The overall score of a country is determined by averaging the scores of the five categories together.[3] The five categories are:

1. Size of Government: Expenditures, Taxes, and Enterprises
2. Legal Structure and Property Rights
3. Sound Money
4. Freedom to Trade with Foreigners
5. Regulation of Credit, Labor, and Business

The *Economic Freedom of the World* report gives scores between 1 (least free) and 10 (most free). In the 2002 report Hong Kong was ranked first with a score of 8.8, Singapore was ranked second (8.6), and the United States was third (8.5). Congo, Dem. Rep. was ranked last at 123 with a score of 3.2 (see Table 2 for other scores).

Table 2
Fraser Institute *Economic Freedom of the World 2002*

Rank	Country	Score
1	Hong Kong	8.80
2	Singapore	8.60
3	United States	8.50
4	United Kingdom	8.40
5	New Zealand	8.20
5	Switzerland	8.20
7	Ireland	8.10
8	Australia	8.00
8	Canada	8.00
8	Netherlands	8.00
15	Chile	7.50
15	Germany	7.50
24	Japan	7.30
30	Argentina	7.20
35	Estonia	7.10
38	Botswana	7.00
38	France	7.00
38	South Korea	7.00
66	Mexico	6.30
73	India	6.10
82	Brazil	5.80
101	China	5.30
116	Russia	4.70

[3] In past editions the Freedom of the World report has tried various different weightings of components.

Although there is a degree of subjectivity, measurement problems, survey data inaccuracy, and weighting problems, both the Heritage Foundation and Fraser Institute measures at least give us some rough indication of the degree of economic freedom and broad respect for private property rights in countries around the world. Although small differences between countries should not be taken to mean that one country is absolutely more or less free than the other, larger differences between countries and changes in a country's score over time, can give a decent approximation of the degree of economic freedom present.

Measuring Standards of Living and Well Being

If measuring economic freedom is slightly ambiguous, defining and measuring well being or a standard of living is even more problematic. Economic freedom is difficult to measure and assign weights to different criteria, but at least it can be objectively defined- the absence of coercion, and complete freedom to engage in voluntary exchange. Picking a measure of well being attempts to measure the outcomes of those voluntary interactions.

The problem of measuring outcomes exists because value is subjective to the individual who participated in the transaction. People have diverse and competing ends. Picking one end and measuring the amount of it in an economy gives little idea whether the society is wealthy or poor. For example, people like shoes, add up the number of shoes in society and use that as a "standard of living measure." Obviously people value things other than shoes that should be counted too. Typically, economists use per capita gross domestic product (GDP) to measure standards of living. This attempts to add up the value of all the goods and services produced in an economy. This still leaves out competing ends that people value, for example leisure. Comparing per capita GDP when one country has 20,000 per capita GDP and an average of a 50 hour work week while another country has 15,000 per capita GDP but only a 30 hour average work week, presents a misleading picture of the level of well being in the two economies.[4] GDP has other problems too. It includes things "produced" by government. Although these services sometimes do have value, they are coercively funded and usually not sold on the open market, so there is no way to find out what value should be assigned. The Soviet Union had a GDP per capita statistic, but since most goods were bought and distributed by the government, there was no indication of how much consumers valued what was produced. Overall as government's share of GDP increases, it becomes a less reliable measure of economic well being.[5]

In addition to GDP, other measures need to be looked at to get a truer picture of well being in a country. None of these other measures is an absolute indicator of well being either. Human life expectancy is another typical measure used. In general a longer life expectancy indicates the people of a country are better off.[6] Other measures typically used are infant mortality rates, and caloric intake, literacy rates, and immigration statistics.

Since none of these measures can be used as an absolute measure of well being, must we say nothing when comparing countries? Even taken by themselves these individual measures do give some indication of well being, we just have to recognize their shortcomings. A reasonable assumption is that as people become more "subjectively wealthy," they will choose to buy more goods and services and GDP

[4] We sometimes find that, in repressed countries, people will substitute more leisure for work in response to having most of the fruits of their labor confiscated.

[5] Even when subtracting government out from GDP to get gross private product (GPP) the problem of competing ends (leisure) remains. Another problem is that although activity in the underground economy enhances consumer welfare, it is not measured in GDP.

roughly measures the amount of goods and services produced. So if people want more of what is measured by GDP as there wealth increases, then GDP per capita will move in the same direction as subjective well being. The same applies to the other measures. For example, if we assume people prefer a longer life to a shorter one and as they become wealthier they will purchase “more life” then that too will be correlated with increased subjective well being. When all indicators are taken together and point in the same direction it is a pretty good indicator of the standard of living in a country.

Economic Freedom, Private Property, and Well Being

Our understanding of voluntary interaction tells us that as people are freed to engage in voluntary trades they will make themselves subjectively better off. We have also seen that although there is no absolute single standard that can be used to compare countries’ standard of living, most of the traditionally used measures should be correlated with people becoming subjectively better off. This is what we find when we observe the world using the measures of economic freedom and well being. Countries that respect individuals’ private property rights in themselves and possessions (i.e. have high degrees of economic freedom) do better in the various measures of well being.

There are a number of studies in professional journals linking past measures of economic freedom and property rights to measures of well being.[7] When we look at the

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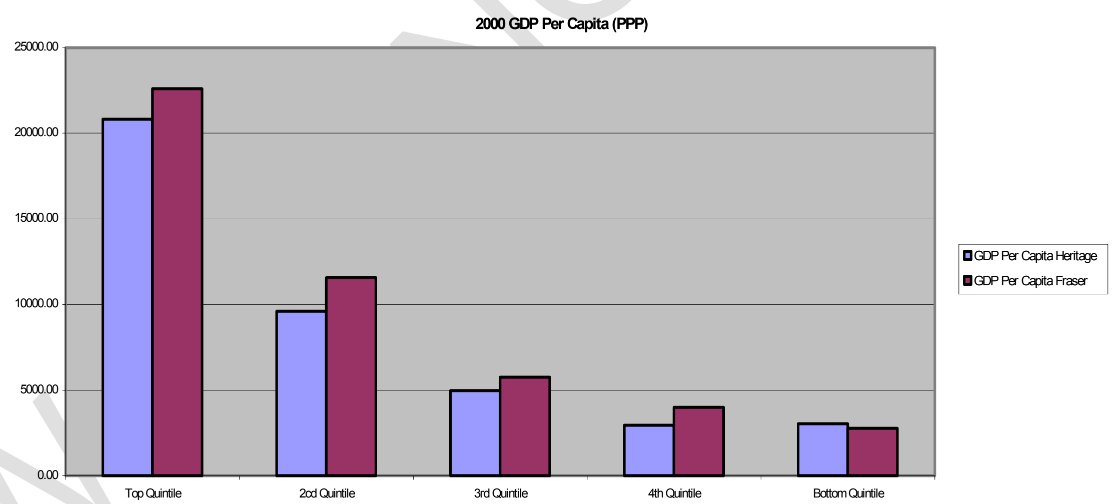
[6] Of course people demonstrate all the time that they are not simply maximizing their life expectancy. An obvious example is that some people choose to smoke even though it reduces their life expectancy. Obviously people have other ends that compete with longevity.

[7] Studies by Scully (1988 and 1992), Barro (1991), Barro and Sala-I-Martin (1995), Knack and Keefer (1995), Knack (1996), Keefer and Knack (1997) all show that measures of well defined property rights, public policies that do not attenuate property rights, and the rule of law, tend to generate economic growth. Gwartney, Holcombe, and Lawson (1998) found a strong and persistent negative relationship between government expenditures and growth of GDP for both OECD countries and a larger set of 60 nations around the world. They estimate that a 10 percent increase in government expenditures as a share of GDP results in approximately a 1 percentage point reduction in GDP growth. Using the Fraser and Heritage indexes of economic freedom Norton (1998) found that strong property rights tend to reduce the deprivation of the world’s poorest people while weak property rights tend to amplify the deprivation of the world's poorest people. Grubel (1998) also used the Fraser Institute's index of economic freedom to find

data in the 2002 reports we find strong evidence that regardless of which measure of freedom or well being is picked, countries that are more free are better off.

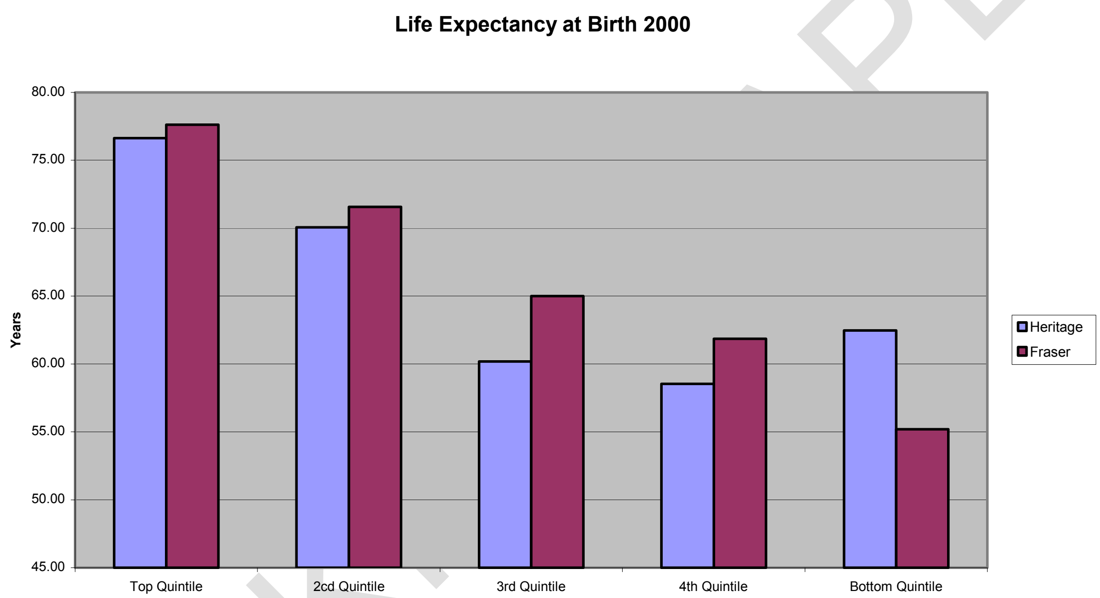
Despite the problems with using GDP as a standard of comparison both the Heritage and Fraser institute indexes show that freer countries have a higher per capita GDP. Chart 1 breaks down the average per capita GDP for both indexes into quintiles. The top quintile is composed of countries that ranked in the top 20% for economic freedom score, the second quintile is composed of countries that ranked less than the top 20% but in the top 40% and so forth (ex: for the Fraser index the countries in the top quintile were ranked from 1 to 24 and those in the second quintile were ranked from 24 to 47). The top quintile for the Fraser index has a per capita GDP of $22,600 while the bottom quintile averaged only $2,773. The numbers for the Heritage index were $20,825 and $3,025 respectively.



Sources: *World Fact Book 2001*, *Economic Freedom of the World 2002 Annual Report, 2002 Index of Economic Freedom.*

that economic freedom is associated with superior performance in income levels, income growth, unemployment rates and human development.

When life expectancy is used as a standard for comparison, we find that freer countries have longer life expectancies. The average life expectancy at birth for someone in a country that is in the top freedom quintile is 77.6 years using the Fraser index and 76.6 years by the Heritage scores, while those in the bottom quintiles have life expectancies of only 55.1 years and 62.4 years (See Chart 2).

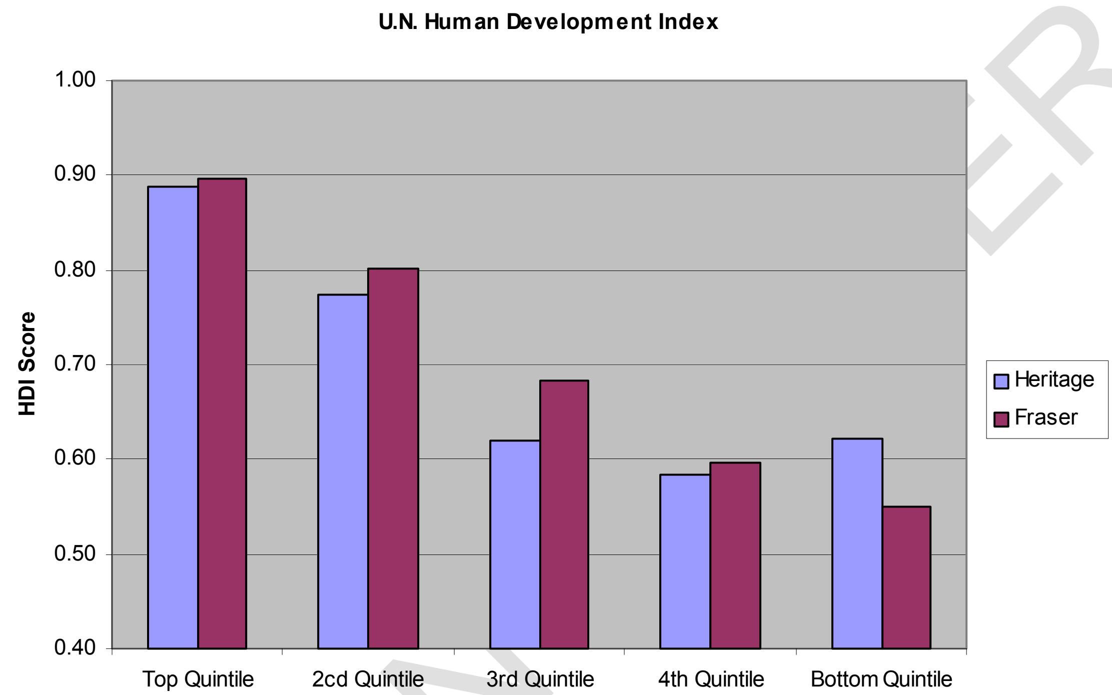


Sources: *World Fact Book 2001, Economic Freedom of the World 2002 Annual Report, 2002 Index of Economic Freedom.*

The United Nations publishes the Human Development Index. This index is supposed to "focus on human well-being, not just economic trends."[8] This index combines measures for per capita GDP, life expectancy, adult literacy, and combined primary, secondary and tertiary education gross enrollment to give a country a score on a scale from zero (lowest) to 1.0 (highest). Again we find that freer countries score higher. The top quintile for both indexes has an average score of 0.89 while the average score in the bottom quintile for the Fraser index is 0.54 and for Heritage a score of 0.62 (See

[8] *Human Development Report 2001* p.133.

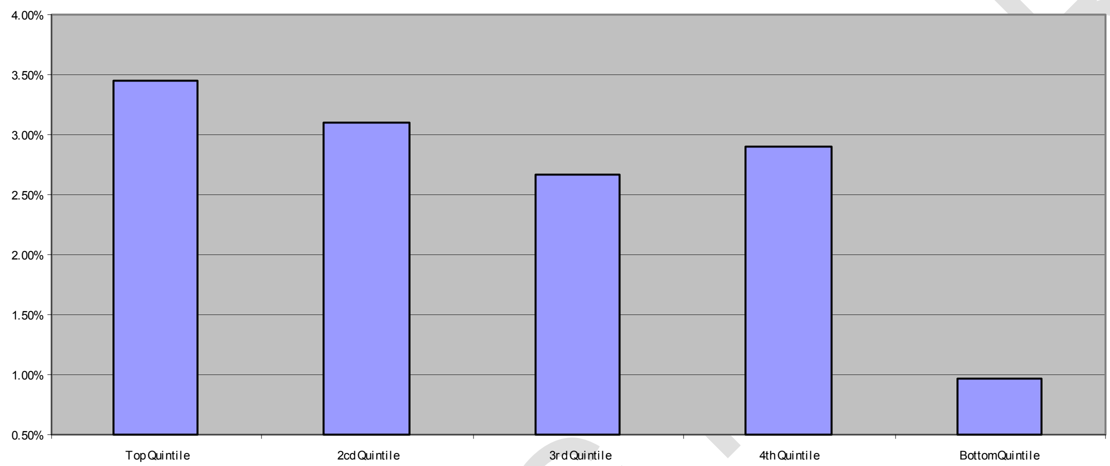
Chart 3). To the extent that the U.N. would like to use this index to make policy recommendations to countries, the evidence should be clear; grant more freedom in your economy and you will achieve higher levels of "human development."



Sources: *Human Development Report 2001, Economic Freedom of the World 2002 Annual Report, 2002 Index of Economic Freedom.*

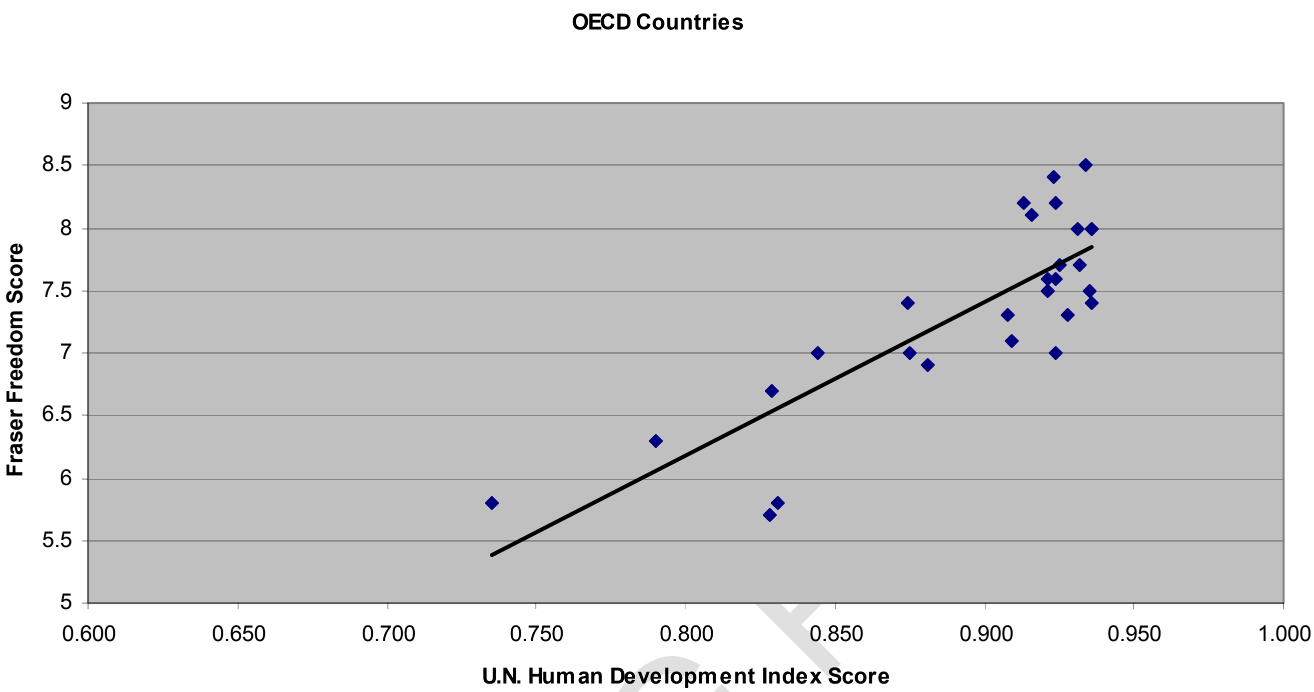
The three measures above are all "snap shots in time." They are all some total measure of well being today and a measure of economic freedom and private property rights today. Some people could assert that the high level of well being was achieved and then the freedom only came afterward. To verify that economic freedom and strong private property rights do not only come after the well being is achieved we can look at growth rates and freedom scores. To avoid the problem of getting a result driven by only short-term business cycles we need to look at the data over a longer period of time. The Fraser institute scores for 1990, 1995 and 2000, have been averaged together to give each country an average freedom score for the decade and then the countries have been sorted into quintiles according to this score. This average freedom score can be compared with the average GDP growth rate for the decade (See Chart 4). We again find that countries in the top quintile had the highest GDP growth rate (3.45%) and those in the lowest quintile had the worst growth rate (0.97%).

1990-2000 Avg. Growth Rate by Avg. Freedom Score Quintile



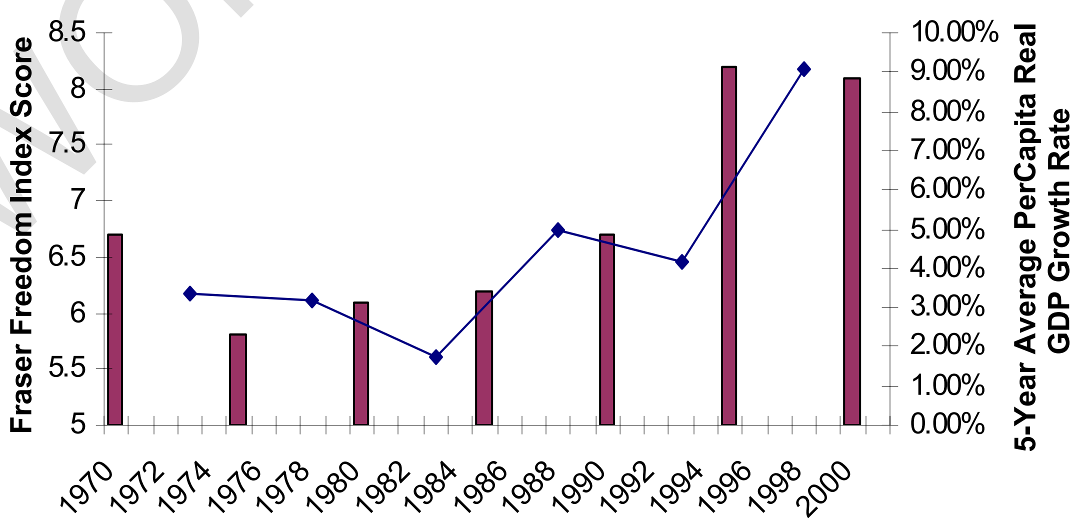
Sources: *World Development Indicators 2001, Economic Freedom of the World 2002 Annual Report*.

To make sure that differences in freedom between countries are still important once a country is already developed and industrialized, we can look at the 29 member countries of the Organization for Economic Cooperation and Development (OECD). Chart 5 plots all of the OECD's 29 countries' U.N. Human development index score and Fraser Institute freedom score. Although all have obtained relatively high scores on both, a clear relationship is still present; more economic freedom for OECD countries still leads to a higher level of human development, as measured by the U.N. The 1/3rd of OECD countries with the highest average freedom scores for the 1990s also averaged the highest growth rate for the decade (3.52% vs. 2.89% for the countries in the bottom 1/3).



Sources: *Human Development Report 2001, Economic Freedom of the World 2002 Annual Report.*

Another useful way to look at the relationship between economic freedom and well being is to look at the changes in the level of economic freedom and growth rates of a single country over time. Although it is not possible to look at all countries overtime in the space here, Ireland provides one illustrative example (See Chart 6).



Sources: *Economic Freedom of the World 2002 Annual Report*, *OECD Annual National Accounts- Comparative Tables.*

During the 1960s Ireland made repeated reductions in tariffs, opening its economy to free trade and experienced 4 percent average GDP growth rates. Ireland's freedom score in 1970 was 6.7. During the 1970s Ireland engaged in many Keynesian stimulus packages, harming both its freedom score and growth rates. After recording an increase in economic freedom in 1980, further spending programs were enacted which precipitated a fiscal crises and inflationary period. Ireland's freedom score and growth rates fell through 1985. In 1986 Ireland made substantial cuts in government spending and inflation rates and brought its budget under control. Economic growth recovered and its freedom rating increased by 1990. The major increases in economic freedom in Ireland occurred between 1990 and 1995, and were then sustained through 2000. During this time Ireland experienced dramatic levels of economic growth that averaged 9.9% from 1995-2000 and after hundreds of years, caught up to the standard of living in both England and continental Europe.[9]

The data in the various charts clearly shows a strong relationship between economic freedom and well being. Although the charts show the first and second quintiles always out perform the rest (and by quite a bit in most cases), the third, fourth and fifth quintiles are often very close and in some cases a lower ranked quintile out performs a higher ranked one. This seems to indicate that economic freedom can produce its best results when it is a complete package. If one area of an economy is freed, while in other areas it remains repressed, the freed sector cannot produce its full potential benefits. Once all sectors of the economy have a high level of freedom then they all sectors can work together to produce a much higher level of well being than in partially repressed countries.

[9] For a more complete discussion of Ireland's experience see Benjamin Powell "Economic Freedom and Growth: The Case of the Celtic Tiger." Working Paper 2002 (This reference should change by the time

Conclusion

Although coming up with objectively quantifiable measures of economic freedom and property rights are difficult, and no single measure exists with which to measure individual's subjective well being, there is still strong evidence that economic freedom makes people better off. A basic understanding of voluntary exchange and the free market's roll in coordinating activity leads us to believe that the free market economy is the best system for people to better obtain whatever it is that they value. We observe in countries that encroach less on the private property rights of their citizens, people achieve higher per capita GDP's and longer life expectancies. The U.N. Human Development Index combines literacy and education with the above two measures and we again find that freer countries do better. Countries with more economic freedom also achieve higher GDP growth rates than those with less freedom. When a single country is looked at over time we can find that it grows fastest when it has the lowest levels of government interference.

Despite measurement difficulties, all the evidence points in the same direction. People in countries that respect private property rights and allow a higher level of economic freedom are better able to satisfy human desires than those who live in countries that interfere more with citizens' private choices.

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