

Robbie Butler  
John Considine  
Hugo J. Faria

Hugo M. Montesinos-Yufa  
Dean Stansel  
Meg Tuszynski

edited by Fred McMahon

# Changes in Economic Freedom in Venezuela, Ireland, and the United States





# Changes in Economic Freedom in Venezuela, Ireland, and the United States

*Robbie Butler, John Considine, Hugo J. Faria,  
Hugo M. Montesinos-Yufa, Dean Stansel, and Meg Tuszynski*

*edited by Fred McMahon*

Copyright ©2016 by the Fraser Institute. All rights reserved. No part of this book may be reproduced in any manner whatsoever without written permission except in the case of brief quotations embodied in critical articles and reviews.

The authors of this book have worked independently and opinions expressed by them are, therefore, their own and do not necessarily reflect the opinions of the supporters, directors, or staff of the Fraser Institute. This publication in no way implies that the Fraser Institute, its directors, or staff are in favor of, or oppose the passage of, any bill; or that they support or oppose any particular political party or candidate.

Published in cooperation with the Economic Freedom Network

Cover design by Heather Jalbout.

Printed and bound in Canada

### **Cite this publication**

Authors: Robbie Butler, John Considine, Hugo J. Faria, Hugo M. Montesinos-Yufa, Dean Stansel, and Meg Tuszynski

Editor: Fred McMahon

Title: *Changes in Economic Freedom in Venezuela, Ireland, and the United States*

Publisher: Fraser Institute

Date of publication: 2016

Digital copy available from <[www.fraserinstitute.org](http://www.fraserinstitute.org)> and <[www.freetheworld.com](http://www.freetheworld.com)>

### **About this publication**

*Changes in Economic Freedom in Venezuela, Ireland, and the United States* is an early release of chapters 4, 5, and 6 from the forthcoming *Economic Freedom of the World: 2016 Annual Report*, by James Gwartney, Robert Lawson, and Joshua Hall, and published by the Fraser Institute in cooperation with the Economic Freedom Network. The authors of the essays in this publication are grateful to Proff. Gwartney, Lawson, and Hall for their careful reviews and important contributions to these essays.

### **Cataloguing Information**

McMahon, Fred

Changes in Economic Freedom in Ireland, the United States, and Venezuela /

Fred McMahon.

Issued also online.

ISBN 978-0-88975-407-2.

1. Economic history--1980- . 2. Economic indicators. I. Fraser Institute (Vancouver, B.C.) II. Title

# Table of Contents

*Introduction* / 1

by Fred McMahon

*Chapter 4 The Critical Role of Economic Freedom in the Venezuela's Predicament* / 17

by Hugo J. Faria and Hugo M. Montesinos-Yufa

*Chapter 5 Economic Freedom and Growth in Ireland, 1980 to 2014* / 41

by Robbie Butler and John Considine

*Chapter 6 Economic Freedom in America, 1980 to the Present* / 61

by Dean Stansel and Meg Tuszynski

*About the Authors* / 77

*Acknowledgments* / 80

*Publishing Information* / 81

*Supporting the Fraser Institute* / 82

*Purpose, Funding, and Independence* / 82

*About the Institute* / 83

*Editorial Advisory Board* / 84



# Introduction

*Fred McMahon*

This volume looks at the profound effect of major shifts in economic freedom in three countries: Venezuela, Ireland and the United States.<sup>1</sup>

Venezuela has been trapped in a lengthy decline in economic freedom that started long before Hugo Chavez assumed the presidency in 1999. But Chavez, his United Socialist Party of Venezuela, and successor, Nicolás Maduro, have presided over a continued, stunning slide in economic freedom that landed Venezuela in dead last place from 2010 to 2014 among the approximately 150 countries ranked in the index published in *Economic Freedom of the World* (EFW). If anything, economic policy in Venezuela has deteriorated during the past two years and, when the data on economic freedom for the current year, 2016, are published in *Economic Freedom of the World* in 2018, Venezuela will almost certainly still be in last place. This has created an immense human tragedy for the people of Venezuela (Casey, 2016), who suffer runaway inflation, lack of even basic medicines and food (except for the politically connected), hunger, riots, and soaring crime, with Caracas taking its place as the murder capital of the world (Yagoub, 2016).

Ireland, on the other hand, is a good news story. Ireland has had a moderately high level of economic freedom all of the way back to the initial year of the EFW data in 1970. In the 1970s and 1980s, its score was typically around 6.5 out of 10 and its rank around 20<sup>th</sup>. Significant reforms were initiated in 1986/1987, pushing Ireland's EFW rating sharply upward to around 8.0. Ireland entered the top 10 in 1995 and it has remained there except for a couple of years following the financial crisis of 2008.

- 
- 1 All economic freedom scores and ranks in this introduction are from the regular index rather than the chain-linked index to allow the use of a longer, more comprehensive time series. The introduction and the chapters published in *Changes in Economic Freedom in Venezuela, Ireland, and the United States* all use data from the 2015 report rather than the 2016 report. Data revisions will result in some small historical differences between the two reports.

---

Citation Fred McMahon (2016). Introduction. In Fred McMahon, ed., *Changes in Economic Freedom in Ireland, the United States, and Venezuela* (Fraser Institute): 1–16.

Authors Fred McMahon is a Fraser Institute Resident Fellow and holder of the Dr. Michael A. Walker Research Chair in Economic Freedom. He manages the Economic Freedom of the World Project and coordinates the Economic Freedom Network, an international alliance of over 100 think-tank partners in about 100 nations and territories.

Its EFW rating dropped to 7.6 and its rank to 20<sup>th</sup> in 2010. But since then, Ireland has regained its momentum in both economic freedom and economic growth. It re-entered the top 10 in economic freedom in 2012. Unlike other European nations that suffered property busts, such as Portugal and Spain, Ireland's economic growth is soaring and even the property market has started to recover (Reddan, 2016).

While the reduction in economic freedom of the United States has been moderate relative to that of Venezuela, the decline has been substantial since 2000. As in Venezuela, the drop has been a non-partisan affair. The United States' high-water mark in economic freedom came in 2000 with a score of 8.65 and a rank of second place, just below Hong Kong. The decline has been steady since. In 2010, the United States fell out of the top 10 and its ranking is now in the mid-teens.

Just as the change in economic freedom has not been as great as in Venezuela and Ireland, the consequences have been less powerful. The United States neither soared nor sunk economically but its recent economic performance has clearly been below par. Thus far, the twenty-first-century growth of real GDP of the United States has been well below its historic average. Job growth and labor force participation have also lagged well behind their levels in recent decades. The US recovery from the Great Recession has been the slowest since World War II. Yet, the United States remains a vibrant economy with great potential if the policy course is reversed.

### International context for the discussion

The purpose of this introduction is not simply to summarize the case studies in this volume. Instead, since the chapters focus on one nation each, the introduction attempts to provide some international comparison and context for their experience. The introduction also explains why economic freedom is important.

The articles focus on the period since 1980. The figures in the introduction date back to 1970. This is in part to add some additional information and because it is interesting in particular to look at the evolution of both economic freedom and growth in Venezuela back to 1970, as the authors of the Venezuelan chapter note. Thus, for the sake of consistency, all figures in the introduction are dated back to 1970.

The charts also illustrate what might be thought of as “turning points”: 1999, when Hugo Chavez became president of Venezuela; the Irish “fiscal adjustment” beginning in 1987, noted by Butler and Considine; and the US decline in economic freedom since 2000.

The GDP charts, to provide relevant contrasts, compare the nations in question to those just above and below them in per-capita income in 1970. For consistency, the economic freedom charts look at the same nations. The figures in the introduction should be treated as illustrative. They are merely snapshots in time but they do reflect more sophisticated research on economic freedom and growth, some of which is cited in this introduction.

## The importance of economic freedom

Why is economic freedom important? Right from the start economic freedom was shown to be positively associated with growth. The first index appeared in 1996 with backdated data to 1970. The next year, the world's most influential peer-reviewed, academic economic journal, the *American Economic Review*, published a study by



key participants in the Economic Freedom of the World project, Michael Walker and Stephen Easton (1997), showing that economic freedom advances growth.<sup>2</sup> More recent research has strongly supported this conclusion (e.g., Gwartney and Lawson, 2004; De Haan, Lundstrom and Strum, 2006).

It is easy to see how and why economic freedom is positively related to economic growth. Any transaction freely agreed to must benefit all parties to the transaction; any transaction that does not benefit all parties would be rejected by the party that would come up short. This has consequences throughout the economy.<sup>3</sup> Consumers who are free to choose are attracted by superior quality and lower price. Producers and sellers, including new ones, find an open marketplace in economically free nations and must constantly improve the price and quality of their products to meet customers' demands or customers will not freely enter into transactions with them. Billions of mutually beneficial transactions occur every day and power a dynamic that spurs increased productivity, wealth creation, more attractive employment opportunities, and reductions in poverty.

In contrast, an increase in the size and breadth of government activities substitutes coercive "transactions" for voluntary exchange. Mutually advantageous open-market exchanges are replaced with coercive taxes, mandates, subsidies, and government spending favored by powerful interest groups and political elites. In turn, the government favoritism provides businesses with a strong incentive to shift resources away from providing consumers with superior products at lower prices toward providing political decision-makers with resources that will help them win elections or cement their power and increase their personal wealth in non-democratic nations. As a result, a type of political cronyism contaminates the relationship between business and government, undermining the forces that drive economic growth.

The influence of economic freedom extends far beyond mere economics. It changes the dynamics of a society and helps build important societal institutions such as trust and tolerance. See, for example, Hall and Lawson, 2014 for a review of the literature on the impact of economic freedom on both the economic and non-economic health of societies. This may be less important for nations like Ireland and the United States, where both social and governmental institutions are strong, but it is crucial for nations like Venezuela where institutions are weak. Moreover, it is quite possible that a prolonged decline in economic freedom can eventually undermine even strong institutions.

Why is this? When a government—or government's friends under crony capitalism—controls the economy, polarization occurs. Individuals and groups battle one and other for wealth and privilege. People gain by cultivating connections, suppressing the opportunities of others, and making them worse off. All too often, the individual gains not as an individual but as a member of a rent-seeking group, whether economic, ethnic, political, or religious. Groups stand against each other, creating a breeding ground for hate and hopelessness—the situation developing in Venezuela. Without economic freedom, the biggest gains accrue to those who cut a bigger slice

---

2 Michael Walker initiated the project and was its co-leader, with Milton and Rose Friedman. Steve Easton participated in the early research and co-edited with Walker one of the early research volumes, *Rating Global Economic Freedom* (Easton and Walker, 1992).

3 This section depends heavily on the reports on economic freedom in the Arab world and North America, of which I am a co-author, and various other of my writings on economic freedom. See, for example, Al Ismaily, Al Busaidi, Cervantes, and McMahon, 2015.

of a limited pie for themselves to the disadvantage of others. This exacerbates existing tensions and undermines institutions as the elites manipulate them for their advantage.

Economic freedom transforms the dynamics of society. When people make their own economic choices, they get ahead by providing others with goods and services that they value highly relative to cost. In other words, people get ahead by helping others get what they want. Those in other groups become customers, suppliers, clients. Over time, this builds tolerance and a common sense of citizenship and reduces tensions between groups (see, e.g., de Soysa and Vadlamannati, 2014).

Thus, with economic freedom, the biggest gains are achieved by people who increase the size of the pie for everyone. It is a dramatic change in dynamics from a society where you get ahead by making people worse off. Over time, this also transforms society and helps build trust. It is a key reason that economic freedom has been shown to promote impartial institutions, democracy, and other freedoms.

The impact that restrictions on economic freedom have on corruption is also highly important. Increasing economic freedom in and of itself will lessen corruption. Lack of economic freedom is the raw material of corruption. If you need to ask someone's permission to do something, then there is someone to demand payments. If you are economically free and able to make your own economic decisions, if you do not need someone's permission to do something, then there is no one who has to be paid off.

## Venezuela

Hugo J. Faria and Hugo M. Montesinos-Yufa are Venezuelans currently teaching at universities in the United States. Both were previously associated with institutions of higher learning in Venezuela. Their article provides background and insight on Venezuela's precipitous drop in economic freedom and well-being since 1970.

Venezuela was once one of the most promising nations in South America, perhaps the most promising. In fact, in 1970, it had the highest level of economic freedom of any nation in South America and a per-capita GDP that was two and a half times the South American average and well above the world average. Remarkably, the 1970 economic freedom rating of Venezuela was higher than Israel, Sweden, the United Kingdom, Iceland, Norway, Taiwan, France, Austria, New Zealand, Ireland, Australia, Singapore, and the Netherlands.

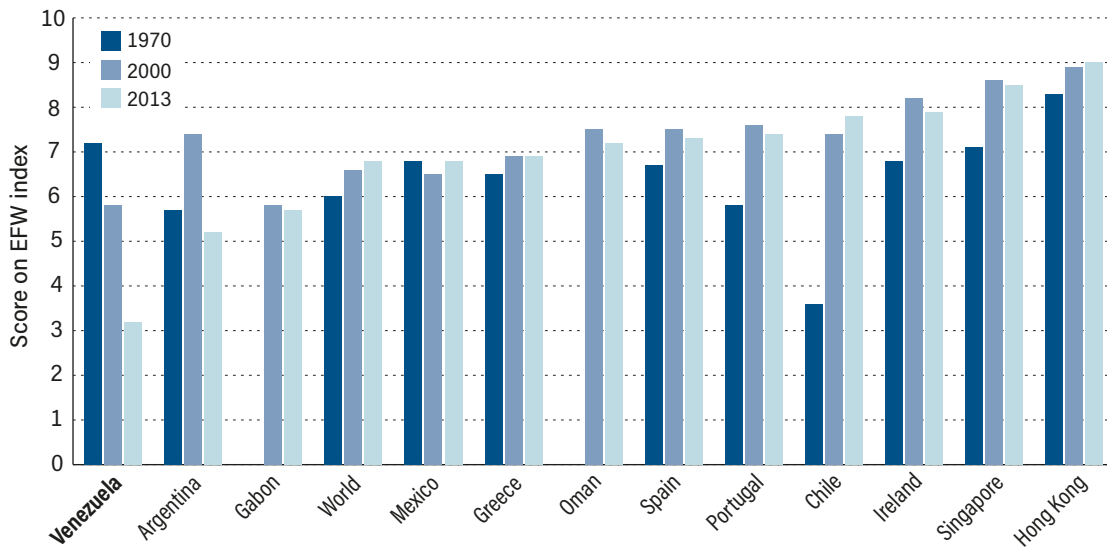
Figures 1a and 1b and figures 3a and 3b select those nations and groups with a per-capita GDP similar to Venezuela's in 1970—to be precise the five nations right above and right below Venezuela in per-capita GDP in 1970. Interestingly, Ireland, which had a lower EFW rating than Venezuela in 1970, is part of this grouping. Of course the economic freedom paths of Ireland and Venezuela were vastly different after 1970. Chile is added to the group even though its income in 1970 was well below that of the other countries in the grouping. Chile provides an important regional point of comparison with Venezuela, given their different trajectories for economic freedom.

As **figure 1a** and **figure 1b** show, Venezuela has been on a steady downward path towards restricted economic freedom since 1970, the first year the EFW data are available.<sup>4</sup> Figures 1a and 1b also reveal an important truth stressed by Faria and

---

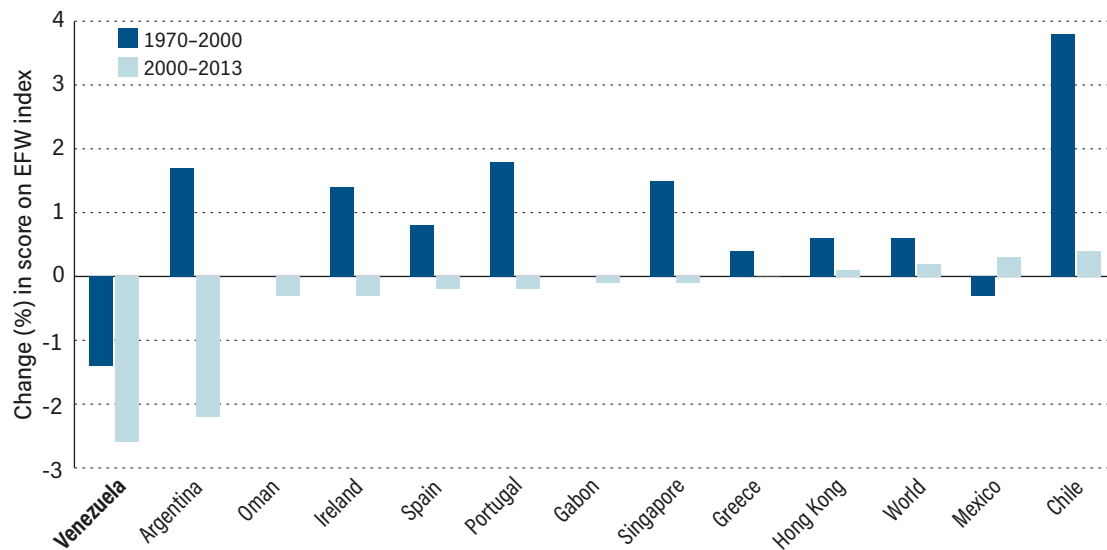
<sup>4</sup> Interestingly, Argentina, which one hopes is now turning away from economic disaster, comes close to matching Venezuela's decline between 2000 and 2013.

Figure 1a: Scores for Economic Freedom of Venezuela and Various Countries, 1970, 2000, 2013



Source: Gwartney, Lawson, and Hall, 2015.

Figure 1b: Change (%) in Scores for Economic Freedom of Venezuela and Various Countries, 1970–2000 and 2000–2013



Source: Gwartney, Lawson, and Hall, 2015.

Montesinos-Yufa: the problems did not begin with the current government, even though it has adopted counterproductive policies that have made Venezuela the least economically free country in the world. Instead, the problem precedes the election of Hugo Chavez in 1999,<sup>5</sup> with the declining trend in economic freedom dating back to 1970. As the authors show, Venezuela was afflicted initially by crony capitalists and later by crony socialists, both of whom were hostile to economic freedom.

5 Since data are only available in five-year intervals prior to 2000, 2000 is used in the charts as the dividing date between pre- and post-Chavez periods.

Figure 2: The price of oil compared to Venezuela's per-capita GDP, 1960–2014

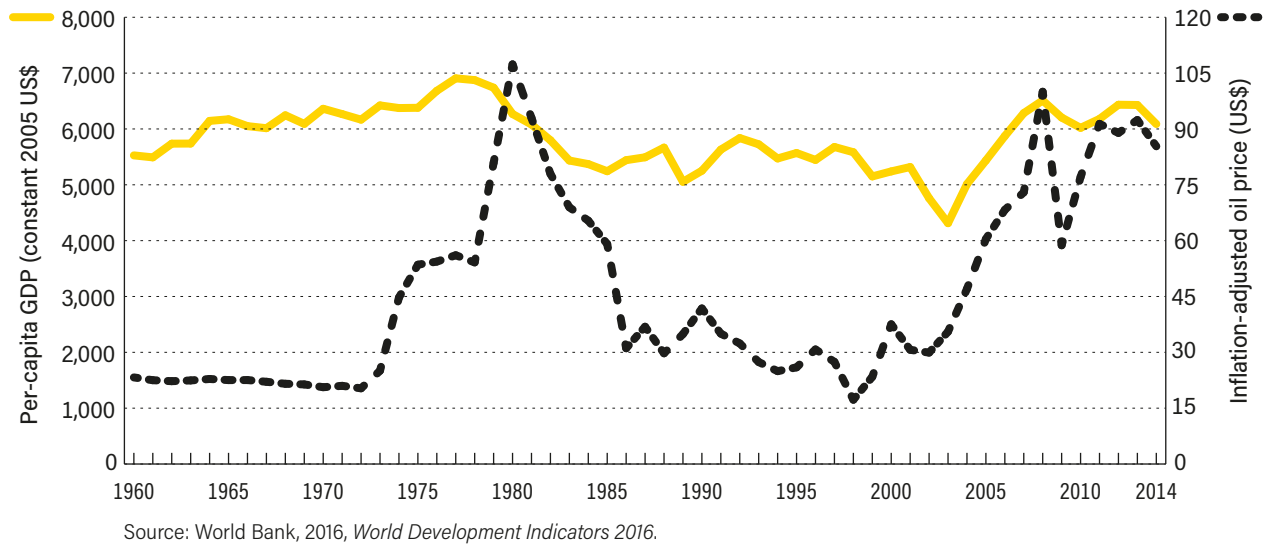


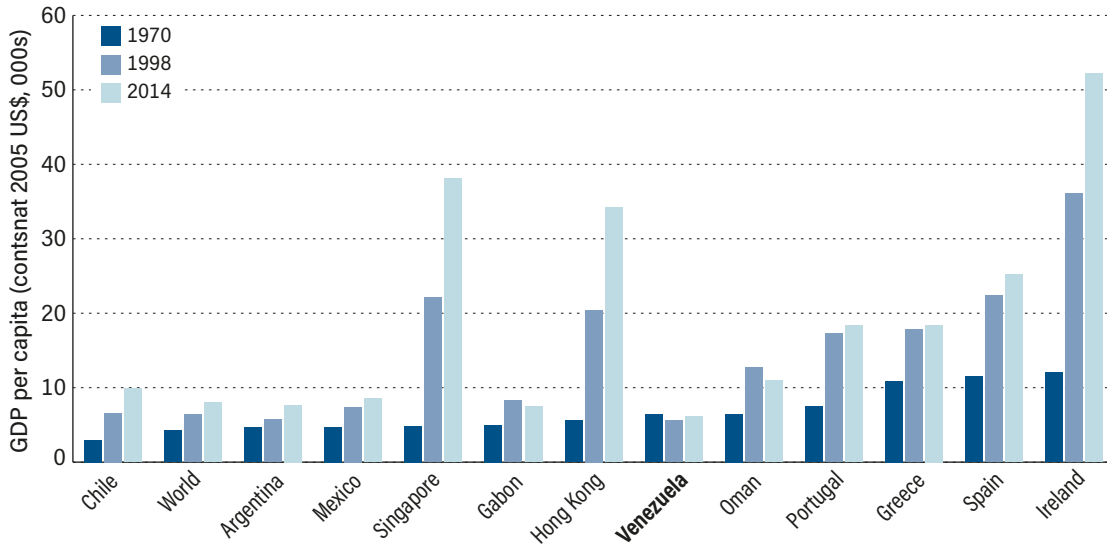
Figure 2 shows that Venezuelan GDP has been closely related to the price of oil since the 1970s. Nonetheless, several interesting facts arise from this chart. From 1960 to the early 1970s, Venezuela had real growth despite flat oil prices. In fact, oil prices in inflation-adjusted terms declined between 1960 and the early 1970s. Figure 1 suggests that economic freedom was relatively high in Venezuela in the period of non-oil-related growth, in that its 1970 EFW rating was well above the South American average. But, the economic freedom of Venezuela began to decline soon thereafter.

Figure 3a compares Venezuela's per-capita GDP to that of nations at a similar stage of development in 1970 and with Chile. Venezuela's per-capita GDP was \$6,361 (all numbers in constant 2005 US dollars). The lowest per-capita GDP in this group close to Venezuela was Singapore at \$4,857; and the highest was Spain at \$11,541. Chile's per-capita GDP of \$2,968 placed it well below the other countries of the comparison group.

Figure 3b shows economic growth patterns. The greatest were Singapore's and Hong Kong's, which in recent decades typically hold the number 1 and 2 spots for economic freedom in the world. Ireland is number 3, providing a poignant example of the dramatically different effects of advances and retreats in economic freedom. Venezuela's growth was dismal. In fact, it is the only member of this similar income group to experience negative growth for the full period from 1970 to 2014. The difference between Venezuela and Chile is striking. While Venezuela moved away from economic freedom, Chile moved in the opposite direction. While the per-capita GDP of Venezuela declined, Chile's soared.

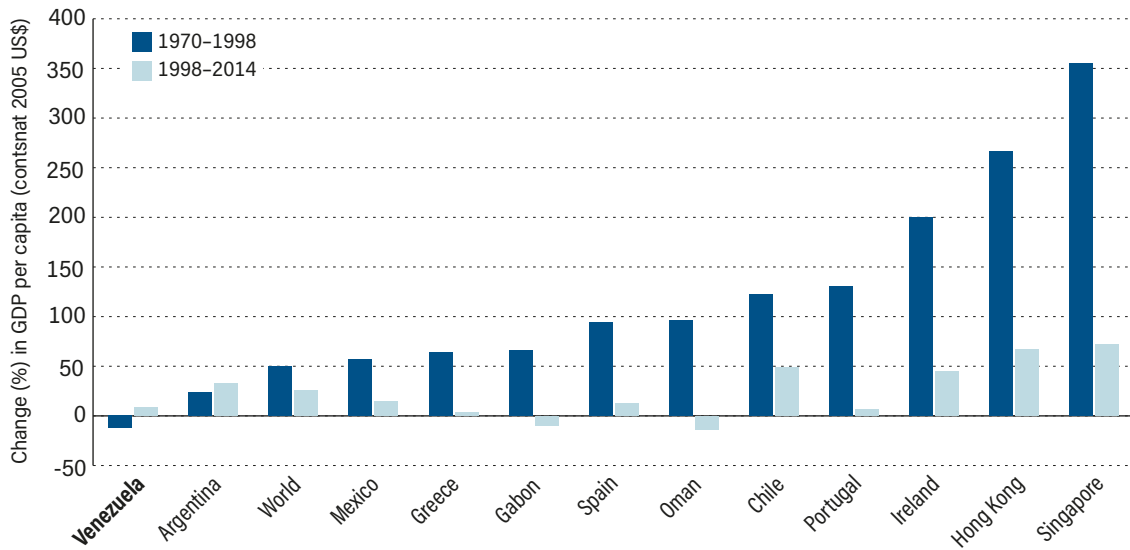
In short, Venezuela shows the disastrous impact of the loss of economic freedom on the income and living standard of the people of a nation. Faria and Montesinos-Yufa thoroughly explain the mechanics of the decline in economic freedom and how it affected the various areas and components in the index of economic freedom.

Figure 3a: GDP per Capita of Venezuela and Various Countries, 1970, 1998, 2014



Source: World Bank, 2016, *World Development Indicators 2016*.

Figure 3b: Change (%) in GDP per Capita of Venezuela and Various Countries, 1970-1998 and 1998-2014



Source: World Bank, 2016, *World Development Indicators 2016*.

## Ireland

Robbie Butler and John Considine describe the components of Ireland's increase in economic freedom and how the individual components contributed to Ireland's stunning growth leap and its reputation as the "Celtic Tiger". Ireland is in many ways the mirror image of Venezuela, and not just that in that Venezuela had a huge fall in economic freedom while Ireland had a great leap upward. Nor that Venezuela has suffered economic stagnation that has been disastrous for its citizens while Ireland has offered hugely increased opportunity and prosperity for its people.

Perhaps the most striking mirror image involves the support for economic freedom. In Venezuela, most sides of the political spectrum stood in opposition to increases in economic freedom: the crony capitalists who opposed economic freedom because, without it, they could manipulate rules and laws to their own advantage to limit the choices and freedoms of the poor and weak; and socialists for ideological reasons and to concentrate their power. In Ireland, on the other hand, a consensus developed across most of the political spectrum in favor of policies supportive of economic freedom. A key turning point, discussed by Butler and Considine, was the fiscal reform of the late 1980s, which significantly reduced the government's footprint in the market place and lowered taxes. This opened up room for increased free exchange while lower tax rates allowed people and companies to keep more of the property they earned as wages or profits.

I traveled to Ireland in 1998 as the Celtic Tiger was in full roar. To my surprise, broad support for economic freedom was highly visible, even among those who might have been expected to oppose free-market economic reform. For example, the unions supported wage moderation and profit enhancement. In other words, on wages, they announced their reluctance to use their monopoly (or near monopoly) in several labor markets to impose settlements that relied on monopoly coercion. On profits, union leaders wanted business to keep more of the income they earned, in other words more of the property they earned, and they supported reduced taxes for individuals. Manus O'Riordan, then head of research for Ireland's largest union association, the Services Industrial Professional Union, put it succinctly to me: "Taxes are a disincentive to work. We need incentives to work". Further, he argued that reduced taxes would help heal a welfare dependency culture that had emerged.

Of course, for the most part, the incentive to reform was based less on an abstract desire for economic freedom and more on its track record for improving the lives of people. "We had declining economic growth and declining employment. Wages were up, but inflation and taxes were up more. Living standards were declining. We knew we had to do something," O'Riordan told me (McMahon, 2000).

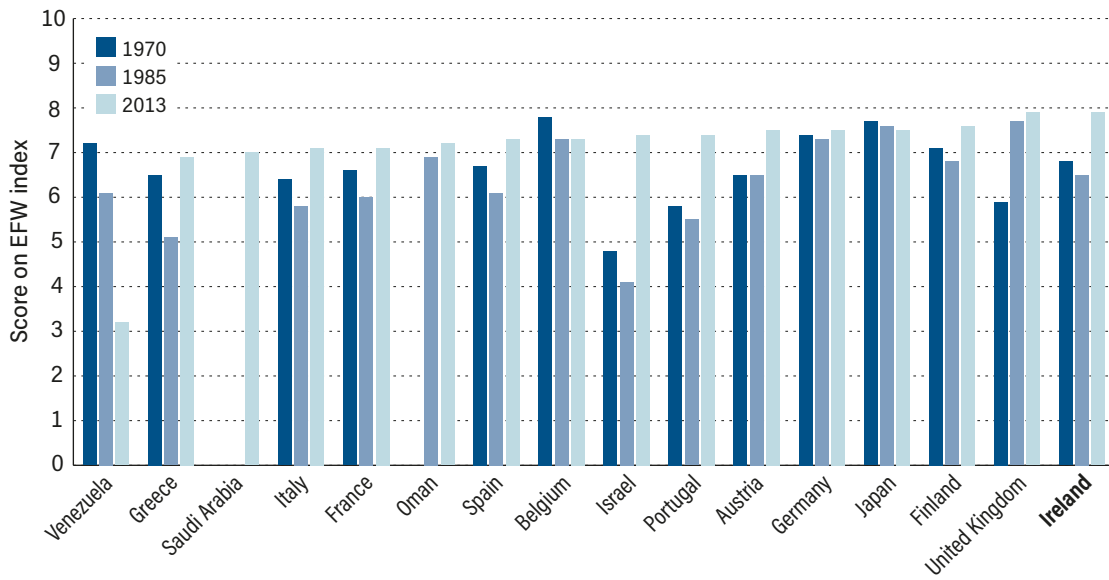
Figures 4a, 4b, 5a, and 5b examine nations that had per-capita GDP similar to Ireland's in 1970, specifically the six nations with GDP just above and just below Ireland, plus three continental European nations—France, Germany and the United Kingdom—with per-capita GDPs considerably above Ireland in 1970, chosen to demonstrate Ireland's ability to rapidly catch up to, and then surpass, once much richer nations as it moved up in the economic freedom ranks.

In 1970, Ireland's economic freedom score was 6.75 but it lost economic freedom between 1970 and 1985,<sup>6</sup> falling to 6.5. Ireland's reforms had a large impact

---

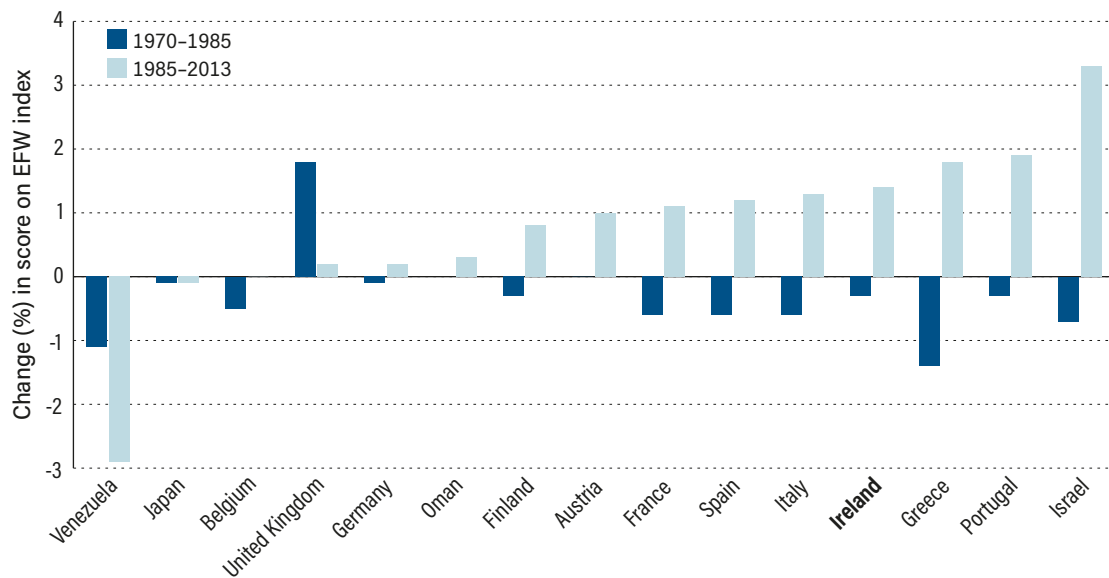
<sup>6</sup> Again, because data are available only in five-year tranches, 1985 is selected to represent the period prior to reforms beginning in 1987.

Figure 4a: Scores for Economic Freedom of Ireland and Various Countries, 1970, 1985, 2013



Source: Gwartney, Lawson, and Hall, 2015.

Figure 4b: Change (%) in Scores for Economic Freedom of Ireland and Various Countries, 1970-1985 and 1985-2013

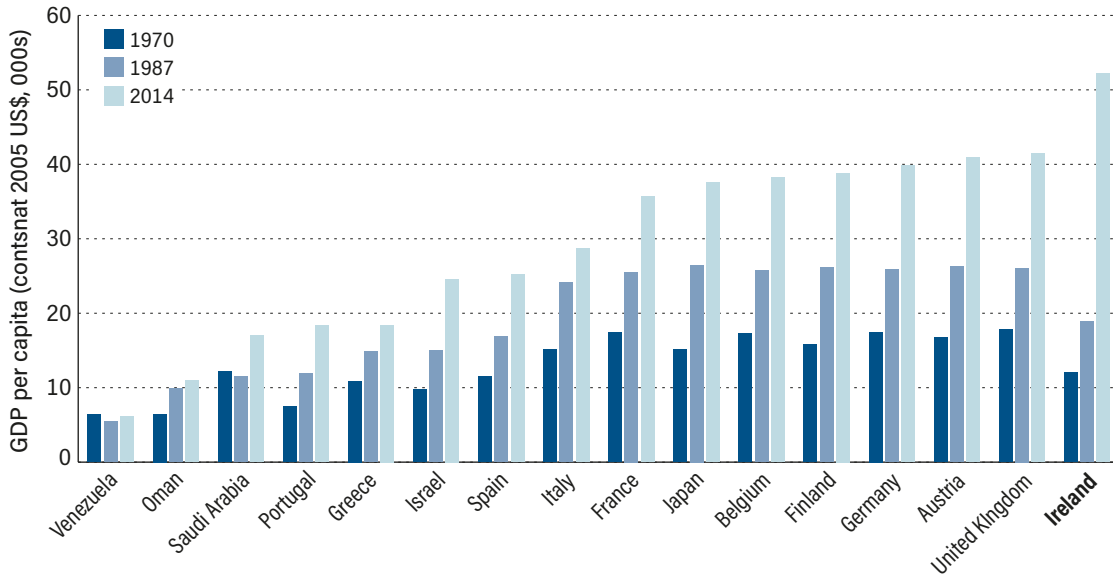


Source: Gwartney, Lawson, and Hall, 2015.

on its economic freedom score after 1985, moving its score up to 7.9 in 2013. Just as Ireland was a star in increasing economic freedom from 1987, not coincidentally it was also a star in economic growth.<sup>7</sup> Venezuela is in this income group and, as noted earlier, performs dismally.

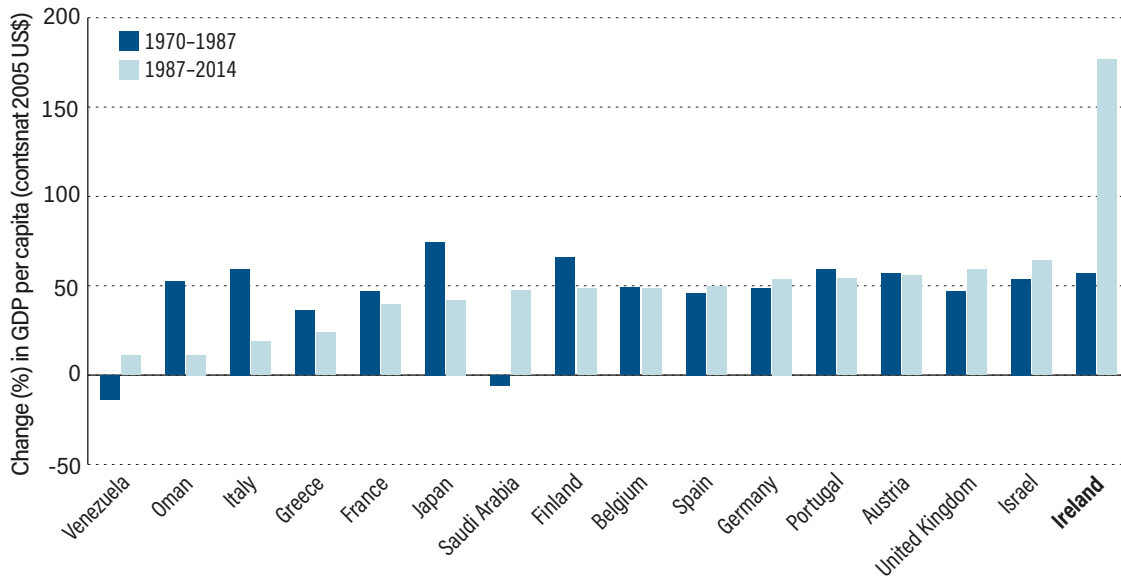
7 Butler and Considine note the controversy over GDP numbers for Ireland but, even if the numbers somewhat overstate the case, the growth record remains spectacular.

Figure 5a: GDP per Capita of Ireland and Various Countries, 1970, 1987, 2014



Source: World Bank, 2016, *World Development Indicators 2016*.

Figure 5b: Change (%) in GDP per Capita of Ireland and Various Countries, 1970-1987 and 1987-2014



Source: World Bank, 2016, *World Development Indicators 2016*.



## United States

Dean Stansel and Meg Tuszynski detail the decline in economic freedom in the United States. The decline hits all five areas of economic freedom—size of government, legal system and property rights, sound money, freedom to trade, and regulation—with the problems concentrated in legal system and freedom to trade.

The United States' decline was part of a similar downward evolution among advanced nations. Between 2000 and 2013, the average rating for the original OECD nations dropped by 0.26 of a point. But, the decline in the United States dwarfed that of the OECD average (Gwartney, Lawson and Hall, 2015: 16). The US decline of 0.9 units from 2000 to 2013 is stunning—the fourth largest among nations with data in both 2000 and 2013. Only Venezuela (2.6), Argentina (2.2), and Iceland (1.2) experienced larger declines in economic freedom during period from 2000 to 2013 than the United States.

Research shows that a one-unit drop in economic freedom will result in a decline in long-term growth of 1.0 to 1.5 percentage points (Gwartney, Holcombe, and Lawson, 2006). The data cited by Stansel and Tuszynski are in line with this result. They report that between 1980 and 2000, the average inflation-adjusted growth in the size of the US GDP was 3.4% per year. But, since the US decline in economic freedom began in 2000, real GDP growth averaged just over half that rate at 1.8%, a decline of 1.6 percentage points.

Of course, the period from 2000 to 2013 included the great recession but Stansel and Tuszynski show that the number of recessionary months in the two periods was roughly similar. The first 20-year period had 30 contractionary months while the second 15-year period had 26 contractionary months. They cite a number of other factors showing that the US economy has been less robust as economic freedom has declined.

Because the fall in economic freedom in the United States has been less stunning than the decline in Venezuela (or the increase in Ireland) and because many other advanced nations have also declined, albeit not so much as the United States, the international comparisons are less sharp than they are in the cases of Venezuela and Ireland. The point of comparison here will be those nations of similar income level in 1970 to the United States, though not including micro-states or petro-nations. The three countries just above<sup>8</sup> and the five just below the United States in per-capita GDP in 1970 make up the comparison group.

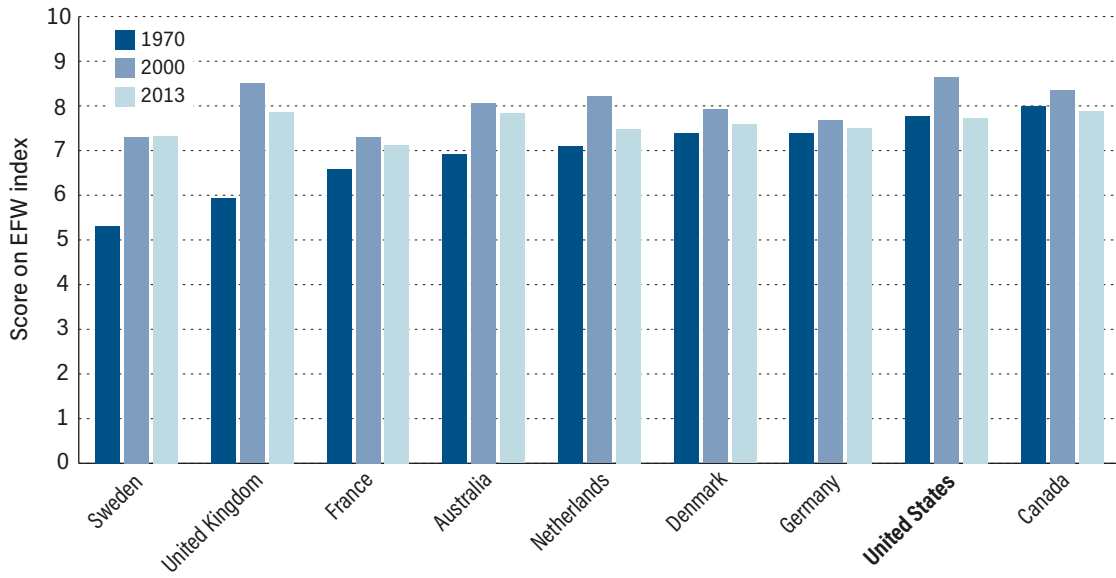
**Figure 6a** shows that the 1970 EFW rating of the United States was higher than for all of the countries in the comparison group except for Canada. By 2000, it had surged ahead of the entire group, including Canada. By 2013, the US rating had fallen behind both the United Kingdom and Canada. **Figure 6b** shows that, while most of these nations have declined in economic freedom since 2000, the decline of the United States was the largest among the comparison group.

**Figure 7a** shows per-capita GDP in 1970, 2000, and 2013.<sup>9</sup> **Figure 7b** shows growth between 1970 and 2000 and between 2000 and 2013. Growth in the first period was

<sup>8</sup> Only three nations that are neither petro-states or micro-states have a per-capita GDP above the United States in 1970.

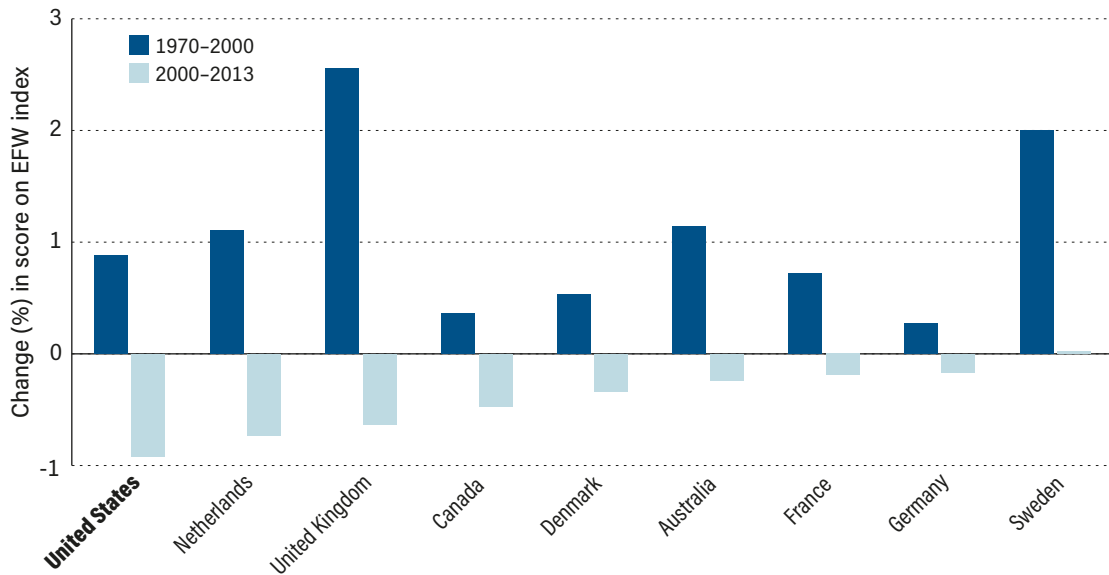
<sup>9</sup> It will surprise some that Denmark is ahead of the United States in per-capita GDP. However, Denmark in earlier decades had a high level of economic freedom and has been on a long decline. This is partially evident in the fact it had the slowest growth of the selected nations after 2000.

Figure 6a: Scores for Economic Freedom of the United States and Various Countries, 1970, 2000, 2013



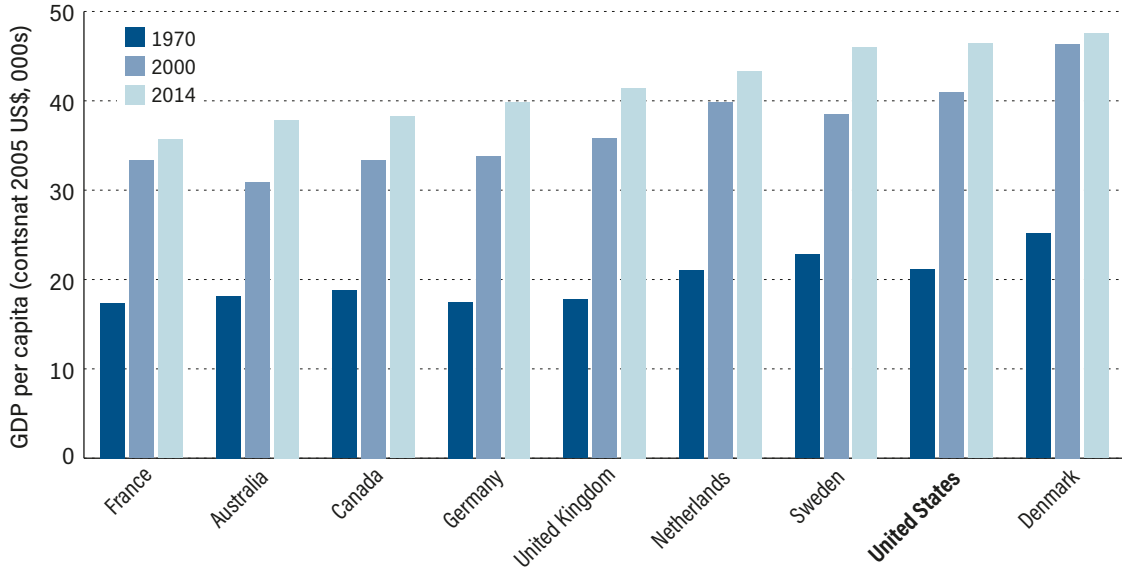
Source: Gwartney, Lawson, and Hall, 2015.

Figure 6b: Change (%) in Scores for Economic Freedom of the United States and Various Countries, 1970-2000 and 2000-2013



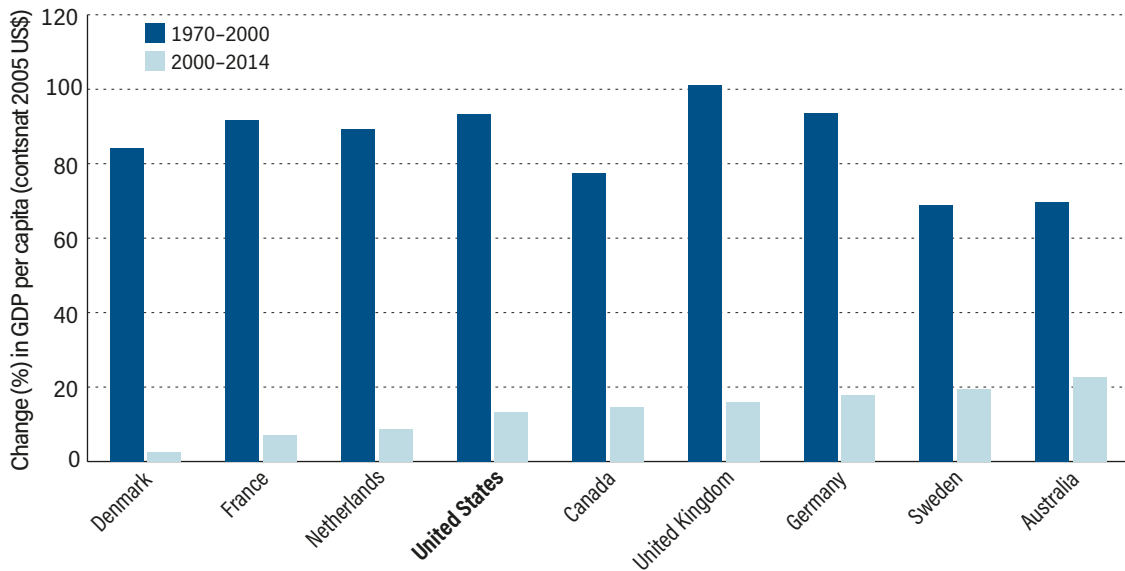
Source: Gwartney, Lawson, and Hall, 2015.

Figure 7a: GDP per Capita of the United States and Various Countries, 1970, 2000, 2014



Source: World Bank, 2016, *World Development Indicators 2016*.

Figure 7b: Change (%) in GDP per Capita of the United States and Various Countries, 1970–2000 and 2000–2014



Source: World Bank, 2016, *World Development Indicators 2016*.

larger for all nations both because the period is longer and because this was a time of increasing economic freedom. Referring back to figure 6b, we can see that all nations considered here had increases in economic freedom during this period while all suffered losses during the more recent period. (See Gwartney, Lawson and Hall, 2015: 15–16 for a discussion of the similar evolution of global economic freedom, including both periods discussed here.)

Between 1970 and 2000, US growth was well ahead of the average of these nations and second only to the United Kingdom, which had transformed its economy during the 1980s. Over this period, the US recorded a growth rate of per-capita GDP of 93% compared to the average of 85% for the group. During the later period, the average per-capita growth was 14%, just above the United States' rate of 13%. In other words, the United State's advantage had disappeared.

Perhaps the more telling comparison is that between Canada and the United State. Both have similar economies and have good access to the market of the other, and that was true even before the Canada-US Free Trade agreement of 1988 further opened up the North American markets.<sup>10</sup> (The North American Free Trade Agreement came into force in 1994.) During the first period, as the United States moved past Canada in economic freedom, US growth dramatically exceeded that of Canada, 93% to 78%. During the second period, when Canadian economic freedom ultimately exceeded that of the United States, Canadian growth was 15% compared to 13% for the United States.

As noted earlier, the figures in this section should be taken as illustrative. They do not capture all elements related to economic growth. However, the US experience is consistent with sophisticated research on the relationship between economic freedom and growth. As the economic freedom of the United States has declined since 2000, so too has its growth rate compared to both its past and relative to other countries. This is indicative of the damage that results when countries move away from economic freedom.

In summary, the three articles in this volume serve as a timely warning of the adverse consequences generated by the loss of economic freedom and the potential gains in prosperity and growth that accompany advances in economic freedom.

---

10 2000 is chosen as it marks the beginning of the US decline in economic freedom. As Stansel and Tuszynski show, US performance declines in a number of measures after 2000.

## References

Al Ismaily, Salem Ben Nasser, Azzan Al-Busaidi, Miguel Cervantes, and Fred McMahon (2015). *Economic Freedom of the Arab World: 2015 Annual Report*. Fraser Institute, in conjunction with the Friedrich Naumann Foundation for Liberty, Cairo office, and the International Research Foundation, Oman. <<https://www.fraserinstitute.org/studies/economic-freedom-of-the-arab-world-2015-annual-report>>.

Casey, Nicholas (2016, June 19). Venezuelans Ransack Stores as Hunger Grips the Nation. *New York Times*. <[http://www.nytimes.com/2016/06/20/world/americas/venezuelans-ransack-stores-as-hunger-stalks-crumbling-nation.html?\\_r=2](http://www.nytimes.com/2016/06/20/world/americas/venezuelans-ransack-stores-as-hunger-stalks-crumbling-nation.html?_r=2)>.

Donald J. Boudreaux, editor, (2015). *What America's Decline in Economic Freedom Means for Entrepreneurship and Prosperity*. Fraser Institute. <<https://www.fraserinstitute.org/studies/lesson-canada-economic-freedom-and-entrepreneurship-critical-economic-growth>>.

De Soysa, Indra, and Krishna Chaitanya Vadlamannati (2014). Free Markets and Civil Peace: Some Theory and Empirical Evidence. In James Gwartney, Robert Lawson, and Joshua Hall, *Economic Freedom of the World: 2014 Annual Report* (Fraser Institute): 211–229. <<https://www.fraserinstitute.org/research/economic-freedom-world-2014-annual-report>>.

Easton, Stephen T., and Michael A. Walker, eds. (1992). *Rating Global Economic Freedom*. Fraser Institute.

Easton, Steven T., and Michael A. Walker (1997). Income, Growth, and Economic Freedom. *American Economic Review* 87, 2 (May): 328–32.

De Haan, Jakob, Susanna Lundström, and Jan-Egbert Sturm (2006). Market-Oriented Institutions and Policies and Economic Growth: A Critical Survey. *Journal of Economic Surveys* 20, 2: 157–191.

Gwartney, James, and Robert Lawson (2004). Economic Freedom, Investment, and Growth. Ch. 2 in Gwartney and Lawson, eds., *Economic Freedom of the World: 2004 Annual Report* (Fraser Institute): 28–44. <<https://www.fraserinstitute.org/research/economic-freedom-world-2004-annual-report>>.

Gwartney, James, Robert Lawson, and Joshua Hall (2015). *Economic Freedom of the World: 2015 Annual Report*. Fraser Institute. <<https://www.fraserinstitute.org/studies/economic-freedom-of-the-world-2015-annual-report>>.

Hall, Joshua, and Robert Lawson (2014). Economic Freedom of the World: An Accounting of the Literature. *Contemporary Economic Policy* 32, 1: 1–19. <<http://onlinelibrary.wiley.com/doi/10.1111/coep.12010/abstract>>.

McMahon, Fred (2000). The Celtic Tiger. In Fred McMahon, *Road to Growth: How Lagging Economies Become Prosperous* (Atlantic Institute for Market Studies): 49–96. <[http://aims.wpengine.com/site/media/aims/book\\_roadtogrowth\\_chapter2.pdf](http://aims.wpengine.com/site/media/aims/book_roadtogrowth_chapter2.pdf)>.

Reddan, Fiona (2016, April 26). Property Prices Up 7.4% in Year to March. *Irish Times*. <<http://www.irishtimes.com/business/economy/property-prices-up-7-4-in-year-to-march-1.2624905>>.

Yagoub, Mimi (2016, January 27). Caracas World's Most Violent City: Report. *InSight Crime*. <<http://www.insightcrime.org/news-briefs/caracas-most-violent-city-in-the-world-2015-report>>.

#### *Data sources*

World Bank (2016). *World Development Indicators 2016*. <<http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators>>, as of June 23 to July 1, 2016.

McMahon, Fred (2016). *Economic Freedom of the World Index*. <<http://efwdata.com>>. Uses data from 2015 Economic Freedom Dataset published in Gwartney, Lawson, and Hall (2015), *Economic Freedom of the World: 2015 Annual Report* (Fraser Institute) and available at <[http://www.freetheworld.com/datasets\\_efw.html](http://www.freetheworld.com/datasets_efw.html)>. Data manipulated by Economic Freedom of the World software, available for free download at: <<http://www.freetheworld.com/>>.

# Chapter 4 The Critical Role of Economic Freedom in Venezuela's Predicament

*Hugo J. Faria and Hugo M. Montesinos-Yufa*

## 1 Introduction

The goal of this introduction is to clarify important terms that are employed in the analysis of the Venezuelan predicament. Rising income per capita across an increasing number of countries is ultimately associated with the quality of formal economic institutions and informal institutions also known as culture.<sup>1</sup> According to North (1990), formal institutions, which are created by the polity, comprise rules and laws, as well as constitutions. Informal institutions, which are intergenerationally transmitted, are made up of norms of behavior, conventions, and self-imposed code of enforcement (Alesina and Giuliano, 2015).

In this paper, formal economic institutions are measured by the index published in *Economic Freedom of the World* (EFW) by the Fraser Institute and built over the years by James Gwartney, Robert Lawson, and Joshua Hall. The EFW index contains a set of economic institutions and policies that provide the rules of the economic game. High levels of economic freedom (EF) create an environment conducive to the maximization of voluntary transactions given demand and supply.<sup>2</sup>

- 
- 1 For recent evidence, see Ang, 2013; Acemoglu, Gallego, and Robinson, 2014; Faria, Montesinos, Morales, and Navarro, 2016; and Bennett, Faria, Gwartney, Montesinos, Morales, and Navarro, 2016; and Bennet, Faria, Gwartney, and Morales, 2016.
  - 2 Increasing EF can also expand voluntary transactions by shifting to the right demand and supply functions. For example, improvements in the protection of property rights may reduce the risk perception of the country, shifting the supply to the right both by the entrance of new suppliers and by a reduction in the cost of doing business. Similarly, lowered risk perception may enhance confidence, enticing new consumers into the market, and shifting demand curves to the right.

---

Citation Hugo J. Faria and Hugo M. Montesinos-Yufa (2016). The Critical Role of Economic Freedom in Venezuela's Predicament. Early release of chapter 4 from James Gwartney, Robert Lawson, and Joshua Hall, *Economic Freedom of the World: 2016 Annual Report* (Fraser Institute): 213–235.

Authors Hugo J. Faria, is a Lecturer in Economics at the University of Miami, Florida, and Professor of Economics and Finance at the Instituto de Estudios Superiores de Administración, Caracas, Venezuela. Hugo M. Montesinos-Yufa is a PhD. student at Florida State University and has taught at the Instituto de Estudios Superiores de Administración, Caracas, Venezuela.

Rules that maximize voluntary transactions are inclusive institutions. Free trade, legal infrastructure protective of properly acquired private property, and sound money are examples of inclusive institutions. Rules that unnecessarily diminish voluntary transactions are exclusionary institutions. Examples of exclusionary institutions are price controls, minimum wage laws, and nationalizations of companies (Faria and Filardo, 2015).<sup>3</sup>

Political institutions are measured by Political Freedom (PF), which is a proxy for democracy, and is calculated as the average of the civil and political rights indices, published by Freedom House (2015). Culture is measured by trust and the individualism-collectivism cleavage. Data on these two cultural variables are provided by Alesina and Giuliano (2016).

The rest of the paper has the following structure. Section 1 presents a brief historical account concerning the economic and political institutions of Venezuela. Section 2 compares the behavior through time of Venezuela and Latin America in the EFW index and discusses the joint behavior of economic and political institutions for Venezuela starting in 1980. Section 3 documents the variations of Areas and components of EFW responsible for the changes in economic freedom documented in Section 2. Section 4 attempts to uncover the influence of cultural legacy, French legal origin, and human capital on the evolution of economic freedom, while Section 5 concludes, addressing the manifold consequences of having a low level of economic freedom.

### 1.1 Brief historical account of Venezuela from the 1800s to 1960

Simon Bolivar, who is known as the liberator and the main founder of Venezuela as a nation, was highly skeptical of the virtues of democracy for Venezuelans (Bolivar, 2003; Hernandez, 2012). Moreover, it can be argued that, while American founders wanted freedom, Venezuelan generals (*caudillos*) wanted independence from Spain. The intent was to replicate locally the vices that existed with the crown (Uslar, 1962; Fronjosa, 2011). Indeed, the privileges that the local aristocracy had obtained during the colonial period persisted in the aftermath of the independence war (Angeles, 2007; Bruhn and Gallego, 2012).

The war for independence was really a civil war in which most participants of non-European descent, led by Spanish generals, fought in defense of the crown against the local European elites who were perceived, correctly, as oppressors. In fact, Venezuela's independence was established in 1821 by European descendants and for European descendants (Faria and Filardo, 2015 and references therein).

Venezuelans' first taste of democratic rule with free and contested elections in a multi-party system as well as universal suffrage came in 1959, nearly 140 years after independence. This democratic transition was catalyzed by unprecedented years of prosperity starting in 1920, featuring sustained high growth rates, and ending in 1957 (Baptista, 2011; Heston, Summers and Aten, 2012).<sup>4</sup> These four decades

---

3 These examples of exclusionary institutions are instances of government failures, on that they needlessly reduce society's welfare. The adverb "unnecessarily" is motivated by the notion that sparingly and intent upon causing the least amount of harm, the government should step in and in the short term reduce voluntary transactions to a level consistent with the social optimum, for example, in the case of negative externalities that are generalized and harmful to society.

4 Venezuela's real income per capita reached its pinnacle back in 1978, and the years between 1958 and 1978 were characterized by low growth rates in comparison to estimated growth experienced from 1920 to 1957. See Faria, 2003, based on data provided by the Central Bank of Venezuela.



of extraordinary economic expansion were triggered by discovery of enormous oil reserves in 1914. Thus, circa 1920 Venezuela decidedly started to escape the Malthusian trap leaving behind the epoch of per-capita income stagnation.

During these years, Venezuela experienced relatively high levels of economic freedom. The period from 1920 to 1957 witnessed remarkable monetary stability made possible either by free banking or a currency board, which through a fixed exchange rate with the US dollar linked the local currency (*Bolivar*) irrevocably to the US dollar. The government owned very few enterprises, the personal marginal tax rate was 12%, oil was extracted and refined by multinational companies, regulations were few, labor laws were flexible, private property was protected, in economic matters people were treated evenhandedly by the judicial system, decentralized corruption was minimal, and the crime rate was low. Finally, fiscal discipline prevailed to the point that government's external and internal debt was paid in full by 1930 (Lahoud, 2015; Sanchez-Coviza and Olcoz, 1966).<sup>5</sup>

Arguably, the advent of democracy and political freedoms sprang from high levels of economic freedom that promoted a flourishing economy. In 1960, income per capita of Venezuelans was equal to 45% of the US per capita income (Heston, Summer and Aiten, 2012). Further, the Venezuelan average growth rate in the 1950s clearly exceeded the growth rate of the so-called German economic miracle (Sanchez-Coviza and Olcoz, 1966). Germany was recovering from the devastation wrought by World War II and therefore, like Venezuela, was benefitting in 1950 from the Hayekian "advantage of backwardness". However, Germany had the extra advantage of a high level of human capital per war survivor, whereas Venezuelan human capital was very low. As will be shown later, inclusive economic institutions prevailing at the time that oil was discovered easily compensated for the human capital deficit of Venezuela.

## 1.2 The democratic period from 1959 to 1980—sowing the seeds of democracy's destruction

Unfortunately, the onset of democracy in 1959 brought along with it accelerated deterioration of economic freedom and thus of economically inclusive institutions and policies. Between 1959 and 1980, many exclusionary policies were adopted (see box, page 216, for a list of the most salient). For a better understanding of this accelerated transition from inclusive to exclusionary economic institutions with the onset of democracy, it helps to bear in mind the economic philosophy of the former presidents who presided over the deterioration in institutional quality. Rómulo Betancourt, while in exile during the Gomez administration in the early 1930s, was instrumental in organizing the communist party in Costa Rica. However, over the years Betancourt gradually became a democratic socialist. Rafael Caldera was a "Social Christian", educated by the Jesuits, a religious order of the Catholic faith that is often antagonistic to

---

5 After independence and prior to the advent in 1908 of J.V. Gomez, a ruthless dictator who died in power in 1935, the country was mired by numerous internal armed conflicts and concomitant political instability, rendering economic development impossible. However, Gomez pacified the country providing the foundation for a system of private enterprise. Thus, in economic matters, Gomez as a Venezuelan head of state was an outlier. Manuel Caballero, a well-known Venezuelan historian, wrote a book titled *Gomez, the Liberal Tyrant* (2007), clearly suggesting that Gomez's economic instincts were congruous with the classical Liberal economic philosophy. We will have more to say on Gomez in section 5.

### The Most Salient Exclusionary Policies Adopted by Venezuela, 1959–1980, and the Presidents Who Initiated the Policies

- 1 European and Latin American immigration was substantially curbed—Rómulo Betancourt;<sup>1</sup>
- 2 creation of OPEC, founded by the Venezuelan secretary of energy—Rómulo Betancourt;
- 3 establishment of CORDIPLAN, an economic planning agency—Rómulo Betancourt;
- 4 an end to the extension of tract lands to oil multinationals to find and extract oil reserves—Rómulo Betancourt;
- 5 creation of the *Corporación Venezolana del Petróleo (CVP)*, a government company in the oil business—Rómulo Betancourt;
- 6 agrarian reform, or redistribution of agricultural lands, where the new “owners” did not receive a property title but only a right to farm the land—Rómulo Betancourt;
- 7 marginal income-tax rates at the personal level were tripled from 12% to 36%, and numerous tax brackets created, increasing complexity of the tax system—Rómulo Betancourt;
- 8 rent controls and strengthening the legal capacity of the rent-payer to remain in the property after contract expiration and against the will of the owner—Rómulo Betancourt;
- 9 exchange-rate controls and devaluation of the Bolívar—Rómulo Betancourt;
- 10 price controls—Rómulo Betancourt and Raúl Leoni;
- 11 the Central Bank Law was amended to allow lending to the government by the central bank—Rómulo Betancourt;
- 12 minimum-wage decrees and rulings to prohibit dismissal of workers—Carlos Andrés Pérez;
- 13 nationalization of the Central Bank (which had been 49% owned by the private sector), iron industry, and oil industry—Carlos Andrés Pérez;
- 14 rampant corruption at all levels of government, including the judicial system—Rafael Caldera and Carlos Andrés Pérez;
- 15 national policy of “import substitution”, increasing the cost of living to average Venezuelans as well as reducing the benefits conferred by a greater choice of goods to buy, let alone the inefficient allocation of resources—Rómulo Betancourt and Raúl Leoni;
- 16 complex regulations that stymie business formation, increase the cost of dismissal, and compel banks to allocate loans to sectors deemed by the government as strategic—Carlos Andrés Pérez.<sup>2</sup>

---

1 See on this Centro Latinoamericano y Caribeño de Demografía (CELADE), 2000.

2 For a more detailed account, see Faria, 2008.

free markets.<sup>6</sup> He turned out to be no less socialist than Betancourt. Carlos Andrés Pérez turned out to be more of a pragmatist, particularly during his second term. However, during his first constitutional term the central bank, and the oil and iron industries were nationalized, and these policies epitomize socialism.

A complementary factor explaining nationalizations is the accompanying power associated with *de facto* ownership by politicians in the government of enormous corporate resources. The irony of the socialist rhetoric is that nationalizations are performed allegedly to empower the people by bestowing on them ownership of key corporate resources. However, these “owners” cannot sell their share in the business and do not receive any income generated by the business operation. Meanwhile, elites in the private sector salivate over these policies, destructive of markets, because it is their custom and culture to accumulate wealth through political connections.

## 2 Pattern of economic freedom 1980 to the present

### 2.1 Comparison of the evolution of economic freedom in Venezuela and Latin America

The EFW rating of Venezuela in 1980 was relatively high: it had a score of 6.69 (figure 4.1). However, to place this rating in perspective, in the same year Hong Kong's rating was 8.62, nearly two points higher. Further, Venezuela's 1980 rating was markedly lower than its rating of 7.0 in 1970. This result should not be surprising based on some of the exclusionary policies adopted (Section 1.2). It is also worth noting that in 1980 Venezuela's EFW rating was substantially higher than Latin America's average of 5.06.<sup>7</sup> In other words, Latin America enjoyed only 75% of Venezuela's economic freedom.

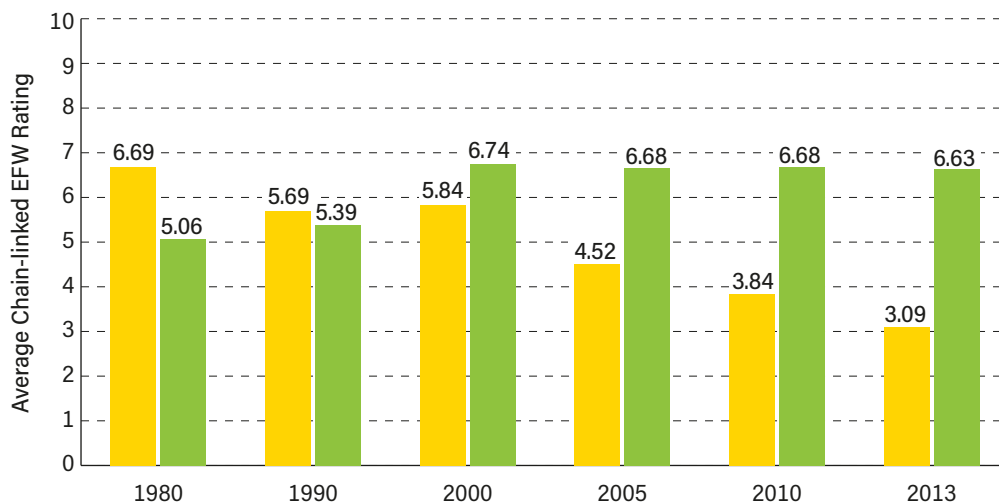
By 1990, ten years later, the ratings for economic freedom of Venezuela and Latin America were nearly the same, as Venezuela's had dropped by a full point to 5.69 and Latin America's had moderately increased by a one third of a point, rising to 5.39. The main culprit for Venezuela's decline in economic freedom was the accelerated inflation suffered by the country in the wake of the 1983 devaluation.

In the year 2000, there was a marginal increase in Venezuela's rating for economic freedom of 0.15 in comparison to 1990. This increase masks a precipitous decline to 4.3 observed in 1995, spawned by major reversals of some policies of economic liberalization adopted in 1990 but overturned with a vengeance by reinstating unnecessary regulations and controls in 1995. The spike in 2000 is owed to the International Monetary Fund's economic recipe, which the government reluctantly accepted in 1996/1997 in the face of the major disarray and prostration of the economy. It goes without saying that the crisis of 1996 originated in the economic U-turn of 1994/1995.

6 Fidel Castro was a Jesuit alumnus in Cuba. Pope Francis, who for Catholics has profound and enlightening reflections on religious issues but, lamentably, generally ignores the achievements of markets and fails to distinguish between cronyism and market allocation, is also a Jesuit. One of the co-authors of this article was educated by the Jesuits and can attest to the anti-market bias instilled into numerous cohorts of students in Jesuit schools.

7 The following 18 countries were included in the calculation of the simple arithmetic average of the chain-linked EFW index for Latin America in the year 1980: Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela. Data for these countries was also used to calculate the average for Latin America in figure 4.1; data for Guyana was included from 1995 onward.

Figure 4.1: Pattern of Economic Freedom for Venezuela and Latin America, 1980–2013



Sources: Gwartney, Lawson and Hall, 2015a; authors' calculations.

After the almost serendipitous freedom increase of the year 2000, economic freedom in Venezuela has headed in a single direction: downhill. This descent remains the case up to the day of this writing. The overall cause of this loss of economic freedom is the exacerbation of the exclusionary policies and institutions adopted after 1959 and through to 1999, prior to the advent of the Chavez-Maduro administrations. More specifically, there is no qualitatively discernible difference between the economic policies and institutions adopted throughout the so-called Fourth Republic, spanning the years from 1959 to 1999, and those policies adopted by the Chavez-Maduro regime, also known as the Fifth Republic. The difference is quantitative. To mention a few, higher inflation, more nationalization, greater numbers of goods and services subjected to price controls, and more shortages as well. In sum, more unnecessary reductions of voluntary transactions spawned by additional exclusionary institutions.

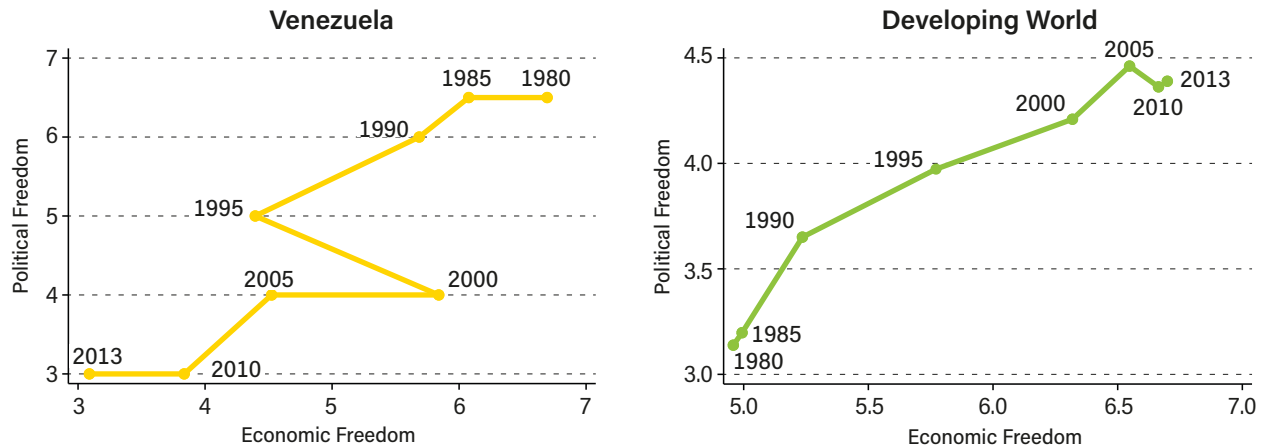
The qualified good news is that, in spite of Venezuela's performance, Latin America's average level of economic freedom has increased. The drawback is that economic freedom in Latin America has remained at a plateau of approximately 6.68 since the year 2000, with a slight tendency to decrease. To provide some perspective, a country with a rating of 6.68 in the latest edition of the EFW index would be ranked 100<sup>th</sup> in the world out of 157 countries, down among the third quartile of countries.

## 2.2 Evolution of Venezuela's economic and political freedoms from 1980 to 2013

This subsection attempts to cast light on the co-evolution of political freedom and economic freedom in Venezuela. To glean a greater understanding of this issue we will contrast Venezuela's results with those of the developing world and the world as a whole aided by graphical results. Further, we inquire if the graphical results are compatible with the hypothesis of portraying economic freedom as a predictor of political freedom.<sup>8</sup>

8 Figures 4.2, 4.3, and 4.4 are based on the graphical exhibits of Lawson and Clark, 2010.

Figure 4.2: Contrasting the Historical Evolution of Political and Economic Institutions in Venezuela and in the Developing World



Sources: Gwartney, Lawson and Hall, 2015a; Freedom House, 2015.

Figure 4.2 presents contemporaneous behavior of both freedoms. The Venezuelan graph to the left suggests that starting in 1980 economic institutions and policies measured by the EFW index generally deteriorated with the sole exception of the spike from 1995 to 2000 discussed earlier. The graph discloses a deterioration of political freedom concurrent with that of economic freedom.

Importantly, for the Venezuelan case, both freedoms generally move from the top right to the bottom left suggesting a decaying process. On the contrary, for the developing world, both freedoms move from the bottom left to the top right of the graph, suggesting an increase of both freedoms and implying an improvement of the political and economic institutional quality.

Figure 4.3 is similar to figure 4.2 except that economic freedom is lagged five years in relation to political freedom. The graph for Venezuela on the left conveys information qualitatively similar to that in the corresponding graph in figure 4.2. In spite of the five year lag of economic freedom, both freedoms move in tandem. That is reductions in economic freedom are a precursor of declines in political freedom.

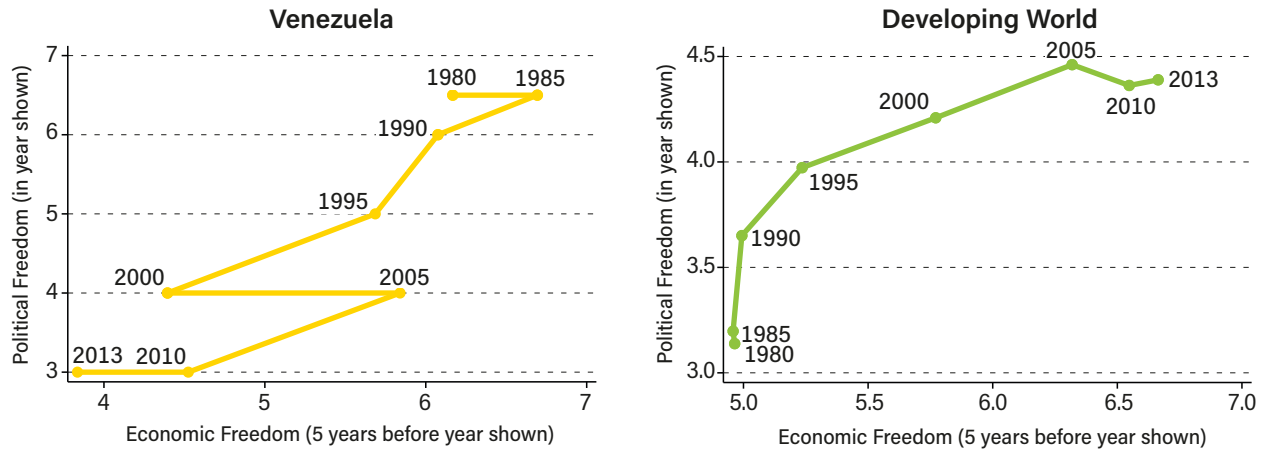
We note that this is what the emblematic English case would predict except, of course, that in England economic and informal institutional quality improved preceding the advent of rule of law and democracy. Venezuela, in contrast, is a case where democratic leaders valued political freedom over economic freedom, resulting in the dissipation of both freedoms.

For the developing world and using lagged EFW data, we find results similar to those in figure 4.2. In fact, lagged increases in economic freedom generally lead to higher levels of political freedom.

Figure 4.4 displays the co-evolution of economic and political freedoms for the world. The graph to the left shows contemporaneous behavior of both freedoms, while the graph to the right lags EFW by five years. For both graphs, political and economic freedoms jointly evolve from the bottom left corner to the top right corner, conveying the information of increasing world freedoms for the period from 1980 to 2013. In addition, the graph on the right-hand side suggests that lagged increases of EFW data predict greater political freedom.<sup>9</sup>

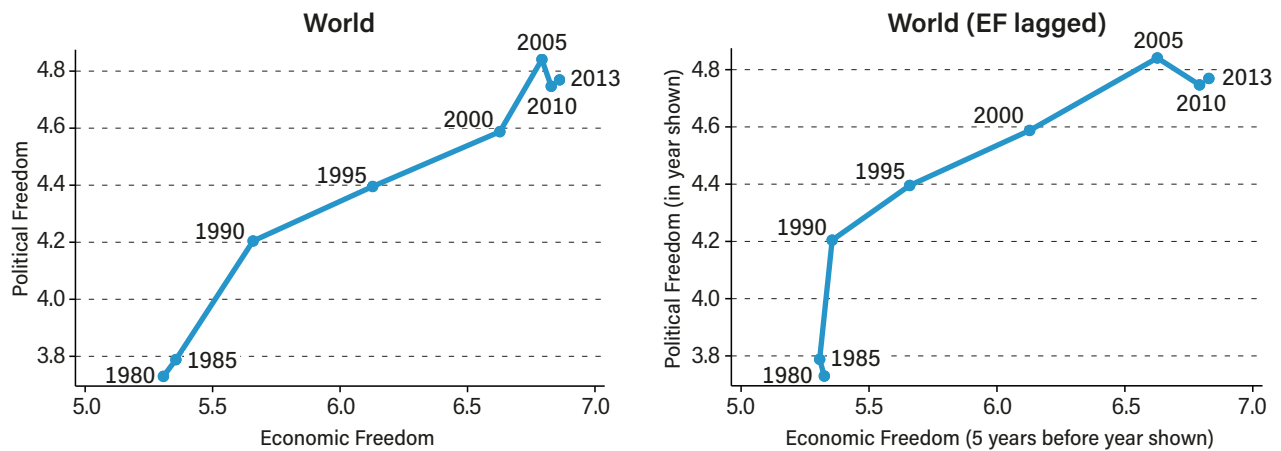
9 For a formal treatment of these issues, see Montesinos, 2016; Boudreaux and Holcombe, forthcoming.

Figure 4.3: Contrasting the Historical Evolution of Political And Economic Institutions in Venezuela and in the Developing World—Economic Freedom Lagged 5 years



Sources: Gwartney, Lawson and Hall, 2015a; Freedom House, 2015.

Figure 4.4: Evolution of Economic and Political Freedoms for the world



Sources: Gwartney, Lawson and Hall, 2015a; Freedom House, 2015.

We suggest a potential channel of influence of economic freedom on democracy for the Venezuelan case. Based on English constitutional history and the Parliament’s auspicious decision to starve the Crown, we contend that it is very difficult to sustain a flourishing democracy when the government obtains substantial revenue that is not financed by taxes levied on the people.<sup>10</sup> In Venezuela, more than 50% of the government’s revenue derives from oil production; thus, the government is the *de facto* owner of the oil wealth, resulting in the citizens’ dependence on the government for sustenance. Yet, a reverse condition—whereby the politicians and bureaucrats are financially supported by the people—is a necessary condition for a sustainable democracy with good quality of government.

<sup>10</sup> Pipes (1999: 133) argues that Parliament made sure the Crown did not gain fiscal independence. Milner argues that “[t]he Crown became poorer and poorer, and when compelled to resort to Parliament, had to surrender constitutional rights in return for funds” (1931: 248). On the contrary, the basis of absolutism in France and Spain was the Crown’s financial independence (Pipes, 1999: 154).

State ownership of the “commanding heights” of the economy is another insidious socialist institution that deprives people of democracy, as well as an accountable and high-quality government. One potential reform consistent with both economic freedom and accountability of government would be to distribute the oil proceeds among all citizens born in Venezuela that are at least 21 years of age. A government deprived of the oil revenues would be more sensitive to the costs and benefits accompanying taxation and spending<sup>11</sup>

### 3 Analysis of major changes in the Areas and components of the EFW index

A closer examination of the Areas and components of the index from *Economic Freedom of the World* reveals a footprint of the economic institutional path in Venezuela. **Table 4.1** displays the chain-linked summary index and chain-linked areas in Venezuela for the years 1980, 1990, 2000, 2005, 2010, and 2013. In addition, it shows the corresponding average ratings for Latin America, the 24 long-standing OECD countries, and the World in the same period. This allows a comparison of Venezuela with these groups of countries in terms of the relative quality of their institutions in each of the five main areas of the index.

The first striking observation is that institutions in Venezuela deteriorated almost systematically and uniformly in all periods and areas. The only exception to this dramatic decline is in the 1990s and it is due to increases in Area 3: Sound Money, Area 4: Freedom to Trade Internationally, and Area 5: Regulation. These increases, however, are substantially lower than the gains achieved in the rest of the world and Latin America, in particular. Venezuela's EFW summary rating in 1990 was 5.69 and it went up to 5.84 in 2000, an increase of 0.25 points. In this period, however, Latin America and the World exhibit a greater, and their greatest, increase. Latin America's average EFW rating in 1990 was 5.39 and by 2000 it was 6.74, an increase of 1.35 points. The World's average EFW rating in 1990 was 5.66 and it went up to 6.63 in 2000, a 0.97 point increase. The long-standing OECD countries also went up from an average of 7.23 in 1990 to 7.90 in 2000, an increase of 0.77 points. During the 1990s, Venezuela's EFW rating moved from being above the World and Latin American averages, in 1990, to being below average in 2000.

#### 3.1 Decline of Area 2: Legal System and Property Rights

The second striking observation is the systematic and dramatic decline in Area 2: Legal System and Property Rights during the period from 1990 to 2005. The chain-linked rating for Venezuela in Area 2 was 5.70 (already low) in 1990 and it went down to 3.75 in 2000, a decline of 1.95 points. Then it went further down to 1.64 in 2005, the second lowest rating for Area 2 in the World: only the Democratic Republic of Congo, with a rating for its legal system of 1.42 in 2005, was lower. It was the eve of something very bad that was about to take place in Venezuela. The realizations of gains from trade, investment, and entrepreneurial discovery depend critically on the existence of a legal system that protects property rights, provides rule of law, and enforces contracts objectively. By 2010, the Area 2 rating of Venezuela went

11 Another issue, of course, is which taxes ought to be levied to minimize taxation's excess burden and foment accountability.

Table 4.1: Economic Freedom of the World (EFW) index and its five Areas for Venezuela, Latin America, OECD countries, and the World, 1980–2013

Venezuela							Latin America						
	EFW	Area 1	Area 2	Area 3	Area 4	Area 5		EFW	Area 1	Area 2	Area 3	Area 4	Area 5
1980	6.69	6.29	6.22	7.40	8.59	4.92	1980	5.06	5.95	3.98	5.01	3.93	5.55
1990	5.69	5.95	5.70	4.74	7.14	4.89	1990	5.39	6.56	4.26	4.86	5.48	5.37
2000	5.84	5.95	3.75	5.56	7.91	6.05	2000	6.74	7.07	4.84	7.89	7.54	6.41
2005	4.52	4.91	1.64	5.10	5.50	5.40	2005	6.68	7.17	4.50	8.11	7.14	6.50
2010	3.84	4.96	1.46	4.72	3.40	4.51	2010	6.68	7.03	4.54	8.16	7.05	6.62
2013	3.09	4.71	1.20	2.74	3.11	3.60	2013	6.63	6.98	4.58	8.18	6.87	6.55
Avg.	4.94	5.46	3.33	5.04	5.94	4.89	Avg.	6.21	6.80	4.46	7.03	6.36	6.20

OECD							World						
	EFW	Area 1	Area 2	Area 3	Area 4	Area 5		EFW	Area 1	Area 2	Area 3	Area 4	Area 5
1980	6.44	4.29	7.18	7.16	7.35	6.23	1980	5.31	5.02	4.96	5.98	4.72	5.48
1990	7.23	4.82	7.90	8.58	8.21	6.64	1990	5.66	5.53	5.25	6.28	5.50	5.59
2000	7.90	5.42	8.57	9.28	9.00	7.21	2000	6.63	6.21	5.97	7.59	7.13	6.32
2005	7.80	5.74	8.35	9.32	8.06	7.52	2005	6.79	6.55	5.86	7.94	6.94	6.70
2010	7.51	5.11	8.05	9.41	7.94	7.06	2010	6.83	6.39	5.88	8.11	7.01	6.76
2013	7.53	5.24	7.93	9.49	7.71	7.29	2013	6.86	6.45	5.78	8.18	6.93	6.88
Avg.	7.40	5.10	8.00	8.87	8.05	6.99	Avg.	6.39	6.05	5.66	7.37	6.44	6.32

Sources: Gwartney, Lawson, and Hall, 2015a; authors' calculations.

down further to 1.46 (last in the World) while the Democratic Republic of Congo moved up to 2.12. By 2013, Venezuela's rating for its legal system was 1.20. Based on the chain-linked rating for Area 2, Venezuela has been in the last position in the World continuously since 2009, among the three worst positions in the World continuously since 2001, and in the fourth (least free) quartile continuously since 1995.

The decline of the quality of the legal institutions in Venezuela was almost uniform as reflected by specific components of Area 2. The components of greatest change since 2000 were: [1] Integrity of the legal system (2E), where the rating went from 6.67 in 2000 to 1.67 in 2013; [2] Impartial courts (2B), where the rating was 3.67 in 2000 and 0.64 in 2013; [3] Protection of property rights (2C), where the rating was 3.40 in 2000 and 0.87 in 2013; [4] Military interference in rule of law and politics (2D), where the rating was 3.33 in 2000 and 0.83 in 2013; [5] Judicial independence (2A), where the rating was 1.67 in 2000, dropping to 0.19 in 2013. All these ratings were initially low on the scale of 0 to 10 and became substantially lower by 2013.

It is not a surprise that the deterioration of the legal system in Venezuela would permeate other areas of the economy and would have implications both for the current Venezuelan crisis and for the fall in other institutional dimensions. Virtually



no country in the world performs well with a low rating for Area 2 because without a good legal structure there is no room for progress. This is the problem of Latin America, where the average rating for Area 2 has been systematically low (below 5.0) despite substantial improvements in monetary stability (Area 3) and mild and erratic improvements in trade (Area 4).

### 3.2 Decline of Area 3: Sound Money

For Area 3: Sound Money, as table 4.1 shows, Venezuela's rating went from 7.40 in 1980 to 4.74 in 1990; a reduction of 2.66 points. A conspicuous exclusionary institution and policy implemented in 1983 during the government of Luis Herrera was the devaluation of the Bolivar and the adoption of exchange-rate controls. Venezuela's government receives oil revenues in dollars from different types of taxes plus dividends, when they exist, from *Petroleos de Venezuela Sociedad Anonima* (PDVSA), the state-owned oil holding company. When the executive branch devalues the currency, oil revenues denominated in Bolivars automatically increase. Higher Bolivar proceeds allows for more government expenditures and simultaneous expansion of the monetary base, creating inflationary pressures. In Venezuela, therefore, there exists a direct link between devaluation and money creation injected into the economy by means of government spending. Moreover, the government typically devalues for fiscal considerations, influenced by low oil prices, and oil revenues represent on average no less than 50% of total tax revenues.

After a slight increase in Venezuela's rating for Area 3 in 2000, it went systematically down to reach 4.72 in 2010 and 2.73 in 2013. Accelerating inflation accompanied with high volatility, exchange-rate devaluations, and exchange-rate controls are important factors explaining the decline of Area 3 since 2000. The inflationary problem has become increasingly severe, inflicting excruciating pain on average Venezuelans. The latest reports provided by the Troubled Currencies Project from the Cato Institute (Hanke, 2016) indicate that Venezuela's annualized inflation rate hovers around 700%, at the threshold of hyperinflation.

In contrast, Latin America's average rating for Area 3 was 5.01 in 1980, 7.89 in 2000, and 8.18 in 2013. The World's average rating for Area 3 was 5.98 in 1980, 7.59 in 2000, and 8.18 in 2013. The long-standing OECD countries had an average rating for Area 3 of 7.16 in 1980, 9.28 in 2000, and 9.49 in 2013, showing a systematic increase in this area. Therefore, in a World and a region showing substantial progress in providing access to sound money, Venezuela has moved dramatically in the opposite direction. The high and volatile inflation rate creates uncertainty that makes it difficult for Venezuelans, and potential foreign investors, to make intertemporal decisions. The poor performance in Area 3, together with the low rating in Area 2, substantially increases the cost of entrepreneurial activity and doing business.

### 3.3 Decline of Area 4: Freedom to Trade Internationally

For Area 4: Freedom to Trade Internationally, Venezuela had a rating of 8.59 in 1980, 7.14 in 1990, 7.91 in 2000, 5.50 in 2005, 3.40 in 2010 and 3.11 in 2013. This systematic decline prevents citizens from trade gains and from developing their comparative advantages. Latin America, in comparison, had an average rating for Area 4 of 3.93 in 1980 that went up to 6.87 in 2013. The World had an average rating of 4.72 in 1980 and of 6.93 in 2013. Again, we observe a World and a region moving substantially toward trade liberalization particularly in the period from 1980 to 2000, while in Venezuela freedom to trade internationally is becoming more and more restricted,

particularly since 2000. Venezuela's policy of foreign-currency control that started in 2003 significantly reduced freedom to trade internationally. Since 2003, the approval of the government is legally required to obtain foreign currency using Bolivars (the domestic currency) or *vice versa*. The request is denied in many cases but most often it imposes additional transaction costs that discourage productive activity and encourage unproductive activities. It was customary for people to specialize in obtaining the government's approval to obtain foreign currency in order to sell it in the black market and to repeat the process again for profit.<sup>12</sup> This was possible because of the controls on foreign currency and the high premium on the black-market exchange rate.

The rating of Venezuela in the black market exchange rates component (4C) was 10 in 2000 and has been 0 almost continuously since 2002. At the present time (2016), the situation has worsened compared to 2013. To give an idea of the most recent monetary situation in Venezuela: the average daily black-market exchange rate in the year 2012 was 11.03 bolivars per US dollar (Bs/\$); it was 37.75 Bs/\$ in 2013, 90.71 Bs/\$ in 2014, and 520 Bs/\$ in 2015. The partial average computed up to April 30, 2016 is 1,060 Bs/\$. Thus, in just four years, the number of Bolivars required to purchase a US dollar has increased by approximately one-hundred fold.

### 3.4 Decline of Area 5: Regulation

For Area 5: Regulation, Venezuela has also experienced a systematic decline from 2000 to the present. With a rating of 4.92 in 1980, it went up to 6.05 in 2000 and then down to 4.51 in 2010 and 3.60 in 2013. Latin America, instead, increased its average rating from 5.55 in 1980 to 6.41 in 2000 and then maintained a relatively stable rating, reaching 6.55 in 2013. The World average reveals a systematic but small improvement in the area of regulation. The average rating for Area 5 for the World was 5.48 in 1980, 6.32 in 2000 and 6.88 in 2013.

The general decline in Area 5 can be seen in its components. Venezuela scored 8.55 in Credit market regulations (5A) and the score here remained high until 2009. By 2010, it went down to 5.93 and by 2013 was 4.76. Latin America's rating, in contrast, for Credit market regulations improved from an average of 5.87 in 1980 to 8.33 in 2000. It has remained relatively stable since then. The World had a path similar to that of Latin America. It started with 5.42 in 1980 and scored 8.33 in 2013. In the component 5B (Labor market regulations), Venezuela exhibited a very low, and decreasing, rating: 4.03 in 2000, 3.61 in 2010, and 2.29 in 2013. Latin America has made progress in Labor market regulations but is still at relatively low level. The average rating of component 5B was 3.73 in 1980, 5.15 in 2000, and 5.58 in 2013. The World has made a little more progress in Labor market regulations, moving from 4.77 in 1980 to 5.16 in 2000 and 6.45 in 2013. Finally, in terms of Business regulations (5C), Venezuela had a rating of 5.57 in 2000, which declined to 3.39 in 2013, a very low level. Latin America's rating has been steady with an average rating of 5.58 in 2000 and 5.89 in 2013. The World has also had a steady rating but with a higher average figure than Latin America. The average rating for the World in the Business

12 For instance, the government imposed foreign currency quotas per person, per year. Soon after a market for those quotas arose. People specialized in buying the quotas for profits. Once they bought the quota, they were allowed (after a certain number of bureaucratic procedures) to buy foreign currency at the official (cheaper) exchange rate. Then, they were able to sell the foreign currency at the black-market (more expensive) exchange rate for profit. They were able to repeat this process again and again.

regulation component was 6.54 in 2000 and 6.41 in 2013. All the numbers for the World and Latin America are higher than the figures for Venezuela, which reflects a tradition of high business regulation and, therefore, low competition in Venezuela.

## 4 Other deeply rooted factors that have influenced Venezuela's economic freedom since 1980

### 4.1 Culture

High levels of economic freedom imply a free-market economic system characterized by [1] personal choice, [2] voluntary exchange coordinated by markets, [3] freedom to enter and compete in markets, and [4] protection of persons and their property from aggression by others. However, cultural factors may conspire against the establishment of an economic system characterized by high levels of economic freedom.

For the Venezuelan economy, we discuss the two cultural traits most intimately related to development. First, trust in others, which is the cultural dimension most widely studied in the literature about economic growth. Its importance dates back at least to Arrow (1972), who argued that virtually every transaction has an element of trust and blamed the lack of trust for much of economic backwardness. Algan and Cahuc (2010) identify a significant impact of (inherited) trust on growth.

Dividing by quartiles, from low to high, trust measurements for countries around the world, Venezuela appears in the first quartile. That is, Venezuela is among the countries of the world with the lowest trust level (Alesina and Giuliano, 2015). Other Latin American countries showing up in the lowest-trust quartile are Brazil, Colombia, and Peru. The Latin American country with the best performance for trust is Uruguay, situated up in the third quartile.

Second, the gap between individualism and collectivism is considered by numerous cross-cultural psychologists as the most important cultural cleavage across countries (Heine, 2008). Individualistic societies privilege personal freedom, achievement, and innovation as well as individual rights. Collectivistic societies, in contrast, accentuate conformity and the notion of individuals embedded in large groups, and discourage individuals from dissent and standing out (Gorodnichenko and Roland, forthcoming). These authors uncover a strong and robust relation between individualism and growth.

Venezuela's measure of individualism, in conjunction with the rating of Colombia, Ecuador, and Peru, fall in the lowest quartile among rated countries in the world. Thus, these two key measures of a culture's proclivity to adopt institutions capable of igniting sustained growth show values suggesting a culture inimical to free markets in Venezuela and, in general, in Latin America. This clash between culture and institutions contributes to explain Latin America's rejection of free markets.

Revealingly, the last two decades have witnessed a wealth of research in cultural economics strongly indicating the existence of a direct channel running from institutions to culture. Prominent research in this area are the contributions of Bowles (1998), Di Tella, Galiani, and Schargrodsky (2007), Alesina and Fuchs-Schündeln (2007), Giuliano and Spilimbergo (2014), and Becker, Boeckh, Hainz, and Woessmann (2016). Given the considerable slow-moving nature of culture over time and formidable obstacles to changing it through education, it seems more reasonable to attempt institutional reforms, mostly in the economic sphere, that deliver growth and potentially faster cultural change.

Adoption of institutions and policies consistent with greater economic freedom will spur growth and improved material well-being.<sup>13</sup> This process elicits a “learning by doing” dynamic, whereby support for the reforms among the people is forthcoming by virtue of their improved standard of living, which in turn may promote an environment more conducive for a cultural change. The changing culture may lead to a set of beliefs and values more amenable to the merits of higher levels of economic freedom. A prime example of this is England, described in section 2.2, where economic institutions in the Malthusian era led to a major cultural change, setting the stage for the onset of the Glorious and Industrial revolutions. Gwartney, Stroup, Sobel, and Macpherson (2015) provide evidence on institutional reforms across the world and over several decades indicating the timing of the reforms. This evidence clearly suggests that economic institutional change of a higher caliber, in terms of inclusiveness, is feasible.

#### 4.2 Historical origin of a country's laws

Another deeply rooted factor that may work against institutional reform of a higher quality is the country's legal origin. Numerous research papers in the field of legal origins have documented that countries belonging to the French civil legal tradition, in comparison with countries in the legal family of English common law, are burdened by higher levels of legal formalism in judicial procedures, less judicial independence, lower protection of corporations' outside investors, higher entry regulations, more rigid labor markets, and greater government ownership of banks and media as well. Moreover, countries in the French civil legal tradition exhibit greater levels of government intrusion via ownership of resources and regulation than common-law countries.

Interestingly, La Porta, Lopez-de-Silanes, and Shleifer (2008) argue that legal origins are central to understanding the different styles of capitalism. Specifically, common-law countries are naturally inclined to rely on market solutions whereas in civil-law countries, particularly in countries where the legal system is of French origin, policies such as nationalization and market suppression are more frequent. Based on the evidence presented, Venezuela can be construed as an extreme case of a country with a legal system originating in French civil law. Venezuela embraces socially conditioned private contracting and not unconditional private contracting; policy implementing and not market-supporting solutions; government allocation of resources replacing markets and not market-driven allocating mechanisms.

Fortunately, the EFW index provides ratings on critical legal institutions that may suggest that a legal reform friendlier to development is convenient. These reforms do not entail a change of legal tradition that would be a radical and more difficult revamping of the legal infrastructure to enact. Reduction of entry barriers and streamlined labor laws are two examples. In other words, like culture, legal origin does not have to be fate.

#### 4.3 Legacy of human capital and the EFW index

Another factor having a negative impact on the EFW index is the low level of educational attainment and particularly of educational achievement. Faria and colleagues

---

13 To the best of our knowledge, the most recent evidence on the nexus between the data from EFW and development is provided by Faria, Montesinos, Morales, and Navarro, 2016a; Bennet, Faria, Gwartney, Montesinos, Morales, and Navarro, 2016; and by a working paper by Faria, Montesinos, and Navarro, 2016b, who report that economic freedom is a better predictor of development than the individualism-collectivism cultural trait.

(2016a, b) and Bennett and colleagues (2016) provide strong evidence suggesting that cognitive skills, a proxy for the quality of education, have a systematic positive effect on the quality of economic institutions.

Education, a critical component of human capital, historically lagged behind that of the United States and Canada in Latin American countries and particularly in Venezuela. Indeed, Argentina, Costa Rica, and Uruguay, which were the pioneering Latin American countries in promoting education for the population, trailed behind the United States and Canada by more than 75 years. In 1925, Venezuela's literacy rate occupied the penultimate position among Latin American countries, surpassing only Guatemala (Sokoloff and Engerman, 2000). Lamentably, a great misfortune still plagues Venezuela's educational quality. Hanushek and Woessmann document that Venezuela within Latin America ranks next-to-last in translating years of schooling into cognitive skills, as measured by international test scores (2012: 502, fig. 3; 504, fig. 4).

Perhaps not surprisingly, to surmount the deplorable state of Venezuela's educational quality, an institutional change congruous with higher economic freedom is urgently needed. The educational institutional reform should have the imprint of greater competition among schools and teachers, as well as promote equal educational opportunities.

To summarize this section, we note that economic institutional reform is the common denominator of all efforts to overcome historical legacies that machinate against high levels of economic freedom. Although the reasoning may sound circular, it is not, due to the material well-being consequent on high levels of economic freedom. High levels of economic freedom lead to prosperity, which is the most convincing argument in support of the claim that soaring economic freedom is the road out of serfdom and into freedom, self-reliance, independence, and mastery. This road out of serfdom should be illuminated with unremitting dissemination of information, explaining the link between enhanced standards of living and augmented economic freedom. This educational endeavor conducted in the media remains true to Jefferson's dictum: The cost of freedom is eternal vigilance.

## 5 Impact of economic freedom developments on the economy and other relevant variables

We consider two categories of variables that are affected by economic freedom—those directly related to growth and those in the domain of public choice analysis.

### 5.1 Effect of economic freedom on variables directly related to growth

Low levels of economic freedom adversely affect economic growth to the point of potentially inducing negative growth over a lengthy expanse of time. Venezuela is a case in point. In the economic literature, Venezuela is known as a growth disaster, as between 1960 and 2000, average growth of per-capita real income was negative. Importantly, with the exception of 2000, this entire period elapsed before Hugo Chávez came to power.<sup>14</sup> Negative to low growth rates result in poverty, lower

14 Some published papers and books describing the disastrous lack of growth of the Venezuelan economy are Jones, 1999; Barro and Sala-i-Martin, 2004; Jones and Romer, 2010; Hanushek and

health, reduced life expectancy, increased infant mortality rates, stubbornly high unemployment, diminished nutritional intake, lower impetus for educational attainment, reduced physical capital and infrastructure, and reductions in both civil and political liberties. This is precisely the Venezuelan case.

### 5.1.1 *Economic freedom and geographical endowments*

A cursory look at the world map immediately reveals a general positive correlation between distance from the equator and national wealth. Various scholars, dating back to Machiavelli (1519/1996) and up to Dell, Jones, and Olken (2014), have argued that climate and temperature, the disease environment, natural resources, and transportation conditions have a strong explanatory power when examining the regularity between latitude and development.

Prior to the first important oil discovery in 1914, Venezuela's main economic activity was agriculture. Given the scarcity of land suitable for agricultural,<sup>15</sup> geography was not benevolent to Venezuela and available evidence suggests that economic development was meager. However, discovery of an important oil field on April 15, 1914 unleashed the country's potential for revenue from oil, ushering in decades of high growth rates, as previously mentioned. By 1935, some 20 years after the major oil-field discovery, Venezuela was the second-largest oil producer of the world, and had become a reliable supplier of oil to the US Atlantic seaboard as well as a strategically important nation to the British Empire.

This experience illustrates how geography can exert an indirect differential effect on development depending on the time period considered. Economic institutional quality, however, is the main driver of this Venezuelan experience. The dictatorship of Juan Vicente Gomez, which encompassed the period from 1908 to 1935, allowed multinational companies to develop subsoil oil reserves. This opening of the economy was made possible by Gomez's pacification of the country, protection of private property, and low taxation, as well as respect for contract agreements. In other words, with Gomez Venezuela started to benefit from the presence of state capacity, captured by monopolization and regulation of violence, though sometimes abused, collection of taxes, protection of property rights, and legal services, as well as provision of public goods crucial for development such as a peaceful country.<sup>16</sup>

The Venezuelan experience contrasts sharply with Mexico's economic rules of the game, influenced by oil nationalization, led by President Lazaro Cardenas in 1935. In 1957, Mexico became a net importer of oil, a direct consequence of

---

Woessmann, 2012. Jones and Vollrath (2013) extend the calculations up to 2008, and Venezuela shows up as a growth disaster for the period from 1960 to 2008 as well. For evidence on the deplorable state of Venezuela's current social indicators, see the report of secretary-general of the Organization of American States (OAS) and references therein (Almagro, 2016). For cross-country evidence, see for example the PowerPoint presentation at <[www.freetheworld.com/2015/EFW2015-Presentation.ppt](http://www.freetheworld.com/2015/EFW2015-Presentation.ppt)> and numerous academic papers published that use the annual reports of *Economic Freedom of the World* <[www.freetheworld.com/papers.html](http://www.freetheworld.com/papers.html)>. See as well Hall and Lawson, 2014 for a recent account of the academic literature discussing the EFW index.

15 For instance, according to the World Bank's World Development Indicators (2016) and our own calculations, both Venezuela's arable land and its agricultural land are relatively sparse. Both indicators, when compared to the rest of the world, are in the lowest quartile and fall below the average for Latin America. This suggests that agriculture is not an area in which Venezuela has a comparative advantage.

16 See Acemoglu, Moscona and Robinson, 2016 on the issue of state capacity and American technology.

government's ownership and monopoly in the oil industry. Today most gasoline consumed in Mexico is imported, a dismal consequence of the nationalization of the oil industry. Thus geography has been benevolent in providing oil to both Mexico and Venezuela. The oil industry in Venezuela flourished up to 1960, reaching a maximum level of production in 1970, while Mexico's stagnated. Differences in institutional quality are at the heart of the contrasting tale of these two oil-producing countries. Venezuela adopted policies consistent with more economic freedom, while Mexico relied on a socialist model.

As previously indicated, in the 1960s, the democratic government of Romulo Betancourt put an end to the extension of tract lands to oil multinationals to find and extract oil reserves, and founded the OPEC oil cartel.<sup>17</sup> In the first half of the 1970s, Carlos Andres Perez nationalized the oil industry. Revealingly, today, the oil industry suffers from the consequences of excessive governmental intrusion. To illustrate this point: in 1958, Venezuela's oil industry commanded a 15% share of the world's export market, compared to less than 3% today. Once again, adoption of measures that reduced economic freedom is the main cause of this downfall.

Geography has also provided Venezuela with a great potential for developing a profitable tourism sector, owing to the abundance of beautiful beaches, mountains, islands, waterfalls, and other natural resources. However, once again, the economic rules of the game have curbed a fledging and potentially thriving tourism industry. In the 1950s, under the dictatorship of Marcos Perez-Jimenez, several government-owned and managed hotels were opened in different parts of the country, as well as two high cable cars, one in Caracas and the other in Merida, in an attempt to provide an initial impetus to the tourism industry.

In the 1960s, the democratic government decided to boost the industrial sector through various policies of import substitutions, among them raising trade barriers in some cases to prohibitive levels and in other cases implementing outright bans of certain imports as well as the extension of soft loans by government-owned banks to industry owners. Naturally, these industries became highly inefficient, curtailing the welfare of the people and misallocating resources.

Thus, this is a case where geography provided propitious conditions for development of a strong tourist industry. On this occasion, however, adoption of policies that restricted economic freedom crippled development of an economic activity where the country has a potential comparative advantage.

The lesson that can be learned from the above discussion is clear. Geography may provide favorable conditions for development of certain sectors; yet, if the institutional quality is not supportive of economic freedom, those sectors will never realize their economic potential.

---

17 No more tract lands for oil exploration implied no new discoveries of oil reserves, limiting extraction from existing wells, and contributing to cap maximum production in a country that has more proven reserves than Saudi Arabia according to the OPEC website. Within OPEC, traditionally Venezuela has voted for reductions in oil production to increase prices. Thus both factors have been conducive to reducing oil production. To compensate for revenue losses stemming from lower production the government through OPEC resorts to the expediency of price manipulations, alleviating the pressure to become competitive and efficient. Additionally, the state-owned oil industry is afflicted by the Tragedy of the Commons, a frequent outcome observed among institutional arrangements based on common property. This tragedy is also instrumental in the lower production and market share as well, in spite of an expanding world market for oil.

## 5.2 Some effects of restricted economic freedom on outcomes explained by Public Choice principles<sup>18</sup>

### 5.2.1 *The socialist-mercantilist alliance*

The commanding heights of the economy of Venezuela have been owned by the government since the mid-1970s, a clear socialist practice inconsistent with economic freedom, as the “subsoil” was owned by the Monarch of Spain during the colonial era and by the government after independence. Commencing in the 1960s, to industrialize the country the government erected high trade barriers—a clear mercantilist practice, incompatible with economic freedom as well. What do socialist politicians and mercantilist entrepreneurs have in common? A profound loathing for markets, the main resource allocation mechanism.

This unholy alliance offers substantial explanatory power for Venezuela’s and Latin America’s predicament of low growth induced by low levels of economic freedom. The alliance has ramifications that extend well beyond affecting adversely only Area 1 and Area 4 of the EFW index. Entrepreneurs benefit from corruption of the judiciary—Area 2—because adjudication of justice is attuned to the interests of the highest bidder. Judges subservient to the executive branch remove important checks and balances on the executive branch, enabling politicians more leeway on the decision-making spectrum.

This alliance also fosters complex business regulations—Area 5—that reduce competition, favoring existing large companies. Complexity also benefits bureaucrats by increasing their power over small businesses seeking a permit. To the extent that obtaining a permit necessitates jumping through various bureaucratic hoops, the potential for greater corruption is ostensible.

The socialist-mercantilist alliance may also affect Area 3: Sound Money. The creation of money may benefit government by allowing the bestowal of government largesse on favored groups of the executive branch. In addition, companies can protect themselves from the ravages of inflation by raising prices. If price controls are in place, a binding ceiling can be raised by virtue of good political connections. Thus, once again, the beneficiaries of the alliance profit at the expense of average citizens, who in Venezuela happen to be poor.

### 5.2.2 *Largess to uncompetitive sectors*

Systematic implementation of policies favoring agricultural and industrial activities is another consequence of low economic freedom explainable by Public Choice theory. For a better understanding of the *raison d’être* of policies favoring agricultural and industrial activities, even today, we note that the onset of the oil revolution caused the so-called Dutch Disease, which rendered agriculture less competitive—and many political leaders as well as elites from the private sector were farm owners.

Taking into account that the Venezuelan people were and are *de jure*, not *de facto*, owners of the oil wealth, no constituency emerged to counterbalance the manifold inefficient programs and policies aimed at helping farmers and industrialists. Thus, the Venezuelan Dutch Disease can also be construed as a Schumpeterian process of creative destruction, which required adaptation to a new reality in the form of economic activity compatible with oil such as tourism (Faria and Filardo, 2015: 379).

---

18 We acknowledge that there is a two-way causality between economic freedom and the outcomes analyzed in this subsection.



Viewing the competitive loss in agriculture and industry as emanating from currency overvaluation, induced by a more competitive sector capable of increasing the flow of hard currency, provides the seeds for the mirage to devalue the currency, reducing people's external purchasing power and possibly instigating an inflationary spiral. Indeed, Alberto Adriani, a well-known economist and politician, who became in Venezuela the equivalent of the secretary of the treasury, in the early 1930s suggested the convenience of devaluing the Bolivar to make agricultural exports more competitive and to leave behind the economic policy of *laissez faire* favored by Gomez. Perhaps needless to say, Mr. Adriani's parents owned a farm in the state of Merida in Venezuela (Lahoud, 2015). Thus, instead of focusing on curbing inflation and becoming efficient, efforts even today are directed towards the expedient of devaluation, which as expected did not enhance the competitiveness of companies.

In sum, given the historical facts presented in this chapter, analyses suggesting that the culprit of Venezuela's current predicament stem from 15 years of Venezuela's revolution are simplistic and misleading (O'Grady, 2016, May 8). Venezuela's economy ails from a vicious cycle of deeply rooted exclusionary institutions, dating back to the colonial period, which now operate through the channel embodied by the socialist-mercantilist alliance, empowering and enriching political and economic elites.<sup>19</sup>

Revealingly, the perverse institutional arrangements persist over time, although the identity of the favored elites may change. A case in point is Mr. Lorenzo Mendoza, the CEO of Empresas Polar S.A., Venezuela's largest conglomerate of beer, soda pop, and food production, who was recently interviewed by a well-known US newspaper (Forero, 2016, June 3). Mr. Mendoza rightfully decries price controls and the government's decision to exclude Empresas Polar from receiving the government-controlled dollars it needs to import raw materials. Unfortunately, the report fails to mention that beer production in Venezuela is basically a duopoly that has excluded most Venezuelans from buying international beer brands, depriving consumers of the benefits conferred by increased variety of goods.<sup>20</sup> Moreover, we have not observed Mr. Mendoza expressing support, privately or publicly, for a dollarization or a monetary-freedom institutional arrangement that allows average citizens, preponderantly poor, to protect the fruits of their labor. In other words, access

19 As aforementioned, inclusive economic institutions enjoyed an interregnum during the Gomez dictatorship. After his death in 1935, inclusive economic institutions persisted until 1957, albeit somewhat deteriorated. With the onset of democracy, economic institutional inclusiveness dissipated rapidly and accelerated with the advent of the Chavez-Maduro government. Today, Venezuela is the country of the world that reliable data shows to have the lowest level of economic freedom.

20 O'Grady correctly denounces the extinction of Venezuela's productive sector by state diktat. However, she fails to mention that Venezuela's industrial and agricultural sectors are generally inefficient, a legacy of the policies implemented prior to Chavez's advent. The survival of these sectors stems from government protection that increased unnecessarily exclusion of poor Venezuelans, let alone an inefficacious allocation of resources. Thus, a more comprehensive analysis of Venezuela's travails clearly reveals that the so-called domestic productive sector is part of the problem. This is one of the elephants in the room that most analyses of Venezuela's predicament decline to see. These partial analyses conceal the real problem, which, as previously stated, is a vicious circle of exclusionary institutions and policies that needs to be broken.

to the dollar, and hard currency in general, in Venezuela is a privilege and the elites loath and disparage its democratization.<sup>21</sup> Ironically, a conspicuous member of the Venezuelan economic elite is now being excluded from access to dollars.

This instance exemplifies a pervasive syndrome present in Latin America and particularly in Venezuela that Acemoglu and Robinson dub the iron law of oligarchies: “The overthrow of a regime presiding over extractive institutions heralds the arrival of a new set of masters to exploit the same set of extractive institutions ... Extractive institutions then not only pave the way for the next regime change, which will be even more extractive, but they also engender continuous infighting and civil wars” (2012: 366, 367). In other words, social mobility Venezuelan style.

## References

Acemoglu, D., F. Gallego, and J. Robinson (2014). Institutions, Human Capital and Development. *Annual Review of Economics* 6: 875–912.

Acemoglu, D., J. Moscona, and J. Robinson (2016). State Capacity and American Technology: Evidence from the Nineteenth Century. *American Economic Review: Papers and Proceedings* 106, 5: 61–67.

Acemoglu, D., and J. Robinson (2012). *Why Nations Fail*. Crown Business.

Alesina, A., and N. Fuchs-Schündeln (2007). Goodbye Lenin (or Not?): The Effect of Communism on People. *American Economic Review* 97, 4: 1507–1528.

Alesina, A., and P. Giuliano (2015). Culture and Institutions. *Journal of Economic Literature* 53, 4: 898–944. <[www.aeaweb.org/articles?id=10.1257/jel.53.4.898](http://www.aeaweb.org/articles?id=10.1257/jel.53.4.898)>.

Algan, Y., and P. Cahuc (2013). Inherited Trust and Growth. *American Economic Review* 100, 5: 2060–2092.

Almagro, Luis (2016). [Report of secretary-general of the Organization of American States.] May 30, 2016. <[www.oas.org/documents/eng/press/OSG-243.en.pdf](http://www.oas.org/documents/eng/press/OSG-243.en.pdf)>.

Ang, J. (2013). Institutions and the Long-Run Impact of Early Development. *Journal of Development Economics* 105: 1–18.

Angeles, L. (2007). Income Inequality and Colonialism. *European Economic Review* 51, 5: 1155–1176.

Arrow, K. (1972). Gifts and Exchanges. *Philosophy and Public Affairs* 1, 4: 343–362.

Baptista, Asdrúbal (2011). *Bases cuantitativas de la economía venezolana, 1830–2008*. Artesanogroup.

---

21 Even in Daniel Ortega’s Nicaragua the dollar circulates freely, suggesting egregious malice among Venezuela’s political and entrepreneurial leaders for opposing an efficient mechanism to protect a basic human right: integrity of the fruits of one’s labor.

Barro, R., and X. Sala-i-Martin (2004). *Economic Growth*. Second edition. MIT Press.

Becker, S., K. Boeckh, C. Hainz, and L. Woessmann (2011). The Empire Is Dead, Long Live the Empire! Long-Run Persistence of Trust and Corruption in the Bureaucracy. *Economic Journal* 126: 40–74.

Bennet, D., H. Faria, J. Gwartney, H. Montesinos, D. Morales, and C. Navarro (2016). Evidence on Economic versus Political Institutions as Determinants of Development. Under review.

Bennet, D., H. Faria, J. Gwartney, and D. Morales (2016). Settlement Conditions, Colonizer Identity, Institutions & Comparative Economic Development. Working paper. Patrick Henry College and University of Miami.

Bolívar, S. (2003). *El Libertador: Writings of Simon Bolívar*. David Bushnell, ed., Fred Fornoff, trans. Oxford University Press

Boudreaux, Christopher J., and Randall G. Holcombe (forthcoming). Economic Institutions and the Durability of Democracy. *Atlantic Economic Journal*.

Bowles, S. (1998). Endogenous Preferences: The Cultural Consequences of Markets and Other Economic Institutions. *Journal of Economic Literature* 26: 75–111.

Bruhn, M., and F. Gallego. (2012). Good, Bad and Ugly Colonial Activities: Do They Matter for Economic Development? *Review of Economics and Statistics* 94, 2: 433–461.

Centro Latinoamericano y Caribeño de Demografía [CELADE] (2000). *La migración internacional y el desarrollo en las Américas*. Publicación de las Naciones Unidas.

Dell, M., B. Jones, and B. Olken (2014). What Do We Learn from the Weather? The New Climate-Economy Literature. *Journal of Economic Literature* 52, 3: 740–798.

Di Tella, R., S. Galiani, and E. Schargrodsky (2007). The Formation of Beliefs: Evidence from the Allocation of Land Titles to Squatters. *Quarterly Journal of Economics* 22, 1: 209–241.

Faria, H. (2003). Las Bases de la Estabilidad. In Hugo Faria, ed., *10 Autores y 7 Propuestas para Rehacer a Venezuela* (Editorial Panapo): 123-154.

Faria, H. (2008). Hugo Chavez against the Backdrop of Venezuelan Economic and Political History. *Independent Review* 12, 4: 519–535. <[www.independent.org/pdf/tir/tir\\_12\\_04\\_2\\_faria.pdf](http://www.independent.org/pdf/tir/tir_12_04_2_faria.pdf)>.

Faria, H., and L. Filardo (2015). Venezuela: Without Liberals, There Is No Liberalism. *Econ Journal Watch*. 12, 3: 375–399.

Faria, H., H. Montesinos, D. Morales, and C. Navarro (2016). Unbundling the Roles of Human Capital and Institutions in Economic Development. *European Journal of Political Economy*: forthcoming.

Faria, H., H. Montesinos, and C. Navarro (2016). Culture or Institutions: Which Is a Better Predictor of Development? Working Paper. Center of Finance, *Instituto de Estudios Superiores de Administracion* (IESA).

Freedom House (2015). *Freedom in the World 2015*. <<https://freedomhouse.org/report/freedom-world/freedom-world-2015#V2Mxhlf6-9o>>. Datasets available at <<https://freedomhouse.org/report-types/freedom-world>>, Individual country ratings and status, FIW 1973-2016 (EXCEL) <[https://freedomhouse.org/sites/default/files/Country%20Ratings%20and%20Status%2C%201973-2016%20%28FINAL%29\\_0.xlsx](https://freedomhouse.org/sites/default/files/Country%20Ratings%20and%20Status%2C%201973-2016%20%28FINAL%29_0.xlsx)>.

Forero, Juan (2016, June 3). Venezuelans, Facing Food Shortages, Rally Behind Vilified Conglomerate. *Wall Street Journal*. <[www.wsj.com/articles/venezuelas-biggest-private-company-fights-for-survival-1464964360](http://www.wsj.com/articles/venezuelas-biggest-private-company-fights-for-survival-1464964360)>.

Fronjosa, Ernesto (2011). La fatal dependencia: El estatismo como cultura en los países latinoamericanos. *Cuadernos Unimetanos* (Universidad Metropolitana, Caracas) 28: 15–37.

Giuliano, P., and A. Spilimbergo (2014). Growing Up in a Recession. *Review of Economic Studies* 81, 2: 787–817.

Gorodnichenko, Y., and G. Roland (forthcoming). Culture, Institutions and the Wealth of Nations. *Review of Economics and Statistics*. Forthcoming.

Gwartney, James, Robert Lawson, and Joshua Hall (2015a). Economic Freedom Dataset, published in *Economic Freedom of the World: 2015 Annual Report*. Fraser Institute. <[http://www.freetheworld.com/datasets\\_efw.html](http://www.freetheworld.com/datasets_efw.html)>.

Gwartney, J.D., R. Lawson, and J. Hall (2015b). *Economic Freedom of the World: 2015 Annual Report*. Fraser Institute.

Gwartney, J.D., R. Stroup, R. Sobel, and D. Macpherson (2015). *Macroeconomics: Private and Public Choice*. Fifteenth Edition. Cengage Learning.

Hall, J., and R. Lawson (2014). Economic Freedom of the World: An Accounting of the Literature. *Contemporary Economic Policy* 32, 1: 1–19.

Hanke, Steve H. (2016). *Troubled Currencies: Venezuela*. The Troubled Currencies Project. Cato Institute–Johns Hopkins University. <<http://www.cato.org/research/troubled-currencies-project?tab=venezuela>>, as of July 22, 2016.

Hanushek, E., and L. Woessmann (2012). Schooling, Educational Achievement, and the Latin American Growth Puzzle. *Journal of Development Economics* 99, 2: 497–512.

Heine, S. (2008). *Cultural Psychology*. W.W. Norton.

Hernández, José Ignacio (2012). Pensamiento constitucional de Juan Germán Roscio y Francisco Javier Yanes. Lecture at Universidad Monteavila, Caracas.

Heston, A., R. Summers, and B. Aten (2012). *Penn World Table Version 7.1*. Center for International Comparisons of Production, Income and Prices, University of Pennsylvania. <[www.rug.nl/research/ggdc/data/pwt/pwt-7.1](http://www.rug.nl/research/ggdc/data/pwt/pwt-7.1)>.

Jones, C. (1999). *Introduction to Economic Growth*. Second edition. W.W. Norton.

Jones, C., and D. Vollrath (2013). *Introduction to Economic Growth*. Third edition. W.W. Norton.

Jones, C., and P. Romer (2010). The New Kaldor Facts: Ideas, Institutions, Population, and Human Capital. *American Economic Journal: Macroeconomics* 2, 1: 224–245.

La Porta, R., F. Lopez-de-Silanes, and A. Shleifer (2008). The Economic Consequences of Legal Origins. *Journal of Economic Literature* 46, 2: 285–332.

Lahoud, Daniel (2015). *Henrique Perez Dupuy Personaje: pensamiento y obra*. Slogan Digital Graphics C.A.

Lawson, R., and J.R. Clark (2010). Examining the Hayek-Friedman Hypothesis on Economic and Political Freedom. *Journal of Economic Behavior and Organization* 74: 230–239.

Machiavelli, N. (1519/1996). *Discourses on Livy*. H. Mansfield and N. Tarcov, trans. University of Chicago Press.

Milner, F. (1931). *Economic Evolution of England*. Macmillan.

Montesinos, H. (2016). On the Lipset and Friedman Hypotheses. A Logit Approach. Working paper. Department of Economics, Florida State University.

North, D. (1990). *Institutions, Institutional Change, and Economic Performance*. Cambridge University Press.

O'Grady, Mary Anastasia (2016, May 8). Venezuela's Hunger Is No Game [also: Fifteen Years of Venezuela's Revolution: High Inflation and Food Shortages]. *Wall Street Journal*. <[www.wsj.com/articles/venezuelas-hunger-is-no-game-1462738401](http://www.wsj.com/articles/venezuelas-hunger-is-no-game-1462738401)>.

Pipes, R. (1999). *Property and Freedom*. Vintage Books (Random House).

Sánchez-Coviza, J., and I. Olcoz. (1966). Informe sobre el Desarrollo Económico de Venezuela. *Orientación Económica* 20 (Jan.–Mar.): 3–88.

Sokoloff, K., and S. Engerman (2000). Institutions, Factor Endowments, and Paths of Development in the New World. *Journal of Economic Perspectives* 14, 3: 217–232.

Uslar, Arturo (1962). *Medio Milenio de Venezuela*. Cuaderno Lagoven, Refolite C.A.

World Bank (2016). *World Development Indicators, 2016*. <<http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators>>. Indicators used: *Arable Land*: Indicator Code: AG.LND.ARBL.ZS; Indicator Name: Arable land (% of land area); <<http://data.worldbank.org/indicator/AG.LND.ARBL.ZS>>, as of February 29, 2016 and May 12, 2016. *Agricultural Land*: Indicator Code: AG.LND.AGRI.ZS; Indicator Name: Agricultural land (% of land area); <<http://data.worldbank.org/indicator/AG.LND.AGRI.ZS>>, as of February 29, 2016 and May 12, 2016.

# Chapter 5 Economic Freedom and Growth in Ireland, 1980 to 2014

*Robbie Butler and John Considine*

## Introduction

Ireland has displayed some of the most impressive economic growth rates in the world in the period since the mid-1980s. While Irish growth rates suffered more than most in the Great Recession, the change in Ireland's relative position over the last three decades has been phenomenal, as can be seen in **figure 5.1**. In terms of Gross Domestic Product (GDP) per capita, Ireland is now one of the leading countries in the world. Even those who criticize the use of GDP as a measure of Irish living standards admit that the Irish economic performance is of a different magnitude since the mid-1980s. While Gross National Product (GNP) grew by just over half a percentage point less per annum for the period, it follows the same pattern as GDP, and it also shows Ireland converging on the world leaders.

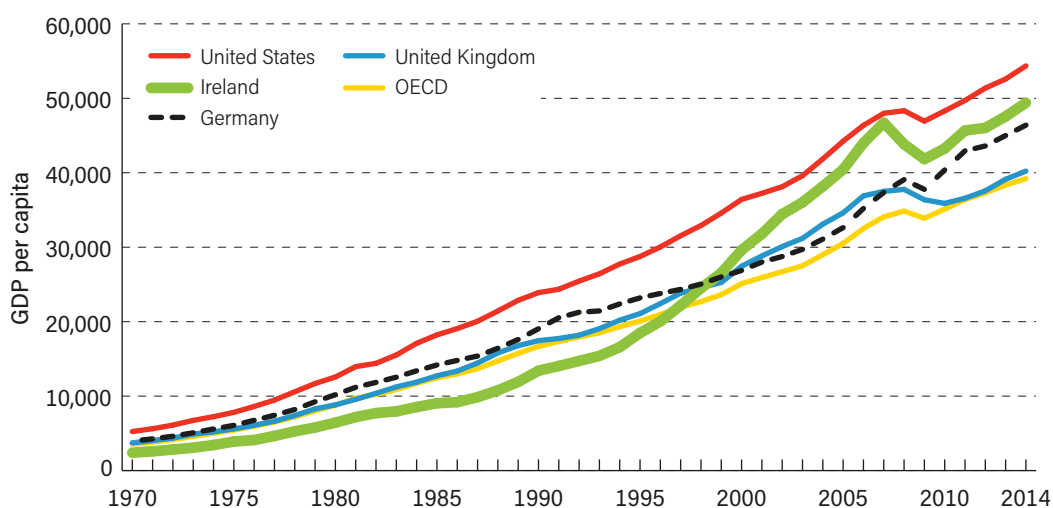
The annual average growth rate, regardless of how it is measured, cannot capture the variation in economic performance over the period. A number of sub-periods can be identified and there is little disagreement from the view that the years 1986/7, 1993/4, and 2007/8 represent important turning points. The annual average GDP growth was 1.47% between 1980 and 1986, and 3.91% between 1987 and 1993. For the full period from 1994 to 2007, the annual average GDP growth rate was 7.18%. Some or all of these years are classified as the "Celtic Tiger" period. Many argue that this period could be sub-divided to reflect different underlying forces. There is agreement that international trade drove the economic growth in the early years and that a domestic credit and property bubble drove economic growth in the years before 2007. The change in the dominant underlying driving force occurred somewhere between 2000 and 2002. One could also wonder if all the years after 2008 should be in the same sub-period or whether 2008 and 2009 should be listed

---

Citation Robbie Butler and John Considine (2016). Economic Freedom and Growth in Ireland, 1980 to 2014. Early release of chapter 5 from James Gwartney, Robert Lawson, and Joshua Hall, *Economic Freedom of the World: 2016 Annual Report* (Fraser Institute): 237–256.

Authors Robbie Butler, is a college lecturer in the Department of Economics, University College Cork. John Considine is a lecturer in the Department of Economics, University College Cork.

Figure 5.1: GDP per Capita in Selected Countries and the OECD, 1970–2014, US\$



Source: Organisation for Economic Co-operation and Development (OECD), 2016.

separately. It was only in 2014 that GDP rose above its 2007 value, with large negative growth in 2008 and 2009. Data for 2015 shows Ireland has returned to posting the largest growth rates in the European Union (EU).

There is a variety of explanations for the Irish growth performance offered in the literature. This chapter will examine the growth performance of Ireland using the index published in *Economic Freedom of the World* (EFW Index) by the Fraser Institute. It will follow the approach taken by Powell (2003) and McMahon (2000), and to a lesser extent Dorgan (2006). The final section of this chapter will locate this explanation within the literature on Irish economic development for the period.

While this chapter will not examine Ireland within a cross-section of countries, it is worth noting the positive relationship between the change in economic freedom and real GDP growth per capita in OECD countries for the period from 1980 to 2014. The correlation between the two variables is 0.46 (the correlation between economic freedom and GDP per capita in 2013 is 0.57). **Figure 5.2** presents both variables for selected countries in descending order of GDP growth per capita.

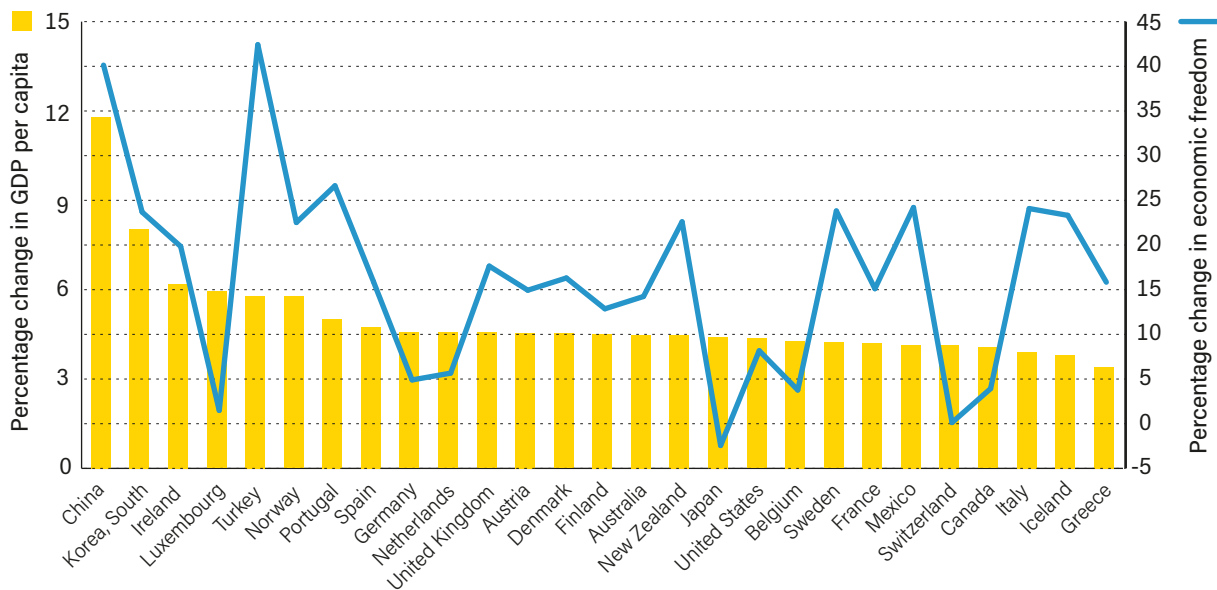
The next section will examine the major changes to the components of EFW Index for Ireland. This will be followed by a section outlining the major policy changes and other factors that influenced these changes. The final section will examine the relationship between economic freedom and other variables on Irish economic development.

## Historical background on political and economic institutions

For all of the nineteenth century and the first two decades of the twentieth century, two islands on the north-west periphery of Europe existed as the political entity called the United Kingdom of Great Britain and Ireland. The Anglo-Irish Treaty of 1921 gave independence to the larger part of the smaller island, which was designated the Irish Free State. The north east of the island remained part of the United Kingdom of Great Britain and Northern Ireland (UK).



Figure 5.2: Average Annual Percentage Change in Real GDP per Capita and the Overall Percentage Change in Economic Freedom, Selected Countries, 1980–2014



Sources: Organisation for Economic Co-operation and Development (OECD), 2016; Gwartney, Lawson, and Hall, 2015.

The Irish Free State remained within the British Commonwealth and it effectively operated a sterling-backed currency for the next 50 years. Maintaining the one-for-one link with sterling was the main purpose of Irish exchange-rate policy and it underpinned Irish monetary policy. A fiscal relationship was tied to these political and monetary linkages. As a member of the Commonwealth, Irish ministers attended the Ottawa Imperial Conference of 1932 where it was decided to give preferential trade terms to members. The protectionist tone of the conference chimed with both the post-1929 economic environment and the philosophy of the newly elected Fianna Fail government. In addition, the sea journey to Canada brought the Fianna Fail delegation into contact with their British counterparts (McMahon, 1984). However, any potential for greater cooperation on economic policies was soon destroyed by the outbreak of an economic war between the two countries. The economic war lasted until the late 1930s when Britain's attention turned to the potential for war in Europe. While the economic war was settled on financial terms that were favorable to Ireland, the economic dislocation caused by the war raised issues about economic nationalism (Bielenberg and Ryan, 2012).

A movement towards self-sufficiency may have been a policy choice during the 1930s but there was little choice in the matter during World War II (or “the Emergency” as it was known in Ireland). During these years, a fledgling air link with the United States was forged via boat-planes from Foynes and regular aircraft from Shannon. After World War II, Shannon witnessed the first significant use of tax reductions to promote regional economic development in Ireland when the Customs-Free Airport Act 1947 was passed. Within a decade, Ireland would embark on a competitive corporate-tax policy designed to promote national economic development.

World War II only served to highlight the strange relationship between Dublin and London. Ireland remained neutral in the conflict but there was relatively free movement of labor between the two political entities. The political links between the

separate entities, which were weakened with the 1937 Constitution of Ireland, were effectively broken with the Republic of Ireland Act, 1948. Crucially, the monetary link remained. For the decades after the World War II, the one-for-one link with sterling was to the forefront of Irish economic policy as the British authorities struggled with the management of sterling. During the late 1940s, efforts to restore the convertibility of sterling at too high a level failed. Suspension of convertibility and devaluation followed. In addition to overvaluing the currency, the sterling zone imported more than it exported. London would communicate this problem to governments in the sterling zone and encourage remedial action. This channel of communication explains the complaints that Irish budgetary policy was written in Threadneedle Street (Bank of England). The importance of the monetary link for fiscal policy is probably best illustrated by the 1952 Budget when faulty UK economic forecasts resulted in one of the most contractionary Irish budgets in the history of the State.

Another example of the complications caused by the link with sterling is the macroeconomic crisis of 1955/6. Domestic policy errors, combined with the sterling link, contributed to the crisis (Honohan and O'Grada, 1998). The decision of the Irish banks not to follow the increase in interest rates of their British counterparts led to an outflow of funds. The problems were compounded when the Irish fiscal authorities sought to address the issue using increased import taxes. Garvin (2004) claims that the macroeconomic crisis of 1955/6 resulted in a collective recognition that the protectionist, inward-looking policies of the previous two decades needed to change. The publication in 1958 of *Programme for Economic Expansion* (Government of Ireland, 1958) is widely seen as a shift away from the isolationist policies that were in place since 1932.

The 1955/6 crisis and the *Programme for Economic Expansion* gave impetus to a change that was already starting to occur (Brownlow, 2010). Policy makers were aware of the difficulties in achieving import substitution and had turned their attention towards increasing exports. A central plank of the new policy was to attract foreign, exporting, enterprises to Ireland and, therefore, provide employment for the Irish and stem the flow of emigration. In 1956, Export Profit Tax Relief was introduced, with 50% tax remission on income from the export sales of manufactured goods. This was increased to 100% remission in 1958. In addition to signalling a change in the orientation of industrial policy, it illustrated what could be achieved by a country with powers over fiscal decisions.

The successful introduction of the Export Profit Tax Relief was a combination of historical accident and clever design. Historical accident meant that there were no powerful vested interests in the industrial sector to hamper the introduction and implementation of the policy (unlike the situation in Northern Ireland as illustrated in Brownlow, 2007). Clever design of the tax resulted in the limiting of relief to income from manufacturing exports. As a result, it did not invite competition in the domestic market, thereby generating political opposition to the measure. In addition, it did not erode that particular part of the tax base. The competitive approach on corporate taxation was to prove hugely successful in attracting investment and contributing to Irish economic growth in the longer term. Over the next six decades, closer ties with Europe would force Ireland to modify its strategy on corporate taxation. While taxation remained broadly a matter of the Irish government, Europe would force the Irish to adjust its stance on the discriminatory application of corporate taxes. Ironically, the forced adjustments made Ireland more competitive in many respects.

Ireland did not seriously consider entering the European Economic Community (EEC) independently during the 1960s when General Charles de Gaulle objected to British membership. Ireland, Britain, and Denmark became members of the EEC in 1973. It represented another step in reorientation towards the world economy. Ireland gained enough confidence during its first six years of EEC membership to opt into the European Exchange Rate Mechanism (ERM) in 1979 even though Britain decided to stay out. This decision broke the one-for-one link with sterling and the Irish currency was free to move against others within the narrow bounds set by the ERM. These narrow bounds were widened in 1993 after a volatile period following the reunification of Germany and Britain's high-profile entry and exit from the ERM. By this stage, Ireland was on the path to full monetary union with a number of European countries.

After Ireland's entry into the EEC, a series of Treaties brought about closer political and economic ties between the European member states. Of particular importance was the Single European Act, which aimed at establishing a "single market" by the end of 1992, and the Maastricht Treaty, which established the European Union and led to the establishment of the Euro.

In less than 80 years, the 26 counties of the Republic of Ireland in the 32-county island went from political and economic integration with Great Britain to being a member of both the European Union and the Euro zone via a flirtation with self-sufficiency and isolation. It is likely that these changes to political and economic institutions had larger long-term implications for Irish economic development than either short-term exogenous shocks (e.g., oil-price shocks, currency market turmoil, and the bursting of the dot-com and property bubbles) or short-term policies.

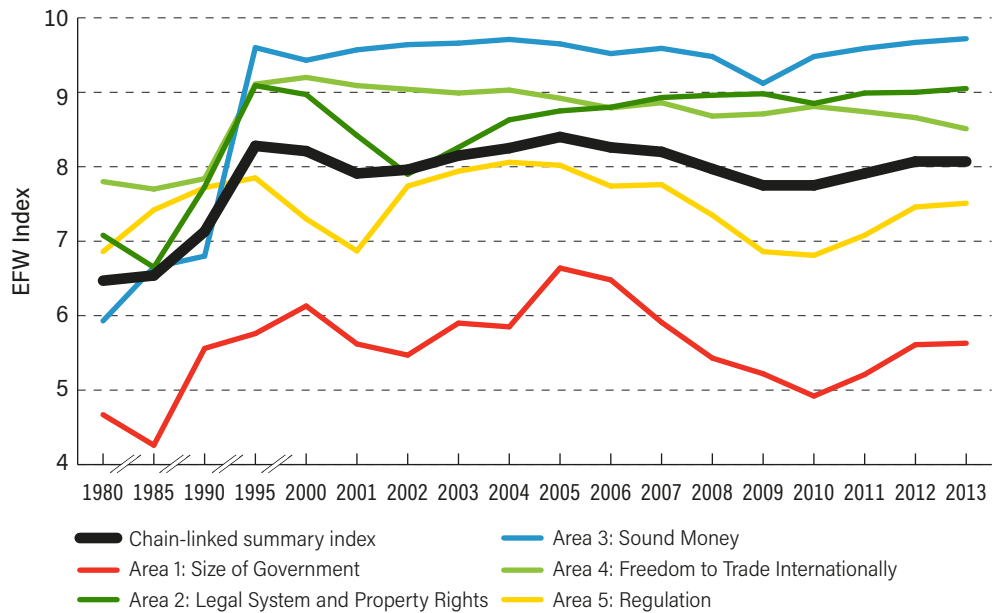
## Analysis of major changes to the main components of economic freedom

The index published in *Economic Freedom of the World* produced a score for 157 countries in the 2015 world report. Ireland's overall score for economic freedom of 8.07 ranked joint fifth highest, and was just 0.80 points behind first placed Hong Kong (Gwartney, Lawson and Hall, 2015). Ireland was the second-highest European country on the index, behind Switzerland, and is the highest among the members of the European Union. Like all of the 157 countries measured on the index, Ireland's overall score is attributed to five equally weighted areas. The five are *Size of Government*, *Legal System and Property Rights*, *Sound Money*, *Freedom to Trade Internationally*, and *Regulation*. These five areas are further broken down into components and sub-components. In total, the five areas have 49 components and sub-components constituting each area score.

Figure 5.3 presents the time profile of the overall EFW Index for Ireland and its five major component parts. Note that there are five-year gaps between the data points up to 2000 whereas the data thereafter is annual. The summary index is represented by the black, heavy line running through the centre of figure 5.3. It increases from 6.54 in 1985 to 8.28 a decade later. It then moves between 8.40 and 7.75 for the following 20 years.

All of the component parts also improve between 1985 and 1995. (Chain-linked data are not available for individual components; the following discussion is of non-chain-linked data.) The most obvious improvement is in *Sound Money* between

Figure 5.3: Economic Freedom in Ireland—Chain-Linked Summary Index and Ratings for the Five Areas, 1980, 1985, 1990, 1995, and 2000–2013



Source: Gwartney, Lawson, and Hall, 2015.

1990 and 1995. This change is the direct result of allowing Irish citizens to own and operate foreign-currency bank accounts outside Ireland. This change arose because of the implementation of the Single European Act. Changes associated with the act can also account for the large increase between 1990 and 1995. The large change in *Area 1: Size of Government* between 1985 and 1990 is explained by the fiscal adjustment undertaken after 1987. From 1995 onwards the two areas that show the greater variability are *1. Size of Government* and *5. Regulation*. Both tend to follow the performance of the economy for reasons that will be explained in the next section. (While it is not the objective of the paper to provide a detailed account of each of these, **table 5.1** illustrates the variables that measure *Area 1: Size of Government*.)

It is more difficult to explain the changes in the *Area 2: Legal System and Property Rights*. The data on the sub-components are not available prior to 2000. In addition, these component parts are based on survey results from the *Global Competitiveness Report*. It is harder to trace these relatively subjective measures. For example, it is possible that the high profile, failed, attempt by the Minister for Finance to nominate a judge to the European Investment Bank reduced this sub-component in the early 2000s.

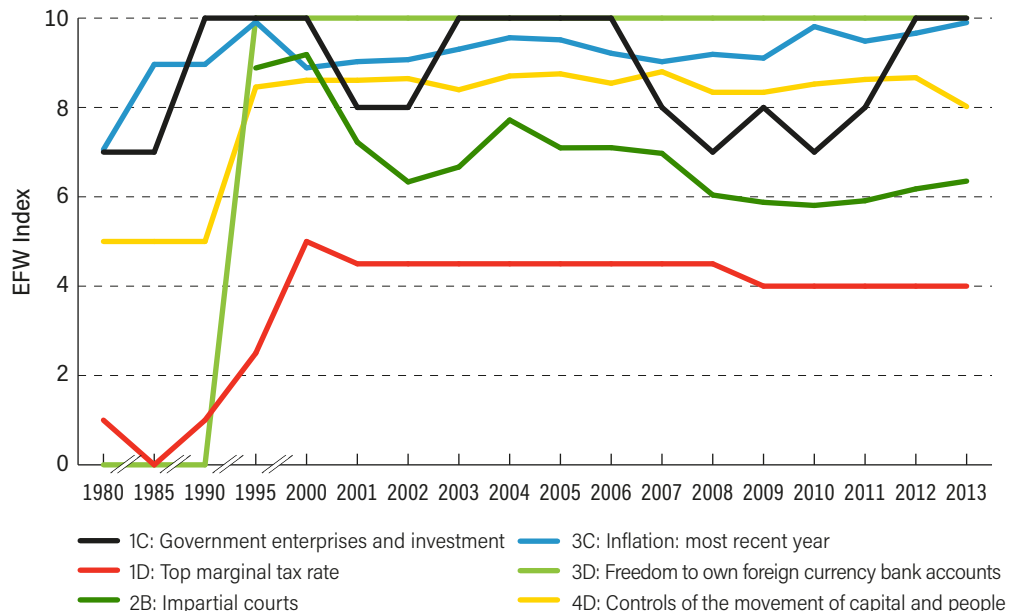
In the case of Ireland there has been movement in all of the component and sub-component parts since 1980, with the exception of component *2E: Integrity of the legal system*. Since data for this became available in 1995, the country has consistently scored the top mark of 10. Other elements of each area have been more unpredictable. **Figure 5.4** is a combined graphic showing some of the more volatile components for Ireland. To be included in this illustration, a component had to change by +2 or –2 points on the EFW Index from the 1980 figure to the 2013 figure. Some components moved outside this range during the period from 1980 to 2013 but revert back and finished inside the range from +2 to –2. These are not included. A component that moves +2 or –2 in a given year or over a number of years is only included if the change still exists in 2013.

Table 5.1: Components and Sub-components of Area 1. Size of Government

Area 1. Size of Government					
Components	1A	1B	1C	1D	
	Government consumption	Transfers and subsidies	Government enterprises and investment	Top marginal tax rate	
Sub-components				1Di	1Dii
				Top marginal income tax rate	Top marginal income and payroll tax rate

Source: Gwartney, Lawson and Hall, 2015: 4.

Figure 5.4: Economic Freedom in Ireland—Components with the Largest Changes, 1980, 1985, 1990, 1995, and 2000–2013



Source: Gwartney, Lawson, and Hall, 2015.

Six components are included in figure 5.4. 1C: *Government enterprises and investment* and 1D: *Top marginal tax rate* are part of Area 1. 2B: *Impartial courts* forms part of Area 2. 3C: *Inflation: most recent year* and 3D: *Freedom to own foreign currency bank accounts* are part of Area 3. 4D: *Controls of the movement of capital and people* is found in Area 4. Regulation (Area 5) has no element included.

Of the six components illustrated in figure 5.4, *Freedom to own foreign currency bank accounts* sees the largest change of any component between 1980 and 2013. This occurred between 1990 and 1995 and captures Ireland’s decision to join the European Union and the creation of the single currency area, the Eurozone. Also in Area 3, *Inflation: most recent year* improved considerably and is reported in 2013 as 9.90. This has risen by 2.84 points on the EFW Index and is representative of Ireland’s move into the Euro area, and the price stability the country has enjoyed since.

Directly connected to the Sound Money components in Area 3, is *Controls of the movement of capital and people*. This component is part of Area 4 and, like the previous two addressed, witnesses a rapid improvement between 1990 and 1995. The same forces are at work, and Ireland's deeper integration within the European Union after 1992 considerably changed the ability of people on the island to move both themselves and capital to other parts of the EU. The index score rises by 3.02 points between 1980 and 2013 and is second only to *Freedom to own foreign currency bank accounts* in terms of the size of the change.

Two further improving components, which both assisted in raising Ireland's score on the EFW Index, are found in Area 1. *Government enterprises and investment* and *Top marginal tax rate* both see an identical increase of three points during the period. In the case of the former, government spending is quite unstable. This can be explained by both the extraordinary period of unprecedented economic growth Ireland enjoyed between 1993 and 2007, followed by the remarkable collapse of the country's public finances following the global financial crisis. The rise and fall of both are disproportionate in size when compared to the world economy. The top marginal tax rate does not include the public service Pension Levy that was introduced in the March 2009. This equated to a reduction of approximately 7% on gross incomes of public-sector workers. It is likely, should the economy continue to recover at the current pace, that these taxes will be reduced or eliminated in the years ahead, further improving the score on the EFW Index for *Top marginal tax rate*.

Lastly, unlike the other five components illustrated and addressed above, *Impartial courts* has largely declined over the course of the past two decades. The index score of 8.88 in 1995 when data starts, compares more favorably to the 2013 score of 6.35. This is a deterioration of 2.53 points. *Impartial courts* is the only component that has substantially declined and is acting as an impediment to Ireland improving its overall score for economic freedom and its relative ranking. Declining from 9.19 in 2000 to 7.22 in 2001, the component began to fall again after 2004, reaching an all-time low of 5.81 in 2010.

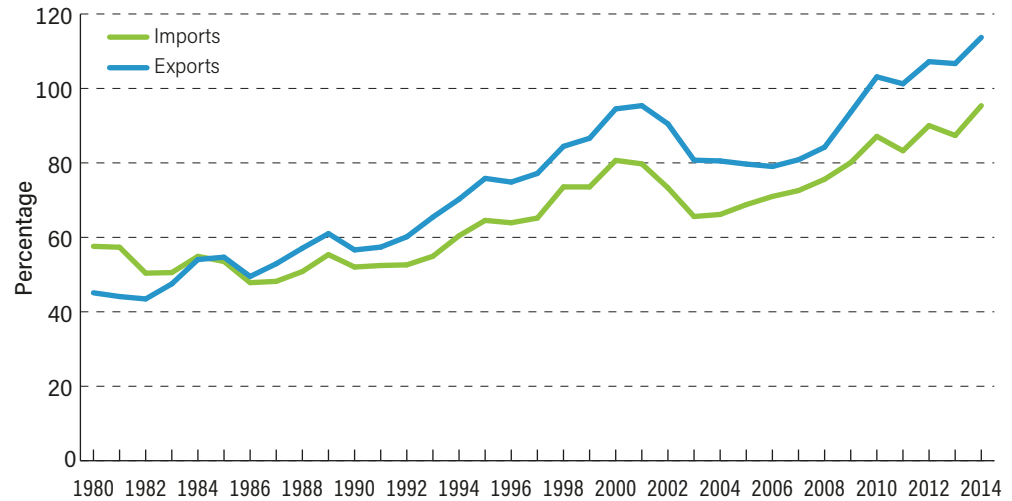
## Policy changes and other factors that have influenced economic freedom since 1980

### Freedom to trade internationally

Irish exports and imports have grown even more dramatically than GDP. This can be seen in **figure 5.5** where exports and imports are expressed as a percentage of GDP. Exports have increased from 45% of GDP in 1980 to 114% of GDP in 2014. Imports have also increased substantially, although not by as much. Given the size of exports and imports relative to GDP, plus the fact that imports and export tend to move in a similar fashion, it is easy to see why Ireland can be seen as an export platform for Foreign Direct Investment (FDI).

It is estimated that "almost 80 per cent of Irish exports are produced by foreign-affiliate companies" (Barry and Bergin, 2014: 1302). This points to the success of the Irish competitive position on corporate taxation. For over 50 years, Ireland has sought to attract FDI through relatively low corporate tax rates. While the initial tax relief was targeted at manufacturing firms exporting from Ireland, the European complaints about the discriminatory nature of the Irish corporate tax regime has encouraged Ireland to extend many of these benefits to all corporate trading. After

Figure 5.5: Ireland—Exports and Imports as a Percentage of GDP, 1980–2014



Source: Central Statistics Office, 2016a, 2016b: table 5, *National Income and Expenditure Accounts*.

joining the European Economic Community, Ireland agreed to phase out the zero rate on Exports Profits Tax Relief. In 1978, Ireland implemented a 10% rate that applied to all manufacturing. In 1987, this 10% rate was applied to those entities operating in the Irish Financial Service Centre. In the 1990s, Europe questioned the discriminatory nature of the 10% rate. Ireland responded by raising the rate slightly to 12.5% but it gradually extended this flat rate to all trading corporations. The nature of these changes reflected the use of tax incentives to compete with other states to attract investment.

The success of the Irish policy is further illustrated by table 5.2. While all four countries in table 5.2 experienced an increase in FDI stock per person, due to the increased flows of FDI during the period, Ireland consistently has the highest amount after 1980. Ireland had some form of early mover advantage in 1980 compared to Spain and France. Spain has narrowed the gap on Ireland but much of this is the result of its relatively low starting position.

The Great Recession has brought greater international scrutiny of corporate tax regimes. It is difficult to know how these will shape the landscape for FDI into Ireland. Barry and Bergin (2014) note that moves by the G20 in 2009 to target regions with financial secrecy laws seemed to benefit Ireland because it adheres to the full exchange on information. However, some of the key players in Europe remain unhappy with the low statutory rate of 12.5% in Ireland. In 2010, they unsuccessfully sought an examination of the regime in return for funding a bailout of the Irish state. In 2013, Europe instigated an examination of an arrangement between the Irish tax authorities and Apple Inc. on the grounds of unfair state aid. In the past, Irish policy makers have satisfied European concerns in ways that actually benefitted the country. Whether they can continue to do this is an open question.

### Money and banking

For the period up to 1979 Ireland maintained a one-for-one link with sterling. During this period, there was a regular complaint that there was a lack of capital for investment in Ireland, although it is also possible to argue that there was a lack of investment opportunities for capital (Daly, 1984). It could be argued that this

**Table 5.2: Foreign Direct Investment Inward Stock per Capita (current US\$), 1985–2014**

	Ireland	United Kingdom	Spain	France
1980	1,102	1,119	137	415
1985	1,313	1,130	233	594
1990	1,569	3,542	1,696	1,720
1995	3,251	3,408	3,331	3,119
2000	15,623	8,079	3,567	4,401
2005	40,590	18,831	10,847	7,927
2010	62,772	17,514	13,602	9,754
2014	80,158	25,720	15,520	11,066

Sources: FDI stock from UNCTAD, 2016; population from Eurostat, 2016; 1980 to 2000 figures from Barry, 2004; 2005 to 2014 from authors' calculations.

contributed to the 1955/6 macroeconomic crisis. Ironically, the decision of the banks not to follow a UK increase in interest rates, which was commended by the Minister for Finance, triggered a flight of capital. The consequences were obviously unforeseen as the fear of capital flight was ever-present in the minds of Irish policy makers, at least since the Exchange Control Act of 1954. The fear of capital flight can also help explain the difference in the taxation treatment of interest income earned by resident and non-residents. Following a 1963 White Paper, non-residents were not subject to tax. In the years that followed this led to wide-scale tax evasion as many Irish residents claimed they were non-resident to benefit from this distortion in the tax system.

Fear of capital flight played a bigger role when the one-for-one link with sterling was broken in 1979 and Ireland entered the European Exchange Rate Mechanism (ERM). There were frequent realignments with the ERM where the Irish pound lost value against the Deutsche Mark (Honohan and Conroy, 1994). The Irish pound was unilaterally devalued by 8% in August 1986 and again, by 10% in March 1993. The pressure to maintain the currency within the narrow bounds of the ERM resulted in the authorities turning a blind eye to tax evasion. While there was a progressive relaxation of exchange controls in the late 1980s and early 1990s in the run up to the “single market”, the exchange control requirements relating to the opening and operation of a foreign currency account outside the state remained in place until December 31, 1992. A major change in EFW Index occurred on January 1, 1993.

The 1990s also had important implications for Irish banking, which in turn had important implications for the Irish economy as a whole. The combination of the Single European Act and Ireland’s membership in the Euro opened up the market to competition. This represented a massive change from the lack of competition for most of the twentieth century (O’Grada, 1994; McGowan, 1986). The increased competition resulted in a lower price and a greater quantity in the market for home loans. There were also important changes in the way commercial banks were conducting business. Traditionally, the banks raised money through deposits from their branch network spread throughout the country. Towards the end of the twentieth



century, they started raising funds by a combination of access to the wholesale money markets and the securitization of their loan book (Whelan, 2014). This new business model was to have catastrophic consequences for the world financial markets within a decade. The problems in Ireland were exaggerated by a related property boom. The result was both a banking and financial crisis. The banking crisis resulted in the winding down of some banks, the government taking a majority ownership in others, the government effectively monetizing the funding of one bank by the use of promissory notes, and a withdrawal of some of the competitors that had entered the market a decade earlier. It also spawned a range of reports and an official enquiry into the crisis. While few Irish people wished for a return to the banking cartel of the nineteenth and twentieth centuries (O’Grada, 1994; McGowan, 1986), there was a concern that banking practice had cost the taxpayer and had contributed to the extent of the economic downturn.

### Size of government

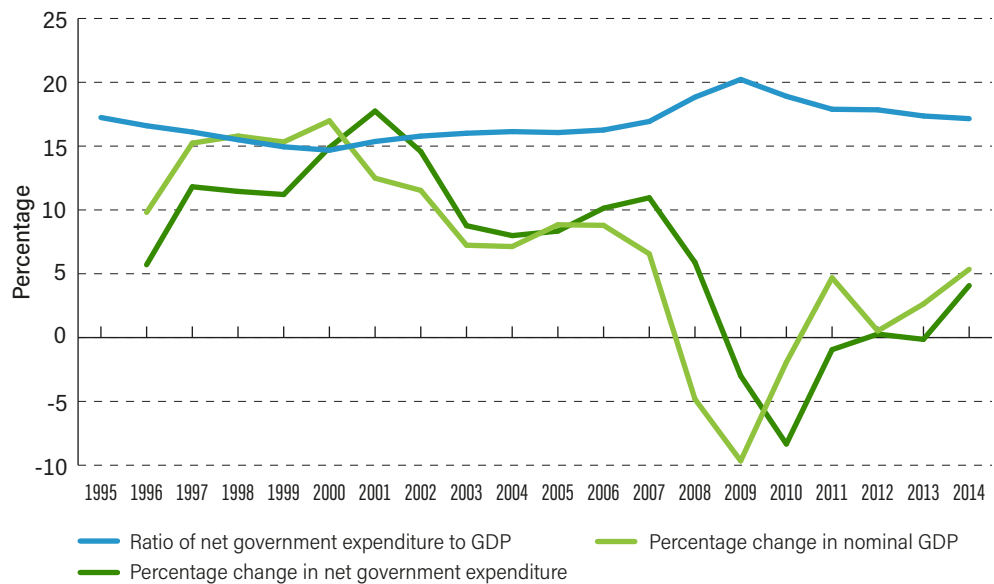
Gwartney (2009) outlines the ten things that have been learned from the *Economic Freedom of the World* project. One of these is that government spending as a share of the economy is not a very good measure of economic freedom or reliance on markets. This is particularly relevant for Ireland for the period under consideration for two reasons. First, the exact measure of economic activity is contested; for example, GDP versus GNP. Second, the dramatic variation in the growth rates of the Irish economy during the period makes it difficult to interpret a ratio measure.

Between 1980 and 2014, the average annual growth in the Irish economy was 4.03% when measured in GDP and 3.36% when measured in GNP. Moreover, GDP has been bigger than GNP since 1975. This represents a sizable difference when accumulated over the 34-year period. GDP is 283% bigger in 2014 than it was in 1980 whereas GNP is 207% bigger. The difference between GDP and GNP is an important factor to consider when considering the performance of the Irish economy and the movement of any variable expressed as a percentage of economic activity.

**Figure 5.6** shows that the ratio of net government (central and local) expenditure to Gross Domestic Product ranged from 14.68% in 2000 to 20.23% in 2009. While this represents a sizable change within a decade, it hides much greater changes that were occurring in both GDP and net government expenditure. Nominal GDP grew dramatically between 1995 and 2007. The average annual nominal growth rate was approximately 11.25% (real GDP grew by 7.35%). Government expenditure then seemed to follow with a lag of one year. The correlation between the percentage change in GDP and government expenditure lagged one year is 0.95. It is difficult to imagine such growth in government expenditure being consistent with economic freedom.

The large growth rates in public expenditure can be explained by a number of factors. First, there was an equally large increase in revenues (**figure 5.7**). Unfortunately, many of the revenue increases in the period from 2000 were windfall gains from a property bubble. Second was the economic philosophy of Charlie McCreevy, as Minister for Finance, which linked changes in expenditure to changes in revenue. It was explicitly stated as “don’t spend it when you don’t have it” but it seemed to also operate as “spend it when you have it” (Glennon, 2001). It was as if the procyclicality of Irish fiscal policy identified in Lane (1998) became policy. Third was an EU deficit rule that was defined as a ratio to GDP. Given the large changes in the denominator (GDP), and the revenue part of the nominator, this rule fostered greater laxity on the public expenditure than might otherwise have been the case.

Figure 5.6: Ireland—Ratio of Net Government Expenditure to GDP, Annual Percentage Change in Nominal GDP, and Annual Percentage Change in Net Government Expenditure, 1995–2014



Note: Net government expenditure is the figure from the expenditure decomposition of national income. It does not include transfers. Including transfers and other payments brings the ratio to between 30% and 45% of GDP. Source: Central Statistics Office, 2016a: tables 5, 21, *National Income and Expenditure Accounts*.

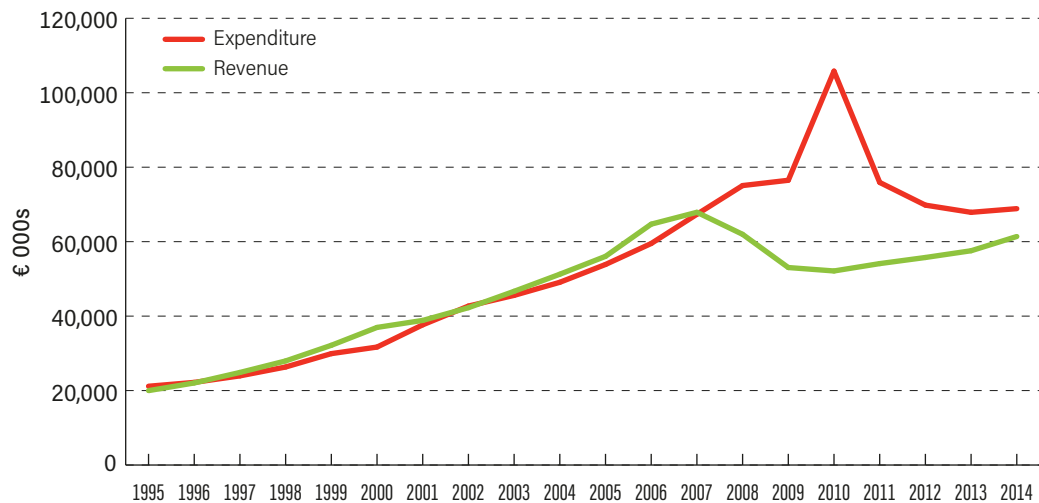
An important element in the improvement in EFW component Size of Government arose from changes in the income-tax system. There were five income tax rates in 1980 with a top rate of 60%. As the government struggled with imbalance on the public finances during the early 1980s they added another rate of 65% in 1983. In 1985, the system was reduced to three rates with a top rate of 60%. National wage agreements, plus a gradual improvement in the public finances, contributed to a reduction in these tax rates from the mid-1980s. The top rate of income tax fell to 56% in 1989 and 48% in 1992. In 1992, there were only two rates of income tax (27% and 48%). These two rates were reduced during the late 1990s so that they stood at 20% and 42% by 2001. A further reduction of 1% in the top rate occurred in 2007.

There were no changes to these rates during the fiscal crisis between 2008 and 2014. That is not to say that taxes on income have not increased in other ways. There has been the introduction of tax levies and there have been increases in these levies. These levies have been transformed into a Universal Social Charge and this explains the increase in the top marginal income and payroll tax rate in the EFW Index.

There were also two important changes to the Irish tax system at the turn of the century. One was the result of a proposal to individualize the tax system. Between 1980 and 2000, married couples received double the tax allowances of single individuals. The change resulted in a smaller tax allowance for a married couple where there was one earner compared to where there were two earners.

The second change in the income tax system resulted in a move from tax allowances to tax credits. With a tax-credits system the first monetary unit a person earns is liable to tax whereas with a tax allowance system the person only pays tax on the amount above their tax allowance. Therefore, it appears that a person is entering a higher tax rate earlier. The change from allowances to credits can help account for a change in component 1D of the EFW Index for Ireland between 2000 and 2001.

Figure 5.7: Ireland—Government Expenditure and Revenue (€ 000s), 1995–2014



Note: The spike in 2010 is the result of over €30bn in Promissory Notes for the Anglo Irish Bank.

Source: Central Statistics Office, 2016a: table 21, *National Income and Expenditure Accounts*.

However, it should also be noted that Irish tax payers enter higher tax rates earlier than many of their European counterparts, as illustrated in Cronin, Hickey and Kennedy (2015). Using the 1996, 2003, and 2012 tax codes, they calculate the average tax rate for all income levels. They show how average tax rates have decreased, for all income amounts, over the period. The highest average income taxes were for the 1993 tax code and the lowest were for the 2012 tax code.

### Regulation and competition

In a broad range of indicators of competition law and policy, Ireland is listed as below average (Hoj, 2007). This is not surprising as both Massey and Daly (2003) and Gorecki (2012) have documented the slow evolution of Irish competition law. On the positive side there has been a trend towards improvement and there is plenty of space for continued improvement.

Massey and Daly (2003: 27–46) document the evolution of Irish competition law during the twentieth century. It was only in 1953 that the State began introducing any legislation in the area. This was the Restrictive Trade Practice Act and it established the Fair Trade Commission (FTC). The FTC could make fair trade rules but these rules were not binding. The FTC could report to the Minister who in turn could make an Order that, if confirmed by the parliament, would become law. No Orders were ever made. A similar pattern was observed with respect to the Mergers, Take-overs and Monopolies (Control) Act of 1978. The Minister could ask the Restricted Practices Commission (previously FTC) to conduct an enquiry. The Restricted Practices Commission (RPC) would report to the Minister who could then take action. The Minister never requested an enquiry. A number of sectors—banking, for example—were exempt from even this limited legislation. This was changed in 1987 with the Restrictive Practice (Amendment) Act but the change made very little impact. As Massey and Daly (2003: 33) state “no order was ever made in respect of such sectors”.

The 1991 Competition Act did seek to transpose European Competition Law into Ireland. Sections 4 and 5 of the Act dealt with cartels and abuse of a dominant position, respectively. It also established the Competition Authority (CA), which did strike down a small number of anti-competitive agreements. “Although the Act gave the

Minister power to bring court proceedings, no such actions were instituted” (Massey and Daly, 2003: 37). The 1991 Act was amended in 1996. While Massey and Daly class it as a disappointment, it resulted in “favourable settlements in four civil actions and brought one successful summary prosecution” (2003: 39). It was slow progress.

Just as the Competition Authority was establishing some credibility with regard to enforcement, it seemed it was about to be emasculated by funding and manpower problems. The numbers of staff fell from 24 in 1998 to 14 in 2000. Fortunately, a report published in the same year, (commissioned by the Department of Enterprise, Trade and Employment) recommended greater staffing and funding. This led to a quadrupling of funding between 2002 and 2007. Staff numbers doubled between 2000 and 2006. And, crucially, a new Competition Act was introduced in 2002. According to Gorecki (2012), these changes were driven by a market model inherent in the legislation.

The transformation in Irish competition law that occurred at the turn of the century was damaged by the Great Recession. Gorecki documents a period of “carve outs and exemptions” (2012: 613) from competition law after 2008. For example, between 2002 and 2005 there were annually between 18 and 42 searches for documents related to anticompetitive behavior, whereas there was none in 2010 and one in 2011. He notes that it was only the conditions imposed by the EU/IMF/ECB, in return for a bailout, that brought renewed vigor to the process: there were nine searches in the first seven months of 2011.

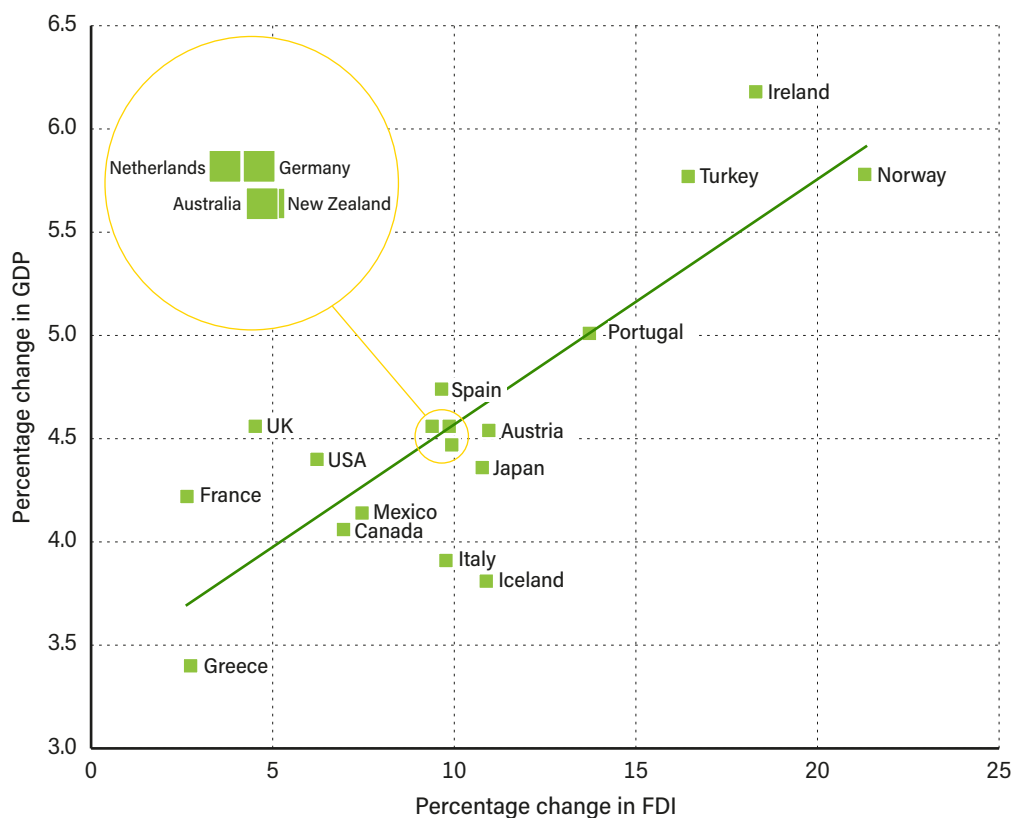
The three distinct periods identified by Gorecki (2012) reflect the changes in the EFW Index in figure 5.3. Economic freedom is lower in the “carve-out and exemptions” period. It is possible that this contributed to a perception of favoritism for particular well-connected firms and could be captured by sub-components like *SCiv: Extra payments/bribes/favoritism*.

## Impact of developments in economic freedom on the economy and other relevant variables

In a critical review of the EFW measure and the literature that uses it to assess its relationship to economic growth, De Haan, Lundstrom, and Strum say that despite the issues they raise, “our conclusion is that the index is both reliable and useful” and that the better studies “find support for a positive relationship between changes in EF and growth” (2006: 182). More recent work than that reviewed by De Haan and his colleagues explains how the investment channel is a key one through which economic freedom influences economic growth. Gwartney, Holcombe, and Lawson (2006) show how economic freedom increases investment and how it also results in more productive investment. In a similar vein, Azman-Saini, Baharumshah, and Law (2010) argue that the impact of foreign direct investment (FDI) on growth is contingent on the level of economic freedom in the host country. They argue that there is support for the idea of absorptive capacity so that FDI has a bigger influence in countries that already have export-oriented policies and where there is some threshold level of human capital. Both of these conditions have held for Ireland for decades.

The relationship between FDI and economic growth for selected countries is presented in **figure 5.8**. A clear positive relationship appears to exist between the two. Ireland has seen the most impressive average annual increase in GDP per capita over the period, and is second only to Norway in terms of average annual increases in foreign direct investment.

Figure 5.8: Average Annual Percentage Change in Real GDP per Capita and Average Annual Percentage Change in Foreign Direct Investment, Selected Countries, 1980–2014



Sources: GDP from OECD, 2016; foreign direct investment from World Bank, 2016.

The impressive performance of the Irish economy has spawned much literature on the subject. A comprehensive review is beyond the scope, and not the purpose, of this study but it is important to locate it within the broad parameters in the literature. It is fair to say that the explanations of the Irish economic performance for the period since 1980 are influenced by when they were written or published and by the period studied. With the passage of time, the empirical reality of dramatic changes in economic growth rates made the explanations more complex. The longer time span, and more data, also focuses attention on the more important underlying issues like institutions rather than shorter-term policies.

Those writing and publishing during the 1980s did not have to worry about explaining the convergence of living standards. As Kennedy, Giblin, and McHugh put it, “when set in the European context, Ireland’s rate of progress emerges as mediocre” (1988: 252). A similar evaluation of Irish economic performance, the causes, and solutions, was offered by the historian Joe Lee. However, Lee did not seem to foresee what was about to happen: “If she [Ireland] now aspires after western European levels of income, therefore, quite spectacular growth rates, far exceeding the average, are necessary” (Lee, 1989: 521). The spectacular growth rate soon arrived.

By the mid-1990s, the changed economic reality was starting to be incorporated into the contemporary accounts of Irish economic history, for example, those of de la Fuente and Vives (1998). O’Grada (1997) noted the improved performance in

a comparative context—for example, Northern Ireland, the United Kingdom, and Europe—while highlighting the potential problems with GDP and GNP as measures of economic performance.

At the start of the new millennium, two animal metaphors appeared in the literature. The more popular metaphor, “Celtic Tiger”, was borrowed from the Asian experience where a transformation in the economic performance of a number of countries led to the term “Asian Tigers”. The second metaphor was “Irish Hare” (Honohan and Walsh, 2002), a reference to the hare’s late burst of activity in the ancient story of its race with a tortoise. A lack of convergence was explained by market-contrary policies and institutions. Delayed convergence was explained by the inclusion of some story explaining how the removal of policies and institutions that hindered convergence was delayed. The problematic policies and institutions included the economic isolationist policies after 1932 and the questionable demand-management policies of the 1970s. Powell (2003) also listed these issues but went on to make an explicit link between Irish economic growth and economic freedom. Delayed convergence was not the only explanation of the Celtic Tiger years. As an alternative to the delayed convergence hypothesis, there was the regional economic-boom hypothesis proposed in Barry (2002). Neither explanation is inconsistent with the economic freedom perspective.

A number of accounts of Irish economic performance have been published since the decline of the Celtic Tiger: for example, Bielenberg and Ryan, 2013; Donovan and Murphy, 2013; O’Riain, 2014; and O’Leary, 2015. All reflect the fact that it is not easy to provide a parsimonious theory that explains the empirical reality of wildly fluctuating economic growth rates of recent decades. Yet, all agree on the problems caused by protectionism. Bielenberg and Ryan (2013) and O’Riain (2014) focus on the importance of a reorientation towards Europe. Donovan and Murphy (2013) and O’Riain (2014) identify the problems associated with passive acceptance and lack of understanding of economic ideas and the importance of institutions. Although he probably has a different set of institutions in mind, O’Riain says that we should begin by “seeking to identify some of the empirical regularities in how institutions are structured” (2014: 26). This is exactly what *Economic Freedom of the World* seeks to achieve. We contend that there is enough evidence in this chapter to indicate that the greater economic freedom enjoyed by individuals and companies operating in Ireland contributed to the improved growth performance of the Irish economy.

## Summary and conclusions

If one is going to blame the policy makers for the delay in convergence, then one must consider giving them credit for the convergence. There is nothing in the literature that suggests convergence of living standards is automatic. Policies and institutions are human artefacts and there is agreement that good institutions aid growth while poor institutions hinder growth. The decision to compete internationally for businesses that in turn would compete in international product and services markets has transformed the Irish economy. The decision to become a member of the EEC, part of the single market, and the Euro has increased the stage on which enterprises located in Ireland now compete. For three decades from 1987, Ireland posted some of the largest growth rates in the world, driven by an even more impressive increase in exports.

Ireland posted the highest growth rate in the EU for 2015 and indications for 2016 suggest a similar performance. Whether this marks a return to the impressive performance of the period from 1994 to 2007 is difficult to say. Respected commentators suggest that further convergence on the leaders is possible (Crafts, 2014). Much will depend on the policies and institutions that the Irish will continue to forge.

## References

- Azman-Saini, W.N.W., Ahmad Zubaidi Baharumshah, and Siong Hook Law (2010). Foreign Direct Investment, Economic Freedom and Economic Growth: International Evidence. *Economic Modelling*, 27, 5: 1079–1089.
- Barry, Frank (2002). The Celtic Tiger Era: Delayed Convergence or Regional Boom. In Frank Adele Bergin, David Duffy, John Eakins, C. MacCoille and Danny McCoy (eds.), *Quarterly Economic Commentary*, Summer (Economic and Social Research Institute): 36–42.
- Barry, Frank (2004). Export-Platform Foreign Direct Investment: The Irish Experience. *European Investment Bank Papers* 9, 2: 8–37.
- Barry, Frank, and Adele Bergin (2012). Inward Investment and Irish Exports over the Recession and Beyond. *The World Economy* 35, 10: 1291–1304.
- Bielenburg, Andy, and Raymond Ryan (2013). *An Economic History of Ireland since Independence*. Routledge.
- Brownlow, Graham (2007). The Causes and Consequences of Rent-Seeking in Northern Ireland, 1945–72. *Economic History Review* 60, 1: 70–96.
- Brownlow, Graham (2010). Fabricating Economic Development. *The Economic and Social Review* 41, 3: 301–324.
- Central Statistics Office (2016a). *National Income and Expenditure Tables: 1995-2014*. Online. <<http://www.cso.ie/en/statistics/nationalaccounts/>>, as of April 22, 2016.
- Central Statistics Office (2016b). *Historic National Income and Expenditure Tables: 1970-1995*. Online. <<http://www.cso.ie/en/statistics/nationalaccounts/>>, as of April 22, 2016.
- Crafts, Nicholas (2014). Ireland’s Medium-Term Growth Prospects: A Phoenix Rising? *The Economic and Social Review* 45, 1: 87–112.
- Cronin, David, Ronan Hickey, and Gerard Kennedy (2015). How Budgetary Policy Has Shaped the Irish Income Tax System. *Administration* 62, 4: 107–118.
- Daly, Mary E. (1984). Government Finance for Industry in the Irish Free State: The Trade Loans (Guarantee) Acts. *Irish Economic and Social History* 11: 73–93.

De la Fuente, Angle, and Xavier Vives (1997). The Source of Irish Growth. In Alan Grey (ed.), *International Perspectives on the Irish Economy* (Indecon): 112–134.

De Haan, Jakob, Susanna Lundström, and Jan-Egbert Sturm (2006). Market-Oriented Institutions and Policies and Economic Growth: A Critical Survey. *Journal of Economic Surveys* 20, 2: 157–191.

Dorgan, Sean (2006). *How Ireland Became the Celtic Tiger*. Backgrounder #1945. Heritage Foundation .

Donovan, Donal, and Antoin E. Murphy (2013). *The Fall of the Celtic Tiger: Ireland & the Euro Debt Crisis*. Oxford University Press.

Eurostat (2016). *European Statistical System*. Online. <<https://ec.europa.eu/CensusHub2/query.do?step=selectHyperCube&qhc=false>>, , as of April 26, 2016.

Garvin, Tom (2004). *Preventing the Future: Why Was Ireland So Poor for So Long?* Gill & Macmillan.

Glennon, Chris (2001). McCreevy Takes Axe to Public Spending. *Irish Independent*. <<http://www.independent.ie/irish-news/mccreevy-takes-axe-to-public-spending-26068064.html>>, as of June 9, 2016.

Gorecki, Paul K. (2012). Competition Policy in Ireland's Recession. *Economic and Social Review* 42, 4: 597–629.

Gorecki, Paul K. (2014). The Quality of Analysis of Irish Merger Decisions. *Journal of Competition Law and Economics* 10, 2: 375–397.

Government of Ireland (1958). *The Programme for Economic Expansion*. Government Stationary Office, as of April 19, 2016.

Gwartney, James (2009). Institutions, Economic Freedom, and Cross-Country Differences in Performance. *Southern Economic Journal* 75, 4: 937.

Gwartney, James, R.G. Holcombe, and R.A. Lawson (2006). Institutions and the Impact of Investment on Growth. *Kyklos* 59, 2: 255–273.

Gwartney, James, Robert Lawson, and Joshua Hall, with Ryan Murphy, Hans Pitlik, Dulce M. Redín, and Martin Rode (2015). *Economic Freedom of the World: 2015 Annual Report*. Fraser Institute.

Høj, Jean (2007). Competition Law and Policy Indicators for the OECD Countries. OECD Economics Department Working Papers No. 568. OECD Publishing.

Honohan, Patrick, and Charles Conroy (1994). Sterling Movements and Irish Pound Interest Rates. *Economic and Social Review* 25, 3: 201–220.



Honohan, Patrick, and Cormac O'Gráda (1998). The Irish Macroeconomic Crisis of 1955–56: How Much Was Due to Monetary Policy? *Irish Economic and Social History* 24: 52-80.

Honohan, Patrick, and Brendan Walsh (2002). *Catching Up with the Leaders: The Irish Hare*. Brookings Panel on Economic Activity.

Kennedy, Kieran A. (2002). Economic Growth in Ireland: Where Has It Come from, Where Is It Going? *Journal of the Statistical and Social Inquiry Society of Ireland* 30: 123–139.

Kennedy, Kieran A., Thomas Giblin, and Deirdre McHugh (1988). *The Economic Development of Ireland in the Twentieth Century*. Routledge.

Lane, Philip R. (1998). On the Cyclicalities of Irish Fiscal Policy. *Economic and Social Review* 29, 1: 1–16.

Lee, J.J. (1989). *Ireland 1912–1985: Politics and Society*. Cambridge University Press.

Massey, Patrick, and Daragh Daly (2003). *Competition and Regulation in Ireland*. Oak Tree Press.

McGowan, P. (1986). Competition in Irish Banking. *Irish Banking Review*, Autumn: 27–40.

McMahon, Deirdre (1984). *Republicans and Imperialist: Anglo-Irish Relations in the 1930s*. Yale University Press.

McMahon, Fred (2000). *Road to Growth: How Lagging Economies Become Prosperous*. Atlantic Institute for Market Studies.

O'Grada, Cormac (1995). *Ireland: A New Economic History 1780–1939*. Oxford University Press.

O'Grada, Cormac (1997). *A Rocky Road: The Irish Economy since the 1920s*. Manchester University Press.

O'Grada, Cormac (2002). Is the Celtic Tiger a Paper Tiger? *Quarterly Economic Commentary* (ESRI), Spring: 52–62.

O'Grada, Cormac, and Kevin O'Rourke (1996). Irish Economic Growth, 1945–88. In N. Crafts and G. Toniolo (eds.), *Economic Growth in Europe since 1945* (Cambridge University Press): 388–426.

O'Leary, Eoin (2015). *Irish Economic Development: High-Performing EU State or Serial Under-Achiever?* Routledge.

Organisation for Economic Co-operation and Development (2016). *Gross domestic product (GDP)*. OECD Data. <<https://data.oecd.org/gdp/gross-domestic-product-gdp.htm>>, as of April 16, 2016.

O’Riain, Sean (2014). *The Rise and Fall of Ireland’s Celtic Tiger: Liberalism, Boom and Bust*. Cambridge University Press.

United Nations Conference on Trade and Development (2016). *Foreign Direct Investment*. UNCTADSTAT. Online. <[http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx?IF\\_ActivePath=P,5](http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx?IF_ActivePath=P,5)>, as of April 22, 2016.

Whelan, Karl (2014). Ireland’s Economic Crisis: The Good, the Bad and the Ugly. *Journal of Macroeconomics* 39: 424–440.

World Bank (2016). *Foreign Direct Investment, Net Inflows (BoP, current US\$)*. Online. <<http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD>>, as of April 18, 2016.

# Chapter 6 Economic Freedom in the United States, 1980 to the Present

*Dean Stansel and Meg Tuszynski*

## 1 Introduction

Americans have long described their country as “the land of the free and the home of the brave,” a description immortalized in the American national anthem, sung before every major sporting competition in the United States. While that description was apt for much of modern history (at least compared to other major economies), over the last decade and a half that description has begun to ring less and less true. The United States was ranked first in economic freedom among OECD countries as recently as 2000—and third overall, typically behind only Hong Kong and Singapore and, in some years, only Hong Kong—and had been since 1980. Unfortunately, it has been declining since then. This chapter will document the pattern of economic freedom in the United States over the period from 1980 to the present, giving particular attention to the decline in economic freedom since 2000.

## 2 Historical background on political and economic institutions

The political and economic institutions in the United States have been relatively stable over time. The existence of formal constitutions (at both the federal and state levels), which include specific limits on the power of government as well as checks and balances on the players in the political process, has tended generally to restrain the ability of government to infringe on economic freedom. This great American experiment in constitutionally limited government is a large contributing factor to the United States being ranked at the top of the list for economic freedom for so long.

---

Citation Dean Stansel and Meg Tuszynski (2016). Economic Freedom in America, 1980 to the Present. Early release of chapter 6 from James Gwartney, Robert Lawson, and Joshua Hall, *Economic Freedom of the World: 2016 Annual Report* (Fraser Institute): 258–271.

Authors Dean Stansel is a Research Associate Professor at the O’Neil Center for Global Markets and Freedom in the Cox School of Business at Southern Methodist University. Meg Tuszynski is a research associate at the O’Neil Center for Global Markets and Freedom.

Unfortunately, the framers of the US Constitution were unable to adequately anticipate the ways in which politicians, interest groups, lawyers, and judges would be able to undermine the restrictions that document placed on the power of government. For example, the founding fathers deliberately included a clause in the Constitution in order to prevent government from using taxpayers' dollars to fund expenditures that benefit only specific individuals or segments of the population (the "general welfare" clause). As Davy Crockett famously argued in the nineteenth century as a member of Congress in opposition to a bill to provide charitable relief to the widow of a distinguished naval officer: "We have the right, as individuals, to give away as much of our own money as we please in charity; but as members of Congress we have no right so to appropriate a dollar of the public money" (Ellis, 1867/2012).

That strict understanding of the Constitution largely persisted well into the twentieth century. Things began to change with the Great Depression that followed the stock market crash of 1929. In 1932, Franklin D. Roosevelt, then sitting governor of the nation's most populous state, New York, soundly defeated Herbert Hoover, the incumbent president, on a platform of creating a "New Deal", a large package of new social programs that Roosevelt felt would spur an economic recovery. The programs largely mirrored what governments in European democracies were already doing. The Supreme Court ruled Roosevelt's proposals unconstitutional. In response, coming off a landslide reelection in 1936, President Roosevelt threatened to "pack the court" with new Supreme Court justices in 1937. His plan would have given him a sufficient majority to get his programs approved. Shortly thereafter the existing justices changed their minds, putting aside concerns about Constitutional restrictions on the powers of the federal government, and found the Social Security Act and the other components of the New Deal to be constitutional. Now, with over half of the federal government's budget going to such entitlement programs—writing checks to specific individuals—the notion that such activity violates the Constitution is not even in the discussion.

More recently, in its landmark decision in *Kelo v. City of New London* (*Connecticut*, 545 U.S. 469 (2005)), the Supreme Court concluded that government could take private property (with "just compensation") and transfer that property to new private owners. Using "eminent domain" had previously been restricted to "public purpose", projects like schools, roads, and so on. In the *Kelo* case, the government was allowed to take homes in Connecticut and tear them down to make way for a research park to be built by the Pfizer Corporation, one of the world's largest pharmaceutical companies. The project was never built, and the vacant land was eventually used as a temporary dump for storm debris after Hurricane Irene hit the area in 2011.

While the political and economic institutions in the United States have not changed greatly over the years, there has been a slow evolution that has served to loosen the constitutional restrictions on the powers of government. That erosion of the limits on government has contributed to the decline in economic freedom.

### 3 Pattern of economic freedom, 1980 to present

According to the *Economic Freedom of the World* annual reports, the United States was right at the top of the list for economic freedom among OECD countries from 1980 through 2000. Over that period, its overall score on the index published in *Economic Freedom of the World* (EFW Index) increased from 7.92, on a scale of 0 to 10, to 8.65. There are five areas measured. From 1980 to 2000, the US score improved

substantially on the first three (Size of Government, Legal System and Property Rights, and Sound Money), but declined slightly on the last two (Freedom to Trade Internationally and Regulation). More detail will be provided in the next section.

Since 2000, the pattern has been quite different. The overall score has declined from 8.65 to 7.73. As a result, the United States has fallen from third most free in 2000 to 14<sup>th</sup> most free in the 2015 report (using data for 2013) (Gwartney, Lawson, and Hall, 2015b).<sup>1</sup> That decline in rank has been sharpest in recent years. By 2008, the United States had fallen only to seventh; since then it has fallen another seven spots, settling at 14<sup>th</sup> place in 2013. This is actually an improvement from its rank of 17<sup>th</sup> in 2011. Though the ranking has fallen faster in recent years, the overall score has declined at a fairly steady rate since 2000 (by about 0.07 points per year). That decrease in economic freedom has come from all five areas of the index, but the most dramatic decline was in Area 2: Legal System and Property Rights. The change in Area 4: Freedom to Trade Internationally was also quite large, from 8.80 to 7.56. The next section will provide more details on the change in each of the five areas of the index.

## 4 Analysis of major changes in the main components of the EFW Index and related policy changes

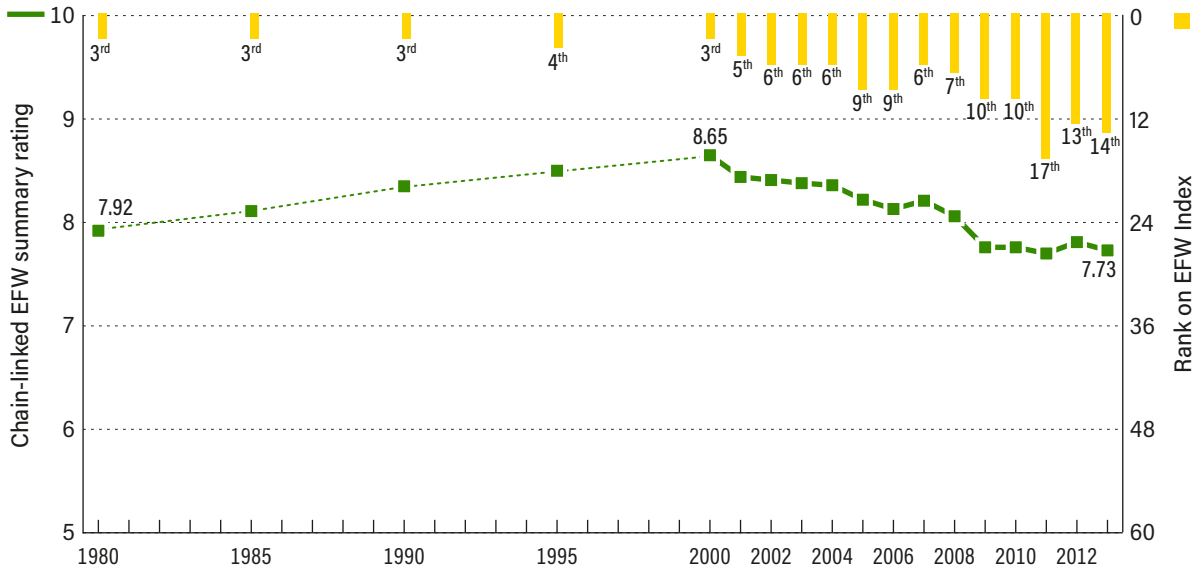
From 1980 to 2000, the overall economic freedom ranking of the United States stayed about the same, though the score moved gradually upward, following the global trend towards greater freedom. Since 2000, that pattern has reversed for the United States (figure 6.1), while the global average has continued to increase, though less rapidly. (The average for OECD countries has also declined over that period though not as steeply.<sup>2</sup>) That decline in US economic freedom has occurred in all five areas of the EFW Index, but has been substantially larger in two areas: Area 2: Legal System and Property Rights; and Area 4: Freedom to Trade Internationally (figure 6.2). Below, we will examine the changes in each of the five areas and provide some insight into the major policies that have contributed to these changes since 1980.

### 4.1 Area 1: Size of Government

In 1980, the United States still had very high personal income-tax rates, which dragged down their score in Area 1 (only 5.08). Largely because of the large income-tax cuts put through by President Ronald Reagan, the score in this category rose dramatically to 6.71 by 1990 and 7.03 in 2000. That score rose further to 7.13 in 2005, but had fallen to 6.88 by 2008. It has seen ups and downs since then, but at 6.61 it is now lower than it was in 2000, though the decline is smaller than was seen in Areas 2 and 4.

- 
- 1 Throughout this chapter we rely on the “chain-linked” data (available at [freetheworld.com](http://freetheworld.com)) for our analysis whenever possible (chain-linked data are not available for individual components of the index). In some cases, using chain-linked data will create small discrepancies with what is listed in the 2015 report itself, where, for example, the United States ranked 16<sup>th</sup>, not 14<sup>th</sup>.
  - 2 Part of the reason for that disparity is that new countries are added to the index published in *Economic Freedom of the World* over time. The countries added tend to be in the developing world and tend to be improving in freedom (which in part is what allows the authors to be able to collect valid data for those countries).

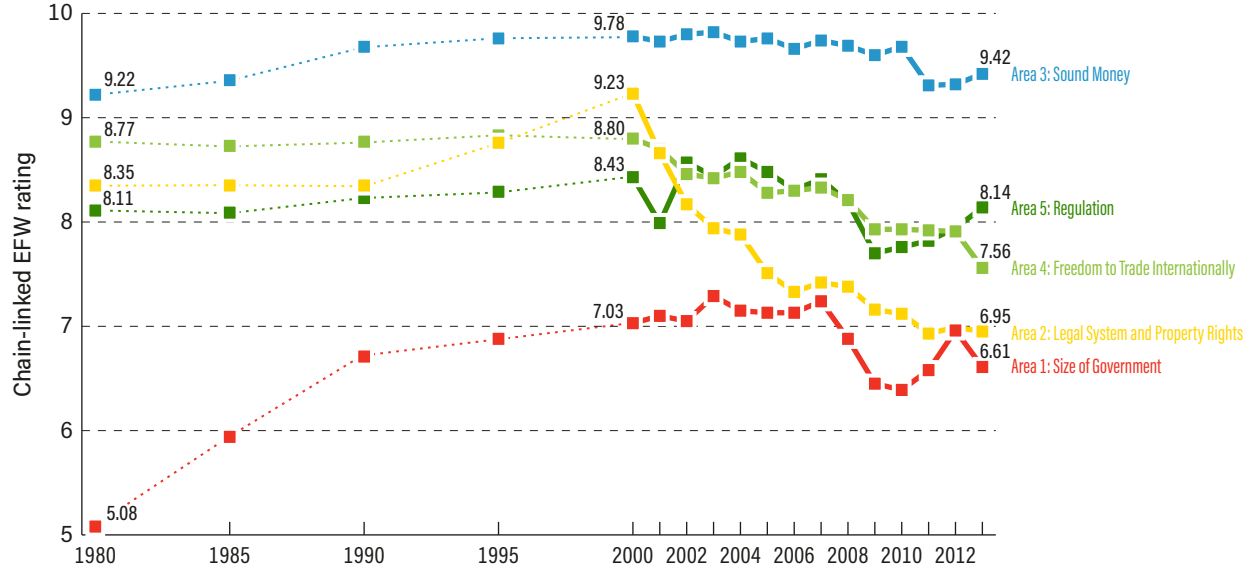
Figure 6.1: Chain-Linked Summary Rating and Ranking of the United States, 1980–2013



Note: Both vertical axes are truncated to highlight the trend. Summary ratings (left axis) are scaled from 0 to 10, though the United States never falls below 7 in the time period examined. To put the rank (right axis) in perspective, it is important to note that the number of countries included in the chain-linked dataset has grown over time. The base year for the chain-linked dataset is 2000, at which time there were 123 countries included in the index. Consequently, from 2000 onward, the rank displayed is out of 123 countries. The 1995 rank is also out of 123 countries. In 1990, there were 113 countries in the index, in 1985 there were 109, and in 1980 there were 102. None of these changes affect the rank of the United States.

Source: Gwartney, Lawson, and Hall, 2015a: 2015 Economic Freedom Dataset.

Figure 6.2: Chain-Linked Ratings of the United States for Areas 1 to 5 of the EFW Index, 1980–2013



Source: Gwartney, Lawson, and Hall, 2015a: 2015 Economic Freedom Dataset.

Those Reagan-era tax cuts reduced the top marginal personal income-tax rate from 70% to 50% in 1982, then further to 38.5% in 1987 and 28% in 1988. That rate was raised twice in the 1990s to 39.6%, then reduced to 35% in 2003. In 2013, the rate was raised back to 39.6%, where it remains today. The tax increases of the 1990s included higher corporate income-tax rates and higher payroll taxes as well.

In contrast to most other index variables, sub-components 1Di: Top marginal income tax rate and 1Dii: Top marginal income and payroll tax rate are measured only as whole numbers, then averaged to derive the score for the effective top marginal tax rate.<sup>3</sup> Consequently, it is difficult to discern marginal effects of tax policy from year to year, since policy must change significantly enough to trigger a full point increase or decrease in the Index before a country's rating in this area changes. Conversely, when a change is observed, this indicates a significant change in tax policy. As evidenced by the consistent positive and negative changes in component 1D, tax policy in the United States was consistently changing throughout the 1990s and 2000s. While the top marginal tax rate component measured 6.50 in 1990, it was up to 7.00 by 2000. It then grew by half a point by 2005, before falling back down to 7.00 in 2010. It has grown since then, but in 2013 saw its lowest measured level at 6.00.

Though component 1D saw ups and downs throughout the course of the 2000s, the three other components of Area 1 saw an unambiguous decline during the recent financial crisis, but have recovered modestly since then. This is to be expected, since the components making up the size of government area of the Index are highly likely to experience declines during economic downturns. Component 1A (Government consumption) fell 11% from 2000 to 2010, from 6.59 to 5.85, but climbed back up to 6.41 in 2013. Since this component measures government consumption as a share of total consumption, the recessionary fall should be unsurprising, since personal consumption fell at the same time government consumption increased.<sup>4</sup>

Likewise, component 1B (Transfers and subsidies) fell 13% between 2000 and 2010, from 6.54 to 5.69, but the rating had climbed up to 6.03 by 2013. The increased number of individuals on various social welfare programs as the financial crisis worsened undoubtedly contributed to the decline in this component. These first two variables measure spending as a percentage of consumption or GDP. Since 2000, federal spending has doubled. (It has tripled since 1990.) Since consumption and GDP have not grown as fast, spending has continued to rise as a share of those measures of the economy, which drives down the US score on these two variables, which represent half of Area 1's score.

Component 1C (Government enterprises and investment), like 1D, is only measured in whole numbers, and remained at 8.0 throughout the 1980s, 1990s, and early 2000s. It fell to 7.00 during the recession but has since returned to its historic level. Because this variable measures government investment as a share of total

3 This is why, though the sub-components can only be measured in whole numbers, component 1D (top marginal tax rate) may not be a whole number. Additionally, while it may seem odd to include top marginal income-tax rate in both sub-components, the Index aims to provide adequate tools for researchers to conduct their own tests with these numbers. While some researchers may want to use only top marginal income-tax rate, others may want a stronger measure of individual tax burden. This is why 1Dii captures both marginal income and payroll tax rates.

4 According to BLS data, between 2007 and 2010 employment supported by consumer spending fell by 3.2 million jobs, before beginning to recover (Bureau of Labor Statistics, 2014).

investment, the decline in private investment coupled with the increase in government involvement in business during the recession is likely the driving force behind this temporary decline.

Though the components of the size of government area all declined during the recent recession, the roots of the expansion in the size of government began many years prior to the onset of the Great Recession. The Community Reinvestment Act (CRA), originally passed in 1977, aimed to make it easier for low-income people to afford houses. Various regulatory and legislative changes throughout the 1990s and early 2000s strengthened the original legislation, which in turn allowed banks to extend increasingly risky loans to low-income individuals, while charging artificially low interest rates. Additionally, the 1992 revision to the CRA encouraged Fannie Mae and Freddie Mac to extend an increasing amount of lending to low-income families. This not only set the stage for the housing market collapse of the late-2000s, but also the subsequent government growth in components A, B, and C of Area 1.

Beginning in 2007, both the scale and scope of government activities rose dramatically. First came the fiscal stimulus of February 2008, followed by the nationalization of Fannie Mae and Freddie Mac. October 2008 saw the enactment of the Troubled Asset Relief Program (TARP). The bailouts of automobile manufacturers followed in December. Between September 2008 and March 2009, AIG, Citigroup, and Bank of America were all bailed out—with AIG requiring two bailouts. The second round of fiscal stimulus came in February of 2009. Bear Stearns was also bailed out in 2008, though Lehman Brothers was not. In addition to expanding the scope of government activity, the bailouts created an uncertain environment for investors, causing investment activity to fall dramatically, which had a negative impact on the US score on variable 1C.

In addition to the major extensions of government into private business activity, there was also an expansion of social welfare spending for purposes of recession relief. While there was an increase in spending on all safety net programs, some programs saw larger increases than others. Between 2007 and 2010, expenditures on the Supplemental Nutrition Assistance Program (SNAP, the successor to food stamps) increased by 18%, and expenditures on the federal Earned Income Tax Credit (EITC) rose by 21%. Along with Medicaid and the School Food Programs, SNAP and EITC are among the four largest means-tested programs in the United States, as measured by caseloads.<sup>5</sup> Among the social insurance programs, the recession saw a significant uptick in the payout of Unemployment Insurance (UI) benefits, and in both retirement (OASI) and disability (DI) portions of Social Security.<sup>6</sup> With respect to UI, continually falling employment during the recession caused Congress to extend unemployment durations to as much as 99 weeks at one point, causing both case loads and expenditures to rise substantially (Rothstein, 2011). Though DI case loads had been rising prior to the recession, an increasing number of individuals were added to the rolls during this period (Maestas, Mullen, and Strand, 2015). Finally, the recession seems to have encouraged some individuals to take an earlier retirement than they otherwise might have done, causing OASI payouts to rise (Moffitt, 2012). These all contributed to a growth in component 1B of the Index.

5 The social safety net in the United States is generally thought to be made up of two parts: means-tested programs, and social insurance programs.

6 OASI stands for Old Age Survivors Insurance. This is the retirement portion of the Social Security Program. DI is then the disability insurance component of the Social Security program.



## 4.2 Area 2: Legal System and Property Rights

In 1980, the US score for Area 2 was 8.35. That rose to 9.23 by 2000. However, since 2000, Area 2 is the one in which there was by far the largest decline for the United States, falling to 7.51 by 2005 (and 7.38 by 2008). Since then it has declined more slowly to 6.95 in 2013 but an eroding legal system and declining property rights are still two of the largest threats to economic freedom in the United States.

Breaking Area 2 down into its component parts allows us a greater understanding of why this area has seen such a startling decline in economic freedom. In 2000, component 2A (Judicial independence) was valued at 8.2; by 2013 it had fallen to 6.84, a decrease of 15%. Even more strikingly, component 2B (Impartial courts) fell from 9.2 in 2000 to 6.09 in 2013, a decrease of 32%. While decreases of that magnitude certainly have a variety of causes, the expanded use of *ex ante* regulations over *ex post* legal alternatives is a major factor. For example, the Food and Drug Administration has increasingly made it more expensive and more time-consuming for companies to produce life-saving drugs and medical devices (Gulfo, Briggeman, and Roberts, 2016). Various forms of “consumer protection” legislation over the years have resulted in decreased innovation and higher prices for consumers (Williams, Graboyes, and Thierer, 2015). Still, those with political connections are able to ensure their projects and products are able to make it through the regulatory hoops (Hoffer and Sobel, 2015). This level of discretion that has accompanied the rise in regulation over judicial alternatives has led to an erosion in the ability of the legal system to promote economic freedom. Indeed, component 2E (Integrity of the legal system) has fallen from a perfect 10.0 in 2000 to 8.33 today.

The increased use of eminent domain and civil-asset forfeiture in recent years has undoubtedly contributed to the marked decline in variable 2C (Protection of property rights), in addition to 2E. Between 2000 and 2013, component 2C saw a 20% decline, falling from 9.1 to 7.25. While component 2H (Reliability of police) was not measured in 2000, it currently is at 7.89, indicating that there is room for improvement in this area. The 2005 Supreme Court decision in *Kelo v. City of New London* set a precedent that made it easier for private parties to seize the property of other private parties through eminent domain. While this case triggered significant backlash, and caused 45 states to enact stricter laws to limit the ability of states to engage in confiscatory activity, many of these laws are more show than substance. Eminent domain continues to provide justification for significant violations of property rights (Somin, 2015). Relatedly, since the 1980s civil-asset forfeiture has become a popular tool for law enforcement to confiscate any property involved in suspected drug activity; and since the early 2000s, it has also been used to seize the property of suspected terrorists. This practice leaves significant discretion to the police and, though legal mechanisms exist to provide restitution to those who have their assets seized incorrectly, the fact that the police have wide latitude to engage in this practice makes property rights less secure.

Additionally, the passage of the Patriot Act in 2001 opened the door to massive circumvention of the legal system. In particular, granting the FBI the ability to wiretap the phones of US citizens without their knowledge constituted a violation of the Fourth Amendment to the US Constitution. The expansion of court jurisdiction, allowing law enforcement to seek a warrant from virtually any judge in the United States regardless of where a crime occurred, also creates room for a possible violation of the Fourth Amendment; law enforcement agents can simply shop around until they find a judge willing to sign their warrant. The American judicial system

has long held that citizens hold a presumption of innocence until proven guilty; the Patriot Act reversed this notion, assuming it was better to engage in small rights violations if it meant that there was a chance of catching suspected terrorists early.

Finally, the increasing militarization of the police in recent years, particularly in response to the War on Drugs and the War on Terror, has jeopardized the liberties of US citizens. In the mid-1980s, only about 20% of metro-area police departments had SWAT teams. This figure is now over 90% (Kraska, 2007). Though use of these teams may be warranted in many instances, stories abound of questionable use. Component 2D measures the extent to which the military interferes in the rule of law and politics. The score for this component declined dramatically from 2000 to 2013, falling 33% from 10.0 to 6.67. The increasing militarization of the US police has surely contributed to this trend (Balko, 2013), as has the use of secret Foreign Intelligence Surveillance Courts.

Perceptions of the populace are important in determining the impartiality of the legal system and the protection of property rights. To the extent that it can, the EFW Index aims to use objective data to measure each variable; yet the nature of understanding how the legal system and property rights have evolved over time requires recourse to survey data to answer some key questions. Indeed, five of the nine components of Area 2 employ survey data.<sup>7</sup> The flagrancy of the rights violations discussed above very likely contribute to the perception that property rights are becoming less secure over time, that the courts are becoming more partial, and that the police are exercising excessive discretion. There are two reasons to believe that the changing perceptions observed in the survey data in fact reflect reality. One, the components of Area 2 that are not based on survey data have also been declining over time.<sup>8</sup> Two, external sources that have examined this data concur that these survey components provide an accurate reflection of changing circumstances in the United States (Anderson and Huggins, 2008).

### 4.3 Area 3: Sound Money

The United States has always had one of the world's most sought-after currencies, in part because of the soundness of its monetary system. In 1980, the score for Area 3 was 9.22, which increased to 9.78 by 2000. It has declined gradually since then, more rapidly after than before the 2008 financial crisis, falling from 9.69 in 2008 to 9.42 in 2013.

While the decline in the score for Area 3 has not been as dramatic as the decline in other areas, it has nonetheless fallen, driven particularly by a decline in component 3A (Money growth). Between 2000 and 2012, this variable saw a 20% decline, falling from 9.94 to 7.95. By 2013, it had recovered marginally to reach 8.18, but is still far below its level in 2000.

Prior to the financial crisis, the Federal Reserve was already engaging in aggressive expansionary monetary policy. Indeed the period from 2001 to 2006 saw the

7 These are components 2A (Judicial independence), 2B (Impartial courts), 2C (Protection of property rights), 2H (Reliability of police), and 2I (Business costs of crime).

8 These components are 2D (Military interference in rule of law and politics), which is based on expert opinion, 2E (Integrity of the legal system), which is also based on expert opinion, 2F (Legal enforcement of contracts), which is an objective measure provided by the World Bank, and 2G (Regulatory costs of the sale of real property), which is also an objective measure from the World Bank.

most expansionary monetary policy since the 1970s. From July 2008 through July 2009 alone, the adjusted monetary base doubled. During this time, the Federal Reserve also continued to push down interest rates, with nominal rates entering negative territory for two years. In order to maintain the low Federal Funds Rate, it further expanded the money supply. It is difficult for money to serve its usual functions when the government is tinkering so assertively with the monetary system. Additionally, component 3A measures the extent to which the growth of the money supply outpaces the growth of real GDP. Since GDP grew at a much slower rate during the recession, while the money supply continued expanding, the decline in this variable is unsurprising.

The Basel Accords, particularly Basel I and Basel II, also weakened the ability of the monetary system to function effectively. Basel I, passed in 1988, lowered the minimum capital requirements for banks, which allowed them to overextend their lending capacities in the run-up to the Great Recession. Basel II, passed in 2004, attempted to correct for some of the increased riskiness created by Basel I, but ended up creating a framework for banks to take on more risky loans. This international set of agreements not only fueled the housing boom, but also caused the signaling value of money to deteriorate. By helping to fuel an unsustainable boom in housing, Basel I and II created the conditions that made monetary expansion seem necessary once the housing bubble burst.

Further, individuals who were taking out mortgages throughout the late 1990s and early 2000s were, for the most part, acting rationally based on the monetary signals they observed. Most people are blissfully unaware of how the monetary system functions, so when banks offered them low-rate mortgages, they accepted these terms, not knowing that the attractive terms they observed were in part the result of the perverse incentives the banks were facing. When the housing market collapsed, it became clear that the price signals they observed had been spurious. Part of the reason that people significantly curtailed their spending habits during the recession was likely due to the fact that they questioned the soundness of the monetary system.

#### 4.4 Area 4: Freedom to Trade Internationally

While the United States has always had some protectionist policies, relative to other countries it has tended to rank fairly high in Area 4, with a score of 8.77 in 1980. By 2000 that had risen slightly to 8.80. Since 2000, it has fallen steadily to 7.36. After Area 2, Area 4 saw the sharpest decline in economic freedom among the five components.

While there has not been a major change in overall tariff rates in the United States since 2000, non-tariff trade barriers have increased substantially. Indeed, this sub-component (4Bi) declined precipitously, from 8.12 in 1980 to 5.61 in 2013. Non-tariff trade barriers are one of two sub-components making up the regulatory trade barriers component. While the other sub-component has remained roughly stable over the past two decades,<sup>9</sup> the dramatic fall in the non-tariff trade barrier score has caused component 4B (Regulatory trade barriers) to fall by 15% from 2000 to 2013.

---

<sup>9</sup> Sub-component 4Bii details compliance costs of importing and exporting, and has remained between 9.50 and 9.35 for nearly 20 years.

Even more dramatically, component 4D (Controls of the movement of capital and people) declined from 8.21 in 2000 to 3.58 in 2013. All three sub-components of this component saw significant reductions in their scores. 4Di (Foreign ownership/investment restrictions) fell from 9.49 in 2000 to 6.46 in 2013. 4Dii (Capital controls) fell from 6.92 in 2000 to 3.85 in 2013. While sub-component 4Diii (Freedom of foreigners to visit) was not measured in 2000, it fell from 4.10 in 2005 to 0.42 in 2013.

While the elimination of most explicit tariffs in the United States over recent decades is certainly laudable, the index seems to indicate that trade barriers may have simply changed form, not intensity. The survey data upon which this component is based indicate that non-tariff barriers have made it significantly more difficult for imported goods to remain competitive in US markets. The “buy American” sentiment that prevailed after 9/11 may be one factor playing into this perception. President Obama’s export initiative, his 2010 pronouncement that he wanted to double the amount exported over the subsequent five years (presumably at the expense of imports), has also likely created an implicit trade barrier. Finally, the subsidization of American farmers through the continuous passage of Farm Bills, despite vociferous objections from the WTO, has made it more difficult for foreign agricultural interests to compete in the United States.

The free movement of capital and labor across borders is a crucial component of economic freedom, and one that has declined precipitously in the United States in recent years. Whether regulatory restrictions or unfriendly policies are the cause is of little consequence; the fact remains that freedom in this area has fallen. Though the 1990s had seen the enactment of modest restrictions on foreign investment,<sup>10</sup> particularly in the form of information-sharing requirements, the fears created by 9/11 caused these restrictions to become much tighter. Public sentiment, reflected in Congressional action, generally held that foreign investment should be limited in areas of crucial concern for national security and economic security. While across-the-board restrictions on foreign ownership and investment do not exist in the United States, numerous restrictions have been leveled on individual industries, including the aircraft industry, communications, and banking (Seitzinger, 2013). Further, the recent world-wide financial crisis, coupled with the high corporate tax rate in the United States, caused foreign investment (FDI) in the United States to decline substantially. While the United States is still the number-one destination for FDI, inflows have fallen from 39% of the world total to less than half that figure over the past 15 years (Ikenson, 2014).

From about the late 1970s through the mid-2000s, following the decline of the Bretton Woods system, countries abolished their capital controls *en masse*. The Washington Consensus ideology that persisted during this time held that capital controls were a drag on economic growth and were to be avoided except during times of crisis. However, the global financial crisis caused many countries, including the United States, to rethink this position. A group of economists from the International Monetary Fund (IMF) found that countries that had maintained limited capital controls weathered the financial crisis better (Ostry, Ghosh, Chamon, and Qureshi, 2012). The increased acceptance of capital controls in the United States has led to a decline in this component of the index. Finally, the ability of foreigners to visit the United States on a visa for tourist and short-term business

---

10 See, for example, the Foreign Direct Investment and International Financial Data Improvements Act of 1990.

purposes is lower than most developing nations, but it has also fallen since 2005, the first year that the data was available. Much of this effect is likely due to the “war on terror”, as well as increased public resentment of foreigners coming to the United States and displacing American workers.

#### 4.5 Area 5: Regulation

Though the changes have not been as dramatic in Area 5, there have been plenty of new regulations enacted since 1980, when the United States had a score of 8.11. By 2000, that score had risen steadily to 8.43. It has gone up and down since then, up to a high of 8.61 in 2004, down to a low of 7.70 in 2009, and back up to 8.14 in 2013.

The period from the 1980s to the late 2000s has a mixed regulatory record. It did see some significant deregulation, particularly in the financial industry. 1980 saw the deregulation of the savings and loan industry, and inaugurated the phase-out of “Regulation Q” ceilings, which controlled the interest that could be charged on savings and other types of bank accounts. The Glass-Steagall Act was significantly reformed in 1999, allowing banks and securities firms to interact once again. The Energy Policy Act of 1992 allowed for greater competition among energy firms, and the Telecommunications Act of 1996 promoted greater competition in the US communications sector.

However, the 2000s also saw the enactment of some very onerous regulations. The Sarbanes-Oxley Act of 2002 significantly raised the costs of government compliance for publicly traded firms, resulting in increased unwillingness for small and foreign firms to register on the stock exchange. Indeed, over the past two decades, the number of publicly traded firms in the United States has fallen by 50% (Grullon, Larkin, and Michaely, 2015). The Dodd-Frank Act, passed in 2010, imposed hundreds of new rules on financial markets. By one estimate, the Act created 27,669 regulatory restrictions—more than all other laws passed during the Obama administration combined (McLaughlin and Sherouse, 2015).

A variety of restrictions on businesses have also accumulated in recent years. Indeed, during the first six years of his administration, President Obama passed 184 major regulations on the private sector (Gattuso and Katz, 2015). A new regulation is classified as “major” if it is expected to have an impact of more than \$100 million on the private sector annually. The negative effects of regulation stem not just from new regulations, but also from the collective burden of those that have accumulated over the years. According to one estimate, the US Code of Federal Regulations contains more than one-million restrictions on American individuals and businesses (McLaughlin and Greene, 2014). Not only do regulations create costly compliance issues for businesses, therefore stunting economic growth and innovation (Dawson and Seater, 2013), they also make existing products more expensive, and prevent better products and operating procedures from emerging. Additionally, the burdens of regulation often fall disproportionately on the poor (McLaughlin and Greene, 2014).

While the rankings for labor market regulations have actually improved on the EFW Index over the past 20 years, credit market regulations and business regulations have seen notable declines. Component 5A (Credit market regulations) fell from 9.81 in 2000 to 7.88 by 2010. It has since recovered slightly, reaching 9.06 by 2013, but still remains below its pre-recession average. The main driver for the decline in this area is the expansion of government borrowing relative to private-sector borrowing, as reflected in sub-component 5Aii (Private sector credit). The global financial crisis and subsequent recession undoubtedly were key drivers of this trend.

As far as business regulations are concerned, between 2000 and 2013, three of the six sub-components making up this component declined dramatically. Sub-component 5Ci (Administrative requirements) saw a 50% decline in score, falling from 7.92 in 2000 to 3.99 in 2013. Sub-component 5Cii (Bureaucracy costs) saw an even more significant decline, falling 68% in score from 8.15 in 2000 to 2.59 in 2013. Sub-component 5Civ (extra payments/bribes/favoritism) fell 29%, from 8.82 in 2000 to 6.24 in 2013. Even at 6.24, this was an improvement over 2010, when the score bottomed out at 5.99. We have already discussed some of the factors that may have led to a decline in the business regulation score, but the decline in the survey-based score detailing the extent to which government officials make political decisions based on favoritism is particularly interesting, since it seems to indicate that an increasing number of firms are seeking to profit through government-granted privilege rather than through market competition. Finally, the ongoing implementation of the Affordable Care Act will continue to impose a variety of substantial burdens on businesses as well as contribute to the uncertainty among entrepreneurs that tends to inhibit their expansionary activity.

## 5 Impact on the economy and other relevant variables

Economists have long sought to understand why some economies are rich and grow rapidly while others are poor and grow slowly. There are many contributing factors, but basic economic theory tells us that higher taxes and government regulations, greater restrictions on trade, and weaker property rights and monetary systems—by creating higher costs for producers—will tend to have a dampening effect on entrepreneurship and thus economic growth.

The index published in *Economic Freedom of the World* was developed in an attempt to be able to quantify just how free individual societies are compared to other societies. It provides a useful tool for scholars to explore these issues. There have been hundreds of attempts to examine the relationship between that index and various economic outcomes such as entrepreneurial activity and economic growth. The general consensus is that areas that have more economic freedom tend to have healthier economies—higher standards of living, more rapidly growing incomes, and so on.<sup>11</sup>

Given the recent decline in economic freedom in the United States, it should not be surprising that there has also been a decline in the health of the US economy. From 1980 to 2000, when the United States was at the top of the charts for economic freedom, real gross private domestic investment increased 5.4% per year on average. Since 2000, the average annual increase is three times smaller, only 1.7%. A decline in the growth of investment must eventually lead to a decline in the growth of the economy, because businesses will have less physical capital and will thus be less productive.

Over the period from 1980 to 2000, the average real growth in the size of the US economy (GDP, or gross domestic product) was 3.4% per year. That included three recessions (30 contractionary months). Since 2000, real GDP growth has averaged only about half that rate (1.8%). That more recent 15-year period included only two

---

11 Hall and Lawson (2014) provide a review of the country-level literature; Stansel (2013) provides a review of the literature considering the sub-national level.

recessions (26 contractionary months). If you consider that there may be a lag in the impact of that decline in investment growth, it may make more sense to look at GDP growth starting in 2005. Average yearly growth since 2005 has indeed been even lower, only 1.4% in real terms. (Growth since 2006 has been 1.3%, and since 2007 it has been 1.2%.<sup>12</sup>)

There has been a similar pattern for incomes. The average annual change in real disposable (after-tax) per-capita personal income was 2.3% from 1980 to 2000. That growth rate fell to 1.3% after 2000. Factoring in a lag, the growth has declined even further to 1.0% over the period from 2005 to 2015.

Looking at real per-capita personal consumption expenditures, which should reflect consumers' standard of living, the average annual increase over the period from 1980 to 2000 was 2.6%. Since 2000, the average increase in consumption has been only half of that (1.3%). Since 2005, it has been less than one-third of the previous growth rate (0.8%).

No matter how you measure it, the health of the US economy has declined substantially since 2000, compared to the trend over the period from 1980 to 2000. That decline in the health of the economy has coincided with a substantial decline in economic freedom. While there are plenty of other factors that affect economic prosperity, it would be hard to argue that the decline in economic freedom has not had a negative impact on the economy. There is a very large literature examining that relationship between economic freedom and economic growth. Most of it finds that there is indeed a direct relationship.<sup>13</sup> That literature strongly implies that, if the 15-year decline in economic freedom in the United States is not reversed, the health of the US economy and the standard of living of its people will continue to get worse. Expanding economic freedom provides the path to prosperity. The United States is on the wrong path.

## References

Anderson, Terry L., and Laura E. Huggins (2008). *Property Rights: A Practical Guide to Freedom and Prosperity*. Hoover Institution Press.

Balko, Radley (2013). *Rise of the Warrior Cop: The Militarization of America's Police Forces*. Public Affairs.

Bureau of Labor Statistics (2014). Consumer Spending and U.S. Employment from the 2007-2009 Recession through 2022. *Monthly Labor Review*, October.

Dawson, John W., and John J. Seater (2013). Federal Regulation and Aggregate Economic Growth. *Journal of Economic Growth* 18, 2: 137–177.

12 Lest the reader think we are cherry-picking the start date, no matter what start date is used from 2000 through 2007, the GDP growth rate through 2015 declines steadily until the trough of the last recession (2008).

13 A review of that literature is beyond the scope of this chapter. However, Gwartney and Lawson (2004) provides an excellent discussion of this topic. For a more recent review of the literature, see Hall and Lawson (2014).

Ellis, Edward S. (1867/2012). *Not Yours to Give*. Foundation for Economic Education (November 19). <<https://fee.org/resources/not-your-to-give-2/>>, as of April 13, 2016.

Gattuso, James L., and Diane Katz (2015). *Red Tape Rising: Six Years of Escalating Regulation under Obama*. Backgrounder no. 3015, May 11. Heritage Foundation.

Grullon, Gustavo, Yelena Larkin, and Roni Michaely (2015). *The Disappearance of Public Firms and the Changing Nature of U.S. Industries*. Working Paper. Available at SSRN: <<http://ssrn.com/abstract=2612047>>.

Gulfo, Joseph V., Jason Briggeman, and Ethan C. Roberts (2016). *The Proper Role of the FDA for the 21<sup>st</sup> Century*. Mercatus Research. Mercatus Center at George Mason University.

Gwartney, James, and Robert Lawson (2004). Economic Freedom, Investment, and Growth. In James Gwartney and Robert Lawson (eds.), *Economic Freedom of the World: 2004 Annual Report* (Fraser Institute): 28–44.

Gwartney, James, Robert Lawson, and Joshua Hall (2015a). 2015 Economic Freedom Dataset, published in *Economic Freedom of the World: 2015 Annual Report*. Fraser Institute. <[http://www.freetheworld.com/datasets\\_efw.html](http://www.freetheworld.com/datasets_efw.html)>.

Gwartney, James, Robert Lawson, and Joshua Hall (2015b). *Economic Freedom of the World: 2015 Annual Report*. Fraser Institute. <<https://www.fraserinstitute.org/studies/economic-freedom-of-the-world-2015-annual-report>>.

Hall, Joshua C., and Robert Lawson (2014). Economic Freedom of the World: An Accounting of the Literature. *Contemporary Economic Policy* 32, 1: 1–20.

Hoffer, Adam J., and Russell S. Sobel (2015). *Protectionism among the States: How Preference Policies Undermine Competition*. Mercatus Working Paper, Mercatus Center at George Mason University.

Ikenson, Daniel J. (2014). *More and Better Foreign Direct Investment*. Cato Online Forum. <<http://www.cato.org/publications/cato-online-forum/more-better-foreign-direct-investment>>.

Kraska, Peter G. (2007). Militarization and Policing—Its Relevance to 21<sup>st</sup> Century Police. *Policing* 1, 4: 501–513.

Maestas, Nicole, Kathleen J. Mullen, and Alexander Strand (2015). Disability Insurance and the Great Recession. *American Economic Review: Papers and Proceedings* 105, 5: 177–182.

McLaughlin, Patrick, and Robert Greene (2014). *The Unintended Consequences of Federal Regulatory Accumulation*. *Economic Perspectives*. Mercatus Center at George Mason University. <<http://mercatus.org/publication/unintended-consequences-federal-regulatory-accumulation>>.



McLaughlin, Patrick, and Oliver Sherouse (2015). *The Dodd-Frank Wall Street Reform and Consumer Protection Act May Be the Biggest Law Ever*. Mercatus Policy Brief. Mercatus Center at George Mason University.

Moffitt, Robert A. (2012). *The Social Safety Net and the Great Recession*. Policy Brief. The Russell Sage Foundation and The Stanford Center on Poverty and Inequality.

Ostry, Jonathan D., Atish R. Ghosh, Marcos Chamon, and Mahvash S. Qureshi (2012). Tools for Managing Financial-Stability Risks from Capital Inflows. *Journal of International Economics* 88, 2: 407–421.

Richard Williams, Robert Graboyes, and Adam Thierer (2015). *US Medical Devices: Choices and Consequences*. Mercatus Research, Mercatus Center at George Mason University.

Rothstein, Jesse (2011). *Unemployment Insurance and Job Search in the Great Recession*. NBER Working Paper No. 17534. National Bureau of Economic Research. <<http://www.nber.org/papers/w17534>>.

Seitzinger, Michael V. (2013). *Foreign Investment in the United States: Major Federal Statutory Restrictions*. Congressional Research Services Report for Congress.

Somin, Ilya (2015). *The Grasping Hand*. University of Chicago Press.

Stansel, Dean. (2013). Economic Freedom and Economic Well-Being at the Subnational Level—a Look at the Literature. In Dean Stansel and Fred McMahon (eds.), *Economic Freedom of North America 2013* (Fraser Institute): 44–50.



## About the Authors



### Robbie Butler

Robbie Butler has been a college lecturer in the Department of Economics, University College Cork, since September 2006, completing his doctorate in 2013 under the supervision of Veblen-Commons Award winner Professor Geoffrey Hodgson. In October 2015, he was awarded the prestigious President's Prize for Excellent in Teaching at University College Cork, becoming one of the youngest staff members ever to receive the award. He is currently completing a Masters in Teaching and Learning in Higher Education (MATLHE). Mr Butler's research interests are focused on institutional economics and the economics of sport. He is a founding member of the World Interdisciplinary Network for Institutional Research (WINIR) and is a member of both the International Association of Sports Economists (IASSE) and European Association of Sports Economists (ESAE).



### John Considine

John Considine is a lecturer in the Department of Economics, University College Cork. He received his BA (Economics and Computer Science) in 1989 from University College Cork. After completing his M.A. (Economics) in 1991, he joined the Department of Economics, UCC. He completed his Ph.D., on the measurement of the fiscal deficit, under the supervision of Huw Dixon in the University of York. He completed the PostGraduate Diploma in Teaching and Learning in Higher Education (PGDTLHE) at UCC in 2008. He has been awarded the President's Prize for Excellence in Teaching and has published a number of journal articles on the use of humour in teaching. In addition to his research interest in the teaching of economics, Mr Considine's research interests include the history of economic thought, public finance, and sports economics.



### Hugo J. Faria

Hugo J. Faria is a Lecturer in the Economics department of the University of Miami and a Professor at *Instituto de Estudios Superiores de Administración* in Caracas, Venezuela. Mr. Faria received his Ph.D. in Finance from the University of South Carolina concluding course requirements for a Ph.D. in Economics as well. He also received an M.P.P. from the University of Chicago, and a B.A. in Economics from *Universidad Católica Andrés Bello* (UCAB) in Caracas, Venezuela. Some of Mr. Faria's refereed scholarly articles address issues in capital structure, corporate governance and executive compensation, the interplay between complex regulations and corruption as well as the nexus between capitalist institutions and corruption. Lately, his research interest has been in the fields of comparative economic and political development, highlighting the critical role of institutional quality for sustained economic growth. Mr. Faria has published in *Public Choice*, *Applied Economics*, *Journal of Institutional Economics*, and *Econ Journal Watch*, among others and has been editor of, and contributor to, several books examining policy and institutional topics in Venezuela: *Para Rehacer a Venezuela* (1998), *El Encarecimiento Injusto* (2006), and *Misión Riqueza* (2007). He is a co-author of *Unbundling the Roles of Human Capital and Institutions in Economic Development*, forthcoming in the *European Journal of Political Economy*. He has also given expert testimony to Venezuela's

National Assembly. Mr Faria won a Fulbright scholarship, Best Teacher awards from Northeastern University and IESA, and has taught economics at Harvard. He has published in the op-ed section of the *Wall Street Journal*, and has been interviewed by CNN, *Fox News*, and the *New York Times*, among others.



## Fred McMahon

Fred McMahon is a Fraser Institute Resident Fellow and holder of the Dr. Michael A. Walker Research Chair in Economic Freedom. He has an M.A. in Economics from McGill University. Mr. McMahon manages the Economic Freedom of the World Project and coordinates the Economic Freedom Network, an international alliance of over 100 think-tank partners in about 100 nations and territories. His research focuses on global issues such as development, trade, governance, and economic structure. Mr. McMahon is the author of numerous research articles and several books including, *Looking the Gift Horse in the Mouth: The Impact of Federal Transfers on Atlantic Canada*, which won the Sir Antony Fisher International Memorial Award for advancing public-policy debate; *Road to Growth: How Lagging Economies Become Prosperous*, and *Retreat from Growth: Atlantic Canada and the Negative Sum Economy*. He has written for numerous publications including the *European Journal of Political Economy*, *SAIS Journal* (School of Advanced International Studies, Johns Hopkins University), *Wall Street Journal*, *Policy Options*, *National Post*, *Time* (Canada), *Globe and Mail*, *Ottawa Citizen*, and most other major Canadian newspapers. Recent research studies he has authored or co-authored include: *Economic Freedom of North America 2015*, *Quebec Prosperity: Taking the Next Step*, *The Unseen Wall: The Fraser Institute's Annual Trade Survey*, and *Economic Freedom of the Arab World 2015*.



## Hugo M. Montesinos-Yufa

Hugo M. Montesinos-Yufa is a Ph.D. Student of Economics at Florida State University (FSU). He holds a Ph.D. in Engineering from Universidad Simón Bolívar (USB) in Caracas, Venezuela, a M.S. in Statistics from USB, a Master in Economics from FSU, and a B.S. in Production Engineering from USB. He also studied two terms of the M.P.P. at the University of Chicago. He has served as the Director of the Center for Statistics and Applied Math at USB, full professor in the Department of Statistics and Scientific Computing at USB, and adjunct professor in the Center of Finance at the Instituto de Estudios Superiores de Administración (IESA) in Caracas, Venezuela. In addition of being a professor, he worked as a consultant in Venezuela for private companies, consultant firms, banks, and the oil industry in Venezuela. He has published in *Public Choice*, *Journal of Institutional Economics*, *Applied Economics*, and *Econ Journal Watch*, among other journals. His most recent co-authored publication, Unbundling the Roles of Human Capital and Institutions in Economic Development, will appear in the *European Journal of Political Economy*. Mr. Montesinos-Yufa has been interviewed in the Venezuelan National Television regarding institutional topics and by the USB regarding more technical topics such as econometrics (see, for example, the video available on Youtube: *La econometría*, Diálogos USB #86). He won the Venezuelan National Olympics in Physics and Mathematics, including the Gold Medal in the Physics National Competition and the first place in the National Experimental contest in Physics. His current interests include comparative economic development, new institutional economics, economic freedom, and econometrics.



## Dean Stansel

Dean Stansel is a Research Associate Professor at the O’Neil Center for Global Markets and Freedom in the Cox School of Business at Southern Methodist University. Prior to taking up his position at SMU, he taught at Florida Gulf Coast University and Eastern New Mexico University. He earned his B.A. in economics (with honors) and politics from Wake Forest University and his M.A. and Ph.D. in economics from George Mason University. Before entering academia, Prof. Stansel worked for seven years at the Cato Institute, a public-policy research organization in Washington, D.C., where he produced over 60 publications on fiscal policy issues. He is the primary author of the Fraser Institute’s annual report, *Economic Freedom of North America*, the sole author of an index of economic freedom for US metropolitan areas, as well as the author of numerous academic journal articles on a variety of issues in public finance and urban economics. Prof. Stansel’s research has been discussed in many publications including the *Wall Street Journal*, *New York Times*, *San Francisco Chronicle*, and *Atlanta Journal-Constitution*; and his commentaries have appeared in the *Wall Street Journal*, *Washington Post*, *Investor’s Business Daily*, and *Chicago Tribune*, among others. He was selected in 2011 by the Economic Freedom Project to help publicize the findings of the various economic freedom reports, and the virtues of economic freedom in general, through a variety of media interviews (about 75 a year).



## Meg Tuszynski

Meg Tuszynski is a research associate at the O’Neil Center for Global Markets and Freedom in the Cox School of Business at Southern Methodist University. She earned her M.A. in economics from George Mason University in 2015, and a dual B.A. in philosophy and economics from the same school in 2011. Currently, she is a Ph.D. candidate in the economics department at George Mason University. Her current research focuses on the evolution of the demand for government programs. Her publications have appeared in *Public Choice* and the *Journal of Value Inquiry*.

## Acknowledgments

The authors of the essays in this publication are grateful to Proff. Gwartney, Lawson, and Hall for their careful reviews and important contributions to these essays.

The Fraser Institute thanks the Charles Koch Foundation and Searle Freedom Trust for their support.

## Publishing Information

### Distribution

These publications are available from <<http://www.fraserinstitute.org>> in Portable Document Format (PDF) and can be read with Adobe Acrobat® or Adobe Reader®, versions 7 or later. Adobe Reader® XI, the most recent version, is available free of charge from Adobe Systems Inc. at <<http://get.adobe.com/reader/>>. Readers having trouble viewing or printing our PDF files using applications from other manufacturers (e.g., Apple's Preview) should use Reader® or Acrobat®.

### Ordering publications

To order printed publications from the Fraser Institute, please contact:

- e-mail: [sales@fraserinstitute.org](mailto:sales@fraserinstitute.org)
- telephone: 604.688.0221 ext. 580 or, toll free, 1.800.665.3558 ext. 580
- fax: 604.688.8539.

### Media

For media enquiries, please contact our Communications Department:

- 604.714.4582
- e-mail: [communications@fraserinstitute.org](mailto:communications@fraserinstitute.org).

### Copyright

Copyright © 2016 by the Fraser Institute. All rights reserved. No part of this publication may be reproduced in any manner whatsoever without written permission except in the case of brief passages quoted in critical articles and reviews.

### Date of issue

August 2016. This publication is an Early Release of chapters that will be included in a book scheduled for publication later this year. If you cite this publication, please specify that it is an Early Release and note that the pagination will differ when it appears as part of the book.

### Citation

Robbie Butler, John Considine, Hugo J. Faria, Hugo M. Montesinos-Yufa, Dean Stansel, and Meg Tuszynski (authors), and Fred McMahon (editor) (2016). *Changes in Economic Freedom in Venezuela, Ireland, and the United States*. Fraser Institute. <[www.fraserinstitute.org](http://www.fraserinstitute.org)> and <[www.freetheworld.com](http://www.freetheworld.com)>.

### About this publication

*Changes in Economic Freedom in Venezuela, Ireland, and the United States* is an early release of chapters 4, 5, and 6 from the forthcoming *Economic Freedom of the World: 2016 Annual Report*, by James Gwartney, Robert Lawson, and Joshua Hall, and published by the Fraser Institute in cooperation with the Economic Freedom Network.

### Cover design

Heather Jalbout

### Cover images

©f11photo, Shutterstock® (Times Square at night, July 2, 2016)

©OLOS, Shutterstock® (Grafton Street, Dublin, Ireland, April 18, 2011)

©Michel Piccaya, Shutterstock® (waiting in line at a public supermarket in Ciudad Bolivar, Venezuela, April 9, 2015)

## Supporting the Fraser Institute

To learn how to support the Fraser Institute, please contact

- Development Department, Fraser Institute  
Fourth Floor, 1770 Burrard Street  
Vancouver, British Columbia, V6J 3G7 Canada
- telephone, toll-free: 1.800.665.3558 ext. 548
- e-mail: [development@fraserinstitute.org](mailto:development@fraserinstitute.org)

## Purpose, Funding, and Independence

The Fraser Institute provides a useful public service. We report objective information about the economic and social effects of current public policies, and we offer evidence-based research and education about policy options that can improve the quality of life.

The Institute is a non-profit organization. Our activities are funded by charitable donations, unrestricted grants, ticket sales, and sponsorships from events, the licensing of products for public distribution, and the sale of publications.

All research is subject to rigorous review by external experts, and is conducted and published separately from the Institute's Board of Trustees and its donors.

The opinions expressed by the author are his own, and do not necessarily reflect those of the Institute, its Board of Trustees, its donors and supporters, or its staff. This publication in no way implies that the Fraser Institute, its trustees, or staff are in favour of, or oppose the passage of, any bill; or that they support or oppose any particular political party or candidate.

As a healthy part of public discussion among fellow citizens who desire to improve the lives of people through better public policy, the Institute welcomes evidence-focused scrutiny of the research we publish, including verification of data sources, replication of analytical methods, and intelligent debate about the practical effects of policy recommendations.



## About the Fraser Institute

Our mission is to improve the quality of life for Canadians, their families and future generations by studying, measuring and broadly communicating the effects of government policies, entrepreneurship and choice on their well-being.

Notre mission consiste à améliorer la qualité de vie des Canadiens et des générations à venir en étudiant, en mesurant et en diffusant les effets des politiques gouvernementales, de l'entrepreneuriat et des choix sur leur bien-être.

### Peer review—validating the accuracy of our research

The Fraser Institute maintains a rigorous peer review process for its research. New research, major research projects, and substantively modified research conducted by the Fraser Institute are reviewed by experts with a recognized expertise in the topic area being addressed. Whenever possible, external review is a blind process. Updates to previously reviewed research or new editions of previously reviewed research are not reviewed unless the update includes substantive or material changes in the methodology.

The review process is overseen by the directors of the Institute's research departments who are responsible for ensuring all research published by the Institute passes through the appropriate peer review. If a dispute about the recommendations of the reviewers should arise during the Institute's peer review process, the Institute has an Editorial Advisory Board, a panel of scholars from Canada, the United States, and Europe to whom it can turn for help in resolving the dispute.

## Editorial Advisory Board

### Members

Prof. Terry L. Anderson

Prof. Herbert G. Grubel

Prof. Robert Barro

Prof. James Gwartney

Prof. Michael Bliss

Prof. Ronald W. Jones

Prof. Jean-Pierre Centi

Dr. Jerry Jordan

Prof. John Chant

Prof. Ross McKittrick

Prof. Bev Dahlby

Prof. Michael Parkin

Prof. Erwin Diewert

Prof. Friedrich Schneider

Prof. Stephen Easton

Prof. Lawrence B. Smith

Prof. J.C. Herbert Emery

Dr. Vito Tanzi

Prof. Jack L. Granatstein

### Past members

Prof. Armen Alchian\*

Prof. F.G. Pennance\*

Prof. James M. Buchanan\*†

Prof. George Stigler\*†

Prof. Friedrich A. Hayek\*†

Sir Alan Walters\*

Prof. H.G. Johnson\*

Prof. Edwin G. West\*

\* deceased; † Nobel Laureate