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Private Property Rights, Economic Freedom, and Well-Being*

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

An understanding of how private property and economic freedom allow people to coordinate their activities while engaging in trades that make all parties better off gives us an indication of the institutional environment that is necessary for prosperity. As the data will show, those countries with an institutional environment of secure property rights and high degrees of economic freedom have achieved higher levels of various measures of human well-being.

Property Rights and Voluntary Transaction

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

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

The freedom to enter into voluntary exchanges clearly increases the well-being of individuals in a society. For example, if two people agree to exchange something, they both demonstrate that they desire what the other has more than what they give up. Both parties expect to benefit from the trade, so both expect their well-being to increase. Regulations that prohibit or interfere with voluntary transactions necessarily must limit the economic well-being people are able to achieve. Regulations prevent people from doing things that they deem will make them happier than if they are unable to do them. The less voluntary interaction is interfered with, the more people will exchange resources to increase their wealth.

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

A decentralized price system and private property provide the incentives and the information for millions of people to coordinate their activities and direct resources to those who value them most. When individual activities are coordinated, the individuals involved gain.

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Table 1
Index of Economic Freedom, Selected Rankings, 2002

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

Source: Heritage Foundation and Dow Jones & Co.

The institutional environment of private property rights and freedom to exchange are necessary in order to achieve coordination.

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

Measuring Economic Freedom

With the failure of communism and Keynesian macro economic management programs in the late 20th century, a rough observation of the world tends to confirm the importance of private property and economic freedom. There is no one absolute measure of economic freedom that can differentiate levels of freedom in the various "mixed" economies. There is no completely objective way to weigh one category of freedom against another. For example, is a country that has low tax rates but allows no international trade more or less free than a country with the policies reversed? This weighting becomes more complex as all the different ways in which the government interferes with the economy are added. Nonetheless, two major organizations have constructed overall measures of economic freedom which they use to rank countries around the world.[2]

The Heritage Foundation and the *Wall Street Journal* co-publish the "Index of Economic Freedom." This index has been published annually since 1995. The 2002 index ranks 156 countries, using ten broad categories that comprise 50 variables. Each category receives a separate score between one (more free) and five (less free). The categories are then averaged together (weighted equally) to obtain a score for each country. The ten broad categories include Trade Policy, Fiscal Burden of Government, Government Intervention in the Economy, Monetary Policy, Capital Flows and Foreign Investment, Banking and Finance, Wages and Prices, Property Rights, Regulation, and Black Market Activity.

According to the 2002 rankings shown in Table 1, Hong Kong had the greatest economic freedom, with an overall score of 1.35. Singapore ranked second and New Zealand third, while Estonia, Ireland, Luxembourg, Netherlands, and the United States tied for fourth. Iraq and North Korea (not shown), both with overall scores of 5.00, had the least economic freedom.

The Fraser Institute began publishing its economic freedom report, *Economic Freedom of the World,* in 1996. An earlier version, written by Block, Gwartney, and Lawson, scored and ranked countries in five-year intervals from 1975 to 1995. This report is now updated annually, and the current edition ranks countries in five-year intervals back to 1970. The measure ranks 123 countries using 37 variables that fall into five broad categories. A country's overall score is determined by averaging the scores of the five categories together.[3] The five categories include Size of Government: Expenditures, Taxes, and Enterprises; Legal Structure and Property Rights; Sound Money; Freedom to Trade with Foreigners; and Regulation of Credit, Labor, and Business.

The *Economic Freedom of the World* report gives scores between one (least free) and ten (most free). In the 2002 report Hong Kong was ranked first with a score of 8.8, while Singapore ranked second (8.6) followed by the United States (8.5). The Democratic Republic of Congo ranked last with a score of 3.2 (see Table 2 for other scores).

Despite their subjectivity, measurement problems, survey data inaccuracy, and weighting problems, both the Heritage Foundation and Fraser Institute measures provide a rough indication of the degree of economic freedom and broad respect for private property rights in countries around the world. Although small differences between countries should not be taken to mean that one country is absolutely more or less free than the other, large differences between countries and changes in a country's score over time are useful for gauging the degree of economic freedom present.

Measuring Standards of Living and Well-Being

Defining and measuring well-being or a standard of living is just as challenging as gauging economic freedom. Economic freedom is difficult to measure, but at least its requirements can be described—the absence of coercion and freedom to engage in voluntary exchange. Measures of well-being attempt to assess the outcomes of those voluntary transactions.

Measuring outcomes is difficult because value is subjective to the individual who participated in the transaction. People have diverse and competing ends. Picking one product and measuring the amount of it in an economy gives little idea of whether the society is wealthy or poor. For example, although people like shoes, adding up the number of shoes in society will not suffice as a "standard of living measure." Obviously people value things other than shoes, so a broader measure is needed.

Economists typically use Gross Domestic Product (GDP) per capita to measure standards of living. This measures the total value of the goods and services produced for final sale in an economy in relation to the population that it supports. However, the measure does not take into account the effort that went into producing it. For example, comparing the per capita GDP of one country with $20,000 per capita GDP that has an average workweek of 50 hours with another country with a per capita GDP of $15,000 but only a 30-hour average workweek presents a misleading picture of the level of well-being in the two economies, as long as people value leisure.[4]

GDP has other problems, too. For instance, it includes things "produced" by government. Although these services sometimes have value, they are generally coercively funded and usually not sold on the open market, so there is no way to find out what value should be assigned. In practice, statistics for U.S. GDP do not even attempt to measure the value of what government produces—they measure only what the government spends. The Soviet Union had a GDP per capita statistic, but since most goods were bought and distributed by the government, there was no indication of how much consumers valued what was produced. As government's share of GDP increases, it becomes a less reliable measure of economic well-being.[5]

In addition to GDP, other measures may help portray an accurate picture of a country's well-being. Human longevity is often cited. However, people have other preferences that compete with longevity; they demonstrate this when, for example, they choose to smoke. Other measures sometimes used include infant mortality rates, caloric intake, literacy rates, and immigration statistics.

In an attempt to collect these characteristics into a single measure, the United Nations publishes the Human Development Index. This index is designed to "focus on human well-being, not just economic trends."[6] It combines measures for per capita GDP, life expectancy, adult literacy, and combined primary, secondary and tertiary education gross enrollment to give a country a score on a scale from zero (lowest) to 1.0 (highest).

Since none of these measures can be used as an absolute measure of well-being, must we say nothing when comparing countries? Even taken by themselves these individual measures do give some indication of well-being; we just have to recognize their shortcomings. A reasonable assumption is that as people become wealthier, they will choose to buy more goods and services. Thus, GDP per capita will move in the same direction as well-being. The same applies to the other measures. For example, if we assume people prefer a longer life to a shorter one, as they become wealthier they will purchase "more life" by increasing their expenditure on health care, eating healthier foods, etc.

Table 2
Index of Economic Freedom of the World, Selected Rankings, 2002

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

Source: The Fraser Institute.

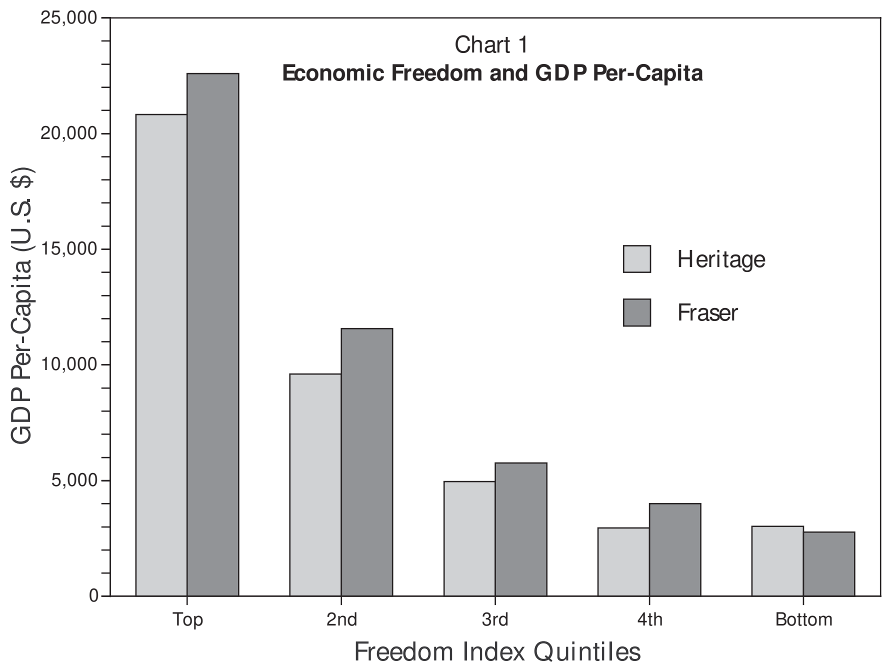
Taken together then, these measures reasonably depict the standard of living in a country.

Economic Freedom, Private Property, and Well-Being

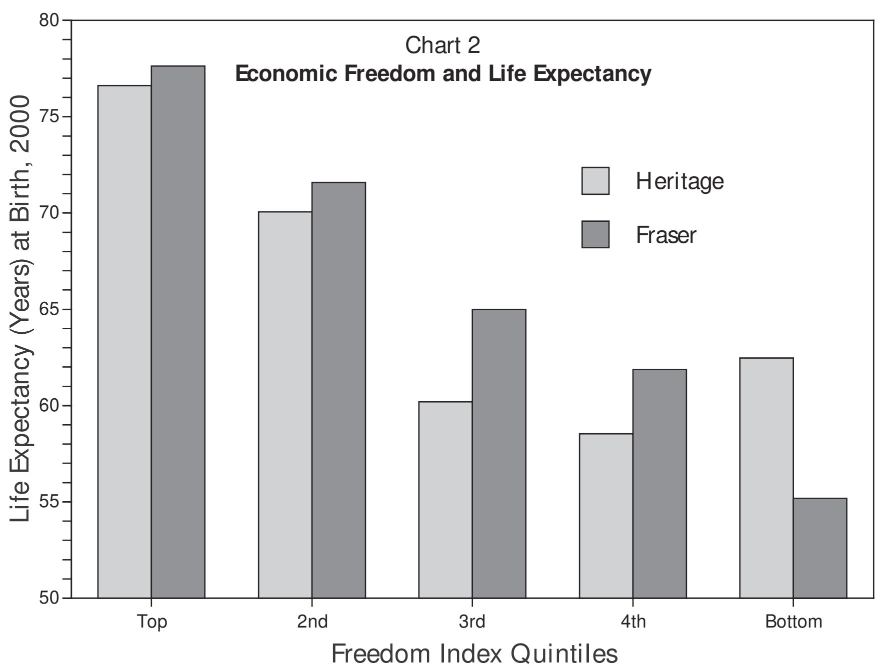
Our understanding of voluntary transactions tells us that as people are freed to engage in voluntary trades they tend to make themselves better off. We have also seen that although there is no absolute standard that can be used to compare countries' standards of living, most of the traditionally used measures should be correlated with peoples' well-being. Moreover, countries that respect individuals' private property rights (*i.e.,* have high degrees of economic freedom) do better in the various measures of well-being.

A number of studies in professional journals link measures of economic freedom and property rights to measures of well-being.[7] Data from the 2002 reports provide strong evidence that, regardless of which measure of freedom or well-being is selected, countries that are more free are better off.

Both the Heritage Foundation and Fraser Institute indexes show that freer countries have higher per capita GDPs. Chart 1 breaks down the average per capita GDP for both indexes into quintiles. The top quintile is composed of countries that ranked in the top 20 percent for economic freedom, the second quintile is composed of countries that ranked below the top 20 percent but in the top 40 percent, and so forth. The countries in the top quintile for the Fraser index have a per capita GDP of $22,600 while those in the bottom quintile average only $2,773. The numbers for the Heritage index are $20,825 and $3,025, respectively.



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



Greater economic freedom is also associated with higher levels of the U.N.'s Human Development Index. The top quintile for both economic freedom indexes has an average Human Development score of 0.89, while the average score in the bottom quintile for the Fraser index is 0.54 and for Heritage it is 0.62 (See Chart 3). To the extent that the U.N. would like to use this index to make policy recommendations to countries, the evidence should be clear: grant more freedom in your economy and you will achieve higher levels of "human development."

The three measures above are all "snap shots in time." They all measure well-being today as it relates to established economic freedom and private property rights. Some people might assert that high levels of well-being were achieved before freedom was attained. To show that well-being does not precede economic freedom and strong private property rights, we can look at growth rates and freedom scores. To avoid getting a result driven by short-term business cycles we need to look at the data over a longer period of time. The Fraser Institute scores for 1990, 1995, and 2000 can be averaged together to give each country an average freedom score for the decade, and then the countries can be sorted into quintiles according to this score. This average freedom score can be compared with each quintile's average GDP growth rate for the decade (see Chart 4). Again, we find that countries in the top quintile had the highest GDP growth rate, 3.45 percent, and those in the lowest quintile had the lowest growth rate, 0.97 percent.

To see whether differences in freedom among countries remain important once a country is already developed and industrialized, we can limit the analysis to the 29 member countries of the Organization for Economic Cooperation and Development (OECD). Chart 5 plots the U.N. Human Development Index score and Fraser Institute freedom score for each OECD country. Although all countries score relatively high on both measures, a clear relationship is still present: greater economic freedom leads to a higher level of human development. The one third of OECD countries with the highest average freedom scores for the 1990s also averaged the highest growth rate for the decade (3.52 percent vs. 2.89 percent for the countries in the bottom third).

The data in the various charts clearly show a strong relationship between economic freedom and well-being. Although the charts show the first and second quintiles always outperform the rest (and by quite a bit in most cases), the third, fourth and fifth quintiles are often very close and in some cases a lower ranked quintile outperforms a higher ranked one. This seems to indicate that economic freedom can produce its best results when it applies within as well as across categories. In other words, countries that exhibit a moderate degree of economic freedom do not fare much better in terms of the measures of well-being than countries with less economic freedom. This finding suggests that having just some economic freedom does not boost well-being much—it is all or nothing.

Conclusion

Although deriving statistical measures of economic freedom and property rights remains problematic, and no single measure adequately measures an individual's well-being, the available evidence strongly supports the notion that economic freedom makes people better off.

Chart 3
Economic Freedom and U.N. Human Development Index

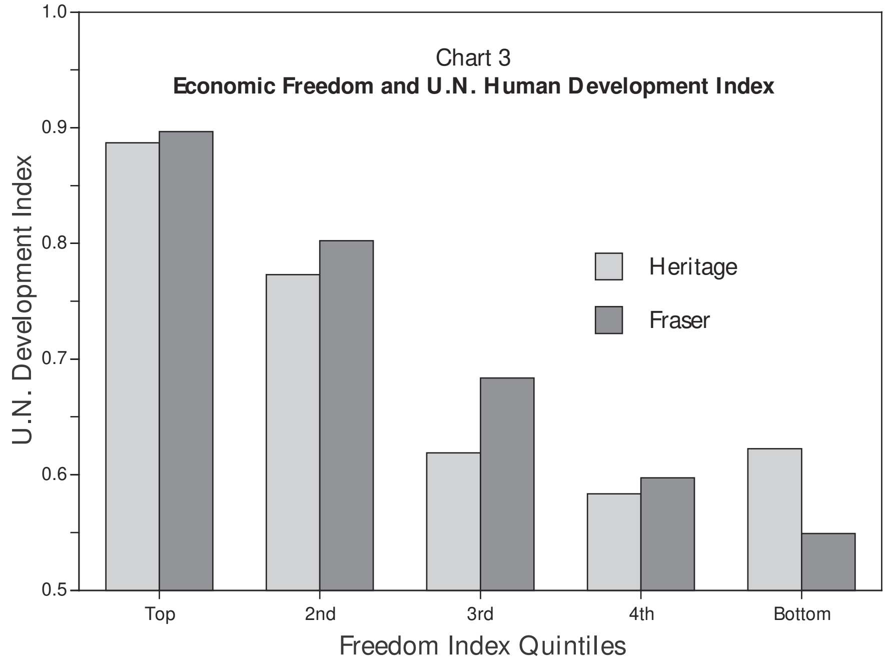
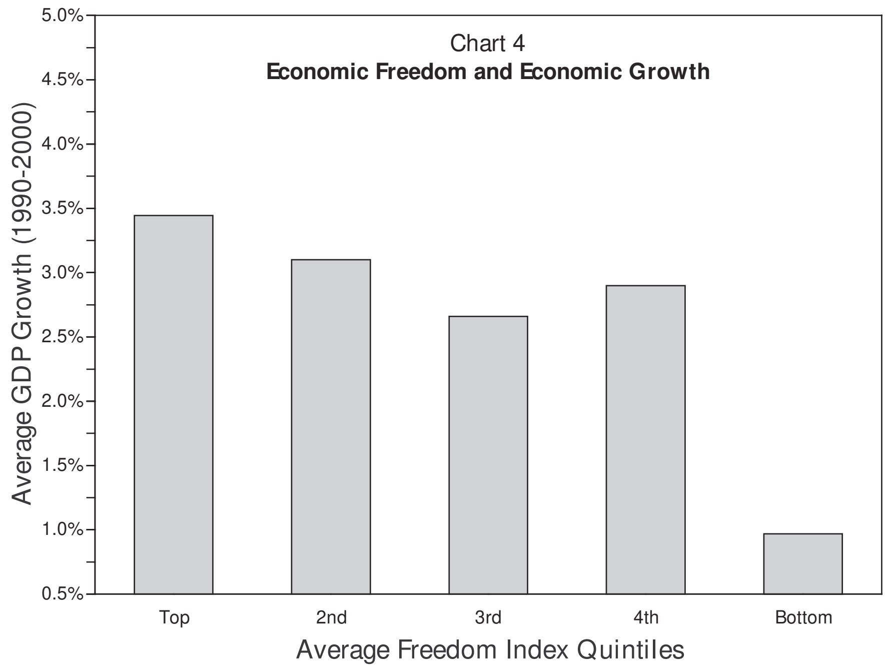
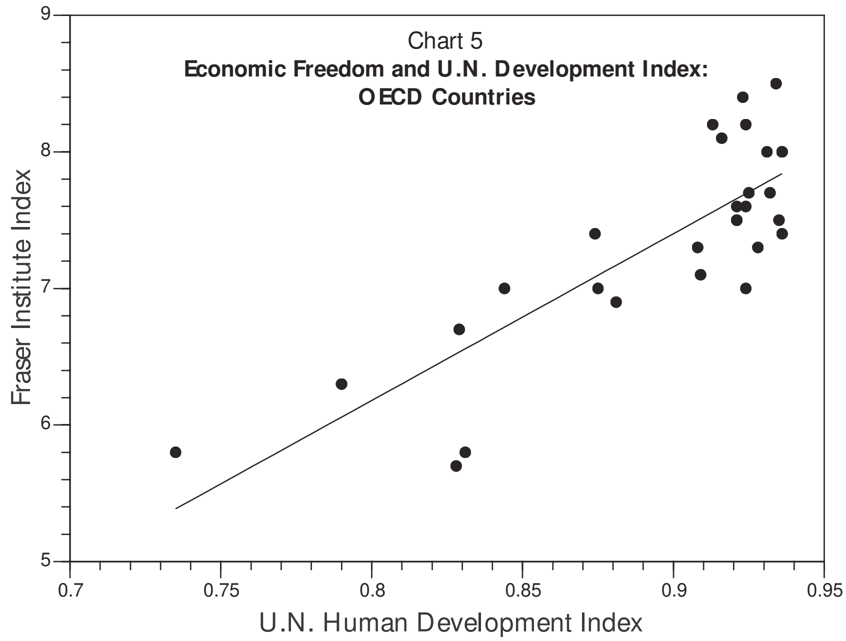


Chart 4
Economic Freedom and Economic Growth





A basic understanding of voluntary exchange and the free market's role in coordinating activity leads us to believe that the free market economy is the best system for people to better obtain whatever it is that they value. We observe that in countries that encroach less on the private property rights of their citizens, people achieve higher per capita GDP and longer life expectancies. The U.N. Human Development Index combines literacy and education with the above two measures and we again find that freer countries do better. Countries with more economic freedom also achieve higher GDP growth rates than those with less freedom.

Despite their difficulties, all these measures point in the same direction. Governments that respect private property rights and allow a higher level of economic freedom are better able to satisfy human desires than those that interfere more with citizens' private choices.

Endnotes

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

[2] Freedom House also provides a measure. However, it focuses more on political freedom and civil liberties than it does on property rights protection, and will not be considered here.

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

[4] In repressed countries people will often substitute leisure for work or engage in non-market activities in order to avoid having the fruits of their labor confiscated.

[5] One way to solve this problem is to subtract government outlays from GDP to get gross private product (GPP).

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

[7] Studies by Scully (1988 and 1992), Barro (1991), Barro and Sala-I-Martin (1995), Knack and Keefer (1995), Knack (1996), and Keefer and Knack (1997) show that well-defined property rights, public policies that do not attenuate property rights, and the rule of law tend to enhance economic growth. Gwartney, Holcombe, and Lawson (1998) found a strong and persistent negative relationship between government expenditures and GDP growth for OECD countries as well as for a larger set of 60 nations around the world. They estimate that a ten-percent increase in government expenditures as a share of GDP results in approximately a one-percentage reduction in GDP growth. Using the Fraser and Heritage indexes of economic freedom Norton (1998) found that strong property rights tend to reduce the deprivation of the world's poorest people while weak property rights tend to amplify the deprivation of the world's poorest people. Grubel (1998) also used the Fraser Institute's Index of Economic Freedom to find that economic freedom is associated with superior performance in income levels, income growth, unemployment rates and human development.

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