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

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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.

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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 14th most free in the 2015 report (using data for 2013) (Gwartney, Lawson, and Hall, 2015b).[1] 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 14th place in 2013. This is actually an improvement from its rank of 17th 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.[2]) 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.

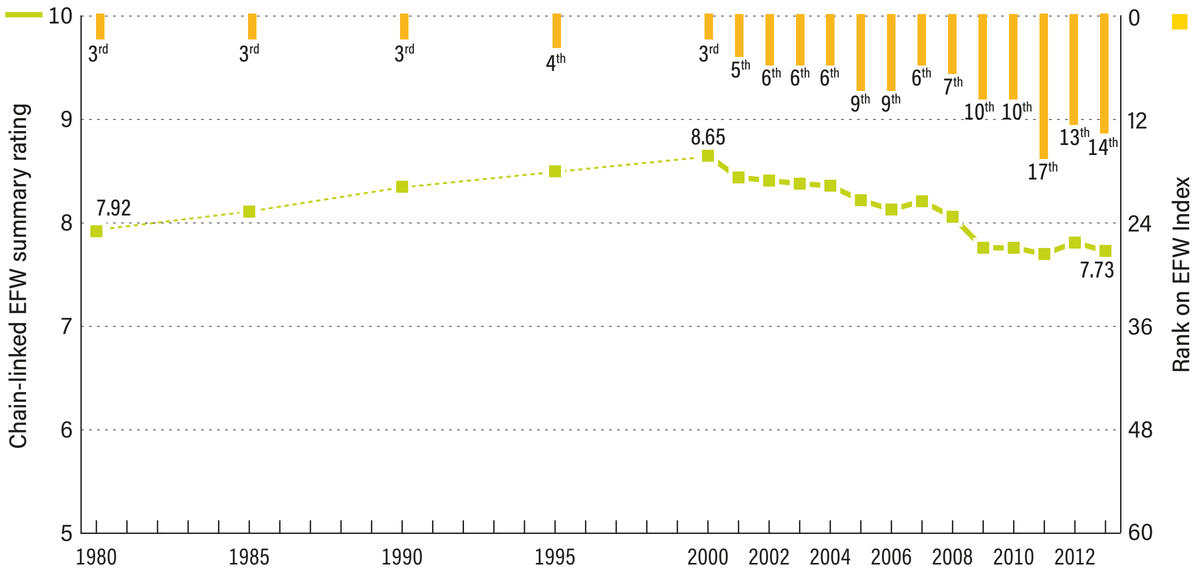
4.1 Area 1: Size of Government

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) 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 16th, not 14th.

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).

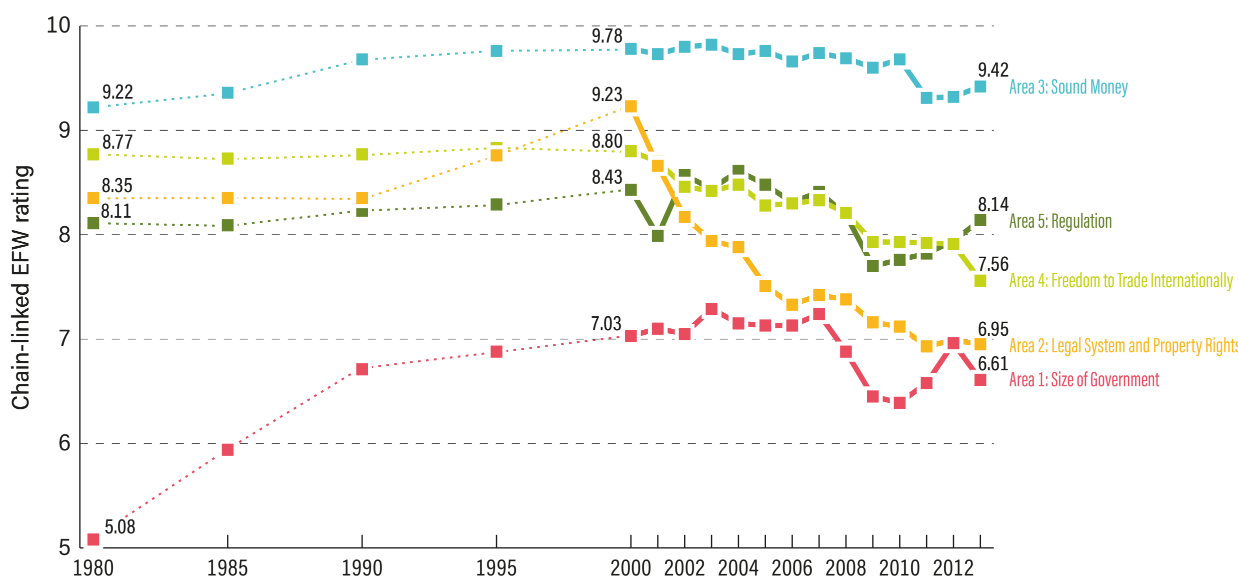
Figure 6.1: Chain-Linked Summary Rating and Ranking of the United States, 1980–2013



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.[3] 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.[4]

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.[5] 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.[6] 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.

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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.[7] 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.[8] 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,[9] 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.

9 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,[10] 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.[11]

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%.[12])

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.[13] 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.

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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).

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