

Economic Freedom and Economic Growth: Some Problems in Conceptualization and Measurement

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ABSTRACT

There has appeared a large body of literature on the subject of Economic Freedom (EF) and its relation to Economic Growth (EG). This paper takes the view that the notion of EF is still in process of being defined and therefore the tools of measuring the same are still evolving. Correlations indicated by empirical research are under debate.

KEYWORDS: Economic Freedom, Economic Growth, Freedom House

1 INTRODUCTION

Decolonization starting in the late 1940s created what have been usually known as developing countries. Most of the new states had indigent and primarily agrarian economies. Governments of the new countries wanted to maximize EG, mainly by dint of industrialization and capital goods production for purposes of autarchy/ national sovereignty.

Two broad models of economic achievement existed, the western capitalist model, with mixed economies in certain influential countries, like Britain and France, and the socialist/ communist model represented by Russia. Most of the Asian and African countries had been the colonies of western capitalist countries and largely followed their path and received bilateral and multilateral aid. To the extent that multilateral institutions were dominated by western key powers, the aid/loan activities of such institutions also reflected the capitalists' interests, ideologies and institutional and economic practices. Some African and Asian countries like Ghana, Egypt, Indonesia, etc asserted themselves initially but were eventually brought under the influence of capitalist powers and multilateral financial institutions.

Initial theories of growth emphasized such factors as capital, labour, human capital and technology. However, growth did not occur the way it was expected. In the developed world as well, the functioning of welfare state and mixed economic systems came under attack. Blame for the situation was laid mainly on wrong policies particularly, price distortions caused by government interventions.

Market-based economies initiated to reassert, echoing an analogous change in mindset among numerous mainstream American intellectuals. There was emphasis on redefining the role of state in the direction of economists like Milton Friedman who had consistently written in favour of market-based economy. According to him:

“Historical evidence speaks with a single voice on the relation between political freedom and a free market. I know of no example in time or place of a society that has been marked by a large measure of political freedom, and

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that has not also used something comparable to free market to organize the bulk of its economic activity.”[1]

The notion of EF contributing to growth began to be operationalized and studied empirically.

2. Major efforts for measuring EF

By now, the list of those claiming to have contributed to uncovering the connection between EF and EG is quite large. Henke and Walters[2] give a list and say that Raymond Gastil and Lindsay Wright were probably the ones who made the earliest attempt to systematically measure EF in the year 1983. The authors did this in producing the Freedom Houses’ annual report on political and civil liberties in that year.

Thereafter, theorists made earnest efforts at measuring EF. Organizations such as

- a) Fraser Institute,
- b) Liberty Fund,
- c) Heritage Foundation and
- d) The Cato Institute

began to sponsor symposia and research on the subject.

G. W. Scully first built on Gastil and Wright’s work of the Freedom House. He provided further systematic empirical evidence of a positive relationship with regard to free economic organization and different quantities of economic wellbeing. In a later book, he undertook further investigation and claimed to have confirmed the favourable effect of economic freedom on EG. This was indicating that increase in government sector had a negative effect on EG. Hanke and Walters say that the empirical relationship so uncovered was confirmed in subsequent studies. Using different proxies for EF, an increasing number of empirical studies sought to set up a strong link between EF and EG. For example, Barro (1996) argued that EFs in form of the free markets, safeguarding of property rights, small government promote growth. Scully and Slottje (1991), De Vanssay and Spindler (1994), Goldsmith (1997), Hanke and Walters (1997), DeHaan and Siemann (1998), all claimed to have confirmed a strong correlation between EF and EG.

Bhagwati emphasized the importance of experimental studies for a positive correlation between EF and EG, saying:

“It is not difficult to assert that economic freedom is likely to have a favorable effect on economic prosperity, for the simple reason that the last fifty years of international experience more or less confirms the fact that wherever governments used markets more and engaged in more open policies in foreign trade and investment, indeed in more economic freedom of different kinds, their countries have tended to prosper. By contrast, those countries that turned inward and had extensive regulations of all kinds on domestic economic decision-making in production, investment and innovation are the countries that have really not done too well.”[3]

2.1. Major EF Indices

The subject of EF and EG attracted great attention because of emergence of indices ranking countries according to a scale running from the least free to the freest. The major EF indices are:

- I. The Fraser Institute,
- II. Freedom House, and
- III. The Heritage Foundation

I. The Fraser Institute's EF Index.

In mid 1980s, Fraser Institute began to hold symposia on EF which attracted many economists, some of them economics Noble Laureates. Such participants at different symposia realized that the Gastil-Wright's work focused only on some liberties and governmental procedures while measuring the EF. Therefore, they worked hard to develop alternative measures. In 1996 finally they were able to published "*Economic Freedom of the World: 1975-1995*." As the title indicated it spanned two decades, Gwartney, Lawson, and Block were the authors. They concluded that the data indicated that during 1975-1995(two decades), there had been a significant correlation between EF and EG. Countries that enjoyed a high level EF had positive EG. Also, those countries that had a significant increase in EF attained positive EG. Likewise, when countries had low level of EF, their per capita income decreased.

II. Freedom House's EF Indicator.

The culmination of Freedom House's efforts was publication in 1995 of *World Survey of Economic Freedom: 1995-1996*. The EF index developed by Freedom gave major importance to some known liberties. Yet the *World Survey* confirmed the significance of EF as a major factor of wealth production: some 27 countries merited "free" rating; they formed just 17% of around population of the world, but they produced 81% output at the global level. This was in contrast to other 20 countries that were designated "not free": they contained one third of the population of the world. However their produce formed only 5% of the global's total output. In this way, the Survey thus joined several other studies showing that EF was the surest path to development and growth.

III. The Heritage Foundation's Index of EF.

Right from its inception, Heritage Foundation also started the publication of an Index on annual basis since 1994. The Heritage's Index further confirmed that there was a strong relationship between EF and EG.

Hanke and Walters, in their survey article of 1997 titled; "*Economic Freedom, Prosperity and Equality*" claim that EF was an essential condition for prosperity. They also stated the view that 'myth' that EG makes for social and economic equity.

There are opposite views as well. Hanson, in his article, "*Proxies in the New Political Economy: Caveat Emptor*," mounted a critique. He attempted to show that authors theorizing about relationship between EF and EG, using pseudo-criteria are producing wrong statistical estimates. In the view of Heckelman, Hanson's attack "may be interpreted as denigrating the empirical EF literature in its entirety." [4]

Heckleman undertakes a "close" scrutiny of the literature and reaches the conclusion. Meanwhile that the literature is not without flaw and some of the concerns raised by Hanson have to be taken into account.

3. DISCUSSION

There is an ongoing debate about the definition/ content/ indicators of EF and construction of EF indexes on the basis of the source. In the process, certain modifications have come about but the debate is on and the matter of causation/ correlation is not yet resolved.

This paper will analyze the way the Fraser Index has been modified several times, also indicate definitional changes to process the point that probably more work is needed to fully establish the correlation/causation between EF and EG.

Gwartney et al. (1996) in their work titled “ *Economic Freedom of the world: 1975-95*” [5] used 17 measures which are being scaled from 0–10, where ‘0’ stands for completely unfree country awhile ‘10’ means completely free country. These components were grouped in four wide areas:

- 1) Government operations and regulations;
- 2) Takings and discriminatory taxation and
- 3) International exchange[6]
- 4) Money and inflation;

In 2001, Gwartney et al. changed the list and grouped in seven wide areas. In the 2002 version of the report, Gwartney and Lawson [7] changed the list yet again. This time, the data were taken from the two important reports which included:

- (a) International Country Risk Guide (ICRG)
- (b) The Global Competitiveness Report (GCR)

21 components were notable, mostly had subcomponents. Therefore their total number raised upto 37. These components were grouped in the following wide categories:

1. Size of government
2. Legal structure and security of property rights
3. Sound money
4. Freedom to trade
5. Regulation of credit and business [8]

In 2012, Gwartney et al. changed the list and the total number of elements raised upto 42. Similarly, The Fraser index can be criticized; it also consisted of amalgamation of diverse variables, including some such variables as property’s rights, are institutional measures. Moreover, EF can’t be calculated in a proper manner; because freedom involves quality and not mere quantity. The Subjective elements would create imprecision.

Some of the elements of the index are disputed. For example, the addition of the taxes’ level is questioned by several economists. Most authors are of the opinion that public authorities do have vital tasks. Such tasks need financing. In that a question arises as to what level of taxes is good enough? De Haan, et al (2006) believes that at least two functions of government were in line with EF:

- (a) Individuals as well as collective property should be protected against internal and external inversions and
- (b) Some public goods – which have characteristics considered to be beyond the resources of private sector to produce.

“When governments move beyond these Protective and productive functions into the provision of private goods, they restrict consumer choice and economic freedom” [9]

But in a later writing Gwartney and Lawson (2003) took the view that since public sector supply services tend to minimize EF of the individual. Heckelman and Stroup (2000) criticized the way that

Gwartney et al. (1996) had employed for aggregation of functions. In their view, the crucial issue was that EF was a variable that could not be observed directly. Information on it was difficult to get.

There was another controversial issue. Whether the level or the change regarding the EF's level should be included when examining the effect of EF on EG. Some authors are sceptical about the outcome of EF's level itself and tend to emphasize the importance of the change in EF. This is true of De Haan et al. (2006).

According to Kapas and Czegledi arguments in "level versus change" discussion, mainly concern with causation; this is so because the importance of the level together with the change of the index may be the sign of reverse causality. No one can elucidate the economies' performance with high EG and high EF, without using the concept of level.

4. **Conclusion.** To sum up, the very debate indicates a lack of a coherent theory of freedom. Again and again, the literature, indicates a strong positive relationship between EF and EG, but never tries to explain the theoretical basis of such relationship. The problem of conceptualization and measurement of EF still remains.

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