

Political Economic Digest Series 26

Dear Political Economic Digest Series Participant,

Welcome to the twenty sixth issue of Political Economic Digest Series. In the last issue of Political Economic Digest Series we discussed about religion, ethics and morality. This issue will cover readings on Freedom and Its Importance for Prosperity. The first reading is an extract from the book HABITS OF HIGHLY EFFECTIVE COUNTRIES LESSONS FOR SOUTH AFRICA by Leon Louw. The second reading is an article “Why Freedom Matters” by James A. Dorn.

Diverse meanings of ‘freedom’

-Leon Louw

Since growth is the most significant precursor of the attainment of most policy objectives, and since the evidence suggests that freedom as defined by various organizations classifying economic, business and political systems is correlated with growth, the nature and significance of these classifications were examined. We are not concerned here with the innate virtues of freedom, or its divergent ideologically informed conceptions, but with the strong correlation between various freedom indices and prosperity, regardless of the philosophy that informs them.

As far as could be established, freedom indices are the only ones that coincide with prosperity to the impressive extent that they do. When countries become freer, they tend to start growing faster and many other things improve, as happened in South Africa after transition.

There is no simple or agreed definition of ‘freedom’ or ‘economic freedom’, even amongst people of the same philosophical persuasion. Fortunately, higher growth tends to coincide with more economic freedom regardless of how its protagonists define it.

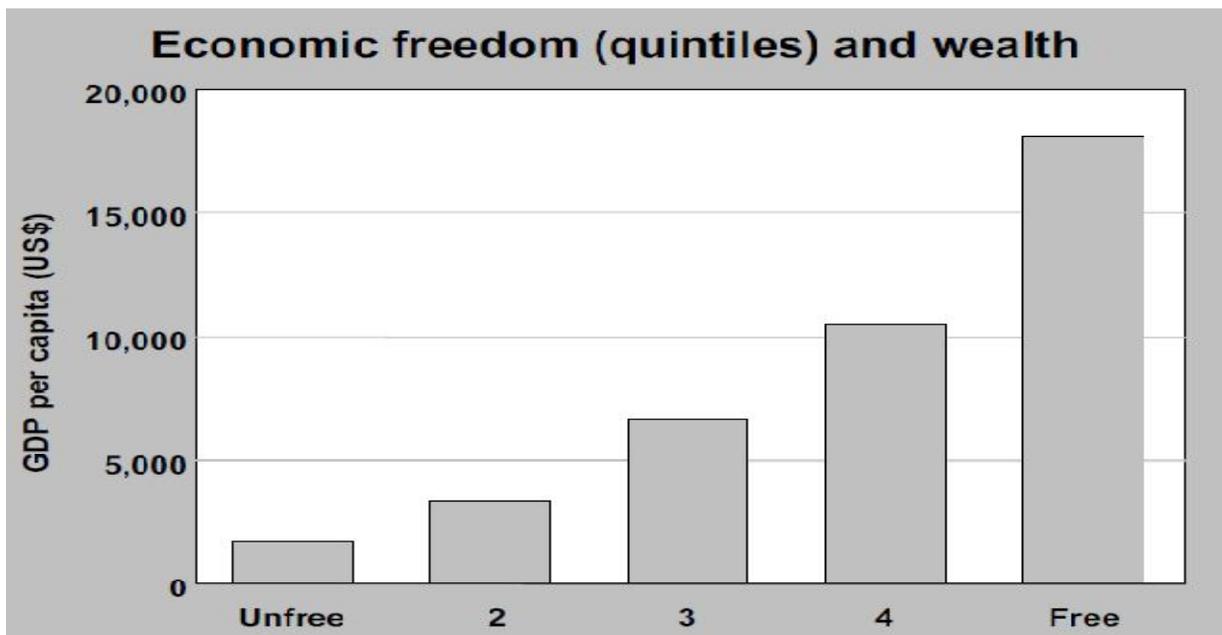
There are only two recognized lists of countries ranked according to how free their economies are. These are the Economic Freedom of the World (EFW) report provided by the Economic Freedom Network (EFN) under the leadership of Canada’s Fraser Institute, and the Heritage Foundation (HF) with the Wall Street Journal (WSJ). In addition, there are closely related classifications of economic and political systems, notably the Competitiveness Index (CI) by the World Economic Forum (WEF), and the Freedom House (FH) Index, which measures freedom generally, including economic freedom, but primarily political freedom.

Many studies compare regulatory environments, or labour and industrial policies, according to indices ranging from the least free to the freest, which may be called ‘open’, ‘flexible’ or ‘accommodating’. These indices and studies were relied on heavily. FH scores for freedom, according to the FH definition (FH-freedom), correlate closely with economic freedom (E-freedom).

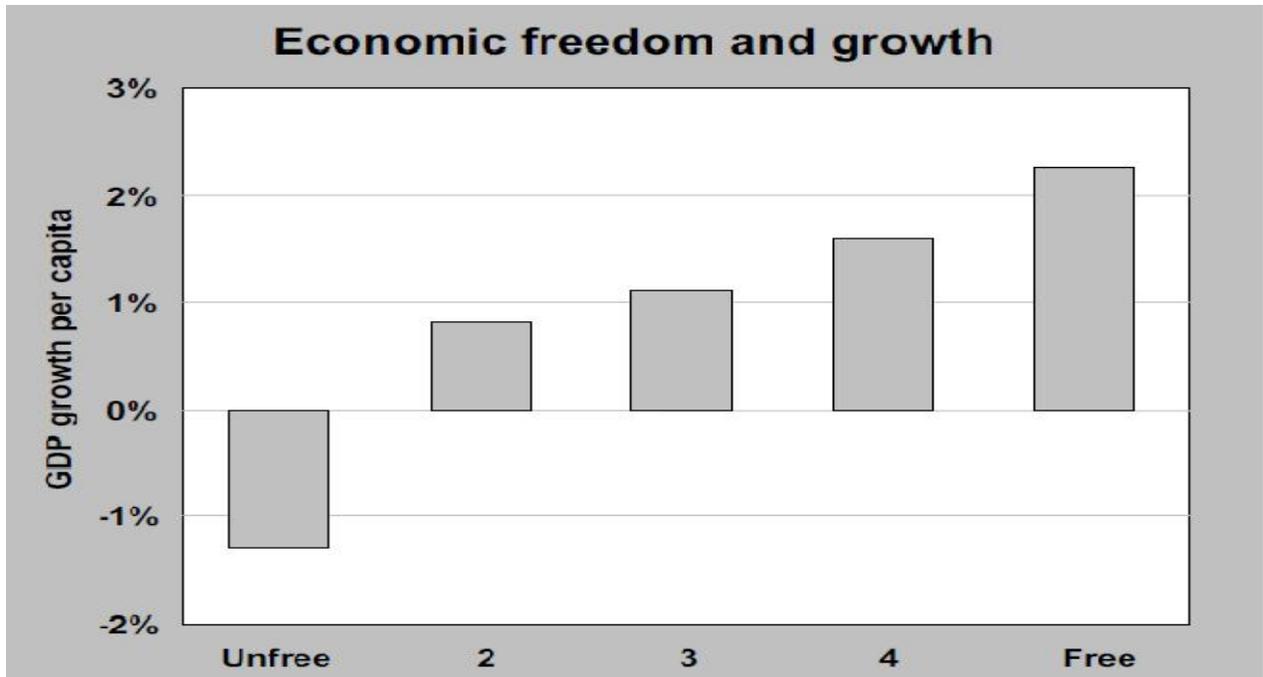
Economic freedom and its consequences

The EFW index shows a strong correlation between economic freedom and wealth (GDP). This correlation is usually interpreted as suggesting that wealth is a consequence of economic freedom, but the correlation by itself could equally suggest that once countries are rich they free their economies. It should also be remembered that, with a few exceptions called ‘economic miracles’, high-income countries got there over long periods, sometimes 100 years or more. This means that their wealth is the consequence of what they did many years ago, rather than now.

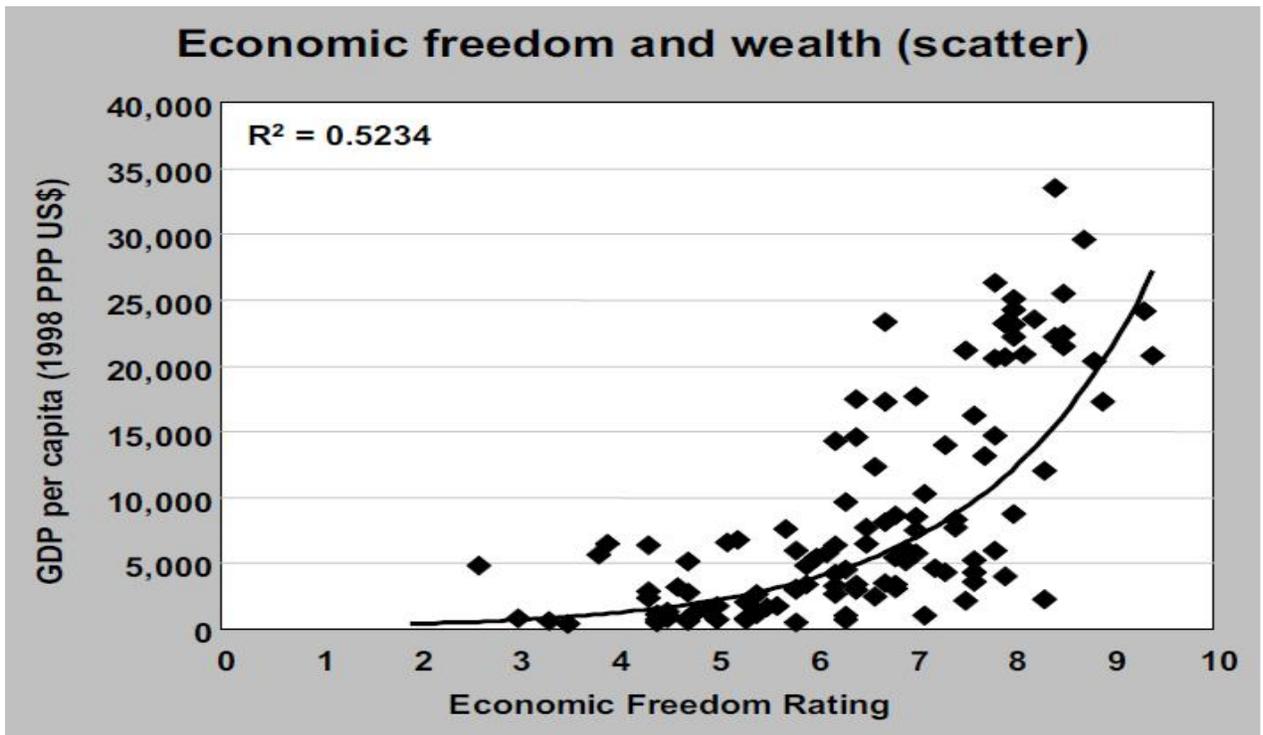
To establish whether economic freedom is the probable explanation of why some countries are rich, it is necessary to establish which policies characterized the periods of their growth. Economies may have stagnated or declined for many years along the way, such as those of post-war Britain and Spain. What has to be established is the sequencing of events – did wealth precede economic freedom or the other way around? Maybe they coincided as consequences of a third factor, such as democracy, and neither contributed to the other.



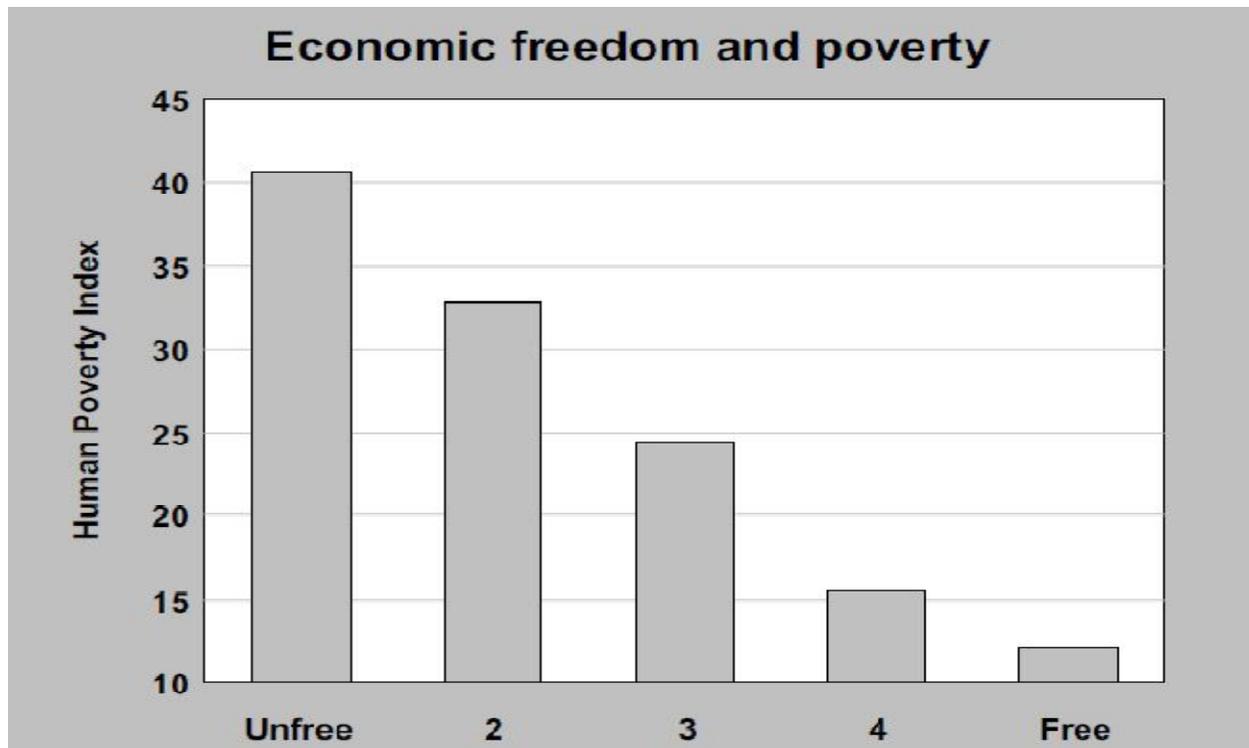
Analysis along these lines shows powerful evidence to the effect that economic freedom precedes growth and wealth, and that economic freedom coincides with democracy. In other words, economic and other freedoms (political, social, religious etc) tend to coincide as if they are aspects of a single paradigm. Aspects of freedom that have the strongest correlations with growth and wealth are economic freedom and its legal-jurisprudential counterpart, the rule of law. The graph shows the GDP per capita in US\$ of five groups of countries (quintiles), grouped together according to their levels of freedom, from ‘unfree’ to ‘free’.



This, for more technically minded readers, is an economic freedom and wealth scattergram showing a R² correlation of 0.5234.



Since economic freedom coincides with growth and wealth, and almost all published indices show better scores in rich countries, it follows that economic freedom will correlate with those indices. There is, for instance, less poverty in freer economies.



Political freedom and civil liberties

It is no surprise therefore that FH-freedom also correlates positively with growth. FH compared FH-freedom with growth and prosperity and found more growth and prosperity coinciding with more FH freedom (<http://www.freedomhouse.org/research/freeworld/2001/essay1g.htm>, and...1h.htm).

Remembering that causality cannot be assumed, this may mean that countries become free as a result of prosperity or prosperous because their people have freedom. To find out which was the case, the sequence of occurrences was analyzed. Indeed dynamic analysis was a feature of the research, in contrast with most research, which examines static relationships.

Static analysis compares data at fixed points while dynamic analysis examines changing relationships. This might reveal that the current status of labour policy is not as significant as the direction of change, or that maximal impacts occur a few years after a policy is implemented. Policies in a given year may have consequences only three, five or even twenty years hence.

Most analyses of the influence of economic policies on economic performance compare economic policy at a specified moment with economic performance at that time, whereas the consequences of economic policies are likely to manifest themselves only a few years, perhaps decades, later. South Africa appears to be an excellent example. The economy did not grow during the first decade of democracy at rate predicted for the economic system implemented by the ANC. Growth improved, but well below what it 'should' have been. This led critics of its 'neo-liberal' policies to say they had failed. Only now, and increasingly during the past three years, has growth accelerated to predicted levels.

Researchers found that freedom (however defined) tends to precede prosperity, but there are instructive exceptions. Prosperity often occurs in countries with poor FH-freedom (China being a celebrated contemporary example; the Asian tigers are earlier examples), if they have high E-freedom. The world's experience appears to support the view that economic freedom may be a necessary and sufficient condition for prosperity. Conversely, FH-freedom sometimes, but not consistently, coincides with modest levels of prosperity in the relative absence of E-freedom. It seems as if countries, once developed, can sustain their prosperity with lower levels of economic freedom than those needed for poor countries to prosper, and the best performance tends to occur when countries combine both forms of freedom.

All the well-known classifications of political, legal and economic systems include overlapping variables. These are a combination of some common factors and some that are index-specific. Policy 'variables' are simply government policies that vary from country to country and within countries at different times.

Some indices use many components (variables), some just a few. FH-freedom includes economic policy variables, on the assumption that more economic freedom is tantamount to more liberty. Equally, the Economic Freedom of the World (EFW) index, which combines 38 components, includes civil liberties on the assumption that there is more economic freedom when there is more respect for civil liberty.

Naturally, most variables in EFW are economic policies. Not only do different indices have some variables in common but they also often draw on each other. EFW, for instance, uses FH rankings to compile the 'economic freedom' index.

Not everyone agrees with Freedom House that more economic freedom is consistent with more liberty. Left wing intellectuals tend to regard less economic freedom as coinciding with more social freedom. Stated differently, the liberal conception of economic freedom is rejected in favour of the view that consumers and workers have more freedom when they are protected from 'exploitation by market forces' through government intervention.

Freedom House findings

In its annual survey, Freedom House analyzed economic growth in countries with populations of one million or more over a ten-year period and found an average annual GDP growth rate of 2.56% in countries classified as Free, 1.7% for Partly Free countries, and 1.46% for countries that are Not Free. This could mean that freedom is a consequence of prosperity and development as opposed to prosperity being a consequence of political and civil liberty.

In order to establish causation FH examined poor countries (less than US\$5,000 annual per capita GDP) separately, and found that Free countries averaged 3.23% growth over ten years, which was more than double the average of 1.39% and 1.52% respectively for Partly Free and Not Free poor countries. FH concluded that, 'as a general principle, economic growth is accelerated in an environment of political freedom'.

Adrian Karatnycky of Toronto University found ‘a high and statistically significant correlation between the level of political freedom as measured by Freedom House and economic freedom as measured by the Wall Street Journal/Heritage Foundation survey’ and that a ‘primary factor’ is the evidence that ‘political freedom tends to reinforce economic freedom and a vibrant private sector based on property rights’.

Karatnycky and most commentators presume it to be ‘the exception rather than the rule’ that a few Not Free countries, such as China, have high growth but this report shows below that China is not an exception to the rule. It shows that there is prosperity where there is economic freedom. It seems to be true that ‘economic growth is accelerated in an environment of political freedom’, but it can and does exist without political freedom. Growth tends to be highest when political and economic freedom are combined in developing countries. The correlation between economic freedom and prosperity is stronger than between political freedom and growth, which is apparent from inter alia impressive gains in Africa which has not seen political freedom increase as much as economic freedom.

Nine of Africa’s 53 countries are Free (17%), 25 are Partly Free (47%) and 19 are Not Free (36%). Freedom increased in eight and decreased in six. As such it is the world’s least free continent, but not its least free region, which is the Middle East. Of Asia’s 39 countries, 18 (46%) are Free, 10 (26%) Partly Free, and 11 (28%) Not Free. Although there is more freedom in Central and Eastern Europe than in Africa, ‘progress toward the emergence of open societies has stalled or failed’ in the less free European countries. Eleven of the region’s countries are Free (41%), 10 are Partly Free (37%), and six are Not Free (22%). High growth in many countries in the Americas coincides with increased freedom there, with 23 (66%) of the 35 countries being Free, 11 (31%) Partly Free, and one (3%) (Cuba) Not Free. The Middle East has one (7%) free country, Israel, three (21%) Partly Free countries, and 10 (71%) Not Free.

‘Pure’ statistics

The purely statistical approach in this report negates the need for taking sides on the debate about the meaning of freedom. It does not matter on which philosophical paradigm an index is based, such as the liberal democratic approach of FH; whether more tax, labour regulation and one-channel agricultural marketing are regarded as constituting more freedom or less is therefore immaterial. As explained, this report is concerned simply with relationships between variables. This entire analysis could be written using terminology that characterises the intellectual left or right without affecting the veracity or legitimacy of its findings. That its terminology is characteristic of classical liberalism is because that is the language most likely to be understood by readers and it is the paradigm within which most empirical growth analysis has been done.

In view of the positive relationship between liberty and prosperity, there is a possibility that it is a bad idea for poor countries to have economic or other freedoms; that they are appropriate or feasible only in developed countries. If that were so, poor countries with less freedom (as defined) would outperform ones with more. Highest growth is found in poor countries especially when they have policies resembling those under which rich countries prosper, especially those which characterised rich

countries when they were becoming rich. More significantly, such policies coincide with much higher growth rates when implemented in poor than in rich countries.

Even if poor countries adopt policies associated with rich countries after they became rich, they perform well, though not as well. In case the data merely reflected ‘the dynamism of the advanced industrial countries’, FH looked exclusively at poor ones and found the differences to be ‘even more dramatic’. This coincides with our ‘Funnel’ showing that poor countries grow and contract faster than rich ones.

FH concludes that ‘the survey’s findings indicate that the promotion of political freedom is not exclusively a matter of values or morality... that political rights and civil liberties can reinforce economic development. And this in turn suggests that efforts to strengthen property rights, market systems, and the rule of law should be part of the effort by less developed countries to achieve growth’.

This extract is taken from the book HABITS OF HIGHLY EFFECTIVE COUNTRIES LESSONS FOR SOUTH AFRICA by LEON LOUW.

Why Freedom Matters

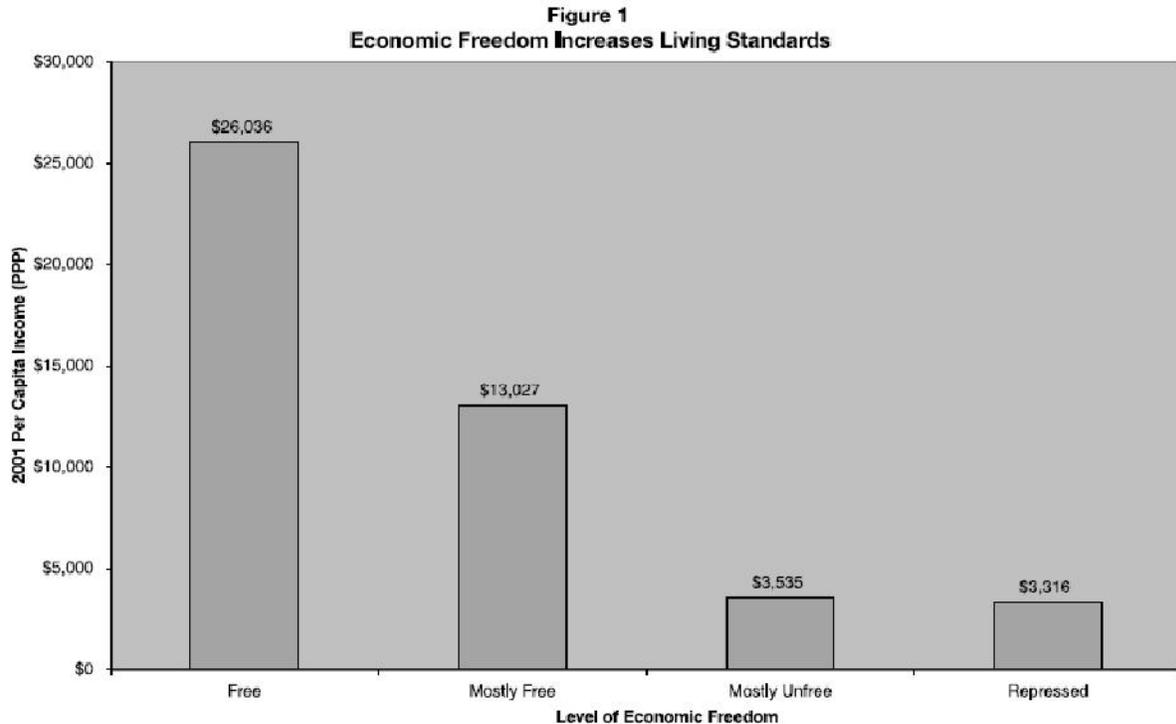
-BY JAMES A. DORN

The future of civilization depends on preserving and spreading freedom. As a moral principle, freedom means we ought to respect private property rights, broadly understood as the rights to life, liberty, and property. As a practical matter, when private property rights are protected by law, individuals will be free to trade for mutual gain and be held responsible for their behavior. Social and economic coordination—or what F. A. Hayek called “spontaneous order”—emerges from the voluntary decisions of millions of free people under limited government and the rule of law. Those nations that have failed to adopt freedom as a first principle have also failed to realize the benefits of freedom. They have ignored the great liberal idea, as articulated in *The Law* by Frédéric Bastiat in the mid-nineteenth century, that “the solution of the social problem lies in liberty.”

By “social problem” Bastiat meant the problem of coordination that confronts every society—that is, the problem of satisfying people’s wants for goods and services without central planning. The beauty of the market system, based on private property rights and freedom of contract, is that it allows individuals to continuously adjust to new information about wants, resources, and technology, and to engage in mutually beneficial exchanges. Economic freedom increases the range of choices and thus the wealth of nations.

Those countries with greater economic freedom have higher standards of living than those with less freedom (figure 1). Moreover, countries that have liberalized more quickly—as measured by the index of economic freedom—have tended to grow faster than countries that have failed to liberalize or that have liberalized more slowly (figure 2). Economists James Gwartney and Robert Lawson, the authors of the Fraser Institute’s annual *Economic Freedom of the World*, find that “long term differences in economic freedom explain approximately two-thirds of the variation in cross-country per capita GDP.” It

is no secret that countries that have opened to the forces of international trade and have restrained the growth of government have prospered, while those countries that have limited the scope of the market have stagnated.



Source: Ana Eiras, "Why Economic Freedom, Not Aid, Is the Answer to Poverty," in Marc A. Miles, ed., *The Road to Prosperity* (Washington: Heritage Books, 2004), p. 39.

Hong Kong's consistent adherence to market-liberal principles has resulted in long-run prosperity and the world's freest economy since 1970. In its 2005 Index of Economic Freedom, the Heritage Foundation and the Wall Street Journal once again ranked Hong Kong number one. On hearing the good news, Financial Secretary Henry Tang remarked, "I am pleased virtues we have been upholding to keep Hong Kong flourishing as a free market economy have once again been reaffirmed by the international community." Those virtues include credibility and reliability, prudence and thrift, entrepreneurial alertness, personal responsibility, respect for others, and tolerance. They are fostered by private property rights, the rule of law, freedom of contract, open trade, low tax rates, and limited government. Nations that have not followed the virtues of Hong Kong have not reaped the long-run benefits of economic freedom. North Korea, Cuba, Sudan, Iraq, and Haiti are but a few examples.

The lesson is that the virtues of the market require constant practice if they are to survive and flourish. Government policy must be market-friendly and transparent; it cannot be muddled. Markets discount future effects of current policy changes. If those changes are in the direction of greater economic freedom, they will be immediately rewarded and wealth created. Illiberal trade policies, higher tax rates, increased government spending, erratic monetary policy, and wage-price controls undermine private property rights, send negative signals to the global capital markets, and destroy the wealth of nations.

The failure of central planning in the Soviet Union and China has moved those countries in the direction of greater economic freedom, but the ghost of communism still haunts Russia, while the Chinese Communist Party has yet to abandon its monopoly on power.

Leaders of emerging market economies need to recognize that economic freedom is an important component of personal freedom, that free-market prices and profits provide useful information and incentives to allocate resources to where consumers (not politicians or planners) deem them most valuable, and that markets extend the range of choice and increase human welfare. Most important, leaders must understand that ultimately economic liberalization requires limited government and constitutionally protected rights.

Emerging market economies, especially in Asia, have discovered the magic of the market; they have also found that chaos emerges when the institutional infrastructure necessary for free markets is weakened by excessive government. When politics trumps markets, coercion and corruption follow.

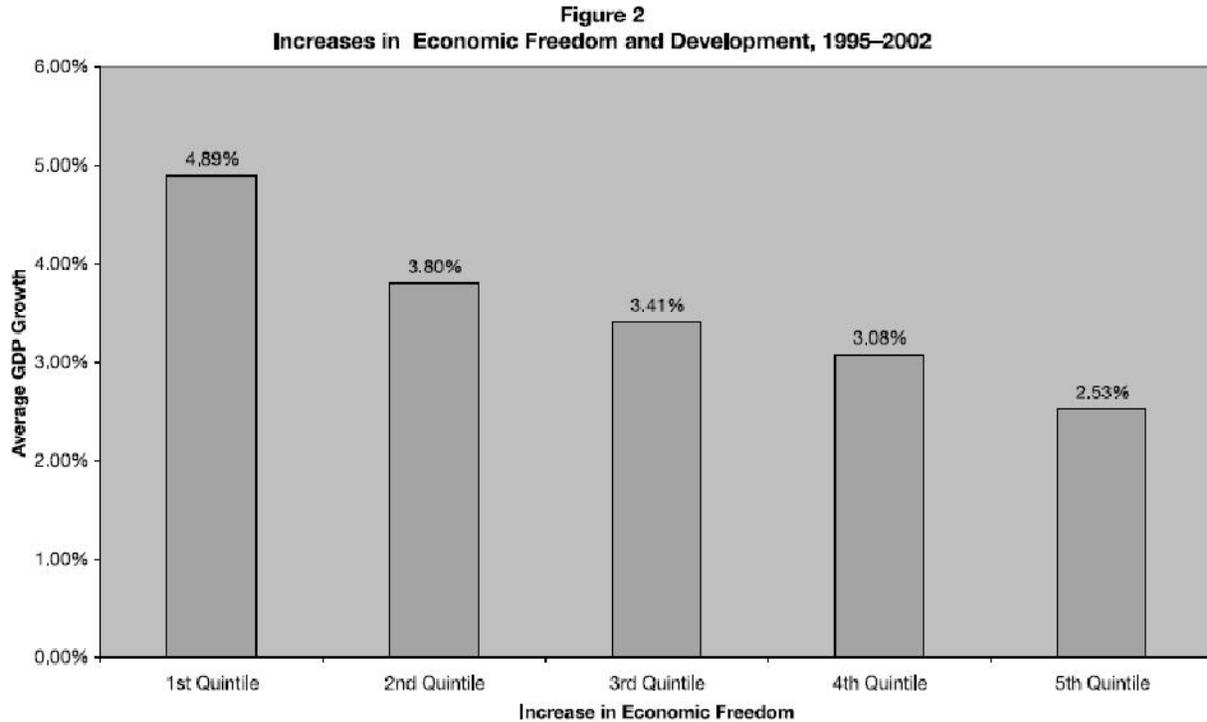
The Ethical Basis

The ethical basis of the market system is often overlooked, but not by those like Zhang Shuguang, an economist at the Unirule Institute in Beijing, who were deprived of their economic liberties under central planning. He compares the coercive nature of planning with the voluntary nature of the market and concludes: “In the market system . . . the fundamental logic is free choice and equal status of individuals. The corresponding ethics . . . is mutual respect, mutual benefit, and mutual credit.”ⁱ

The moral justification for individual freedom is self evident. In *Ethics for the New Millennium*, the Dalai Lama wrote: “We all desire happiness and wish to avoid suffering. . . . Ethical conduct is not something we engage in because it is somehow right in itself but because, like ourselves, all others desire to be happy and to avoid suffering. Given that this is a natural disposition, shared by all, it follows that each individual has a right to pursue this goal.”

Freedom without rules is an illusion. The famous Zen master Shunryu Suzuki wrote in his classic text, *Zen Mind, Beginner’s Mind*: “People, especially young people, think that freedom is to do just what they want. . . . But it is absolutely necessary . . . to have some rules. . . . As long as you have rules, you have a chance for freedom.”

The rules necessary for a market-liberal order are rules to protect the private sphere so individuals can pursue their self-interest while respecting the equal rights of others. Without clear rules to limit the use of force to the protection of persons and property, freedom and justice will suffer—and economic development, properly understood, will cease.



Source: Eiras, p. 40.

Note: Countries with the largest increase in economic freedom, as measured by the Heritage/Wall Street Journal index, are in the 1st quintile; those with the smallest increase are in the 5th quintile.

In 1740 the great liberal David Hume wrote that “the peace and security of human society entirely depend [on adherence to] the three fundamental laws of nature, that of the stability of possession, of its transference by consent, and of the performance of promises” (A Treatise of Human Nature). His legacy of liberty should not be forgotten.

Development and Freedom

In *Economic Analysis and Policy in Underdeveloped Countries*, the late Peter (Lord) Bauer argued that economic development and freedom are inseparable: “I regard the extension of the range of choice, that is, an increase in the range of effective alternatives open to people, as the principal objective and criterion of economic development.”

Economists have found that countries with secure private property rights create more wealth (as measured by real GDP per capita) than countries in which property is not protected by law. Trade liberalization is vital to the process of development. Voluntary international exchange widens consumers’ range of effective choices and lowers the risk of conflict.

There is a saying in China: “Wu wei ze wu shu bu wei”—“If no unnatural control, then there is nothing you cannot do.” In the *Tao Te Ching*, Lao Tzu advocates the principle of nonintervention (wu wei) as the ideal way of ruling. The wise ruler says, “I take no action and the people of themselves are transformed. I engage in no activity and the people of themselves become prosperous.”ⁱⁱ To take no action does not

mean to do nothing, but rather, as Chinese scholar Derk Bodde has noted, to refrain from those actions that are “forced, artificial, and un-spontaneous.”ⁱⁱⁱ

A natural order is one consistent with free markets and free people; it is Adam Smith’s “simple system of natural liberty.” As former Czech President Václav Havel so elegantly stated after the collapse of the Soviet Union, the free-market economy is “the only natural economy, the only kind that makes sense, the only one that can lead to prosperity, because it is the only one that reflects the nature of life itself.”^{iv}

Leaders in the West as well as the East should keep the following five lessons in the forefront of their minds as they contemplate future policy decisions: (1) private property, freedom, and justice are inseparable; (2) justice requires limiting government to the protection of persons and property; (3) minimizing the use of force to defend life, liberty, and property will maximize freedom and create a spontaneous market-liberal order; (4) private free markets are not only moral, they create wealth by providing incentives to discover new ways of doing things and increase the range of alternatives; and (5) governments rule best when they follow the rule of law and the principle of noninterference.

ⁱ Zhang Shuguang, “Foreword: Institutional Change and Case Study,” in Zhang Shuguang, ed., *Case Studies in China’s Institutional Change*, vol. 1 (Shanghai: People’s Publishing House, 1996), p. 5.

ⁱⁱ In Wing-Tsit Chan, ed., *A Source Book in Chinese Philosophy* (Princeton, N.J.: Princeton University Press, 1963), p. 167.

ⁱⁱⁱ Derk Bodde, trans., in Fung Yu-lan, *A History of Chinese Philosophy*, vol. 1, 2nd ed. (Princeton, N.J.: Princeton University Press, 1952), p. xxiii.

^{iv} Václav Havel, *Summer Meditations on Politics, Morality, and Civility in a Time of Transition* (London: Faber and Faber, 1992), p. 62.

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