Rating Global Economic Freedom

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Edited by

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and
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Milton Friedman is a Senior Research Fellow at the Hoover Institution, Stanford University; and Professor Emeritus of Economics, University of Chicago, where he taught from 1946 to 1976. Born in Brooklyn, New York in 1912, he received a B.A. in 1932 from Rutgers University, an M.A. in 1933 from the University of Chicago, and a Ph.D. in 1946 from Columbia University. In addition to numerous scientific books and articles, Professor Friedman has written extensively on public policy, always with primary emphasis on the preservation and extension of individual freedom. He is past president of the American Economic Association, the Western Economic Association, and the Mont Pelerin Society, and is a member of the American Philosophical Society and the National Academy of Sciences. He has been awarded honorary degrees by universities in the United States, Japan, Israel, and Guatemala, and is the recipient of the Nobel Prize in Economic Science (1976), the Presidential Medal of Freedom (1988), and the National Medal of Science (1988).

John C. Goodman is president of the National Center for Policy Analysis, a Dallas-based think tank founded in February, 1983. Dr. Goodman has a

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Introduction

THIS VOLUME IS THE THIRD in a series of books reporting on a program of research and discussion in The Fraser Institute Rating Economic Freedom project. The project has emerged out of a series of symposia which are part of the program of the Liberty Fund Inc. and which are designed to explore the relationships among civil, economic and political freedom, and to devise methods of theoretically isolating these concepts and providing measurements of them.

Four such symposia have been held. The first held in the Napa Valley, California was prompted by Milton and Rose Friedman's comment in the book *Capitalism and Freedom* that "historical experience 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 that has not also used something comparable to a free market to organize the bulk of economic activity." One of the obvious questions that occupied the first colloquium was whether or not political freedom in the sense of freedom to elect one's political representatives is a necessary condition for maintenance of a competitive markets approach to economic organization. This became clearer in the first symposium and the ones that followed.

The idea of economic freedom is a difficult one to articulate. This is particularly the case as economists are wont to be precise, and there is as yet no unambiguous, clear conceptual definition of economic freedom to which most people are willing to subscribe. The Liberty Fund-Fraser Institute conferences on economic freedom have followed this issue along two distinct paths. The first is theoretical, and the second is empirical. Most of the authors have proposed one definition or another of economic liberty, or at least impediments to it. In designing empirical measures to correspond to their notions, they have frequently come face to face with both the limitations of their characterization of economic freedom, and the adequacy with which they could measure it.

But unlike other efforts of pure philosophy, our authors have made the effort to draw the relevant evidence to the theory wherever possible. It is worth reminding the reader that these papers have been drawn from two conferences hosted by the Liberty Fund and The Fraser Institute. The authors were working from relatively specific guidelines at both conferences, but these differed as the second built upon the contributions of the first. At the first conference, authors were asked to assess economic freedom in sectors of the economy for a number of different countries. At the second, some were asked to provide a candidate index for future research in comparing countries. In both cases there were many measures proposed and many issues developed that will serve as guides for future research.

The book has been divided into three sections corresponding to emphasis since most papers deal in some measure with both theory and empirics. The first section develops characterizations of economic freedom which range from philosophical to empirical. The four papers in this section share the general characteristic of delving into the problem of what kinds of restrictions should be measured as reducing economic freedom. The first paper, by Jones and Stockman, is primarily theoretical although it does sketch an agenda for empirical research. Easton's two papers rely on a definition of impediments to economic freedom that allows him to make measurements consistent with those made for consumer surplus. He calculates a number of indexes of economic freedom in the international sector, the first paper, and for a number of different countries in the second. Jack Carr considers an output based measure of impediments to economic freedom in his paper on capital markets. The second section stresses the development of indexes for a wide range of countries. Gwartney, Block and Lawson provide a consistent index for four different time periods for nearly eighty countries. Spindler and Miyake develop indexes consistent with suggestions made at previous conferences, while Scully and Slottje introduce factor analysis to collapse many variables into a few specific measures of economic freedom. Included, too, in this section is a survey or experiment conducted by Milton and Rose Friedman using the (Sea Ranch) participants as the sample. In their experiment, they tried to assess the ability of the group to rank eleven relatively well known countries according to their relative levels of economic freedom. The third section provides a look at particular problems. Denzau considers why particular prices are so politicized while DiLorenzo tackles the labour market and its distortions. Reynolds rounds out this section by reporting on particular expenditure and tax distortions in several Latin American countries.

Section I

Ronald W. Jones and Alan C. Stockman explore the consequences of defining the loss of economic freedom as the consumer and producer losses associated with third party constraints on transactions. Constraints include both prohibited and mandated behaviour. Their illustrations include the appropriate calculation of the losses associated with transfers, taxes, minimum consumption requirements, and both quantity and price coercion. Their framework is broad and exciting. They introduce the notion of "bundling" to pose the question of whether government restrictions on freedom should be treated individually and their costs computed, or whether the whole package of restrictions should be treated as one bundle. Such a distinction is important if we think of Peter being required to transfer one dollar to Paul and then Paul being forced to transfer one dollar back to Peter. If these are lump-sum transactions so that there is no distortion, on a bundled basis neither is worse off. On a transaction by transaction basis, both are worse off. In addition to providing a formal proof of the freedom reducing character of an "optimal" tariff, they raise a host of important conceptual problems with what we think we mean when we discuss economic freedom. Their framework, however, allows for the calculation of many of the costs of impediments to freedom and is an extension in both the theoretical and empirical literature on economic freedom.

Stephen Easton in exploring economic freedom in the international markets develops a quantitative measure of the loss in economic freedom as an extension to consumer surplus related measures. In particular he asserts that any distortion that impedes free exchange is a loss in freedom. Thus the value of the loss in freedom is the value of the distortion. Unlike the consumer surplus triangle, however, the direct loss in freedom includes both the rectangle (the tax revenue, for example) plus the triangle. In the case of international trade taxes the loss in freedom is complicated by the domestic production of importable goods. The imposition of a trade tax reallocates rent to domestic producers, and Easton includes this as an indirect loss in economic freedom. He shows that even though an "optimal tariff" will raise income, it will result in a loss in economic freedom.

In his second paper in this volume, Easton develops his measures of economic freedom for a variety of different countries. To this end he uses two gross indexes—the ratio of government expenditure to national income and the number of government employees relative to population. The former is a measure of direct government intervention by way of the tax "rectangle" distortion while the latter is an attempt to measure the impediments to freedom posed by government regulation. Each government worker is (heroically) assumed to impede economic freedom by the same amount. Easton aggregates the two measures by estimating the relative price in terms of income of each government employee and then summing the two measures. This he does through an immigration function. The level of immigration from country A to country B is written as a function of government expenditure and government employees per head and per capita income. The amount of income it would take to induce an additional person to immigrate (per change in the number of government employees) provides the implicit price of the regulatory environment. Thus his approach allows for an explicit pricing of the implied cost of regulation although his measure only considers immigration to the United States or Canada.

In examining capital markets, Jack Carr takes the stance that economic freedom is not an end in itself, and thus does not include it as a separate argument in the utility function. Anything that impedes free exchange will impinge on economic freedom, and this, he suggests reduces economic welfare. The notion of a definition of economic freedom, he argues, is like the definition of money. It is not independent of the uses to which it will be put. He proposes a measure that would be one of many factors of production in the aggregate output function. Economic freedom is seen as being the index that best helps predict aggregate output. His paper finds that deregulation of financial markets has increased freedom over the past twenty years in several of the more developed countries. To measure economic freedom in this sector he considers such features as the regulation of the central bank, the regulation of commercial banks, the regulation of capital flows and the regulation of the stock market. Among the group of six countries considered, West Germany was the least impeded, followed by Canada, the United Kingdom and the United States, while France was the most impeded of the group.

Section II

The second section explores a number of empirical measures of economic freedom typically involving a wide range of countries and the consideration of many possible contributors to an index. The first by Gwartney, Block and Lawson rates 79 countries along dimensions such as price stability, the size of government, discriminatory taxes, and restraint of international trade. Their index is devised for four periods, 1975, 1980, 1985 and 1988. It shows Hong Kong as the economically most free and permits an extensive ranking of the rest of the countries in the sample. Further analysis suggests that countries with high indexes of economic freedom tend to have grown more rapidly than those with poorer levels of economic freedom. Their extensive data set has been reproduced in the Appendix to the paper and is also available on diskette.

Gerald W. Scully and Daniel J. Slottje used 15 attributes (from foreign exchange regimes and freedom to travel, to the rule of law and conscription) combined into indexes weighted by the ranks of the attributes, the principle components of the attributes and a hedonic representation of the attributes. Based on these indexes Scully and Slottje provide an overall index that combines the component rankings into a final assessment.

Zane Spindler and Joanna Miyake provide a number of rankings for different countries by integrating several measures of economic freedom that were suggested at a previous conference. (Hence their use of the title the "homework" measures.)

Milton and Rose Friedman took the opportunity to survey the assembled group. Their point was that while we have different indexes available, we need some mechanism to test whether they conform to our own notions of usefulness. In particular, they argued, we must be sure that whatever ratified combination of objective factors we observe, they conform in some measure to our general sense of which countries are more economically free than others. By surveying the audience, they found considerable consistency of view (over the dozen countries they listed), but were not convinced that the other indexes which had been constructed reflected the general consensus too well.

Section III

Arthur Denzau argues that a critical feature of the restriction to economic freedom derives from the state's politicization of prices. Rather than being free to buy and sell, firms must first meet various political tests before they are allowed to buy and sell. Such added costs to the pricing mechanism reduced economic efficiency, but also formed the basis for the argument that the microenvironment is the critical location from which we should measure impediments to economic freedom. Detailed questionnaires form the basis for current research into the kinds of impediments present in the Peruvian economy.

Labour market freedom was assessed by Tom DiLorenzo for four major countries: the U.S., Canada, England, and Japan on the basis of some thirty categories. These categories included whether there was compulsory collective bargaining, agency shop, taxes on immigration, and temporary work permits to mention a few. Rather than construct a weighted index, Di Lorenzo ranks each of the thirty categories from zero to ten and sums them for each country. Although he finds England the most free and Japan the least in this small group, a number of categories could not be assessed, and he is reluctant to view these rankings as final.

Alan Reynolds considers the tax and expenditure policies of a number of countries. His paper reports in some detail on tax rates in a small group of Latin American countries in which the taxes (income tax, sales tax, social security tax, wealth tax and investor tax) are used to construct an overall rating of different tax regimes. In the final analysis, Bolivia scores relatively well (even when measures of the deficit are included) followed by El Salvador and Brazil, then Mexico and Argentina.

Concluding Remarks

These papers have devised many measures of economic freedom. Progress has taken place over the past several years. The ideas we have now of economic freedom are substantially advanced over those that we explored at the first conference. Although there is anything but universal agreement about which measures are the most appropriate, we have identified a number of useful ways in which to think about economic freedom conceptually, and a number of good candidates for indexes to correspond to those conceptualizations. To drive home the point that the ideas and measures are still in development, we have included a synopsis of some of the main features of the discussion that followed each paper. Although many of the remarks may at times appear pointed, they serve the purpose of sharpening the issues that need to be further discussed. In this context, however, it is worth recalling that the papers were presented at two conferences (the first taking place at Banff, Alberta and the second at Sea Ranch, California) and are incorporated in the current volume as a function of their content, not their chronological development. As a result some of the issues may appear slightly redundant in light of papers developed "earlier" in the volume, some of the papers have been revised to reflect particular comments, and some commentators are conspicuous by their absence in some of the commentaries — they may have only attended the "other" conference. But on the whole we believe that the wide-ranging discussion serves to enliven, enlighten and elaborate the text.

Notes

[1] From the first conference the selected papers are by Carr, Di Lorenzo, Easton, Reynolds, Scully and Slottje, and from the second, Denzau, Easton, Gwartney, Block and Lawson; Jones and Stockman.

[2] The earlier conferences are chronicled in Michael Walker, ed. *Freedom, Democracy and Economic Welfare*, Vancouver: The Fraser Institute, 1988, and Walter Block, ed., *Economic Freedom: Toward a Theory of Measurement*, Vancouver: The Fraser Institute, 1991.

[3] The Table of Contents identifies at which conference the paper was given. The Banff conference was held a year before the Sea Ranch conference.