Determinants of Economic Freedom

Theory and Empirical Evidence

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FREE MARKETS

DEBT REDUCTION

FREE TRADE

TAX REFORM

LESS GOVERNMENT

DEFICIT REDUCTION

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Executive Summary

Many studies have shown that economic freedom is a major determinant of countries' living standards, economic growth, and other indicators of social and economic well-being. This paper represents an effort to understand the determinants of economic freedom in individual countries and through time through the use of the theories of public choice and of limits to its success.

The paper postulates that the level of economic freedom is the product of fights between politicians on one side, who attempt to buy votes by providing interest groups with special benefits through subsidies, regulation, and tax-breaks, and politicians on the other side, who appeal for votes by making the public aware of the cost of the policies advocated by their opponents. In order to quell opposition to vote-buying policies, their originators often hide their costs by the use of deficit financing, which passes the costs on to non-voting future generations. Inflation caused by the deficit financing often leads to the development of new opportunities for vote-buying policies from interest groups suffering from the consequences of the inflation.

In well-functioning democracies, the fight between the proponents and opponents of policies that reduce economic freedom leads to political standoffs and equilibrium levels of economic freedom. Such *equilibria* are determined by the countries' history, culture, and institutions. They are also influenced by the extent to which media keep the public informed about vote-buying policies and their costs. Since these determinants change only slowly, equilibrium levels of economic freedom tend to change at the same pace.

However, equilibrium levels can be changed more quickly through the development of new political paradigms of the government's role in the operation of the economy. Examples of such changes in paradigms are the Marxist-inspired use of economic planning, the social-democratic agenda for income redistribution and regulation, and the free-market agenda emphasizing freedom and the role of market incentives.

Such paradigms often emerge in the wake of major economic and political crises such as those that followed the collapse of the Czarist regime in Russia at the end of the First World War, which produced the Marxist revolution. The Great Depression in the United States caused American voters to elect Franklin Roosevelt, who promised voters more government activism to end the economic crisis. The stagflation in the late 1960s and early 1970s resulted in a new paradigm favouring markets that led to the election and policies of President Ronald Reagan in the United States and Prime Minister Margaret Thatcher in Britain.

New paradigms can also be forced upon governments by external forces like international organizations and financial institutions, which in recent decades attached paradigm-changing conditions for the disbursement of financial aid to Greece in 2012/13 and a number of other countries.

The empirical part of this study examines the history of economic freedom in the light of the determinants just discussed in a number of countries: high-income democracies, transitional economies, and southern European countries in crisis. Some countries were found to have been in equilibrium levels of economic freedom for prolonged periods. Changes from these levels were associated with changes in the economic paradigm and the efforts of strong political leaders acting on them. Some countries experienced slow changes in economic freedom while others had quick changes imposed on them by external forces.

The analysis of this study mainly sheds light on a subject that has been relatively neglected in the burgeoning literature around the measures of economic freedom that have entered the public domain since about 1990. One of its implications is that fights between political parties are a sign of a well-functioning democracy that should be encouraged rather than deplored. The study also implies that parties engaged in these fights should be required to support their policy proposals by benefit/cost calculations reviewed by independent agents; that media should be encouraged or even required to inform voters about party platforms in the run-up to elections; that prohibitions against deficit financing be created and enforced and that all new regulations be approved by legislatures rather than adopted by autonomous regulatory authorities.

Introduction

The Fraser Institute in Canada in conjunction with co-publishers in over 90 nations publishes an annual report entitled *Economic Freedom of the World* (EFW).[1] It presents information about the level of economic freedom existing in different countries of the world. The index is a composite measure reflecting the size of government, the country's legal structure and security of property rights, access to sound money, freedom to trade internationally and regulation of credit, labor, and business. This information relies primarily on objective information that is supplemented by survey data and other indices published by reputable organizations.

The composite index for all countries is adjusted statistically so that it falls within a range of 1 to 10: the greater the number, the greater economic freedom. The first publication of the index was in 1996. The recent Fraser Institute publications include data at five-year intervals between 1970 and 2000 and annual thereafter. The number of countries analyzed has increased steadily since the first publication in 1996 and in 2014 stood at 152. The annual publications rank countries assigning first place to the one with the highest level of economic freedom.

In 2012, Hong Kong and Singapore had the highest levels of economic freedom in the world (Gwartney, Lawson, Hall, 2014: 8). According to the International Monetary Fund (IMF, 2013) the per-capita incomes of these two countries in 2012 were the sixth and third highest in the world, respectively. Among countries in the world without significant natural resource endowments, Singapore ranks second (behind Luxembourg) and Hong Kong is in third place. At the other extreme, in 2012 the countries with the lowest per-capita incomes in the world, such as Republic of Congo, Chad, and Zimbabwe are close to the bottom of the economic freedom ranking.

The media, politicians, and academics have paid increasing attention to the data on economic freedom. Academics have used them in their explorations of the determinants of national income and other important indicators of economic and social well-being. Joshua Hall and Robert Lawson surveyed the academic literature and found 402 articles that had cited *Economic Freedom of the World*. Of these, 198 used the index published there as an independent variable in empirical studies, the results of which are summarized in the abstract found on the cover page of Hall and Lawson's review: "Over two-thirds of these studies found economic freedom to correspond to 'good' outcomes such as faster growth, better living standards, more

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1 These annual reports are available for download at the Fraser Institute's website, <http://www.freetheworld.com>.

happiness etc. … The balance of evidence is overwhelming that economic freedom corresponds with a wide variety of positive outcomes with almost no negative trade-offs" (Hall and Robert Lawson, 2013).

Given these findings, it might be expected that all countries would adopt policies that increase economic freedom to raise their economic and social well-being. Yet, while the average level of economic freedom in the world has increased, during the period for which data are available the experience of individual countries varies widely with periods of unchanged levels in some and large increases and decreases in economic freedom in others.

Of special interest is the record of the United States and its large economy. Between 1975 and 2000, it ranked between fourth and second in the world. However, after 2000 its world ranking dropped steadily and reached a low of 19th place in 2011 before it rose back to 14th in 2012. In comparison, Canada's rank fluctuated between second and eighth place without any significant trend during the years 1970 and 2012. In 2012, it was in fourth place. Croatia improved its ranking steadily from 98th in 1995 to 43rd in 2012.

The index of economic freedom is used in many empirical studies as an explanatory variable alongside traditional ones to evaluate the role it plays in the determination of economic and social indicators of well-being across countries and time. Only a relatively small number of papers consider what determines economic freedom itself. The collection of essays by Hall and Lawson (2011) contains four articles in this tradition.[2] The paper by Crampton (2011) reviews the papers that had been published before he wrote his own. A summary of his review is found in the footnote below.[3] His own study finds that in OECD countries changes in economic freedom are strongly correlated with changes in voter preferences as they are reflected in the platforms of political parties and their electoral success.

The present paper is a theoretical exercise that postulates that economic freedom results from the operation of two opposing political forces. One of these forces is described by public-choice theory and known popularly as the vote-buying practices of politicians. The other force is one identified by Gary Becker (1983), who argues that politicians can provide effective limits to the ability of their opponents to buy votes by pointing to the cost these policies impose on them, even if these costs are relatively small for each citizen.

The policies resulting from vote-buying usually cannot be justified on the grounds of economic efficiency but typically politicians claim them to be needed for many different reasons, including the need to protect producers and consumers from foreigners, reduce the market power of firms, safeguard the environment, and

2 The papers in this collection are by Eric Crampton (2011); Walter G. Park (2011); Benjamin Powell and Matt E. Ryan (2011); and Lauren R. Heller (2011).

3 "De Haan and Sturm (2003) argue that increases in measures of democracy predict increases in economic freedom in developing countries. Heckelman (2000) finds that economic growth may precede the 'government intervention' component of the Heritage Foundation's economic freedom index, but that, on the whole, economic freedom precedes growth. La Porta, López-de-Silanes, Pop-Eleeches and Shleifer (2004) find English forms of judicial independence and common law structures correlate with higher economic freedom" (Crampton, 2011: 132). References in this note have been updated and are found in the reference section of this paper.

create a more equitable distribution of income. The policies required to produce these alleged benefits lead to changes in taxation, spending and regulations that show up as reductions in economic freedom.

Limits on vote-buying in democracies comes from opposition politicians who gain votes by calling attention of the electorate to the cost of the vote-buying policies and to the fact that benefits accrue to a few members of interest groups only. Success in this endeavour is facilitated by the fact that only a rather small proportion of the general electorate has to be persuaded that the proposed policies reduce their well-being and that it is in their interest to vote against politicians who propose them.

The two opposing forces tend to create levels of economic freedom that may be considered to be in equilibrium and remain relatively stable through time. These levels are different for each country and are determined by history, culture, and economic and social institutions, as well as the nature of the economic paradigm about the general role of government in the economy and society that dominates the views of the electorate. Just as these national characteristics tend to change only slowly, the equilibrium levels often remain unchanged for prolonged periods of time.

However, the equilibrium levels of economic freedom can change rapidly when new and often radical political and economic paradigms about the role of government are developed and accepted by the population. Such new paradigms often appear after countries or the entire world have experienced severe economic crises or ended costly military conflicts. Increases in economic freedom in the wake of such crisis and accompanying shifts in paradigms have taken place in Britain under the leadership of Prime Minister Margaret Thatcher and in the United States under the aegis of President Ronald Reagan.

Dramatic decreases in economic freedom took place in the first half of the twentieth century when the countries of the former Soviet Union, China, and India embraced the Marxist and socialist paradigm and replaced markets with economic planning. While no data exist to record the detrimental effects economic planning had on economic freedom and economic performance in these countries, the change to the market paradigm and the adoption of market policies near the end of the twentieth century are fully reflected in growing levels of economic freedom.

The dramatic decrease in the economic freedom ranking of the United States since 2000 under the presidencies of both George W. Bush and Barack Obama may reflect a persistent shift of public preferences towards more government intervention in markets and the distribution of income. The emergence of the Republican Party with majorities in the House and Senate in the Congressional elections of 2014 may signal that this shift has not been persistent. However, only time will reveal the voters' persistence in their ideological preferences in the longer run.

Chapter 1 discusses in greater detail the forces that lead to vote-buying policies that determine the level of economic freedom in individual countries. The predictive power of this theory of the determinants of economic freedom is evaluated in chapter 2 in the light of data on economic freedom in several important countries. Chapter 3 presents a case-study of Greece's economic performance in the light of policies that affected its economic freedom and that were influenced by membership in international organizations and by democratic elections. The concluding chapter 4 considers the policy implications resulting from the preceding analysis.

1 Explaining Levels and Trends in Rankings

Until the 1960s, conventional wisdom was that government spending, subsidies, and regulation are needed to provide public goods and correct market failures to create efficiently operating market economies. This wisdom included the notion that these government policies were initiated by politicians upon the advice of technocrats who were fully informed about the resultant economic and social benefits and costs. Furthermore, it was assumed that the policies were administered by civil servants who were technicians and operated without motives other than their efficient implementation.

This conventional wisdom was shattered by new theories and empirical evidence first published in the 1960s and 1970s. James Buchanan,[4] Gordon Tullock,[5] and Mancur Olson (1965) pioneered Public Choice Theory, which questions the view that politicians are only motivated by their desire to serve the public interest. The theory postulates that politicians often propose and initiate spending and regulatory programs that are not in the public interest and lower welfare in order to buy electoral support from groups of voters benefitting from them. William Niskanen (1971) showed that the implementation of policies often is influenced by the ability of civil servants to provide politicians with biased information that results in the inefficient expansion of spending programs but increases the incomes and power of the civil servants. Alfred Kahn (1970) and George Stigler (1971) showed that regulations often result in unexpected changes in the behaviour of the regulated industries that generate inefficiencies and that regulatory agencies often are captured by the representatives of the regulated industries who shape policies that benefit the industries at the expense of the public.

The costs of vote-buying through these policies may be expected to mobilize forces to prevent them. Public Choice Theory argues that this is unlikely to happen because typically these costs tend to very small for each voter and therefore the voters have little incentive to fight these policies, or even inform themselves about their nature. Their voting decisions instead are dominated by bigger economic and political issues. In addition, these costs often are hidden from the public or minimized

4 Buchanan (1968) contains a collection of essays explaining his most important ideas on the relationship between politics and economic policy, including one of his earliest contributions (1954).

5 The book co-authored by Gordon Tullock and Buchanan (1962) reveals the ideas on public choice both authors had developed at the time.

by the populist rhetoric of politicians. Importantly, in many cases politicians take advantage of the opportunity to avoid tax increases to pay for their vote-buying policies and the resultant loss of votes by incurring budget deficits, which in effect pass the cost on to non-voting future generations who will have to service the debt.

The use of deficits to finance vote-buying policies imposes additional costs on the public if the countries' central banks buy the government obligations with newly printed money, as they often have done. The resultant inflation gives rise to a wide range of problems such as the effects it has on real wages, imbalances in international payments, and the diversion of savings into non-productive investments.

To deal with these problems, governments use policies that reduce economic freedom such as the imposition of wage and price controls; the granting of subsidies or regulatory protection to industries made non-competitive by the inflation; public investments in industries starved of funds by the flight of private capital into inflation-proof assets; lax enforcement of tax codes to permit voters to escape their effective rates of taxation caused by inflation; and the progressivity of the income tax rates.

All of the policies stemming from vote-buying by politicians, the pursuit of self-interest by civil servants, and the actions of employees of captured regulatory agencies reduce economic freedom and lower economic efficiency and growth. Economic freedom is further reduced through the enactment of policies designed to deal with the consequences of inflation. However, given the nature and strength of these forces, the question arises why they do not dominate economic and political processes and lead to an ever decreasing level of economic freedom?

Limits on vote-buying

The answer to this question is that the ability of politicians to buy votes is limited through a process described by Gary Becker (1983), who argues that in well-functioning democracies opposition parties attempt to expose the costs of vote-buying policies to the public and court their votes with the promise to prevent them from enactment. These efforts can easily be successful because only a relatively small percentage of all voters have to switch their votes to the opposition to match or exceed the gains made by the politicians who promise the vote-buying policies.

For example, consider a policy that benefits an interest group, which guarantees the delivery of 3% of the total vote to the political party proposing it. Under these conditions, opposing politicians need to persuade only about 4% of the remaining 97% of the electorate to vote for them to neutralize the benefits of the vote-buying proposal. The ability of opposition politicians to expose the nature and cost of vote-buying policies thus represents an effective direct restraint on politicians. It also influences the shape and cost of proposed policies since politicians must always be concerned with the success of the opposition to expose flagrantly self-serving and costly policies.

The success of opposing parties' efforts to restrain vote-buying politicians differs from country to country. It is greatest in countries where history has created cultures and public attitudes that lead to widespread concerns over the role of big government, burdens on future generations, and the costs of dealing with inflation.

On the issue of big government, for example, Americans have long been known for their opposition to policies that increase the role of government in their lives. This cultural characteristic stems from the experience of early immigrants and

settlers, who had fled the heavy hand of European governments and found prosperity under limited government and its high level of economic freedom. Germans strongly oppose deficits and inflation because of the collective memory of the economically and socially devastating effects of the hyperinflation of the 1920s, which was caused by their central bank's creation of excess amounts of money needed to pay for the bonds issued by the government to finance the deficits.

In Sweden, unemployment, disability, and health insurance programs are relatively generous but have resulted in less public abuse than could be expected in comparison with other countries. The explanation of this phenomenon is found in the country's geography and history. Cold and long winters in the mostly rural nation led Swedes to practice cooperation and mutual assistance that obviously brought benefits to all at risk while the closeness of members of the community prevented abuse of its generosity. These values and practices still exist in the large settlements of recent history and limit the abuse of generous public social programs.

Equilibrium and changes in paradigms

The preceding analysis suggests that in well-functioning democracies there is a constant battle between politicians who wish to buy votes and who oppose their efforts.[6] When these forces are of equal strength, the standoff prevents changes in the levels of policies that were bought and the country's resultant level of economic freedom. These levels may be considered to represent equilibrium. They are different for every country and depend on the history and culture in each. Since national cultures tend to change only slowly, equilibrium levels of economic freedom normally also rise or fall only slowly.

However, these equilibria can be disturbed and lead to significant decreases or increases in levels of economic freedom over relatively short periods of time if new paradigms about the role of government enter the public domain and influence perceptions of its role in the allocation of resources, the shape of the income distribution, the protection of the environment, the mitigation of climate change, and other externalities. These changes in paradigms allow politicians to argue successfully that certain vote-buying policies bring great benefits, which blunts the ability of political opponents to oppose them. Changes in paradigms can lead to either reductions or increase increases in economic freedom.

During the twentieth century, the development and widespread acceptance of the Socialist, Fascist, and Marxist ideologies has led to many policies that decrease economic freedom. Large proportions of the populations in many countries of Western Europe and in North America embraced the socialist paradigm after they had experienced the devastating effects of the Great Depression of the 1930s and the Second World War. The ideas of John Maynard Keynes and interpreters of his views about the inherent flaws of market economies provided much of the intellectual basis for this change in the dominant public view on the role of government in the postwar period.

6 The paper by Crampton (2011) noted above provides insights into, and empirical evidence for, how the election campaign documents of political parties present voters with information that influences their decisions so that election results tend to reflect public preferences for and against vote-buying policies.

The new public views allowed "progressive" politicians to buy votes by introducing social programs, increased regulation, strong income-redistribution policies and public ownership of business. However, these policies in most countries did not lead to one of the corner-stones of socialism, the public ownership of all means of production. The resultant mixed system is known as social democracy, which presently dominates policies in all developed countries in Western Europe and elsewhere.

In Germany, the public acceptance of socialist ideals during the 1930s did not lead to social democracy even though Adolf Hitler's party famously called itself the "national socialist party of Germany". After gaining power through elections, Hitler instead based economic policies on the fascist model, which venerated the ability of the state and outstanding leaders to serve the national interest and create a strong economy. It introduced some social welfare programs but primarily used planning and coercion to reduce unemployment, build large infrastructure facilities, and encourage the expansion of middle-sized enterprises and large industrial firms capable of producing weapons.

While Hitler's fascist regime enjoyed substantial success in reducing unemployment and raising economic growth, it engaged in many policies that reduced economic freedom. It used what today is known as "cronyism" to favour large enterprises, protect them from foreign competition, and employ their productive prowess to equip its growing army, which in 1939 was used to start the Second World War. The regime also corrupted the judicial system and violated property rights of the entire population but especially of racial and ethnic minorities.

Marxism has been the most radical and costly change in economic and social paradigms in modern times. It was adopted by leaders in several countries, the most important of which were Russia and China. Leaders in these countries did not come to power through democratic elections but through violent revolutions. The dictatorships established by these leaders used economic planning and complex administrative incentives to pursue the Marxist ideals of the public ownership of the means of production and equality of incomes for all inhabitants.

This is not the place to describe the sordid history of Russia, which includes its conquest of neighbouring countries and led to the formation of the Soviet Union of Socialist Republics; its use of brutal coercion symbolized by the actions of its secret policy and the operation of Gulags; its failure to create income equality because it bought the political support of small political elites through the secret provision of large economic benefits to them; and its creation of a powerful military to back efforts to spread Marxism to the rest of the world. China's policies inspired by Marxist ideology were similar to those of Russia, except that they mostly affected its own population and devoted much less effort to exporting Marxism to rest of the world. While empirical data do not exist, there is no doubt that economic freedom in both of these large and populous countries reached very low levels. The resultant economic stagnation powerfully supports the view that economic prosperity is an increasing function of economic freedom.

Counter-revolutionary change in paradigm

Starting in the late 1960s, in all countries that had adopted strong socialist and Marxist policies, public opinion turned against the policies destructive of economic freedom that they had created. This change was driven partly by poor economic

performance, inflation, and dissatisfaction with the loss of political and economic freedom. It was also driven by the publication of papers extolling the superiority of free-market economies, which were written mainly by economists from the Austrian and Chicago Schools and the neoconservatives living primarily in New York. Independent think tanks like the Heritage Foundation and the CATO Institute in the United States, the Institute of Economic Affairs in England and the Fraser Institute in Canada did much to create and distribute these views to large audiences.

The renewed public acceptance of the free market prepared the ground for the election of President Ronald Reagan in the United States and of Prime Minister Margaret Thatcher in Britain. They both acknowledged the influence these conservative writers and think tanks had on their legislative programs, which led to substantial increases in economic freedom. Over the last two decades of the twentieth century in the Soviet Union and China, leaders emerged who abandoned the Marxist paradigm and adopted many free-market policies.

Paradigm changes can also be caused by outside interventions in domestic politics and polices when countries require financial assistance from abroad. For example, the International Monetary Fund (IMF) has a long record of making the receipt of financial assistance by developing countries conditional upon the adoption of policies that encourage competitive markets and economic freedom. Much the same conditions have accompanied the distribution of aid to Greece by the IMF and the European Economic Community.

2 The History of Economic Freedom in Selected Countries

This chapter attempts to explain observed levels of economic freedom in a number of countries by considering the forces just described theoretically as determining them. Before turning to this task, it is important to note that the publications reporting economic freedom do so by giving for every country both its level of economic freedom and its ranking amongst the countries of the world included in the index. The media and most commentators tend to report and discuss rankings rather than the levels, mainly because the rankings are easier to relate to and do not require abstract discussion of the components used to construct the levels. For this reason, rankings are also used to report on such indices as ease of doing business, corruption, political freedom, longevity, and happiness, which are published regularly by think tanks and national and international organizations. Rankings of economic freedom have an added advantage over levels because they reflect a country's ability to compete on a global scale for foreign capital and immigrants, which expect returns to be greater in countries with high rather than low levels of economic freedom.

In this context, it is interesting to note that changes in levels and rankings of a given country for economic freedom can provide seemingly contradictory information. Thus, a country's level of economic freedom can increase while its ranking drops. This event occurs when a country's increase in economic freedom is less than that of countries with similar levels. The following analysis considers mainly levels of economic freedom but also rankings when they can add to the understanding of the forces determining economic freedom.[7]

The analysis will be applied to events in three groups of countries. The first group consists of the United States, Germany, Canada, and the United Kingdom, which are industrial countries with some of the highest levels of income and economic freedom in the world. The second group consists of three economies in transition, Russia, Georgia and Croatia, which, since the break-up of the Soviet Union had moved from planned to market economies and improved their levels and rankings significantly. The last group is made up of Greece and Spain, which experienced serious financial crises in the wake of the Great Recession that started in 2008.

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7 The following analysis, except where otherwise noted, uses the chain-linked economic freedom index, which is the most appropriate to examine changes over time. *Economic Freedom of the World* contains both the chain-linked and an unadjusted index, which is the most appropriate to compare nations at a single point in time.

In considering the data presented in the charts below, it is important to note that they are in five-year intervals for the period 1970 to 1990 and annual only thereafter. The early data covering five-year snapshots are the only ones available and are likely to hide some interesting annual changes but, since all countries in the sample are subject to this problem, inter-country comparisons remain relevant.

High income democracies

Figure 1 shows a remarkable similarity of levels of economic freedom in Canada, Britain, the United States, and Germany in the years 2010 to 2012. However, the developments through time reveal some interesting differences among these countries. Most striking is the increase in Britain's levels from 5.8 in 1970—the lowest by far appearing in the graph—to a high of 8.5 in 2000. This strong improvement in Britain's level is explained by a change in paradigm from the country's devotion to socialism after the Second World War to the spread and wide acceptance of free-market principles by the public and politicians. Prime Minister Margaret Thatcher, who was the in power from 1979 to 1990, forcefully led the implementation of the free-market policies that enhance economic freedom. However, the data show that the change had started before she was elected and continued for a decade after she left office.

Between 1970 and 2000, the United States experienced a similar though less pronounced upward trend in the levels of economic freedom. President Ronald Reagan, who was in office from 1981 to 1989, did much to advance economic freedom. After he left office, his ideas and policies continued to play an important role in the continued increase in economic freedom, which in 2000 reached an historic peak of 8.7.

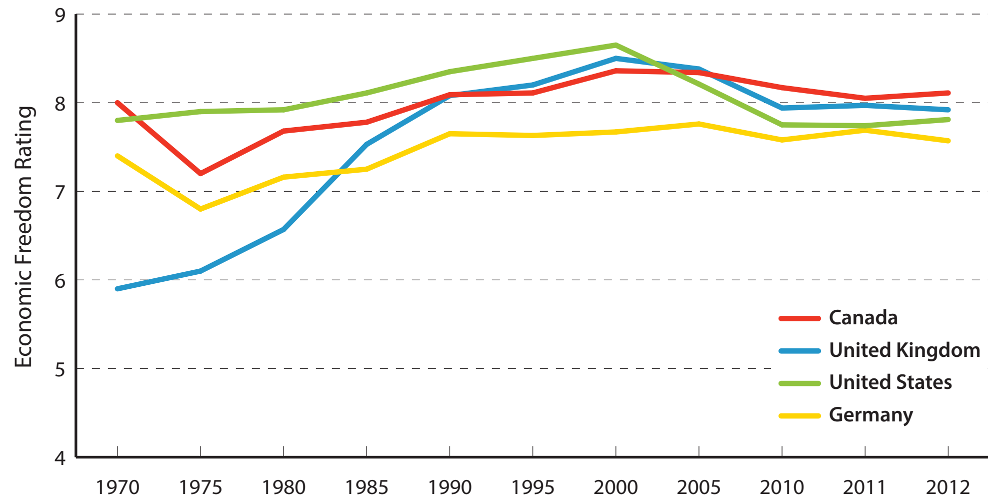
The figure shows that after 1975 economic freedom in Canada also increased at nearly the same rate as the United States, though the level was about .3 point lower on average. The increase was due to the rise in economic freedom in the United States and the historically close economic relationship and commonality in policies between the two countries. The growth in economic freedom was assisted by efforts of the newly founded Fraser Institute, which through its research and publications informed the public about the merit of market-based policies in the Canadian context.

These policies in Canada were initiated in large part by Prime Minister Brian Mulroney, who was in office during the years from 1984 to 1993, and are symbolized by the signing of the North American Free Trade Agreement, the privatization of many crown corporations, the introduction of an efficiency-increasing value-add tax, and the use of tight monetary policy to deal with damaging levels of inflation. However, the Mulroney government failed to deal with large budget deficits.

The elimination of this deficit was the focus of the election platform of the newly formed Reform Party, which in 1993 enjoyed a significant and unexpected electoral success resulting in its becoming the unofficial opposition in parliament.[8] This success signalled that the people of Canada shared the party's concern with the deficit and influenced the governing Liberal Party in 1995 to adopt a budget that for the

8 The official opposition was the Party Quebecois, which had won one more seat than the Reform Party but whose role in parliament was blunted by its agenda to force the creation of a separate and independent Quebec.

Figure 1: Levels of economic freedom, high-income countries, 1970–2012



Source: Gwartney, Lawson, and Hall, 2014. Data and publication: <http://www.freetheworld.com/release>.

Note: The indices are chain-linked to obtain the most reliable time-series information.

first time in Canadian history cut the existing level of spending. It also led to the enactment of a number of policies favourable to economic freedom that had been advocated by the Reform Party and previously shunned by the traditional parties.

The downward trend after 2000

The figure reveals a significant downward trend in the levels of economic freedom in the United States from its second place in 2000. During the eight years of George Bush's presidency, the country was in fifth place on average and had its lowest rank of seventh in 2007. In 2008, at the start of President Barack Obama's administration, the United States ranked in eighth place. However, after the start of the Great Recession the rank dropped to 14th in 2009, 16th in 2010 and 19th in 2011. In 2012, the United States had recovered to 14th place.

The cause of decrease in the ranking of the United States for economic freedom has been in part the recessions in 2001 and 2008 but it may also reflect a shift of public views towards favouring greater reliance on government policies in place of free markets to determine economic processes and the distribution of income. This shift allows the use of many vote-buying policies that are justified in the name of improving economic and social conditions for the general population. President Barack Obama's first election campaign was based on the vague promise of "change" combined with criticism of past government policies that implied his commitment to this paradigm. Many of the policies unfavourable to economic freedom that were put in place during the first six years of his presidency have reflected his and his party's ideology, which resembles much that prevailing in Europe.

According to Gwartney, Lawson, and Hall, the most important contribution to this decline between 2000 and 2010 stems from a 2-point decrease in the component of the index reflecting the Legal System and Protection of Property Rights. The authors specifically mentioned "the increased use of eminent domain to transfer property to powerful political interests, the ramifications of the wars on terrorism and drugs, and the violation of the property rights of bondholders in the bailout of automobile companies" (2012: 17). Reductions in overall economic freedom

were also caused by declines in ratings for the Freedom to Trade of Internationally, increases in the number of Regulations, and the greater Size of Government. Most of these changes took place during Obama's administration.

The violation of property rights may be seen to have been motivated in part by the ideologically driven desire for the redistribution of income. The lowering of freedom to trade are attributable to greater efforts in the war on terrorism and drugs that had been started before Obama took office. The increase in regulation through passage of the Dodd-Frank Act (U.S. Senate Committee on Banking, Housing, and Urban Affairs, 2010), which imposed on financial institutions many new regulations and reporting requirements liable to reduce economic freedom, has been driven by the ideologically based distrust of free financial markets and the disregard of the role played by government policies in the creation of the financial crisis. Similarly ideologically driven was the dramatic increase in regulations designed to protect the environment and prevent climate change. The Affordable Care Act was designed to reform the US healthcare system so that health insurance would be available to all Americans at rates and under conditions similar to those available in the social-democratic countries of Western Europe.

The expansion of government, also liable to reduce economic freedom, was caused in part by the mandated increases in government spending relative to national income on social programs like unemployment insurance and food stamps, but also by stimulus spending considered necessary for a quick economic recovery. This spending, some of which is likely to remain in place once the economy has recovered, went to finance public works projects, increased subsidies to education, more generous unemployment insurance benefits and the bailout of automobile manufacturers and financial institutions. This expansion of government is consistent with Obama's social-democratic views on its role in the allocation of resources and the distribution of income.

The election of President Obama and the adoption of the policies just discussed may be interpreted as a manifestation of the electorate's acceptance of the social-democratic paradigm he promoted during the election campaigns. The public had been primed for this acceptance by the spread of much news about the alleged ways in which private economic activity is damaging the environment, threatening human health, and causing climate change and the depletion of natural resources, news distributed by a new crop of skillful advocates with the help of new means of communication like Facebook, Twitter and other social media.

What will be the fate of the new paradigm? It is uncertain. On the one hand, voters in the 2014 Congressional elections handed the Democratic Party and President Obama a major defeat. The interest groups benefiting from Obama's policies obviously have been outnumbered by voters dissatisfied with the policies enacted during the preceding six years. However, it remains to be seen whether US policies will be changed and economic freedom will be increased again. After all, the drop in the US rankings started under the Bush administration and politicians in the future might be able to find more votes with promises of policies that would reduce or increase economic freedom.

Germany's increase in economic freedom

Returning to the data in figure 1, it can be seen that Germany increased its economic freedom between 1975 and 1990, suggesting that it had embraced the new market paradigm just like the other three high-income countries. However, Germany's peak level of economic freedom never reached that attained by the other countries, probably

because the German public's strong commitment to the "social market economy" model, which shaped policies in the immediate postwar years under the leadership of Chancellor Konrad Adenauer and the Minister of Economics, Ludwig Erhard and has been credited with the creation of an "economic miracle". This commitment prevented the emergence of a strong leader like Thatcher or Reagan and resulted in the country's relatively low levels of economic freedom throughout the 1980s and 1990s.

These low levels were the result of important policies that had been inspired by the commitment to a social market economy. Germany had very rigid labour markets supported by legislation protecting the rights of workers. It had very generous social insurance programs and strong unions with the power to influence national wage rates and the policies of privately owned enterprises.

In 2002, Germany embarked on a remarkable agenda for changes in these policies, which presumably has been inspired by the new market paradigm that had gained ground in the other high-income countries. The changes were initiated by Chancellor Gerhard Schroeder who had appointed a commission to study the problems caused by Germany's heavily regulated labour markets. The commission was headed by Peter Hartz and recommended a set of "innovation modules", which were implemented gradually in stages called Hartz I–IV between 2002 and 2005.

These reforms raised Germany's economic freedom at a time when economic freedom in the other high-income countries decreased. It also has been responsible for contributing a great deal to Germany's superior economic performance during the global Great Recession that had started in 2007/08. Unfortunately, after 2006 the country's economic freedom dropped again slightly. Between 2000 and 2012, it averaged 7.6 with only small annual deviations from that level, suggesting that this average is Germany's equilibrium.

It is interesting to note that from 2009 to 2012 all four countries shown in figure 1, the United States, Britain, Canada and Germany had attained remarkably similar levels suggesting the existence of common, shared views on the optimal level of economic freedom in their countries.

High-income countries and rankings for economic freedom

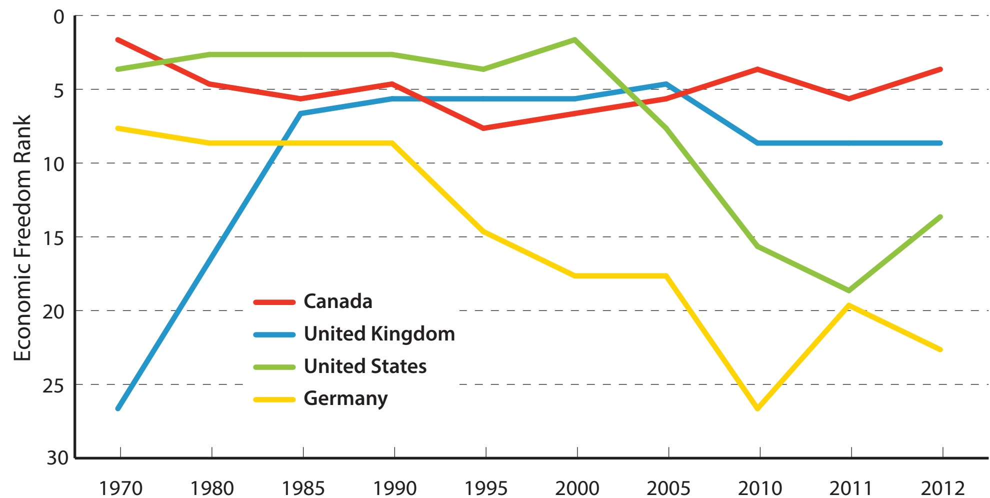
The data presented in figure 2 show the world rankings of the four high-income countries for the period from 1970 to 2012, which were influenced not just by changes in the levels in each country but also changes in countries whose values were similar. Thus, while between 2000 and 2012 levels of economic freedom in the United States dropped from 8.65 to 7.74 (10%), its ranking fell from second to 19th place because, during this period, competing countries with very similar levels had experienced smaller reductions or even increases in economic freedom.

Transitional economies

The levels of economic freedom of three transitional economies are shown in figure 3. The data are limited to the years after these countries adopted market economies and credible, relevant national data were published. For Russia and Croatia the starting date is 1995 and for Georgia, 2005.

Figure 3 shows Russia's level of EF in 1995 at 4.3 and Croatia's at 5.0. In comparison, during that year the level of high-income countries averaged 8.1 and ranged between 7.6 and 8.5. The relatively low levels of economic freedom in these

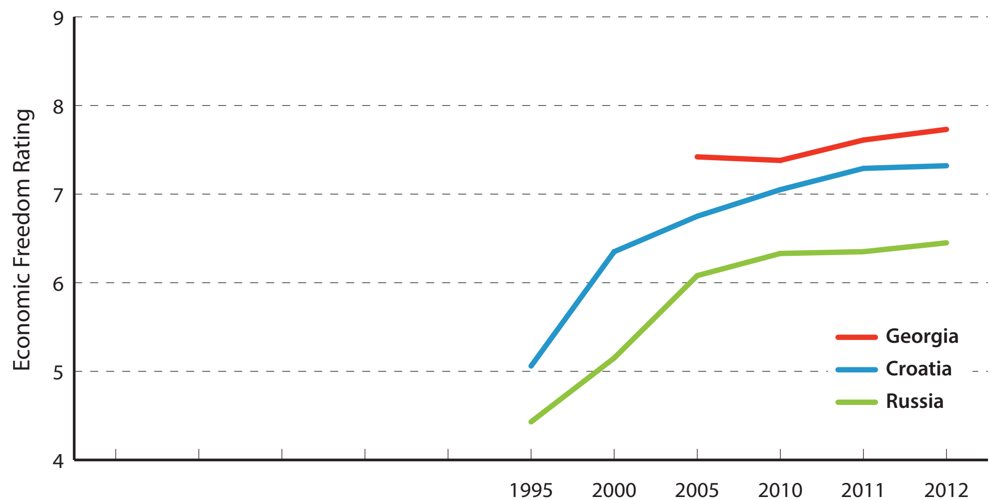
Figure 2: Rankings for economic freedom, high-income countries, 1970–2012



Source: Gwartney, Lawson, and Hall, 2014. Data and publication: <http://www.freetheworld.com/release>.

Notes: [1] The indices are chain-linked to obtain the most reliable time-series information. [2] Rankings in the figure differ from that shown in Exhibit 1.2 of *Economic Freedom of the World: 2014 Annual Report*, which shows the United Kingdom and the United States tied in 12th place. Exhibit 1.2 displays the unadjusted ranking and this figure the chain-linked ranking. Both methods are used and reported in *Economic Freedom of the World*.

Figure 3: Levels of economic freedom, transitional economies, 1995–2012



Source: Gwartney, Lawson, and Hall, 2014. Data and publication: <http://www.freetheworld.com/release>.

Note: The indices are chain-linked to obtain the most reliable time-series information.

transition economies are explained by the fact that they had just emerged from a pervasive system of economic planning, which operated with extremely low levels of economic freedom. The switch from the economic planning to the market paradigm resulted in the rapid rise in economic freedom between 1995 and 2006 shown in the graph. Thereafter, the levels remained unchanged, suggesting that these countries may have reached equilibrium at 6.45 in Russia and about 7.32 in Croatia.

Georgia's index was first calculated for the year 2005, when at 7.42 it was better than the indices of Croatia and Russia. It then fell slightly to 7.23 in 2010 and

rose in the following two years to 7.61 and 7.73. This level in 2012 put Georgia in 16th place in the world ranking, only 2 places below that of the United States in 14th place.[9]

Georgia's improvements in EF levels and rankings have been achieved in a process well described in an article by Neil Emerick and Gia Jandieri:

> [In 2003,] a reform government was elected in what came to be known as the "Rose Revolution". The new government … decided radical reform of the business environment was required … The priorities for … reform included liberalising the tax system, deregulation, making the process of starting a business easier, high-speed privatisation and public-sector reforms that included eliminating corruption, lowering the number of state agencies and downsizing the rest.
>
> In the area of tax reform, personal income tax was decreased from 20% to a top, flat rate of 12%. Social taxes went from 31% to 20% and were then abolished. Value-added tax was lowered from 20% to 18%. Corporate tax was reduced to 15%, while dividend tax came down to 5%. The total number of taxes was reduced from 22 to six. In 2011, Georgia adopted the *Economic Liberty Act*, which prohibits government spending of more than 30% of GDP, a budget deficit of more than 3%, and public debt of more than 60% of GDP. Impressive reforms were made at customs. All procedures were simplified to allow importers to cross the border in a few hours, while most tariffs were eliminated. Top rates were brought down from 32% to 12%, with the average tariff rate at 1.3%.
>
> In 2005, the government adopted enabling legislation for business licensing, competition, labour, electricity production and supply. More than 800 licences and permits were abolished. New rules of competition prohibited any governmental intervention that would result in artificial monopolies. Legislation in the energy sector allowed for vertical integration, unregulated pricing, and unrestricted export opportunities. In health, the government eliminated most licences, allowed for a total opening of the market to medicines produced and licensed in nations of the Organisation for Economic Co-operation and Development, and removed restrictions on vertical integration in the industry.
>
> Production of medicines was also deregulated, supporting the sector's development and competitiveness. The result of the reform saw the total number of health-sector companies increase 10 times, while the number of chain pharmacies increased from three to six. Last year, the Curatio International Foundation survey found standard treatment prices were 50% to 60% lower than in 2009.
>
> Drastic steps were taken to root out corruption in the public sector. The Georgian government fired thousands of corrupt officials and, in an amazing singular political event, fired its entire police force of 40,000, completely abolishing the

9 The data for Georgia cover too few years to allow the construction of a chain-linked index so that the comparison with the chain-linked indices for Croatia and Russia introduces a measurement bias, which however is likely to be small and does not affect the general conclusion that Georgia's economic freedom is significantly above that of Croatia and Russia.

> traffic department. About 15,000 officers were gradually hired back after investigation and interviews. Zero tolerance towards crime and corruption has helped Georgia become one of the safest countries in the world.
>
> In 2004, economy minister Kakha Bendukidze announced full-scale privatisation, saying: "We are going to sell everything except our honesty". Georgia sold the ports to private companies, which were allowed to sell them on. The entire telecommunications industry was privatized, along with the energy and distribution sector. Most hospitals were placed in private hands, along with public buildings, which the government leased back on the outskirts of cities rather than in the centre. Land privatisation included law amendments eliminating discrimination in certain types of land ownership. Public servants were cut from 400,000 to 280,000.
>
> The results of the "Rose Revolution" are impressive. In terms of economic growth, real GDP doubled between 2004 and last year (8% year on year), while average salaries quadrupled. The number of registered companies went from 50,000 in 2003 to 400,000 last year. Bank deposits increased eightfold, renewing trust in the financial sector ... Despite the lower tax rates, total tax collected went up tenfold. (Emerick and Jandieri, 2013)

This account of the reform policies enacted by Georgia shows how a government can improve its economic freedom quickly and decisively, which can be a useful guide for other countries whose governments want to improve the well-being of their citizens.

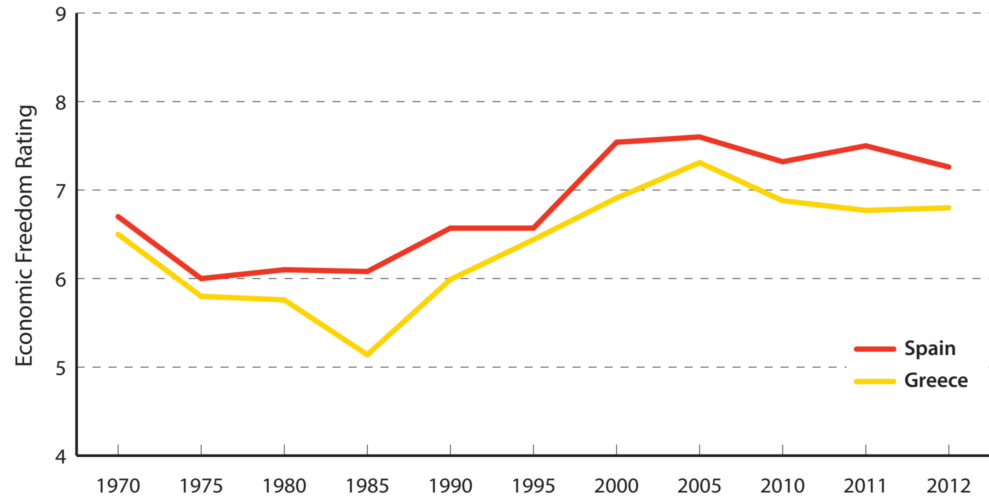
Southern European countries in crisis

Figure 4 shows the levels of economic freedom in Greece and Spain, two countries that experienced serious financial crises, high unemployment rates, and declining national income after the start of the Great Recession at the end of 2007.

Greece in 1985 had a level of 5.1, which indicates that economic freedom in that country was close to that found in some of the planned economies of the Soviet Union shortly after they switched to policies derived from the market paradigm. For example, Croatia in 1995 had a level of 5.0. However, as can be seen, the level of economic freedom in Greece increased rapidly over the following 18 years until it reached a plateau at 7.4 between 2003 and 2007. After the onset of the global recession in 2007, the level fell and slowly fell to 6.8 in 2012. Spain's record of economic freedom followed much the same pattern as that of Greece, though the levels always were about one point higher in all years.

Figure 5 shows the world rankings, which convey a somewhat different story from that indicated by the levels found in figure 4. Thus, during the years 1985 to 2003, Greece's ranking improved much less than its levels did. After 2003, its rankings fell consistently even during the period from 2003 to 2007 when its level of economic freedom was constant. This difference in the pattern of ranking and level is a result of the fact that, especially during the latter period, economic freedom in other countries with similar levels improved more than it did in Greece.

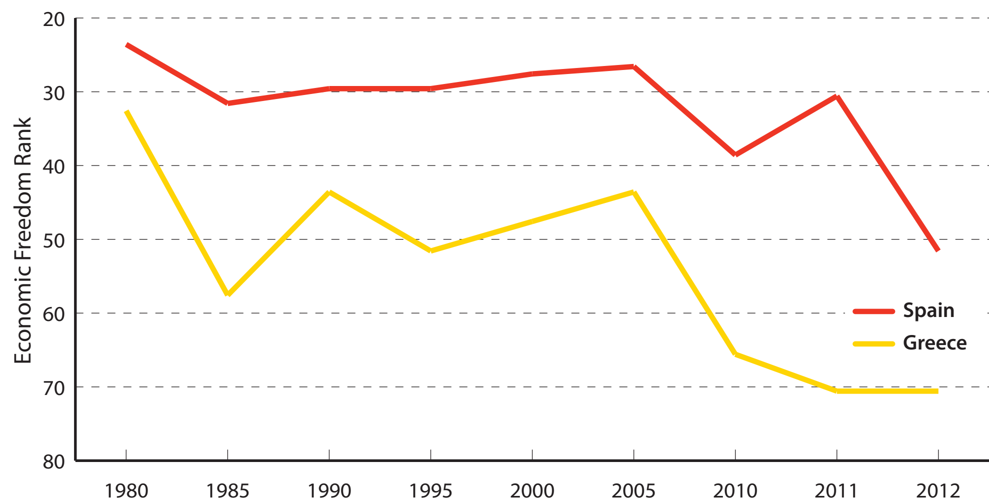
Figure 4: Levels of economic freedom, Southern European countries in crisis, 1970–2012



Source: Gwartney, Lawson, and Hall, 2014. Data and publication: <http://www.freetheworld.com/release>.

Note: The indices are chain-linked to obtain the most reliable time-series information.

Figure 5: Rankings for economic freedom, Southern European countries in crisis, 1980–2012



Source: Gwartney, Lawson, and Hall, 2014. Data and publication: <http://www.freetheworld.com/release>.

Note: The indices are chain-linked to obtain the most reliable time-series information.

A very similar pattern of rankings exists for Spain before 2007. However, the drop after 2007 is less pronounced than Greece's for two years and thereafter Spain's ranking improved until 2011 while that of Greece continued its decline.

Both countries in 2012 had rankings for economic freedom in the middle range of all countries in the world and near the bottom of Western democracies. In that year, Greece ranked 71st and Spain 52nd, while Canada ranked fourth, the United States 14th, Germany 23rd, and Georgia 16th.

3 A Case Study of Economic Freedom in Greece

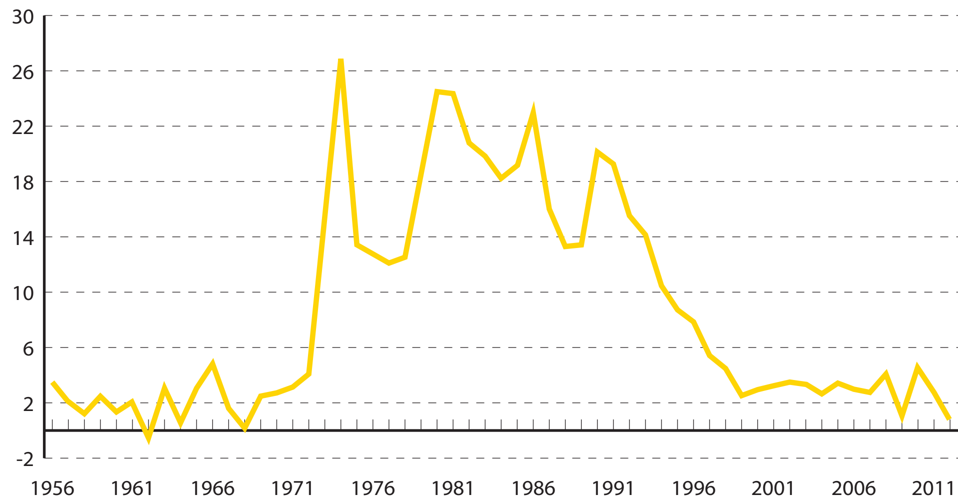
In the years from 1944 to 1967, Greece had 33 Prime Ministers and experienced a civil war that pitted the democratically elected government against a self-appointed communist government. During this period, the entire country and the economy were in turmoil. In 1967, a military government was formed. Like military regimes everywhere, it used planning, regulations, and controls to restore economic and civil stability, which produced the steep reductions in economic freedom after 1970 shown in figure 4 and figure 5.

The military ceded power to democratic forces in 1974 when the Third Hellenic Republic was established. The early governments of this Republic continued the policies that had started under the military regime and lowered economic freedom, but justified them by reference to the social-democratic paradigm for the organization of the economy. Konstantinos Karamanlis, who had been prime minister from 1974 to 1980, had led the implementation of many of these policies. Andreas Papandreou, who was prime minister from 1981 to 1989, continued with this policy trajectory with the backing of the Panhellenic Socialist Movement (PASOK) party, which he had founded in 1974.

The social-democratic policies enacted during the regimes of Karamanlis and Papandreou brought about a substantial expansion of the public sector; the nationalization of many important private firms such as Olympic Airways and the Emporiki Bank; the creation of a National Health System; and significant increases in the power of unions and their right to strike. All of these policies reduced economic freedom directly while the fiscal deficits and inflation that developed during this period did so indirectly. These deficits were financed with newly printed money, which led to the record of inflation shown in figure 6. As can be seen, modest price increases existed between 1956 and until the early 1970s. Thereafter, high rates of inflation started and lasted for about 20 years, mostly when Karamanlis and Papandreou were in office. During the early 1990s, the rate of inflation declined and by 1999 had reached the same levels that existed in the countries that were members of the European Economic Union.

An earlier version of this chapter appeared as Grubel, Herbert (2013). Will Greece Go Bankrupt and Kill the Euro? *Procesos de Mercado, Revista Europea de Economia Politica* 10, 1 (Spring): 65–90. Reprinted with permission.

Figure 6: Greece, historic inflation rate (CPI, % p.a.), 1956–2012



Source: Greece Inflation Rate Historical Chart, About Inflation <http://www.aboutinflation.com/inflation-rate-historical/greece-inflation-rate-historical-chart>.

The 20 years of high inflation were accompanied by the usual financial distress of the public and the misallocation of real resources. The government dealt with these problems using more policies that tended to reduce economic freedom, many of which perpetuated the inflation: wages and benefits for workers in the over-staffed civil service and nationalized industries were indexed to maintain real incomes; unions in the private sector obtained the same nominal pay increases as the public-sector workers using new powers the government had granted them; subsidies and protective regulations were used to deal with the financial problems the inflation had caused for private-sector firms; the enforcement of tax statutes was reduced to placate the many voters whose tax payments were increased by the interaction between inflation and progressive marginal income tax rates.

As figure 4 shows, the vote-buying, social-democratic policies just described lowered economic freedom for 25 years after 1970, which reached its nadir in 1985. However, after that year, economic freedom increased rapidly and inflation fell at uneven rates. By the early years of the new millennium, inflation was tamed and economic freedom remained at what appeared to be equilibrium levels until the onset of the Great Recession in 2007.

These improvements in Greece's levels of inflation and economic freedom were brought about by the efforts of the government to meet the requirements for membership in the European Union, which it had joined in 1981. It had to open its border to free trade with member countries, which led to increased price competition from abroad and the maintenance of the exchange rate. Later, as the criteria for membership in the Eurozone were developed, Greece made further policy adjustments to meet them. Greece joined the zone and adopted Euro notes and coins in 2001.

The increase in economic freedom in Greece after 1985 demonstrates the influence external forces such as the European Union and Eurozone membership requirements can have on the outcome of the continuous battles between politicians trying to buy votes and politicians opposing their efforts. The leveling of economic freedom during the years 2003 to 2007 suggest that these battles had reached a stalemate and that the country had reached its equilibrium, which ended up only slightly below that found in other members of the European Union.

However, economic freedom did not remain at this level. The development of the Great Recession starting in 2007 resulted in a severe economic fiscal crisis in Greece, which in turn led to the drop in economic freedom seen in figure 4. The main reason for the crisis in Greece is that the recession caused large fiscal deficits to develop and international lenders were demanding high-risk premiums on further credits. The higher borrowing costs threatened that the government's deficits and debt would enter into a vicious cycle destroying any possibility of its serving its debt obligations.

The effects of the recession on Greece were aggravated by the fact that its true level of deficits had been hidden through the use of misleading accounting and other administrative methods. Miranda Xafa (2012b) discusses the questionable accounting practices that were used to understate the size of the deficit. For example, the government paid large sums to the government-owned railroad, which were designated for investment. Under internationally agreed accounting rules, such investment is not considered to be contributing to current expenditures and fiscal deficits. In fact, however, the railroad used the funds to cover deficits in its operation, which otherwise would have been recorded as general government spending.

Xafa also reports on the collusion between the Greek government and international private financial intermediaries to convert expected future income streams into cash equal to the present value of these streams. Income streams used in this manner were the profits from the national lottery and development assistance provided by the European Union. The cash thus obtained was used to reduce the deficit in the years it was obtained. Thereafter, the size of the deficit increased correspondingly.

Even statistics tracking inflation were manipulated to lower rates to levels needed for gaining membership in the Euro-zone. According to available evidence (Grubel, 2013) officials replaced in the inflation index one vegetable that had higher prices with another vegetable that had stable prices so that the official increase in consumer prices was lower than it would have been if the basket of products had remained unchanged.

Developments since 2008

The severe economic and fiscal crisis in Greece that started in 2007 raised the spectre that the government would default on its sovereign debt. If that happened, other countries with large fiscal deficits like Portugal, Ireland, Spain, and Italy would face much higher risk premiums on loans they needed to finance their borrowing needs, sending them into an unsustainable spiral of larger deficits and debts. The possibility that they might exit the Euro in order to deal with these problems threatened the very existence of the common currency. In addition, European banks holding Greek debt would suffer great losses and their ability to serve credit markets would be diminshed. For example, the balance sheets of German banks would deteriorate and their ability to make loans to German firms diminished, adding to the existing recession on the Continent.

To prevent Greece from defaulting on its debt and causing the financial turmoil it would produce, the European Union and the International Monetary Fund (IMF) offered financial assistance to the government. For the present purposes of analysis, it is important that this assistance was accompanied by severe conditions concerning the government's policies on spending, taxation, privatization, and regulations. These conditions were much more binding than those associated with meeting

requirements for membership in the Eurozone. Moreover, the international lending institutions took steps to monitor the government's policies to prevent the kind of manipulation of official performance records that had marred the preceding decade.

The government of Greece accepted the conditions the lending institutions had imposed, mainly because alternative methods for dealing with the financial crisis were higher than the costs of meeting them. Xafa (2012a) discusses the costs Greece would have faced if it had exited the Eurozone, a policy that was hotly debated in the country. The exit would have brought unpredictable financial and economic problems arising from the return of the drachma. It is certain that domestic inflation and currency depreciation would have occurred with all their negative economic consequences. Most important, the exit would not have dealt with the fundamental problems that have plagued the country as a result of the vote-buying practices used by the social-democratic governments before 1985.

The slow introduction of the reforms demanded by the international lenders were opposed by the many interest groups who were about to lose the special benefits the existing policies had created for them. There were public demonstrations and protests. The political landscape was changed by the entry of new politicians, whose populist but unrealistic policy proposals attracted a substantial share of votes in national elections.

However, the political establishment led by Prime Minister Lucas Papademos and Lucas Samaras persisted in the implementation of the reforms. Some public intellectuals like Professor George Bitros and the former IMF economist Miranda Xafa in private correspondence have expressed their skepticism about the ability of Greece's political system to implement the reforms fully and noted that the reform process has been very slow.

Bitros and Xafa were right. In January 2015, the people of Greece elected a government headed by Alexis Tsipras, who was the leader of the left-wing Syriza party. The election was won on the basis of a platform that promised to disregard all of the conditions international lenders had imposed on the country. Greek voters obviously liked this promise and accepted the party's view that international lenders would continue their financial support in spite of this policy.

It will take some time to determine whether lenders will act as Tsipras had predicted. If, in fact, international lenders end their support, the government will have to default on its debt and the country will experience economic turmoil. It will have to replace the Euro with drachma. The resultant exchange rate will eventually be low enough to restore international competitiveness, reduce unemployment, and restore economic growth. It will also bring inflation and currency depreciations.

However, the retention of all of the policies, which lenders had insisted needed to be changed, will make Greece suffer from continued low levels of economic freedom and cause its economic performance to suffer correspondingly. The extent of this suffering can be appreciated by a comparison of the performance of Greece and Austria, two countries of equal size and comparable natural-resource endowment but a much different history of economic freedom.

Results of low levels of economic freedom

After the Second World War, Greece was a country with one of the lowest incomes per capita of countries that later formed the European Union (EU) and adopted the Euro. When Greece joined the EU in the early 1980s, its income was expected to converge with those of the members with higher incomes as a result of its adopting

free-market policies and the latest production technologies while the inflow of private capital and aid from the EU allowed the construction of new factories and productivity-enhancing infrastructure.

However, because of the comparatively low levels of economic freedom when the country joined the European Union, this potential was not realized. In 2008, Austria's index of economic freedom was 7.61, which placed it 15th in the world while Greece had an index of 6.95 and was in 60th place.

On the basis of the evidence discussed above concerning the positive relationship between economic freedom and economic growth, it is not surprising that per-capita income in US dollars in Greece in 1980 was 52.2% of that of Austria. By 2011, it had decreased slightly to 51.7%,[8] implying that there had been none of the expected convergence. Low levels of economic freedom had condemned Greeks to an average income that remained at one half of that of Austrians', in spite of the opportunities for improvement created by Greece's membership in the European Union.

8 Real GDP is at constant 2005 national prices (in US$2005 millions); source: <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD>.

4 Conclusion

Many studies have shown that economic freedom is a major determinant of countries' living standards, economic growth, and other indicators of social and economic well-being. This paper represents an effort to understand the determinants of economic freedom in individual countries and through time through the use of the theories of public choice and of limits to its success.

The paper postulates that the level of economic freedom is the product of fights between politicians on one side who attempt to buy votes by providing interest groups with special benefits through subsidies, regulation, and tax-breaks and politicians on the other side who appeal for votes by making the public aware of the cost of the policies advocated by their opponents. In order to quell opposition to vote-buying policies, their originators often hide their costs by the use of deficit financing, which passes the costs on to non-voting future generation. Inflation caused by the deficit financing often leads to the development of new opportunities for vote-buying policies from interest groups suffering from the consequences of the inflation.

In well-functioning democracies, the fight between the proponents and opponents of policies that reduce economic freedom leads to political standoffs and equilibrium levels of economic freedom. Such equilibria are determined by the countries' history, culture, and institutions. They are also influenced by the extent to which media keep the public informed about vote-buying policies and their costs. Since these determinants change only slowly, equilibrium levels of economic freedom tend to change at the same pace.

However, equilibrium levels can be changed more quickly through the development of new political paradigms regarding the role of government in the operation of the economy. Examples of such changes in paradigms are the Marxist-inspired use of economic planning, the social-democratic agenda for income redistribution and regulation, and the free-market agenda emphasizing freedom and the role of market incentives.

Such paradigms often emerge in the wake of major economic and political crises as those that followed the collapse of the Czarist regime in Russia at the end of the First World War, which produced the Marxist revolution. The Great Depression in the United States caused American voters to elect Franklin Roosevelt who promised voters more government activism to end the economic crisis. The stagflation in the late 1960s and early 1970s resulted in a new paradigm favouring markets that led to the election and policies of President Ronald Reagan in the United States and Prime Minister Margaret Thatcher in Britain.

New paradigms can also be forced upon governments by external forces like international organizations and financial institutions, which in recent decades attached paradigm-changing conditions for the disbursement of financial aid to Greece in 2012/13 and a number of other countries.

In the empirical part of this study, the history of economic freedom in a number of countries was examined in the light of the determinants just discussed. Some countries were found to have been in equilibrium levels of economic freedom for prolonged periods. Changes from these levels were associated with changes in the economic paradigm and the efforts of strong political leaders acting on them. Some countries experienced slow changes in economic freedom while others had quick changes imposed on them by external forces.

The analysis of this study mainly sheds light on a subject that had been relatively neglected in the burgeoning literature around the measures of economic freedom that had entered the public domain since about 1990. It also has some policy implications.

Policy implications

First, fights among politicians over policies and stalemates over their enactment are not to be deplored but should be recognized as evidence of a well-functioning democracy as they lead to the discovery of the level of economic freedom that is preferred by the voting public as a result of countries' history, culture and institutions. There is a need to raise the public's awareness of the important and positive role political conflicts play in the determination of policies. They are not evidence of a poorly functioning democracy.

Second, discussions about the costs and benefits of vote-buying policies lead to rational voting decisions only if they are based on the best available information about the effects of these policies on beneficiaries and tax-payers. For this reason, politicians should be required to produce well-reasoned and thoroughly documented analyses of the expected consequences of the policies they propose. Politically independent government agencies should assess the accuracy of such analyses and private institutions like think thanks should do the same and add broader perspectives by discussing the international and historic effects of economic freedom on economic and social well-being.

Third, the media play an important role in informing the public about the costs and benefits of government policies by the proper interpretation and dissemination of the often technical information provided by politicians and assessed by independent agents. Governments should pursue policies that protect and encourage the ability of media to inform the public.

Fourth, deficit financing to cover the cost of vote-buying policies that destroy economic freedom leads to lower levels of economic freedom since the cost of these policies is hidden from voters who might otherwise oppose them at the ballot box. There is a great need to inform the public about this consequence of deficit spending and the unfairness of passing the costs of vote-buying policies on to future generations that cannot protect themselves by casting votes against the politicians who impose these costs on them. In addition, deficit financing also often causes inflation, which leads to policies designed to deal with the costs and inequities caused by the inflation. These policies cause further reductions in economic freedom. To take away

the ability of politicians to use deficit financing, countries should prohibit it directly through the adoption of appropriate laws or constitutional clauses, which have proven successful in many jurisdictions in reducing both deficits and vote-buying.

Finally, in most countries regulations are passed by agencies that are under the control of the government, which can use them to pass regulations that bring electoral support from their beneficiaries. Legislators have only very indirect control over the actions of the regulatory agencies. To reduce the ability of governments to use their regulatory authority to buy votes and increase the probability that regulations serve the general interest, the enactment of regulations should become the responsibility of legislators. To avoid placing an excessive burden on them, they should be required to vote only on regulations with economic impacts above a certain threshold value.

The US Congress has drafted legislation to this effect. It is called the Regulations from the Executive in Need of Scrutiny (REINS) Act.[1] It would force all regulations resulting in an annual cost exceeding $100 million to be reviewed and passed by both houses of the legislature and signed by the President before they come into force.

In Canada and other countries with Westminster systems of government, the proposed regulations would be examined in committees in which all parties are represented. This process is subject to scrutiny by the media and the resultant publicity helps to ensure that the regulations serve the public interest even if, in the end, the government and ruling party have the ultimate control over the wording and design of the regulations. After passing the committee stage and the final formulation of the regulations, they are passed by majority vote in parliament.

In the United States, legislation before Congress can be amended by individual members before it is submitted for a vote. To prevent manipulation of the proposed regulations by the legislators, the REINS Act requires the regulations to be submitted to an up-down vote in both houses without permitting their modification through amendments. This strategy has long been used successfully in legislation involving free-trade negotiations.

1 For analysis of this legislation see DeMuth (2014).

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