Prosperity and Economic Freedom

A Virtuous Cycle

JOHN R. HANSON II

That economic freedom promotes affluence is Adam Smith's most important principle, but as the new millennium arrives, contrary attitudes are in vogue around the world. The early post–World War II ideal of a Third Way between socialism and the market has been revived by such world leaders as Bill Clinton and Tony Blair and has been at least tentatively embraced by electorates in a number of countries.

The recent publication of several statistical analyses of the relation between economic freedom and national prosperity is therefore timely. The most statistically rigorous of these studies, by Steve Hanke and Stephen Walters (1997), discovers close correlations between economic freedom and income per capita for a large cross section of countries in 1995, using the measures of economic freedom developed by Freedom House, the Heritage Foundation, and the Fraser Institute, the current leaders in the measurement effort.[1] Each of these organizations independently reaches the same conclusion, as do several academic studies using different proxies for institutional conditions or the policy regime.[2] These studies interpret their findings as confirmations of Smith's principle.

Normally, however, the public is encouraged to concentrate on and believe the converse: affluence promotes economic freedom, whereas poverty incubates revolution, usually of the anti-market variety. This idea was an early rationale for expanded

John R. Hanson II is a professor of economics at Texas A&M University.

The Independent Review, v.IV, n.4, Spring 2000, ISSN 1086-1653, Copyright © 2000, pp. 525–531

American foreign aid to poor countries. Seeking support to establish the Agency for International Development, John F. Kennedy extolled the ameliorative possibilities of foreign assistance. He exhorted, "I urge those who want to do something for the United States . . . to channel their energies behind the new foreign-aid program to help prevent the social injustice and economic chaos upon which subversion and revolt feed" (Eberstadt 1988, 33). Kennedy, who was aware of communism's political gains in the United States during the Great Depression of the 1930s and recognized its dangerous potential in the less developed world, thus announced and endorsed what has since become a familiar explanation of left-wing political movements. One scholar writes, for example, that "economic hardship may have helped precipitate the [1970] Lon Nol coup" in Cambodia (Harff 1991, 232–33). Many historians explain in similar terms the independence movements in European colonies and the allure of the Third Way for many of the newly independent nations (Hopkins 1974).

The unresolved coexistence of these competing doctrines is confusing and potentially dangerous because they have contrasting policy implications for poor countries and because each point of view is identified with particular interest groups and political programs. The absence of consensus also implies that in this case the personal impressions of experts and other informed persons, enlightening as their views may be, will not suffice to settle the issues.

Fortunately, the new economic freedom measurements of the Fraser Institute, combined with simple statistics, provide a succinct, original alternative to the argument from authority. Not only does this evidence confirm the empirical findings of Hanke and Walters and others, but it also describes a virtuous spiral of economic freedom and income in the developing world during the final quarter of the twentieth century. Retreat from free-market philosophy in favor of interventionism packaged as a Third Way therefore runs the risk of interrupting the virtuous cycle of economic freedom and prosperity and, in the worst case, replacing it with a vicious cycle of repression and poverty.

Statistical Tests

Official economic policies influence a nation's future economic performance through their effect on incentives for production and consumption. Furthermore, economic regimes tend toward stability in the short run and often in the long run as well. Therefore, we can express Smith's principle by postulating that, other things being equal, the rate of change of income per capita in poor countries during a given period

1. See Hanke and Walters 1997; Messick and Kimura 1996; Johnson and Sheehy 1995 and subsequent years of the Heritage Foundation's *Index of Economic Freedom*; and Gwartney and Lawson 1997. A notable older effort is Scully and Slottje 1991.

2. For a discussion and list of some of these studies, see Johnson, Holmes, and Kirkpatrick (1998, chap. 1); see also Haan and Clemens 1998.

depends on the level or degree of economic freedom at the start of the period. Correlating the two variables for several time periods, making sure that other relevant factors are held constant, will reveal whether in recent times otherwise similar economies have enjoyed faster economic growth under more liberal economic regimes. The factors held constant here are geographical region—distinguishing Asia, sub-Saharan Africa, the Middle East and North Africa, and Latin America including the Caribbean—and initial income per capita, a good proxy for a country's economic condition and prospects.

Similarly, by correlating the absolute change in measured economic freedom during the period with the initial level of income per capita, holding region and the original level of economic freedom constant, we conduct an analogous but separate and independent test of Kennedy's alternative to Smith's principle. A positive change in economic freedom is equivalent to the adoption of more market-oriented policies, which in this context are identified particularly with hospitable treatment of investors, especially foreign ones. The statistical associations will reveal whether liberalization—that is, pro-market policy change—was more likely to occur in higher-income countries when the initial policies and general economic conditions were otherwise comparable.

The Fraser Institute index of economic freedom, which runs from 1 (minimum economic freedom) to 10 (maximum economic freedom), is less familiar than the Heritage Foundation index and perhaps the Freedom House index, but it is the only historical one available. The index covers the two decades between 1975 and 1995 at five-year intervals, using consistent methods and data for each year. (The other indexes start in 1995.) The Fraser index also is grounded in economic theory and uses more sophisticated methods than the other indexes do. An international group of distinguished scholars, including Milton Friedman, advised in its preparation.

The Fraser Institute, like the Heritage Foundation, equates economic freedom with capitalist policies. Although its index is billed as a measure of economic freedom, it is better described as an index of the quality of the investment or business climate. The index embodies more than anything else the foreign investor's normal criteria for evaluating the business environment, such as low taxes, sound monetary policy, international openness, and so on, all of which economists consider fundamental to successful economic growth and development. Fortunately, these elements can be measured without a great deal of difficulty, lending credibility to the end product. The Fraser index, to be sure, lacks a direct measure of the extent of private property rights, a surprising and worrisome omission. The absence of this hard-to-measure element nevertheless is consistent with the rigorous quantitative methodology followed in constructing the index. Moreover, the state of property rights is likely to be well correlated with the index.

The estimates of income per capita used in the analysis are taken from the most recent version of the United Nations International Comparison Project (Mark 5.6), led by Robert Summers and Alan Heston, which unfortunately stops with the year 1992.[3] The World Bank's purchasing-power-parity estimates for 1995 (World Bank 1997), which are computed similarly and are therefore comparable to the others, are used to complete the data set. I include as many countries as possible at each date, except that I include no industrialized countries or former Soviet territories that are now independent countries. Thus, the data sets used for the correlations make the tests directly applicable to the less developed world. (Computations including a larger set of countries yielded nearly the same results.)

Table 1 presents the relevant partial correlation coefficients in columns 1 and 2. Partial correlation coefficients show the degree of association between two variables, holding potentially confounding variables constant. Being of no particular interest here, the results for the latter are omitted from the table.[4] The differing sample sizes (n) within and across the columns indicate the number of observations for each calculation. Every feasible time period between 1975 and 1995 is examined. These periods are all multiples of the five-year increments of time the Fraser Institute uses, with a maximum period of twenty years.

Findings

Column 1 backs the case for free markets. For every period, there is a positive partial correlation coefficient between the level of the Fraser "business climate" index at the beginning and the subsequent growth rate of income per capita. The majority of the correlation coefficients are modest but not paltry in size and are statistically significant at least at the 5 per cent level. Clearly, the more liberal the economic regime, the more rapid was subsequent economic growth. This relationship implies, in turn, an increase in the relative incomes of countries with more liberal economic regimes.

Column 2 contains almost equally striking results. A positive partial correlation coefficient exists between the level of income per capita at the beginning of every period and the subsequent absolute change in the Fraser index. These coefficients are about the same size as those in column 1, and a majority of them are statistically significant at least at the 5 per cent level. Generally speaking, the correlations in column 2 are highest for longer periods; for only one five-year period, the most recent, is the coefficient statistically significant. I have no explanation for the lower correlations for the shorter periods, but one possibility is that political systems typically do not respond as quickly to economic conditions as does the market to liberalization of policy.

3. Summers and Heston 1991. The more up-to-date 5.6 data were downloaded from the National Bureau of Economic Research Web site.

4. In the first set of calculations the level of income per capita is not typically correlated with its subsequent changes. In the second set the initial level of economic freedom is always negatively and statistically significantly correlated with its subsequent changes. The regional variables do not conform to a fixed pattern, although the coefficient for Africa is often negative and the one for Asia positive.

The correlations confirm that, just as Kennedy imagined, the better-off countries in the less-developed world have risen on the scale of economic liberty. Conversely, the maintenance of liberal economic policy has fallen with declines in income, implying that economic failure is not conducive to free-market reform. Consistent with this point is the lack of enthusiasm for structural economic reform in the Asian countries that suffered from the recent financial crisis (Paul 1999). The statistical relationship is also consistent with historical experience: capitalism has been rejected only in poor countries, and the Great Depression begat everywhere a multitude of restrictions on private enterprise. These restrictions, one might argue, in turn intensified and prolonged the crisis.[5]

Table 1
Partial Correlation Coefficients for Economic Freedom and Income

Date	(1)	*n*	R^2	(2)	*n*	R^2
1975–95	0.28‡	65	0.32	0.28†	73	0.41
1980–95	0.22‡	72	0.23	0.25†	83	0.33
1975–90	0.38†	64	0.40	0.21†	74	0.23
1985–95	0.21‡	74	0.14	0.26†	85	0.40
1980–90	0.36*	71	0.42	0.21†	84	0.17
1975–85	0.36†	74	0.31	0.10	74	0.14
1990–95	0.25†	67	0.16	0.33*	73	0.33
1985–90	0.39*	73	0.34	0.14	86	0.21
1980–85	0.17‡	84	0.31	0.11	84	0.04
1975–80	0.26†	74	0.25	0.10	74	0.12

Note: Column 1 refers to the growth rate of income per capita correlated with the initial Fraser index; column 2 refers to the absolute change in the Fraser index correlated with initial income per capita. *n* is the number of countries used for each calculation. * = 0.01 level of statistical significance; † = 0.05 level of statistical significance; ‡ = 0.10 level of statistical significance. One-tail tests for column 1; two-tail tests for column 2. Statistical significance levels are based on a heteroscedasticity correction. Coefficients of determination (R^2) are adjusted for degrees of freedom.

Source: Author's calculations based on data from Gwartney and Lawson 1997; Summers and Heston 1991; and World Bank 1997.

The implications of the processes just described for simple (not partial) correlations between prosperity and economic freedom are interesting to notice. Let us correlate income per capita and the Fraser Institute's economic-freedom index for the available dates and country groups—about a hundred countries in each year. The ordinary correlation coefficients between these variables for the benchmark years 1975, 1980, 1985, 1990, and 1995 are, respectively: 0.30, 0.40, 0.39, 0.52, and 0.64. Excluding industrial countries—for which the coefficients are positive, nearly always statistically significant, but trendless—the coefficients for the remaining countries are 0.26, 0.36, 0.36, 0.40, and 0.59. All of these coefficients are statistically significant, and matched samples for each date tell the same story. The upward progression of coefficients is the outcome of cumulative interaction among several forces, aptly described as a virtuous cycle.

Conclusion

The continuation of capitalistic economic progress in developing countries will not be automatic. According to the Heritage Foundation, economic freedom receded in the world during 1998, and other evidence reveals that, contrary to popular opinion, the acclaimed free-market revolution of recent times remains far from complete (Johnson, Holmes, and Kirkpatrick 1999; Hanson 1999). A global ideological reappraisal, should it occur, raises the specter that the cumulative spiral of economic freedom and growth in the developing world will be supplanted by a cumulative spiral of economic regulation and retardation, even regression. An unraveling of the recent trend would shake fragile public support for market-oriented reform, embolden anti-market propagandists, and compromise the future of economic freedom in poor countries, probably without compensating economic gains.

This prospect is not the only possibility, however. Assuming the absence of a global economic catastrophe, recent income gains should provide a bulwark against counterreform movements. As the Asian financial crisis and other global economic difficulties fade, the potential for anti-market and anti-reform elements to exploit economic adversity must be fading as well. Pro-market reformers still have an opportunity to recapture the initiative.

5. *Editor's note*: For argument and evidence along these lines, see Robert Higgs, "Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War," *The Independent Review* 1 (Spring 1997): 561–90.

References

Bruno, M., and W. Easterly. 1998. Inflation Crises and Long-run Growth. *Journal of Monetary Economics* 41 (February): 3–26.

Eberstadt, N. 1988. *Foreign Aid and American Purpose*. Washington, D.C.: American Enterprise Institute.

Gwartney, J., and R. Lawson. 1997. *Economic Freedom of the World: 1997 Annual Report*. Vancouver, B.C.: Fraser Institute.

Haan, J. de, and S. Clemens. 1998. Further Evidence on the Relationship between Economic Freedom and Economic Growth. *Public Choice* 95: 363–80.

Hanke, S., and S. Walters. 1997. Economic Freedom, Prosperity, and Equality: A Survey. *Cato Journal* 17 (Fall): 117–46.

Hanson, J. 1999. Are We All Capitalists Now? *Independent Review* 3 (Spring): 565–73.

Harff, B. 1991. Cambodia: Revolution, Genocide, Intervention. In *Revolutions of the Late Twentieth Century,* edited by J. Goldstone, T. Gurr, and F. Moshiri. Boulder, Colo.: Westview Press.

Hopkins, A. 1973. *An Economic History of West Africa*. New York: Columbia University Press.

Johnson, B., and T. Sheehy. 1995. *1995 Index of Economic Freedom*. Washington, D.C.: Heritage Foundation.

Johnson, B., K. Holmes, and M. Kirkpatrick. 1998. *1998 Index of Economic Freedom*. Washington, D.C.: Heritage Foundation.

Messick, R., and K. Kimura. 1996. *World Survey of Economic Freedom*. New Brunswick, N.J.: Transaction Publishers.

Paul, J. 1999. Asian Economies May Suffer a Relapse. *Wall Street Journal,* May 5.

Scully, G., and D. Slottje. 1991. Ranking Economic Liberty across Countries. *Public Choice* 69: 121–52.

Summers, R., and J. Heston. 1991. The Penn World Table (Mark 5.6): An Expanded Set of International Comparisons, 1950–1988. *Quarterly Journal of Economics* 106 (May): 327–68.

Vanssay, X., and Z. A. Spindler. 1994. Freedom and Growth: Do Constitutions Matter? *Public Choice* 78: 359–72.

World Bank. 1997. *World Development Report, 1997*. New York: Oxford University Press.

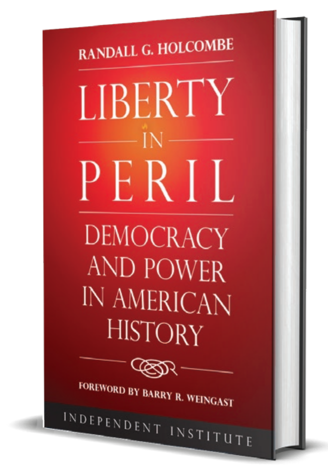
Yergin, D., and J. Stanislawski. 1998. *The Commanding Heights*. New York: Simon and Schuster.

SUBSCRIBE NOW AND RECEIVE A FREE BOOK!

"***The Independent Review*** does not accept pronouncements of government officials nor the conventional wisdom at face value."
—**JOHN R. MACARTHUR**, Publisher, *Harper's*

"***The Independent Review*** is excellent."
—**GARY BECKER**, Nobel Laureate in Economic Sciences

Subscribe to *The Independent Review* and receive a free book of your choice such as ***Liberty in Peril: Democracy and Power in American History***, by Randall G. Holcombe.



Thought-provoking and educational, *The Independent Review* is blazing the way toward informed debate. This quarterly journal offers leading-edge insights on today's most critical issues in economics, healthcare, education, the environment, energy, defense, law, history, political science, philosophy, and sociology.

Student? Educator? Journalist? Business or civic leader? Engaged citizen? This journal is for YOU!

Order today for more *FREE* book options

SUBSCRIBE

The Independent Review is now available digitally on mobile devices and tablets via the Apple/Android App Stores and Magzter. Subscriptions and single issues start at $2.99. Learn More.

Download on the App Store · GET IT ON Google Play · Available on MAGZTER

INDEPENDENT INSTITUTE, 100 SWAN WAY, OAKLAND, CA 94621 • 1 (800) 927-8733 • ORDERS@INDEPENDENT.ORG