

## Economic Freedom

***"Without Economic Freedom you can't exercise the other freedoms that we all cherish"***

In 1984, Michael Walker (L), executive director of the Canada-based public policy research organisation, Fraser Institute, set out to explore the relationship between economic, political and civil freedoms. He was joined by Milton Friedman. This resulted in an Economic Freedom Index (EFI), which now ranks 123 nations for economic freedom, and is published in the annual Economic Freedom of the World. The report is authored by James D. Gwartney and Robert A. Lawson, professors of economics at Florida State University and Capital University, Ohio, respectively. The EFI has 38 indicators grouped under five heads: size of government, legal structure and security of property rights, access to sound money, freedom to exchange with foreigners and regulation of credit, labour and business. In this interview with Seetha, at a recent workshop on Economic Freedom in Asia, Walker dwells on the conceptual framework of the EFI while Lawson discusses its finer points. Excerpts.

### **What is the purpose of the Economic Freedom Index?**

Walker: It originated from a scientific curiosity about the relationship between economic, political and civil freedoms. The question that concerned me was the extent to which economic freedom had been gradually eroded over time and we have accepted that. We are all seduced into being dependent on the State in the hope that we will escape the anxieties associated with variations in our ordinary lives.

So we thought it might be interesting to construct an index that would be as reliable as the Freedom House index on political freedom. As we began to work with it, it became evident that this was more than just an academic toolkit and that it could have practical implications in the policy world.

### **What is the relationship between the three freedoms?**

Walker: It seems to be the case that if you have economic freedom, you will eventually get political freedom. There may be a lag, but a country that becomes economically free begins to get more politically free. It's common sense because if a government is controlling a large part of the economy, if it is controlling people's incomes, access to the capital markets, etc., then it will be fairly easy for it to squelch any resistance. Because the foundation of truly independent political institutions is the existence, in the private sector, of an alternative power bloc to the government. If the government has control over both the politics and the economics, it's very difficult for the people to be politically free.

### **India is an exception to that rule. It had practically no economic freedom for many years but had a very vibrant democracy.**

Walker: India, like many former British colonies, was a great beneficiary of colonialism (though colonialism has its issues). The British brought a certain heritage of respect for the rule of the law, the parliamentary system of governance and so on. It created a kind of capital stock of institutions that don't decay very rapidly. So, I don't think there's very much of a puzzle here.

### **Why is economic freedom so important?**

Walker: Without economic freedom you can't exercise the other freedoms that we all cherish. If a country is imposing exchange control as India did for many years, one of the fundamental rights of mobility is lost effectively as you can't travel abroad without foreign exchange. If the government is taxing 70% of your income, the chances of your using your creative powers to expand the opportunities for your family, avail of all of the things that are important for human development are restricted.

### **Can you leave the market entirely unregulated? Shouldn't there be some system for co-ordination, preventing negative externalities?**

Walker: Let me tell you a story. A person auditioned two organists for his daughter's wedding. When the first organist played, the father said, "that's terrible - the second guy couldn't possibly be as bad as that". And he picked the second organist without listening to him.

Similarly, people say human beings have a lot of frailties and are devious. Now that's true. But that does not mean that picking the second organist, picking the government to regulate the market, is going to produce a better outcome. In some cases, it may produce a better outcome; in some cases, the regulator will be captured by the people that it is regulating.

So before we go into this thicket, we have to remind ourselves that just because we put a government agent in charge, it doesn't mean we have eradicated all those human foibles that we thought were going to cause problems in the first place. Yes, from time to time, the market will produce outcomes that are not good. And we have to recognise that just as there are market failures, there is government failure. It is really a trade off. As we move to solve a problem that is emerging from the market, we're going to create another problem. If we are going to intervene in a situation, it is important that we understand the full implications of that intervention.

### Are you saying that government failures are worse than market failures?

Walker: You won't solve a lot of these problems that we think we can solve by putting a government regulator in charge. The implication of saying that we don't have the information in the market but a government bureaucrat will have that information is an appeal to a god-like solution that we don't have. Because they don't have the information either.

"India, like many former British colonies, was a great beneficiary of colonialism"  
Michael Walker

We must recognise that there is a trade off. Whenever we set out to eliminate risk - whether it is in drugs or food or automobiles - there is another effect - it sometimes reduces the supply of a product and that has consequences. In the US, there are a lot of drugs called orphan drugs which will never see the light of day because the market for these would never be large enough to recoup the cost of extremely stringent regulations. But everyone knows they will help. They eventually passed a law called the orphan drug rules that will allow some of these drugs to be put through a less stringent process. The point is that this process of approving drugs keeps drugs off the market for years and, as a consequence, people die.

That's not to say that there's no room for enforcement, for setting penalties on people who cause injuries. Much of our reaction to risk must relate to thinking about the incentives that cause people to behave in a better way, rather than having a bureaucrat do that. So you can say if you're caught putting additives in food that you haven't declared on the wrapper, then you will be subjected to jail terms.

### So a condition like that would not reduce economic freedom?

Walker: Well, no. Saying that we should all agree to provide more information to consumers is not a violation of economic freedom. In a way, it is an enhancement. It's the appropriate role of government to stop fraud. The question is what is the least intrusive way to stop fraud?

Country	Rank	Score
Hong Kong	1	8.6
Singapore	2	8.5
United States	3	8.3
New Zealand	4	8.2
Thailand	44	6.7
Malaysia	60	6.4
Mexico	69	6.2
India	73	6.1
Brazil	82	5.8
China	100	5.5

Source: Economic Freedom of the World, 2003, Fraser Institute

### Would you say economic freedom is nirvana?

Walker: No, what I'm saying is that human beings are self-interested beings, who will always manage to put their own interests before yours. The notion that because someone has now become a regulator of drug trade, they now change into being altruistic, that they can now be relied upon to deliver the best possible outcomes for everybody, is nonsense. Because people are still self-interested. So the government process inevitably becomes the manifestation of the various self-interested behaviours that we thought we were going to cure by having a government agency.

We're not saying that human beings are perfect. But we need to recognise their imperfections and organise society in such a way that turns that imperfection into an advantage. So the nirvana that I have

in mind is the harnessing of this enormous power of self-interest by the market so that it becomes a powerful engine of prosperity.

**The Economic Freedom of the World, 2003 report says there is a correlation between the EFI and the UNDP's Human Development Index. What is the basis for this?**

Robert Lawson: If you look at the components of the Human Development Report, they are income, longevity, etc. Economic freedom gives people the opportunity to make more money, frees them and their entrepreneurial zeal, and the evidence says that free people are more prosperous, and prosperous people live longer and so on. The components of the HDR are exactly the kind of things we have always argued that markets bring about.

**But the UNDP would say that growth is a necessary, but not sufficient, condition for human development.**

Lawson: And they're completely wrong. There is no place that I know of - and there is empirical data for this - where there has been significant economic progress and the poor have been left behind. Name one. You can't find it. It's become a mantra that we need to protect the poor or they'll be left behind. But there's no evidence that it's ever happened. At least not when development has taken place in the context of real economic growth in the markets. Yes, there are places where some people get richer at the expense of others but that's not development, that's just robbery and theft.

**Doesn't that then justify not carrying the economic freedom concept too far?**

Lawson: I hope to have to deal with this some day. Right now, most places are nowhere near the point where there is too much economic freedom. Certainly, India is not there. Here, you are looking at a place that is over regulated, over controlled and the normal entrepreneurial zeal of people is being squandered and stifled. Economic freedom means open markets. It is very difficult for any one person to become too powerful in an open market, because it is, by definition, competitive. If any one person became too powerful in the open market, there is nothing to prevent other people from coming in and competing.

<b>Ratings on the five components of EFI</b>					
Country	Size of govt. (includes expenditures & taxes)	Legal structure	Access to sound money	Freedom to exchange with foreigners	Regulation of credit, labour and business
<b>Hong Kong</b>	9.1 (1)	7.0 (27)	9.2 (38)	9.8 (1)	8.0 (1)
<b>Singapore</b>	7.8 (9)	8.5 (15)	9.6 (16)	9.4 (2)	7.0 (9)
<b>India</b>	7.3 (19)	5.7 (58)	6.9 (89)	5.7 (103)	5.0 (102)
<b>China</b>	3.8 (115)	5.1 (68)	6.9 (87)	7.0 (67)	4.7 (111)

Figures in parentheses are the rankings for each of the five components  
Source: *Economic Freedom of the World, 2003*, Fraser Institute

**But there are market distortions like monopolies, collusive pricing, etc.**

Lawson: They happen only in markets where you have government power reinforcing those monopolies. They are very rare in true open markets. In an open economy, real monopolies that last quite long are unusual. The ones that last a long time are there because of some government privilege. The monopolies in the US are all in the areas that the government is regulating too much.

So, in many cases, the regulation is doing exactly the opposite of what the rhetoric says - that we need regulation to protect the poor from monopolies. In fact, the regulation ends up creating a monopoly. Maybe it is a regulated monopoly, but they are still monopolies. The right way to fight monopoly is through open markets and allowing people to compete. Free trade is the best anti-monopoly policy. Regulators have proved themselves to be bumbler.

**Would you say this even of genuinely independent regulators?**

Lawson: There isn't any question that the more independent they are, the more professional they are. But our experience of regulated industries in the US has been that even when they are very independent professionals, there is a tendency for the industry to get very cosy with them and that, over time, the regulators become almost the mouthpiece for the interests of the industry. I think this is a natural tendency in politics. I have found this in the case of the regulated industries in the developed world and I would hate to see the developing world repeat the mistakes that we are now trying to get out of.

"Economic freedom is the ability to do as you please with resources you have"  
Robert A. Lawson

**You argue that countries that are more economically free grow faster. However, India and China seem exceptions to this rule.**

Lawson: Both countries are very heavily repressed economies. What we've seen in both cases is just a tiny bit of opening. But from the standpoint of India and China it looks like an amazing flowering of opening up because of where they've started from. So opening up a little bit just created a rush of activity.

But one of the concerns I have for both countries is that it seems that this openness has reached a point where they've got a certain bang for the buck. But now the question is can you go to the next level? I'm worried that in the next decade - or 15 years - we'll see a slowing unless the progress continues.

**A country's economic freedom ranking is lowered with a higher government presence in the economy. What is wrong if government is in certain areas so long as it does not keep the private sector out?**

Lawson: It's certainly better to allow the private sector. But the question is what are the failings of the private sector? Why have the public sector firms? And the answer usually is because of an interest group that wants to stay in business even if it is running at a loss. In every case, the state-owned enterprise, in the event of running a loss, will receive a transfer from the State. As a result, they produce poor quality products without worrying about bankruptcy. So they end up wasting resources. No country is rich enough to waste resources. Certainly India isn't.

**But when the government spends on basic infrastructure like roads and power, that only increases economic choices for the people.**

Lawson: We don't look at economic freedom as increasing options. Economic freedom is the ability to do as you please with the resources that you have. Human beings will never have all the options that they want. We're going to have constraints on us. All we can do is relax those constraints by building roads and bridges and so on. Freedom is a different concept. It means allowing you to use whatever resources you have in a legal sense. One problem of looking at economic freedom in the other way is that you confuse it with development. We want to be able to say that freedom - the absence of control - generates more options.

**Isn't there a case for a separate index for developing countries, with different components that are more relevant to their situation?**

Lawson: I disagree. Economic freedom is economic freedom and people are people. What freedom is to someone in Luxembourg is the same as to someone in India. Having said that, it is true that the dimensions of economic freedom will probably be different in developing and developed countries. In Asia, the focus will be more on the rule of law and contract enforcement and openness to foreign trade. Whereas, in Europe, we will spend a lot more time talking about taxes and the size of government, etc.

**Why do subsidies, which do not restrict any kind of freedom, have a negative influence on freedom rankings?**

Lawson: Where do subsidies come from? They come from money taken from people and taxes. And when money is taken from you by force, you are substituting the will of the State for your individual will about how the resources should be spent. So you are now less free. Strictly speaking, if we're thinking

only about freedom, taxes always diminish the choice we have over our resources. We get something in return but that's not always the concept we are looking at.

**Is economic freedom the panacea for all ills?**

Lawson: No. We still live in a world of scarcity. Mother Nature is stingy. We still have to get up in the morning and go to work. We have to create wealth and that's not easy. Economic freedom makes that easier by reducing the barriers that we human beings put against ourselves. We don't instantly get the land of milk and honey from economic freedom. But we still have to produce milk and honey. Economic freedom makes it easier.

*Businessworld*, 3 November 2003