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Measuring Economic Freedom

By Robert A. Lawson

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Since the time of Adam Smith, economists have generally argued that free economies will be productive economies. But where's the evidence?

Debate on this question has been inconclusive, since both sides have been able to show favorite countries and indicators while avoiding larger questions of general historical trends. Without a concrete and sophisticated measure of economic freedom, it has been difficult to answer this question unambiguously.

More than 10 years ago, Nobel laureate Milton Friedman and Michael Walker, president of the Fraser Institute (a freemarket think tank based in Vancouver, British Columbia), organized a series of conferences to design a reliable measure of economic freedom.

The conferences led to the formation of the Economic Freedom Network–a consortium of research institutes in 47 countries, including the Cato Institute in the United States. The network's just-released "Economic Freedom of the World 1997" is the culmination of its research.

Although measurement of economic freedom is a demanding task, we have made considerable progress. The report measures economic freedom in four major areas: sound money and price stability, reliance on markets, freedom to keep what is earned and international exchange.

The index is a state-of-the-art measure of economic freedom in at least four respects.

First, its components are systematically designed to measure freedom in the four major areas of concern. This reflects the input of some of the world's leading economic scholars, including Nobel Prize winners Friedman, Gary Becker and Douglass North.

Second, this index relies primarily on objective measurement of variables, rather than subjective evaluations.

Third, the country ratings cover a 20-year period, which allows measurement of the results of pro-freedom policies over the long run.

Finally, the raw data used to derive the ratings for each of the 17 components are presented, which should eliminate any mystery about why some countries get high ratings and others get low.

By a wide margin, the index indicates that Hong Kong was the freest economy in the world throughout the last two decades. Its 1995 summary rating was far higher than that of Singapore, the second-highest-rated economy. The next seven freest economies (that is, the third through ninth) are New Zealand, the United States, Mauritius, Switzerland, the United Kingdom, Thailand and Costa Rica.

At the other end of the spectrum, the index indicates that in 1995 the economies of Algeria, Croatia, Syria, Burundi, Haiti, Iran, Nigeria, Zaire, Ukraine and Albania were the world's least free. Those economies are generally characterized by rapid money growth, variable and unpredictable inflation, heavy reliance on government spending and regulations, high taxes and restrictive trade policies.

This index demonstrates definitively that economic freedom creates growth.

Examination of the 10 countries that registered the largest increases in economic freedom over the last 20 years and the growth rate of their per-capita gross domestic product during the last decade conclusively demonstrates the linkage of freedom and growth.New Zealand, Chile, Mauritius, Iceland and Portugal head the list.

Some of these countries, including Chile, Mauritius and Portugal, made substantial progress toward a free economy throughout the 20-year period of measurement. The gains of others, such as New Zealand Argentina and Iceland, have occurred almost exclusively during the last decade.

Since 1985, all 10 of the freer economies have demonstrated solid growth. Their annual per capita GDP growth rate has averaged 2.4%. However, the growth rate of the 10 countries with the largest reductions in economic freedom was dramatically different. The average per capita shrinkage of GDP was 2.1%. Only one of those 10 economies–Syria's–was able to register any growth.

The link between freedom and growth was present throughout and is best appreciated by examining the effects of significant changes between 1975 and 1995 on the growth rate of the countries in our study. Countries with at least a three-unit increase (out of 10) in economic freedom achieved per capita growth of 2.7% during the last decade. Those with increases of between two and three units achieved growth rates of 2.1%. Smaller increases in economic freedom were associated with slower rates of growth.

When economic freedom declined, so did the growth of per capita GDP. The relationship between a freer economy and the higher growth illustrated by these statistics is no coincidence. The index measures real elements of economic structures and policies.

The consistent, positive relationship between economic freedom and economic growth provides powerful evidence that Adam Smith was right more than 200 years ago. Free economies give citizens the opportunity for more productivity and higher incomes.

Robert A. Lawson

James Gwartney and Robert Lawson are co-authors of “Economic Freedom of the World 1997,” whose publishers include the Cato Institute. James Gwartney is also an adjunct scholar with the Cato Institute.