

Economic Freedom and International Economics: A Primer

ECON3171

Fall 2007

Economic Freedom

- Of growing interest for at least three reasons:
 - Seek a working definition: what does it mean and is it good?
 - What impact does economic freedom have on various aspects of human life/condition?
 - What policies foster economic freedom, especially in countries with less?
- There are at least three groups measuring economic freedom
 - Fraser Institute : www.freetheworld.com
 - Heritage Foundation: www.heritage.org
 - Freedom House: www.freedomhouse.org

Why should we care in ECON3171?

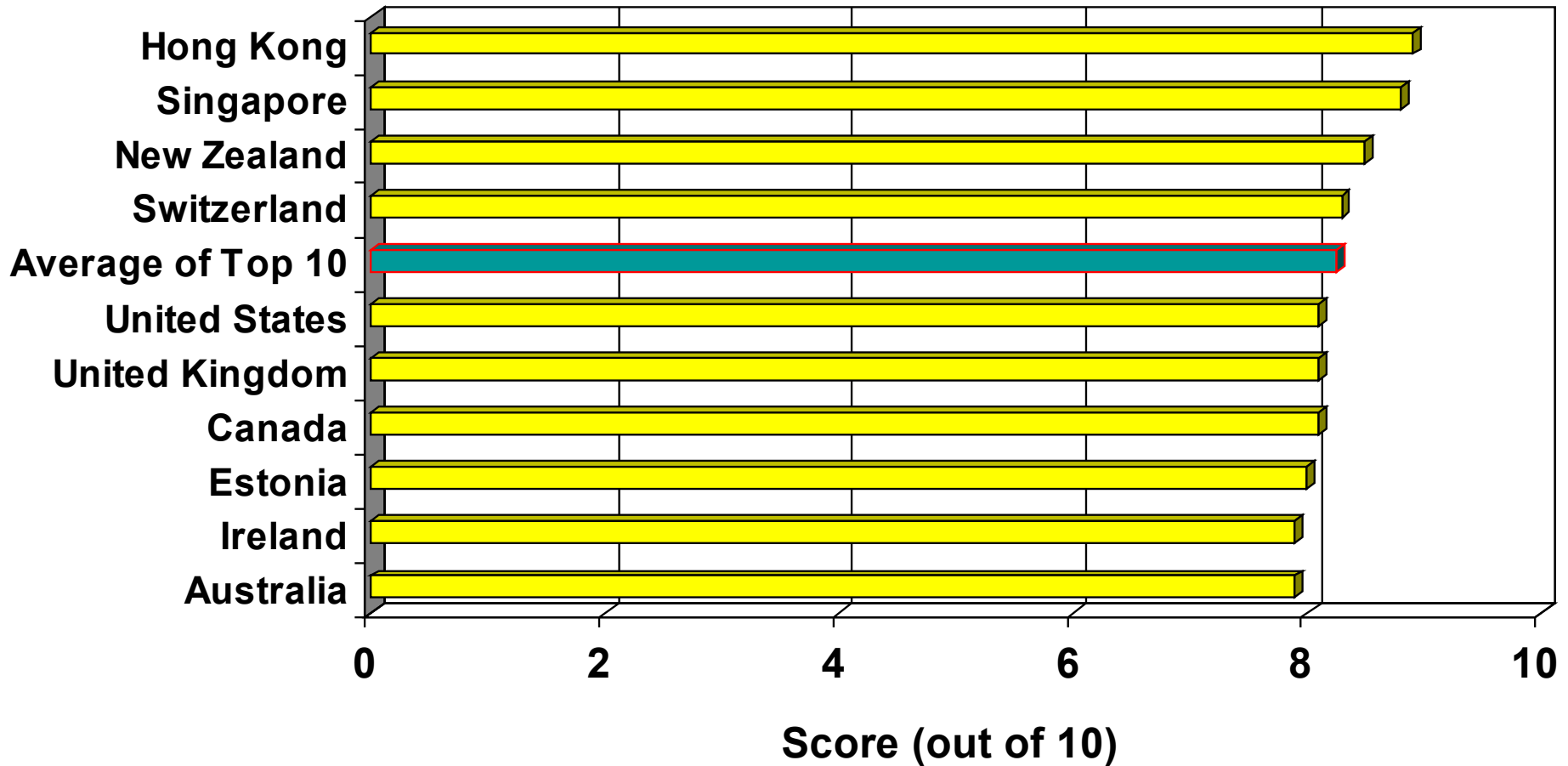
- International business requires interaction between parties in different countries.
- Perhaps transactions are easier in countries that are more “free”?
- Perhaps transactions are more profitable in countries that are more “free”?
- Perhaps trends in economic freedom are indications of where easier/profitable transactions can occur in the future?

Components of Economic Freedom as measured by the Fraser Institute

- Size of government and taxation
- Private property and the rule of law
- Soundness of money
- Trade regulation and tariffs
- Regulation of business, labor and capital markets

- Fraser Institute vs. Heritage Foundation
(correlation = 0.90)

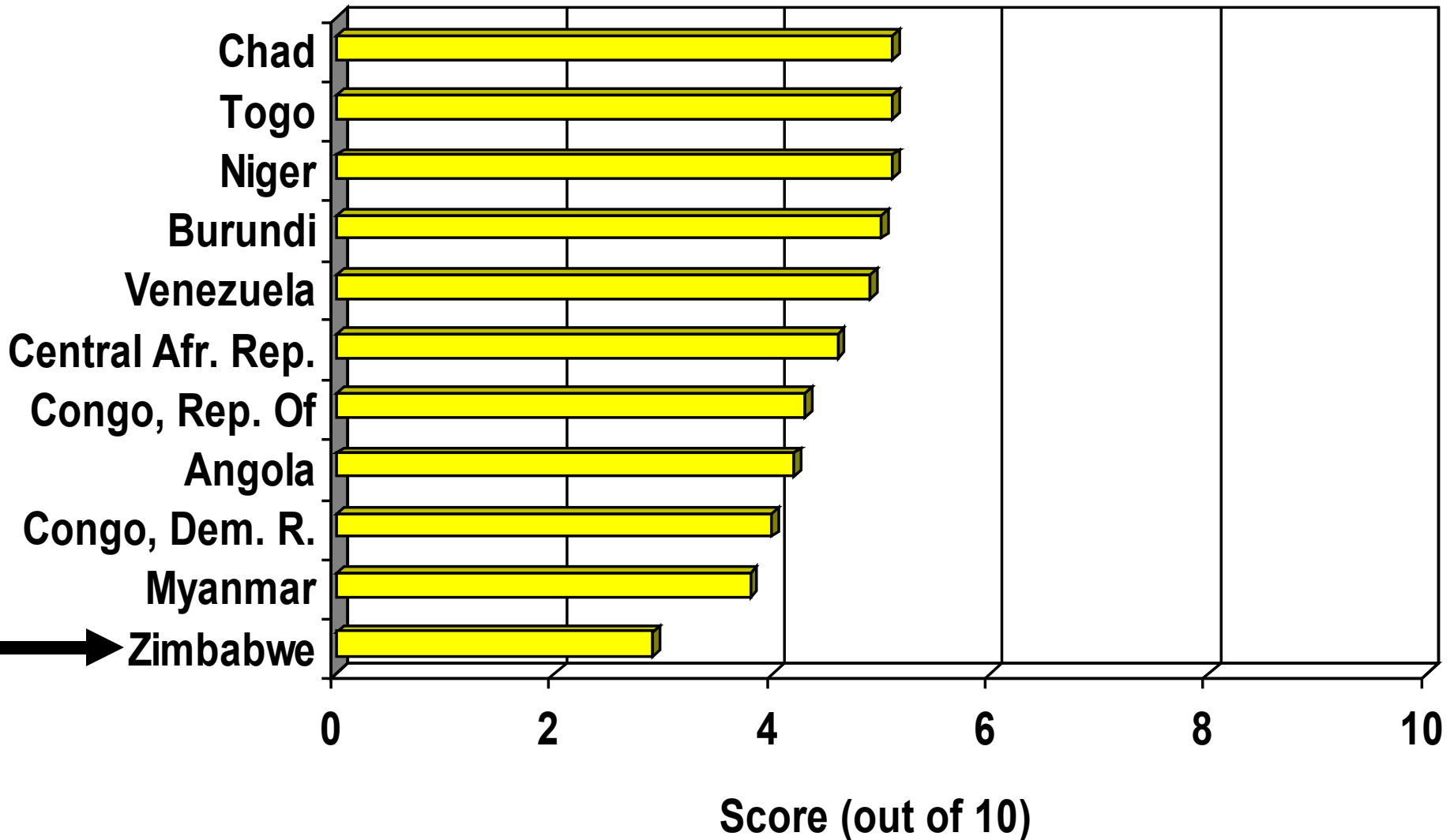
Ten “most free” countries (2005)



Source: The Fraser

Institute

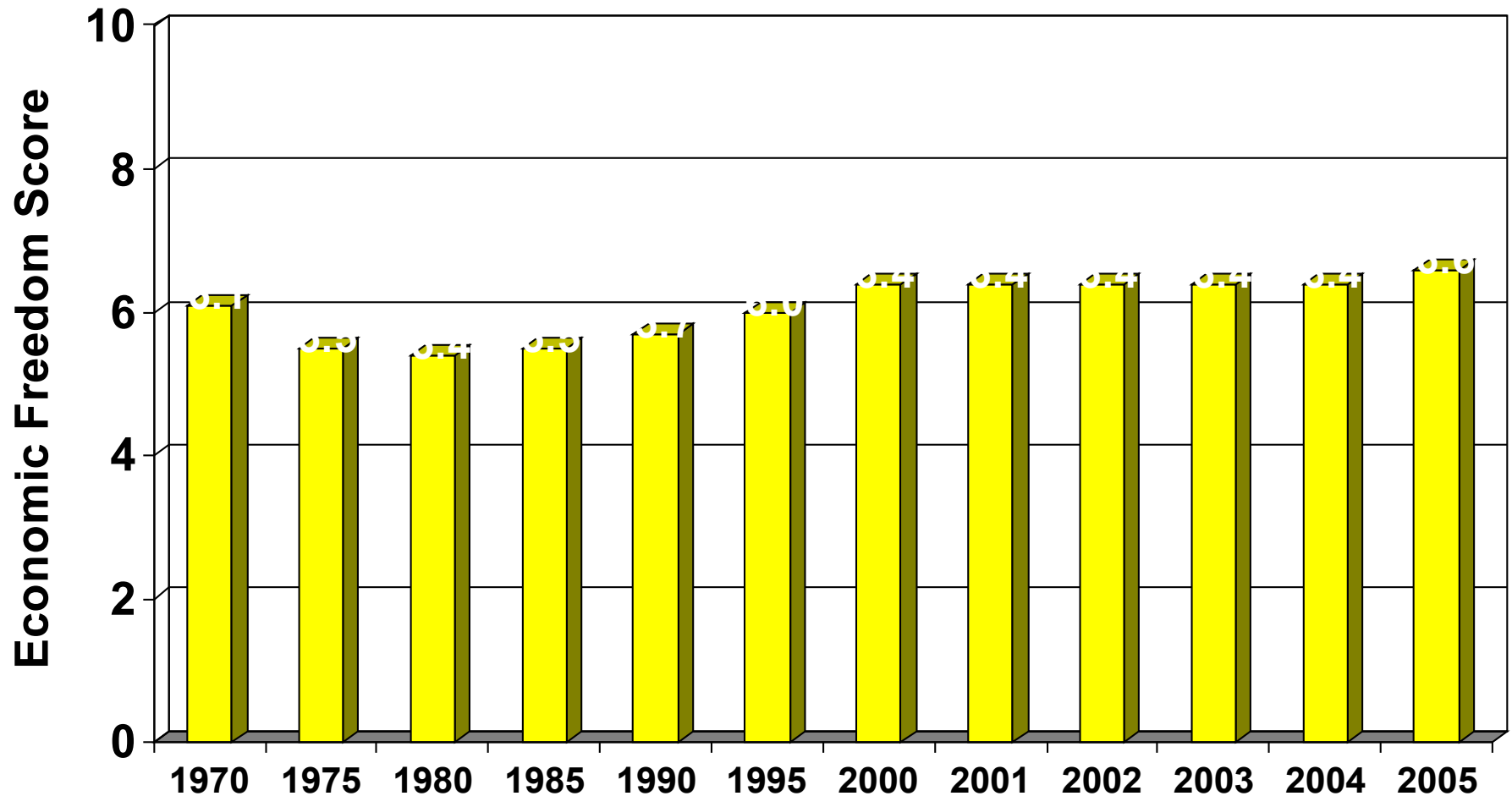
Ten “least free” countries (2005)



Source: The Fraser

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World Average Economic Freedom Over Time

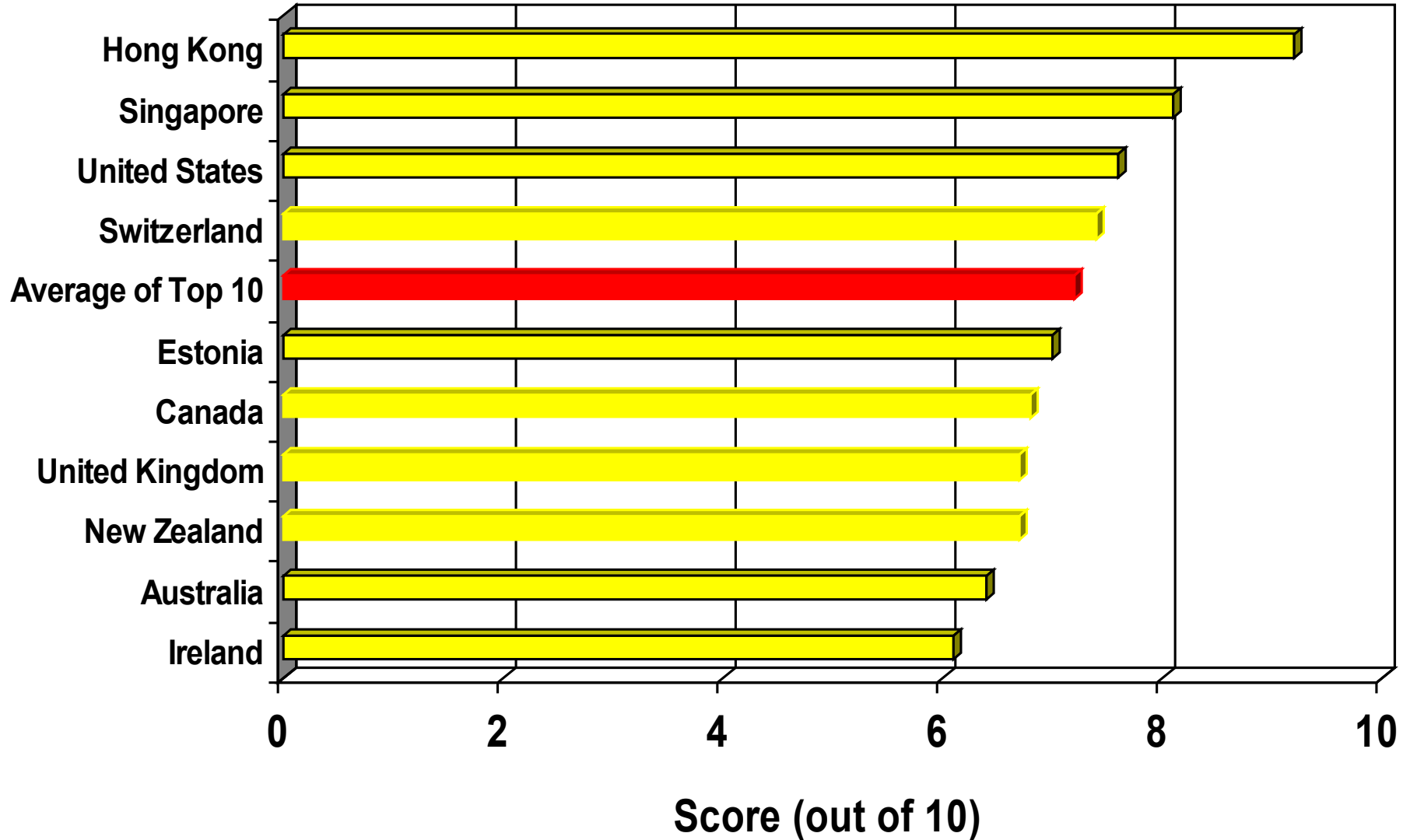


Drop in 1970s? Parts of Asia, Africa, and South America have political regime changes that dramatically lower economic freedoms.

Source: The Fraser

Institut

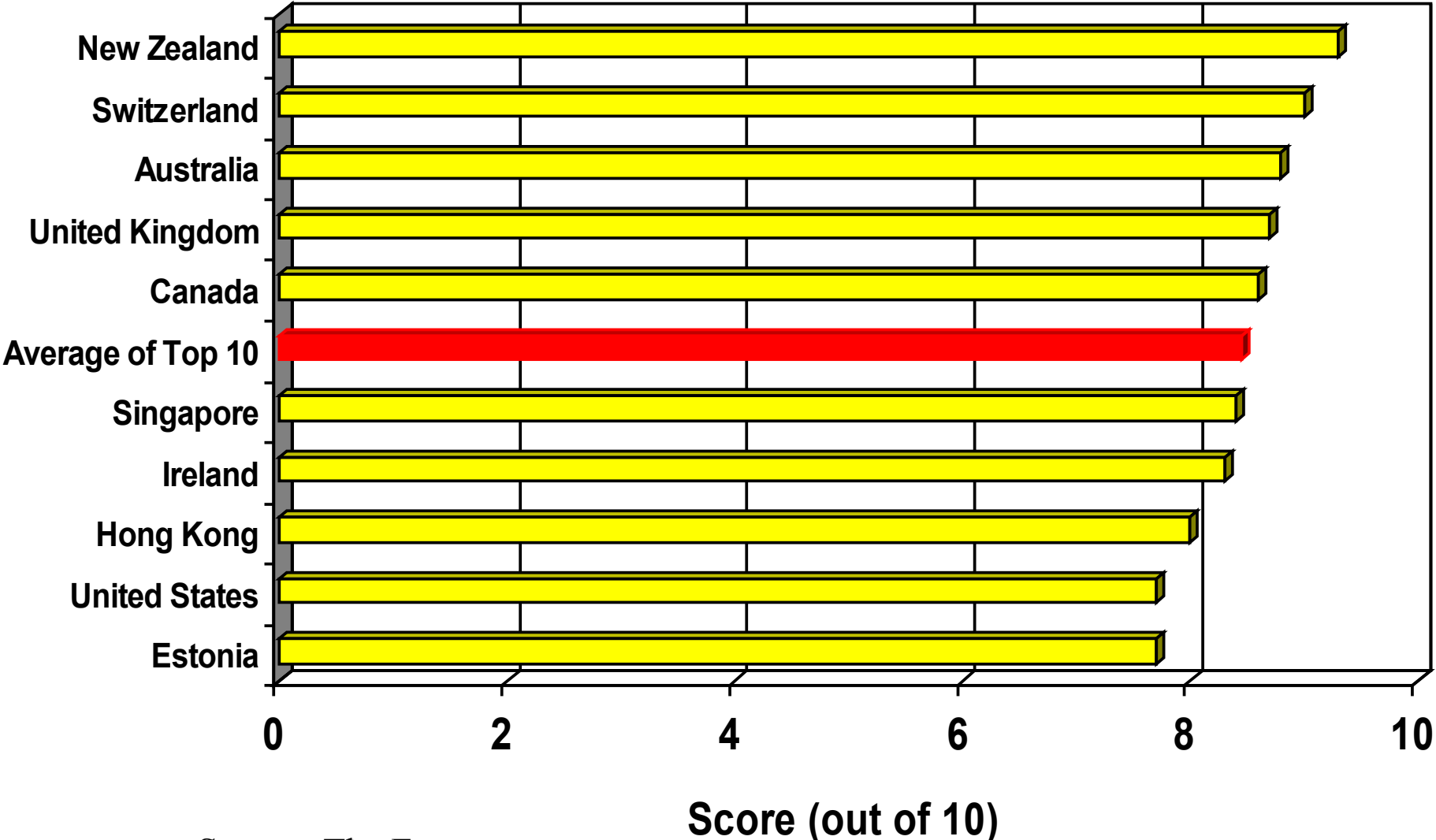
Size of Government among the “most free”



Source: The Fraser

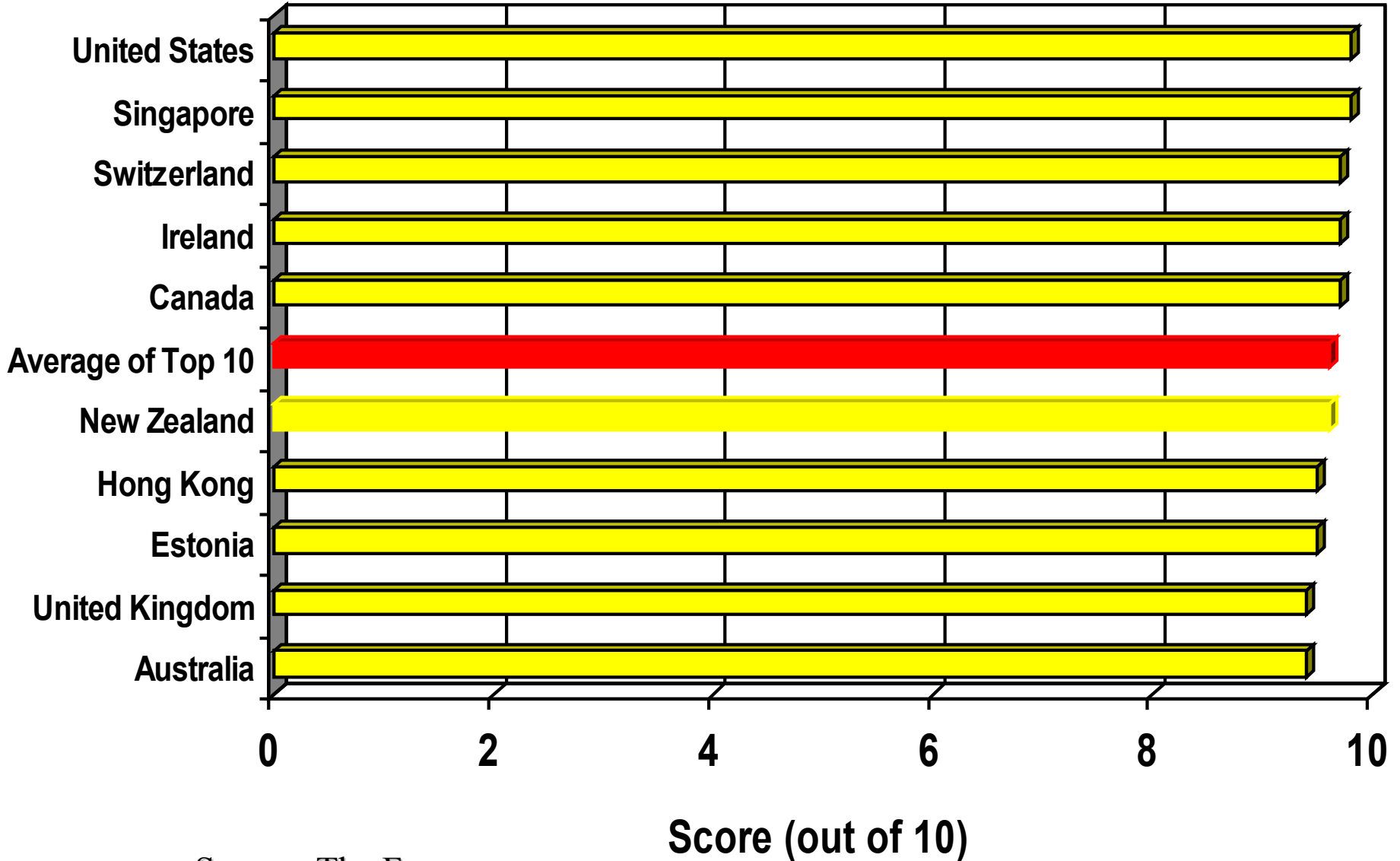
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Legal Systems among the “most free”



Source: The Fraser

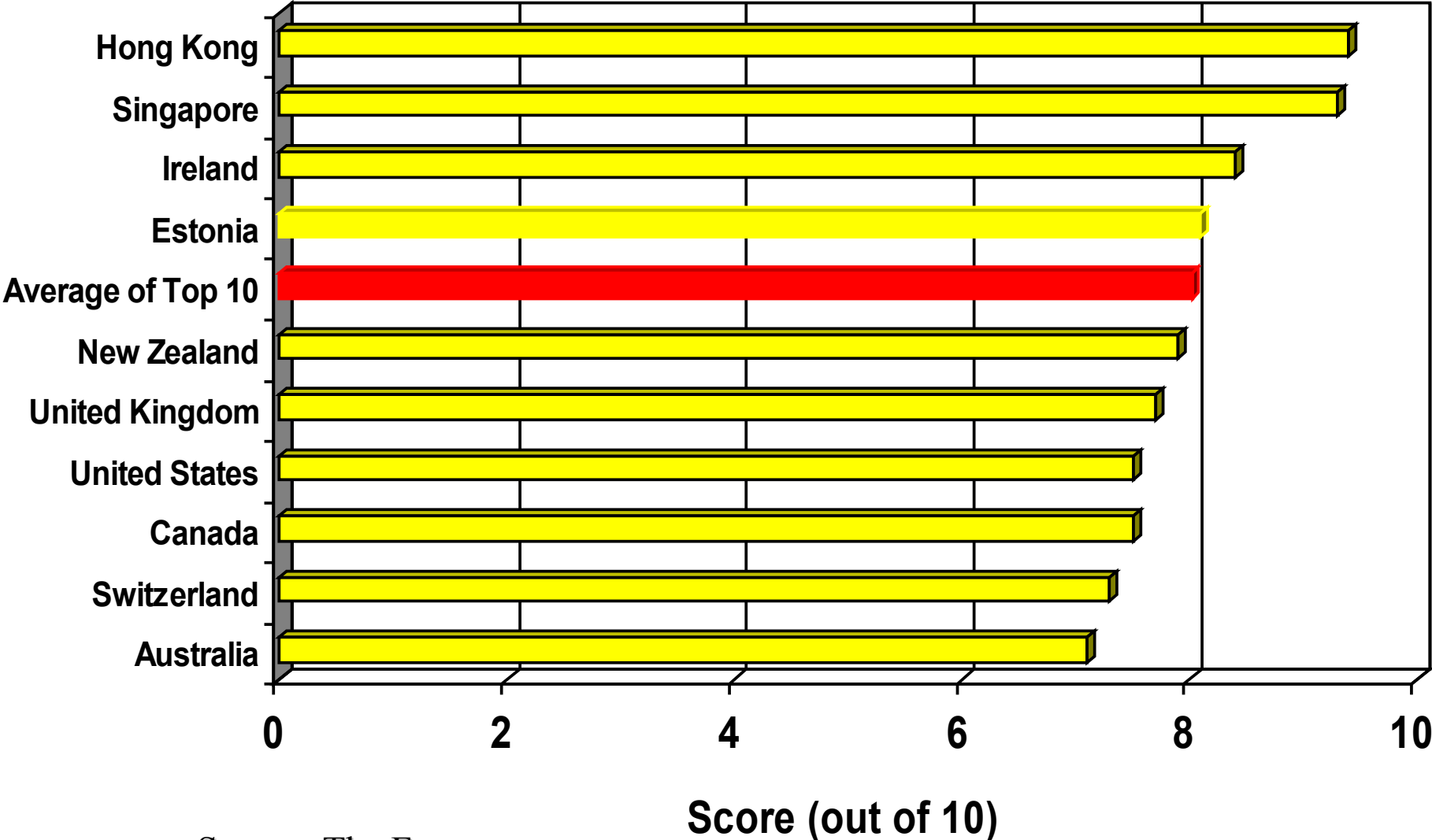
Sound money among the “most free”



Source: The Fraser

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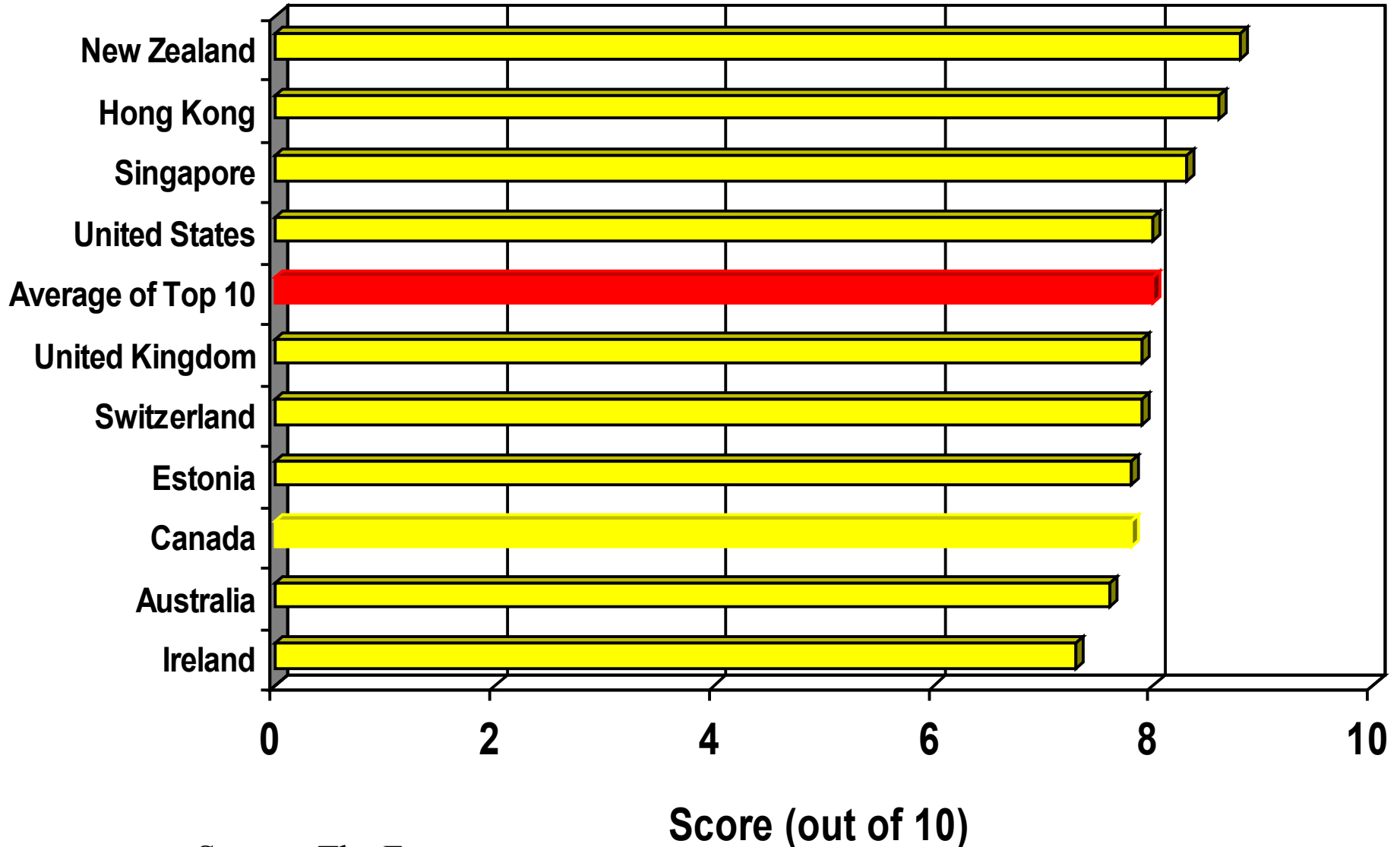
Freedom to Trade among the “most free”



Source: The Fraser

Institut

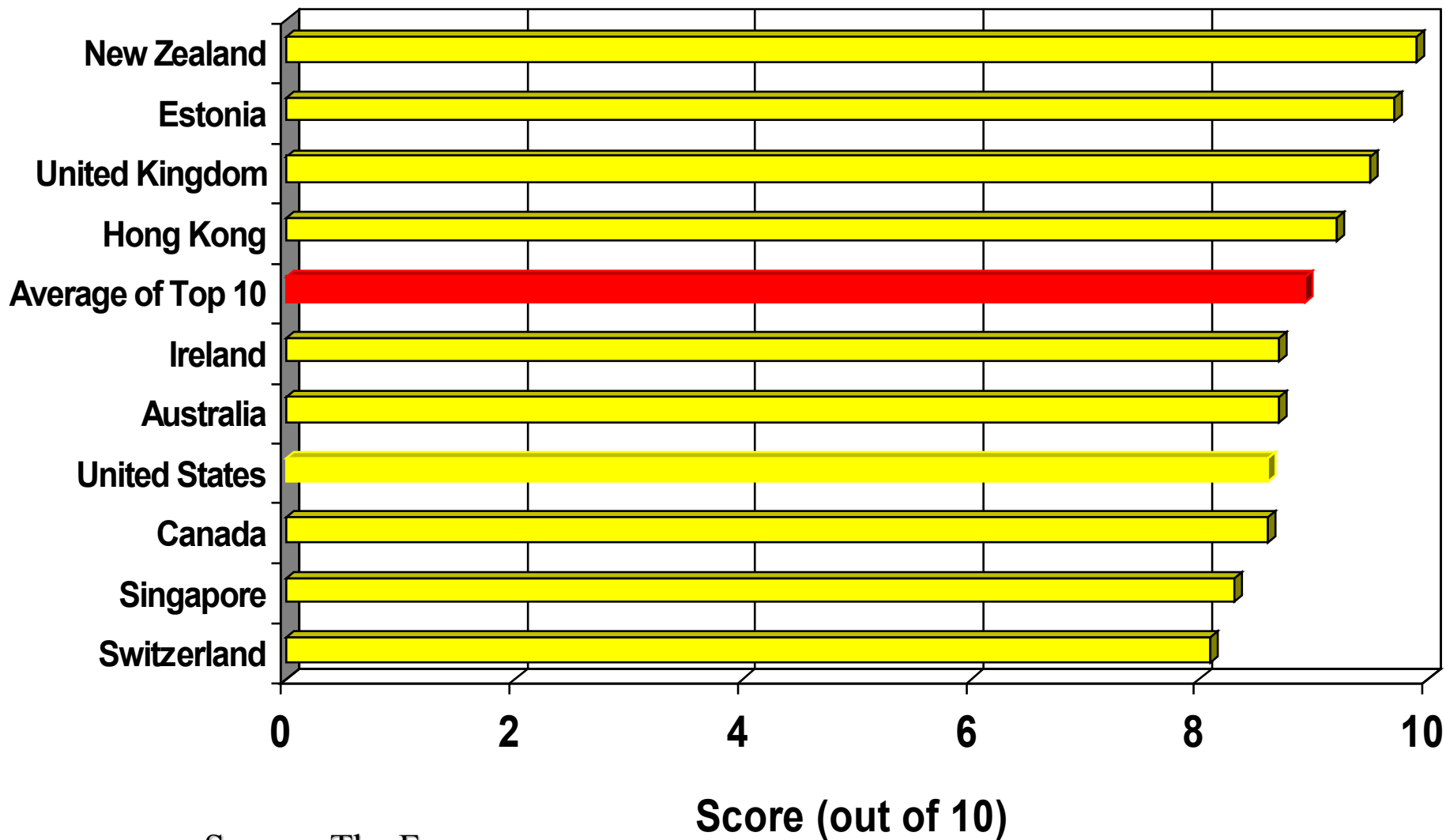
Level of Regulation among the “most free”



Source: The Fraser

Institute

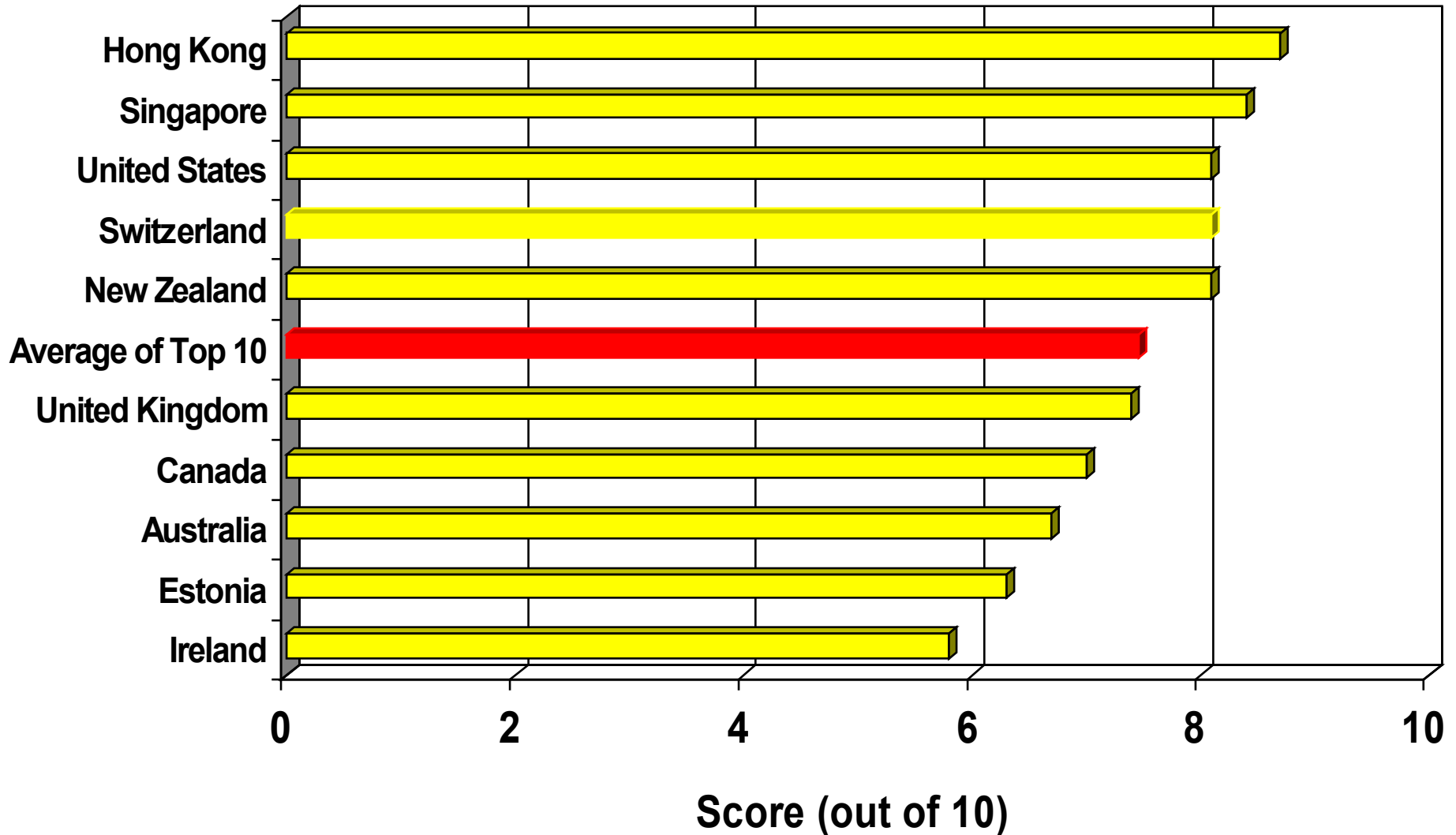
Credit Market Regulations among the “most free”



Source: The Fraser

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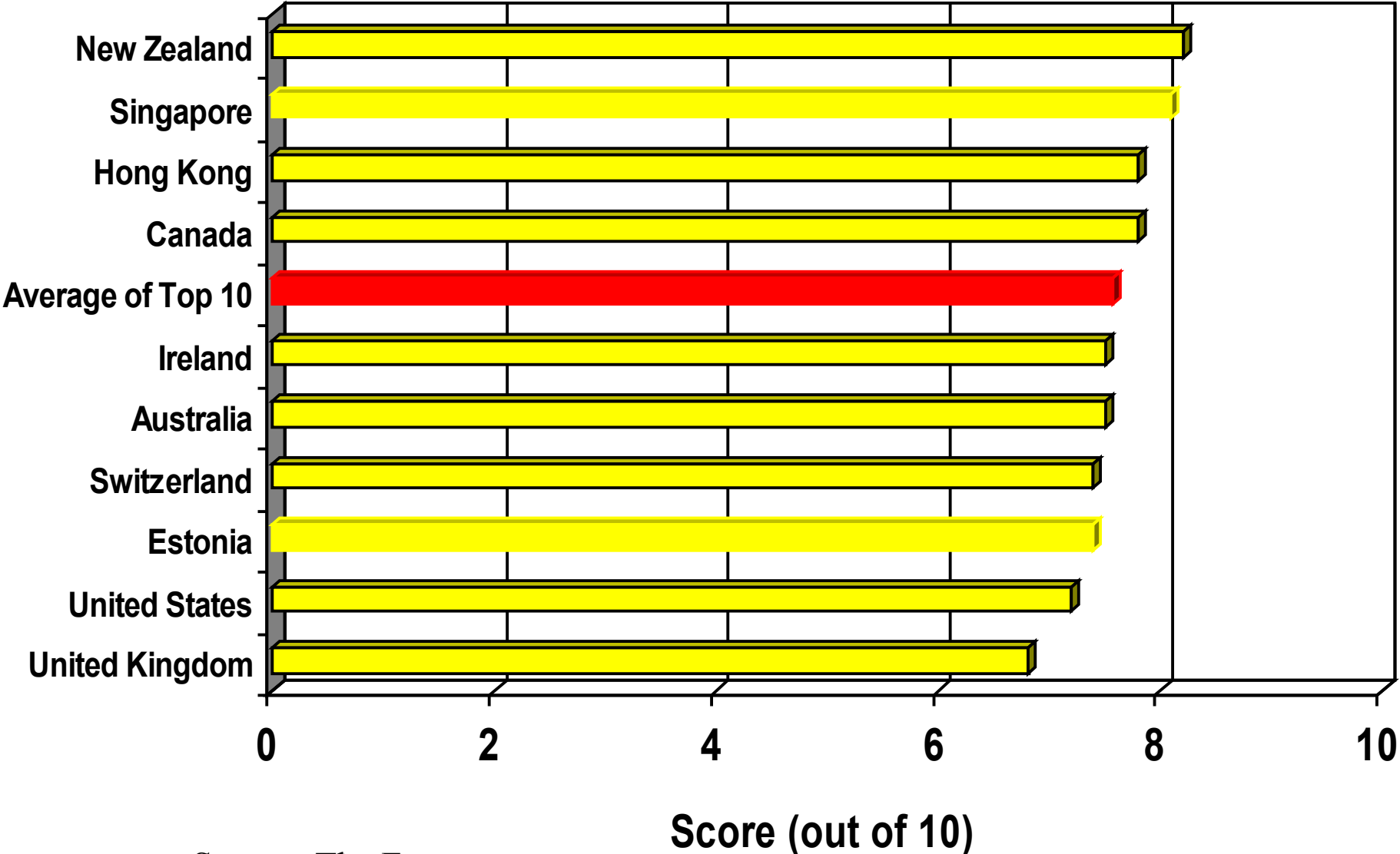
Labor market regulations among the “most free”



Source: The Fraser

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Regulations on Business among the “most free”



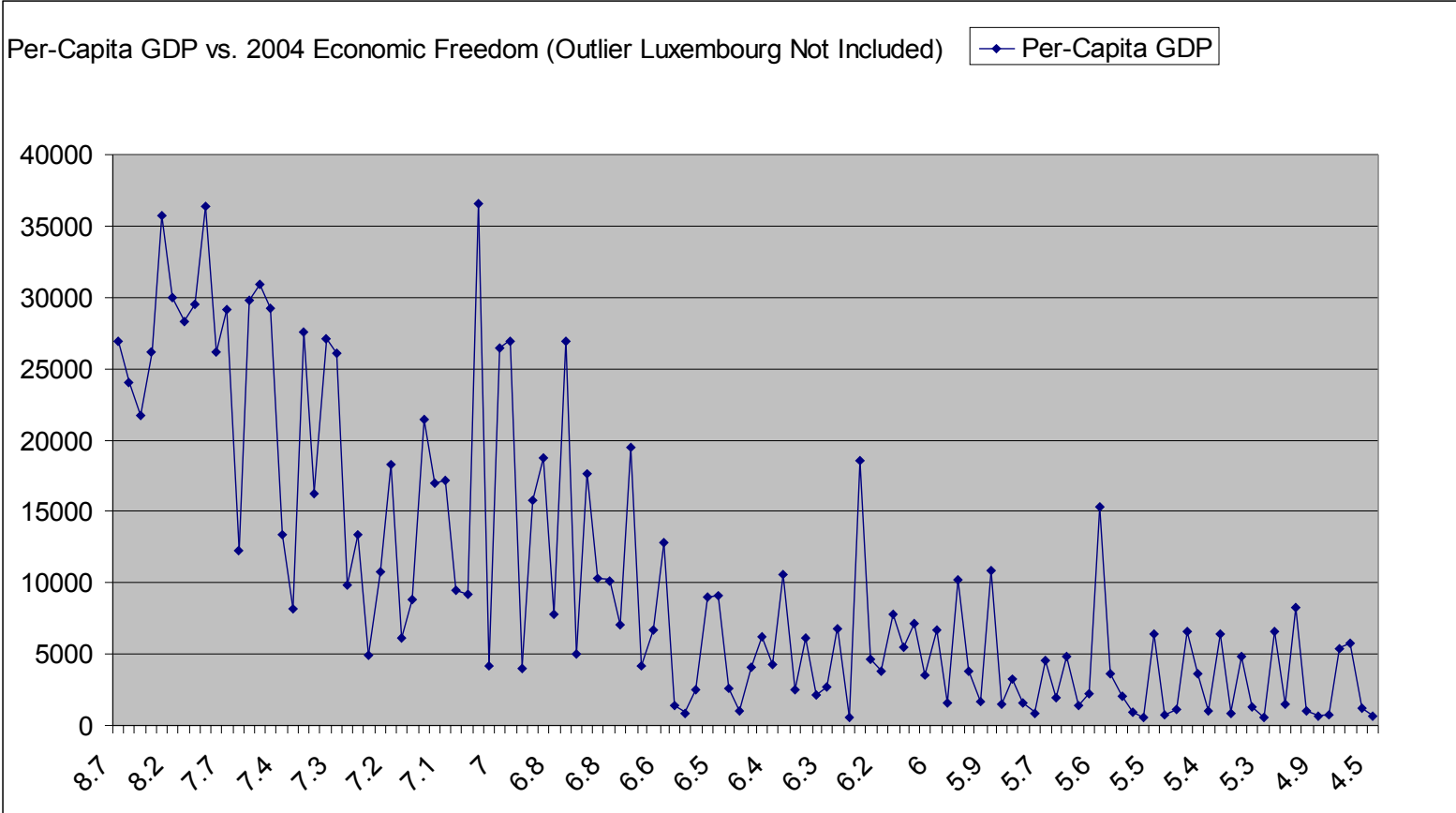
Source: The Fraser

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Why is Economic Freedom Important?

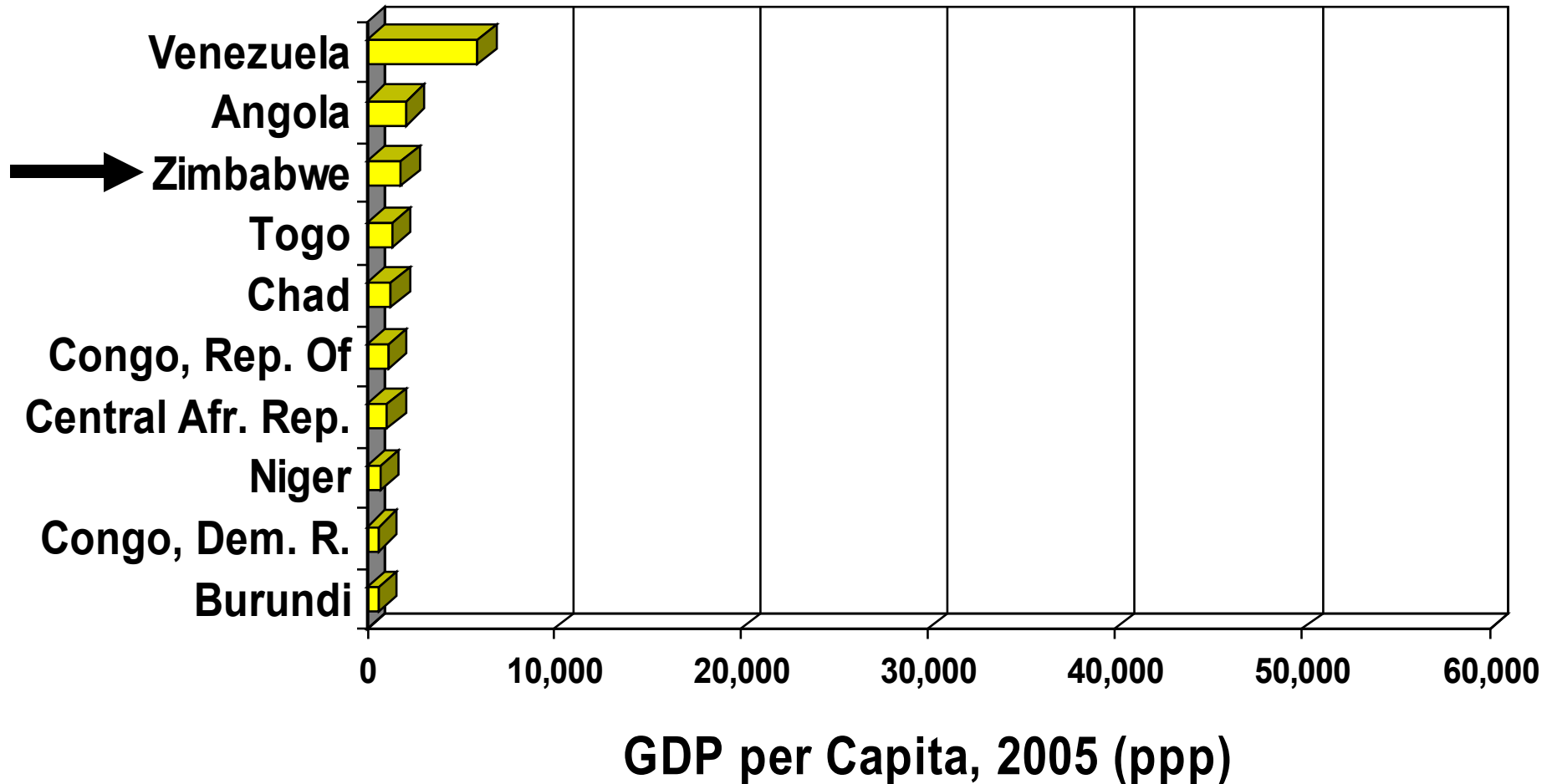
- Economic freedom may influence
 - Economic efficiency
 - Economic growth
 - Increased international trade
 - Intellectual property rights enforcement
 - Broader human development
- There is some debate about whether economic freedom is a prerequisite for these issues.
- Further complications - We do not have a perfect definition for what constitutes economic freedom. However, we often know what constitutes a lack of economic freedom.
- In other words, there might not be a universal prescription on how to attain economic freedom (e.g., U.S. Constitution?), but reducing economic freedoms is relatively simple to achieve (and perhaps difficult to stave off?)

Economic Freedom and Per-Capita GDP



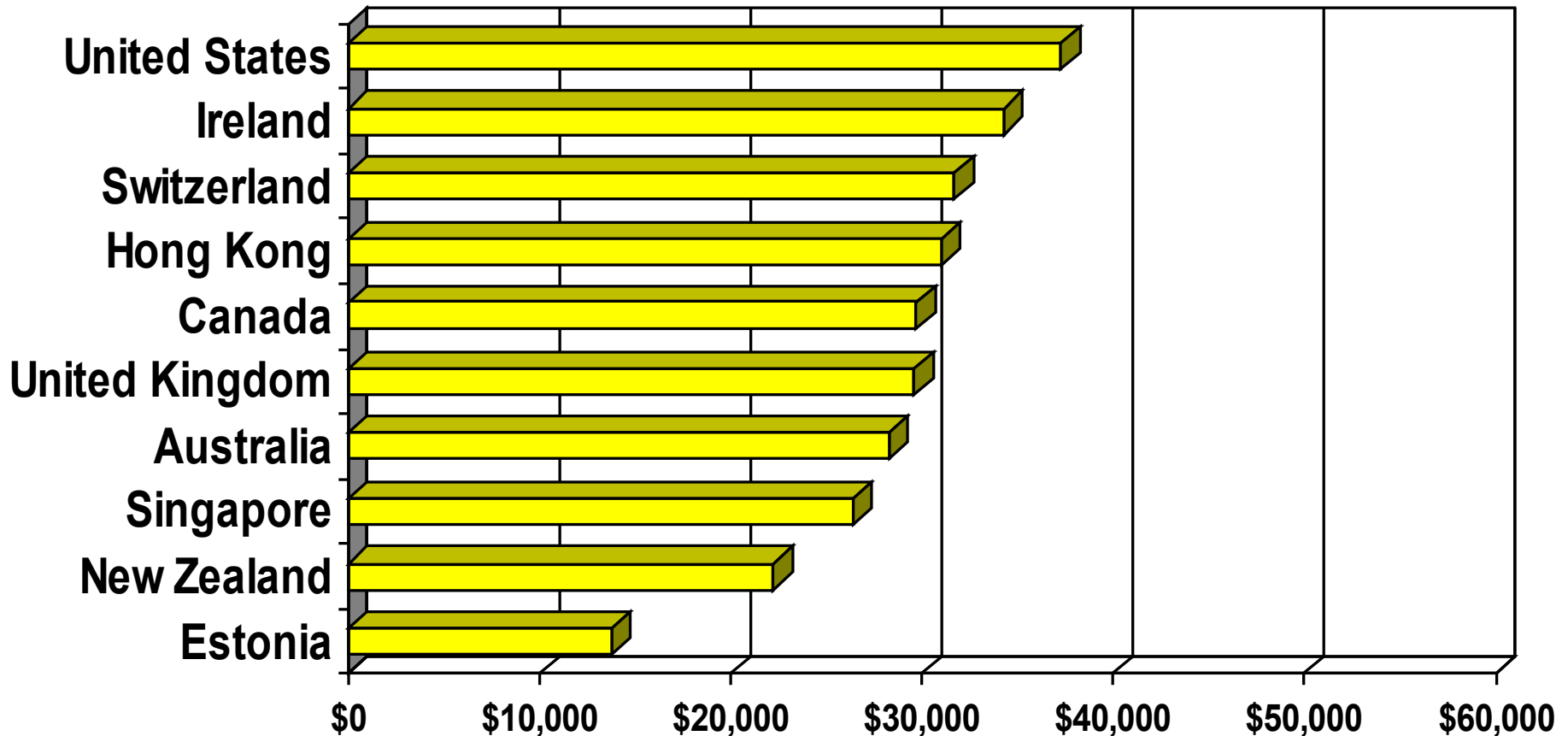
Countries with greater economic freedom tend to be more wealthy

Per-capita income among the “least free”



Sources: The Fraser Institute; The World Bank, World Development Indicators CD-ROM, 2007.

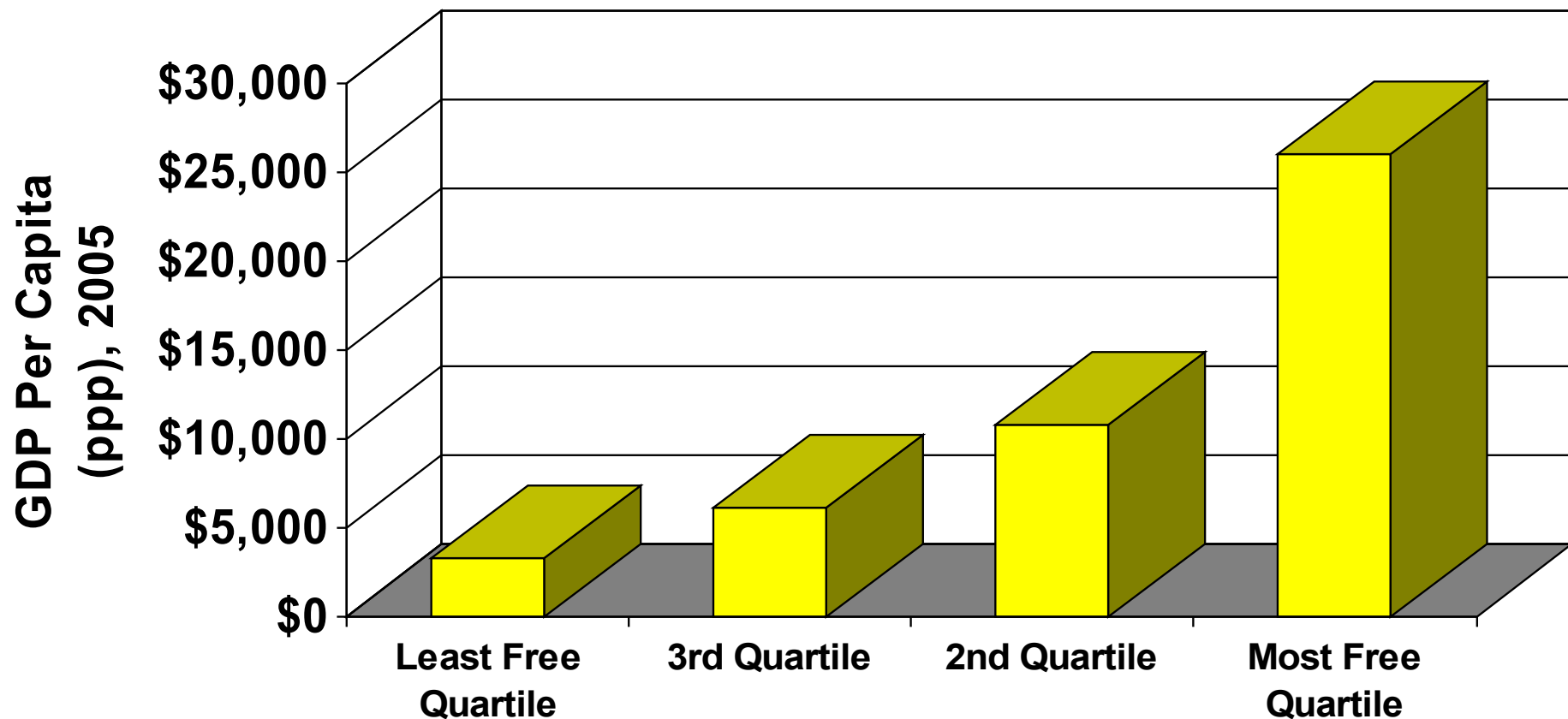
Per-capita income among the “most free”



GDP per Capita, 2005 (ppp)

Sources: The Fraser Institute; The World Bank, World Development Indicators CD-ROM, 2007.

Per Capita Income and Economic Freedom

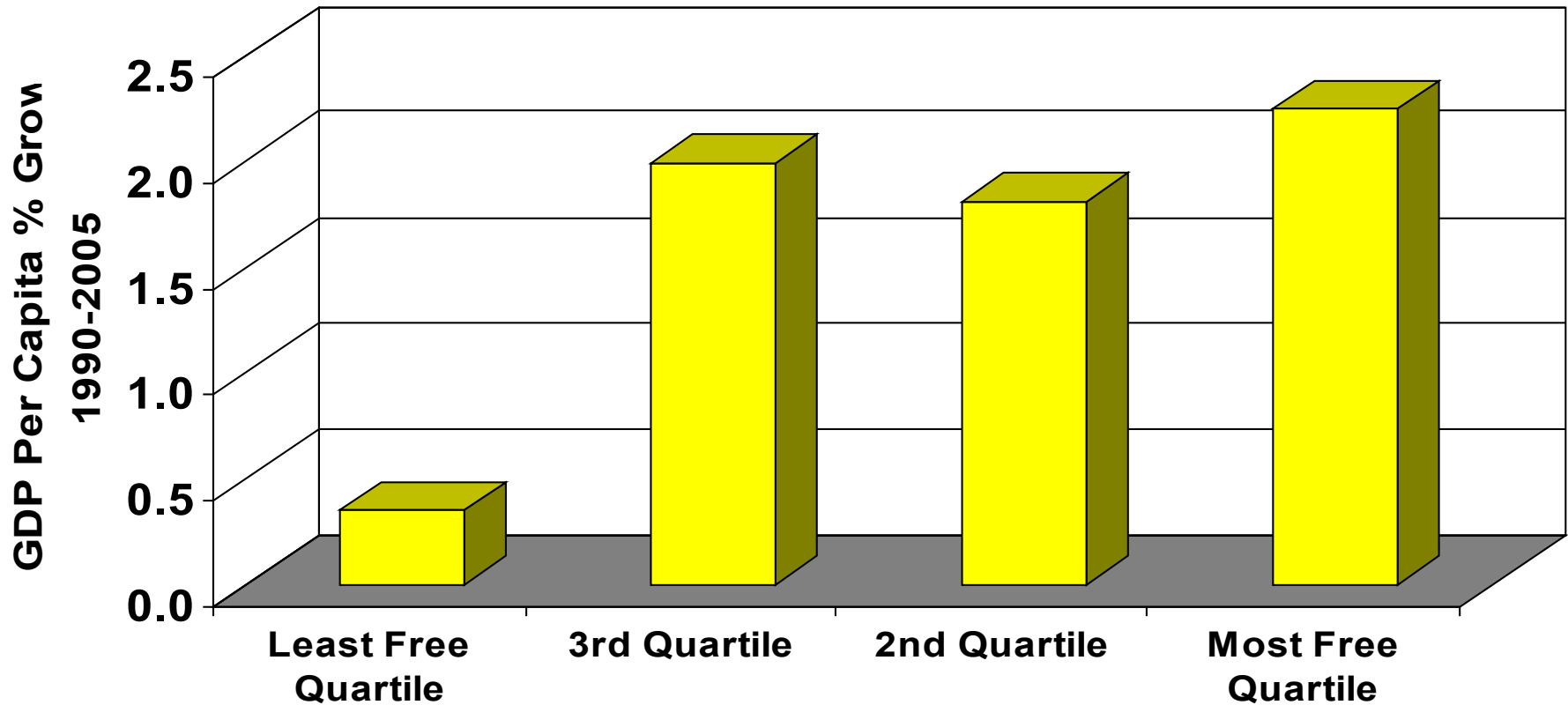


Sources: The Fraser Institute; The World Bank, World Development Indicators CD-ROM, 2007.

What can we take from this?

- Source(s) of Disparity?
 - Do rich countries get rich on the “backs of the poor”?
 - Do free countries get rich on the “backs” of the less free?
- Causation?
 - Are countries that are more wealthy more free?
 - Are countries that are more free more wealthy?
- This is an important question which is being investigated by a number of economists.
 - The results, thus far, suggest that (on average) countries that are more free are/become more wealthy over time.

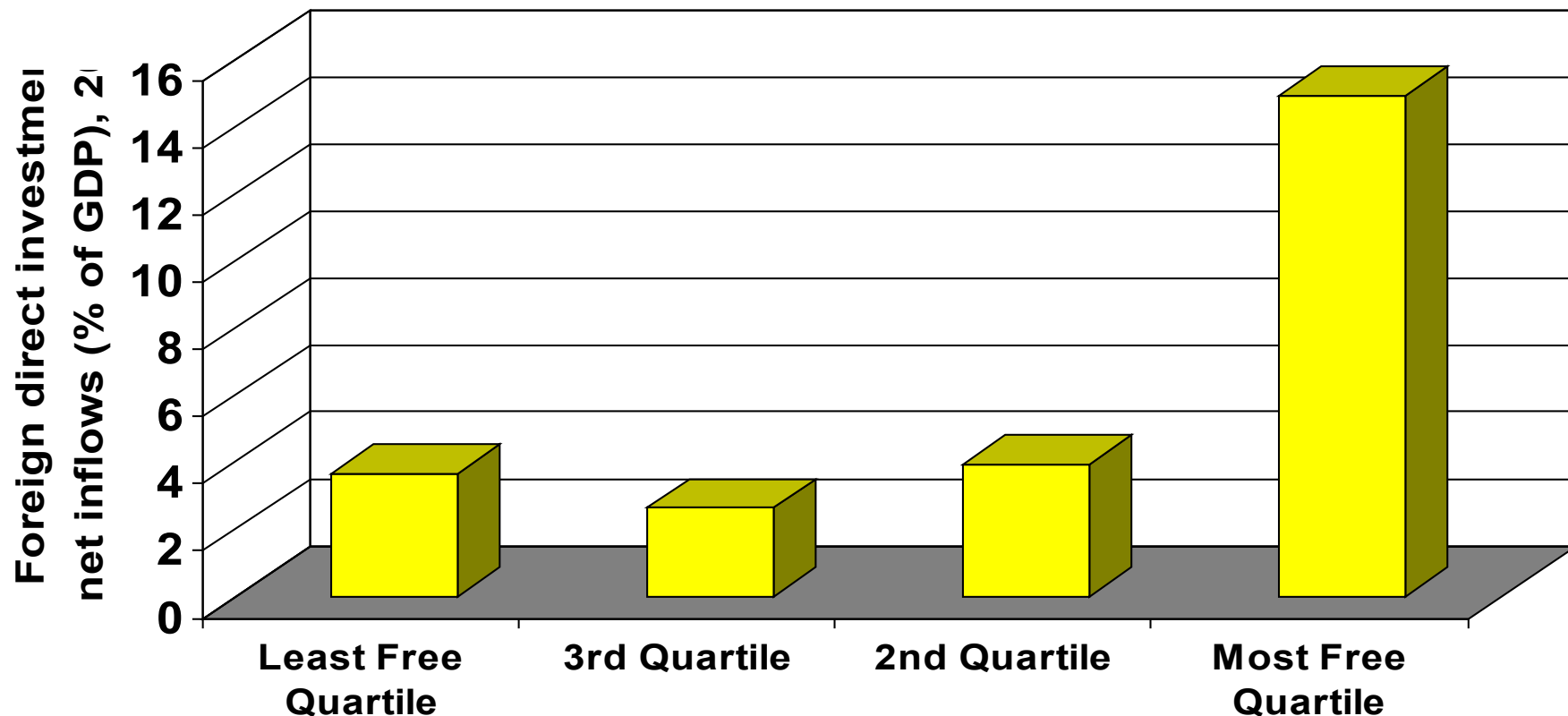
Growth in Real GDP Per Capita and Economic Freedom



Least free – economies double in size every 205 years

Most free – economies double in size every 30 years

Foreign Direct Investment and Economic Freedom

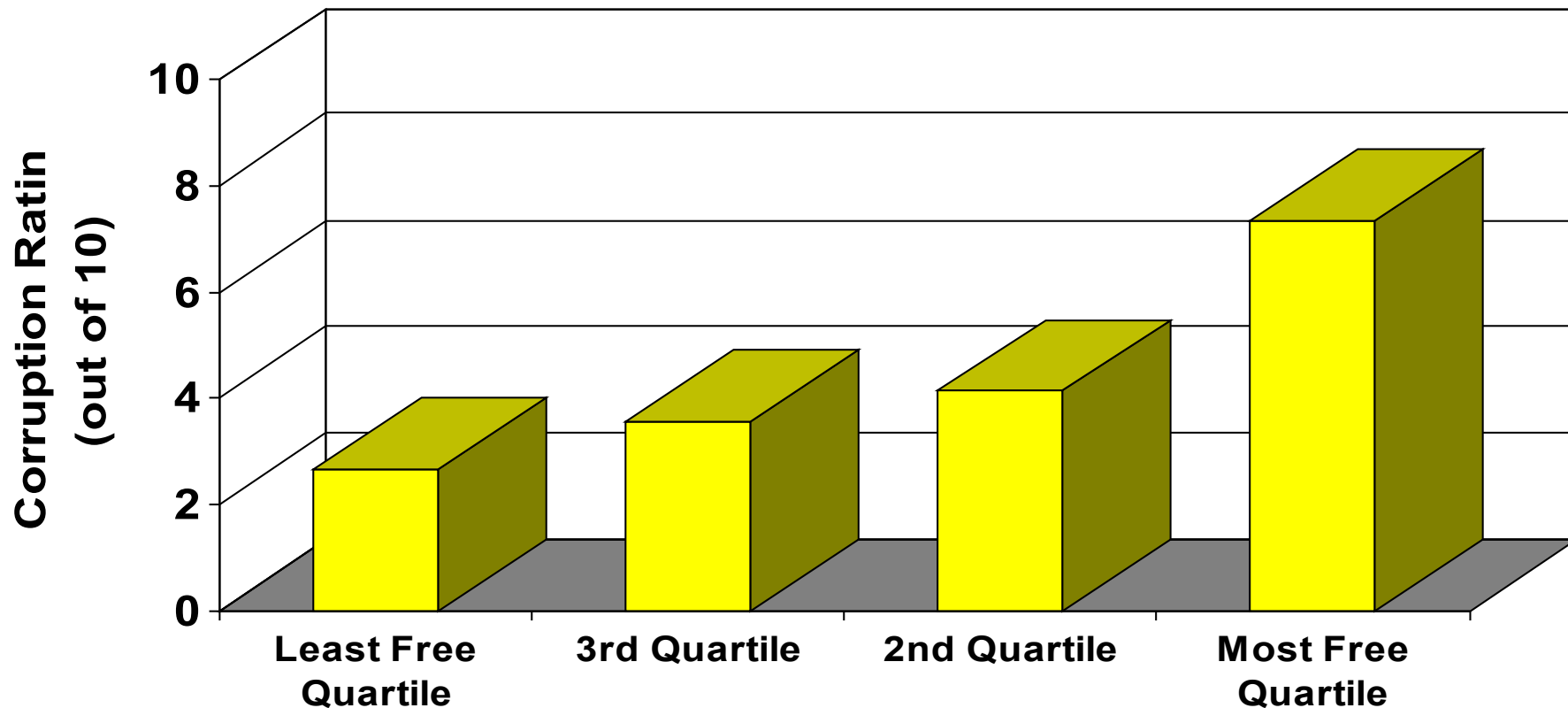


FDI flows towards countries with greater freedom – perhaps because returns are less risky?

Sources: The Fraser Institute; The World Bank, World Development Indicators CD-ROM, 2007.

Economic Freedom Versus Corruption

Higher value indicates lower level of corruption



Countries with greater economic freedom have less corruption.

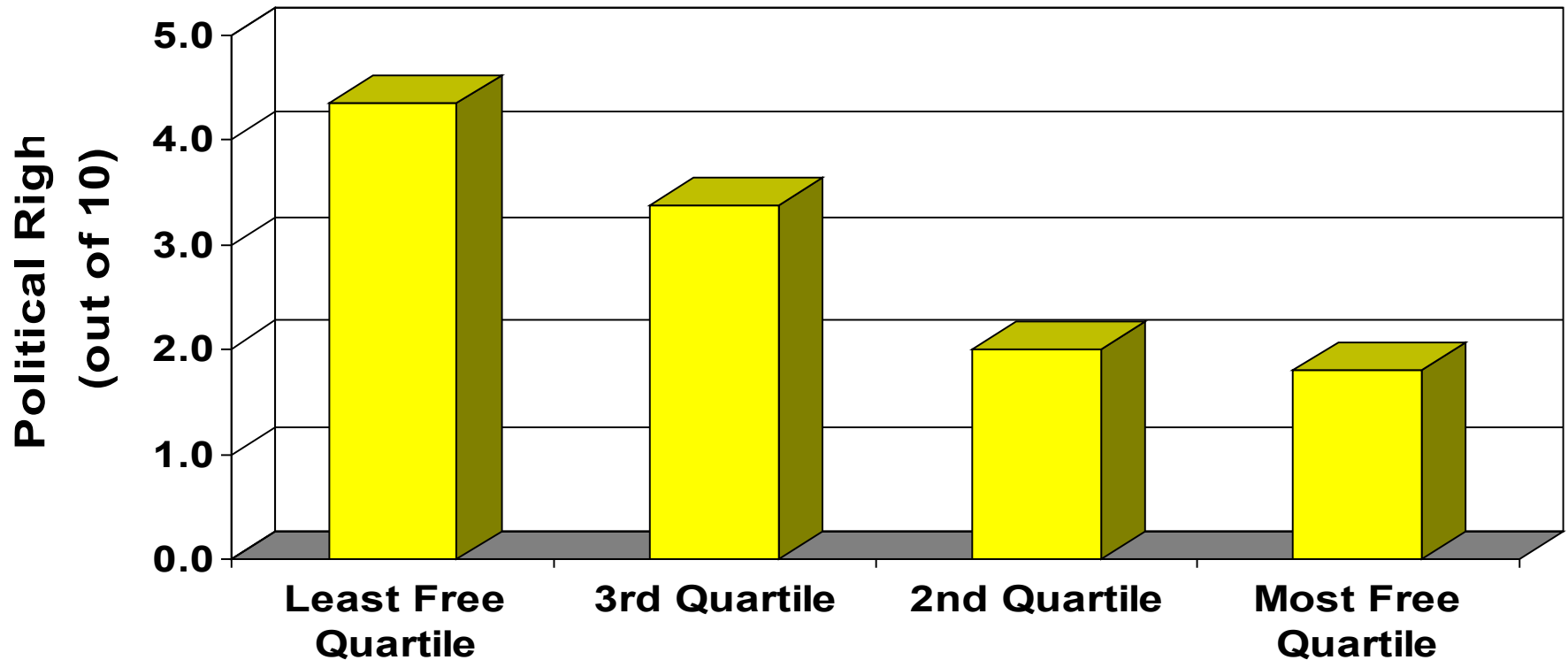
Sources: The Fraser Institute; Transparency International, Corruption Perceptions Index, available at <http://www.transparency.org>.

What does this tell us?

- Foreign Direct Investment entails a person in Country A investing in a project located in Country B.
- However, the individual in Country A has little control over what happens in Country B
- If Country B is corrupt or less free, projects might be nationalized or heavily taxed.
- Corruption entails bribery, extortion, or unnecessary bureaucracy, and can reduce the net returns on a project – hence less FDI.

Economic Freedom and Political Rights

Lower ratings indicate higher level of political rights

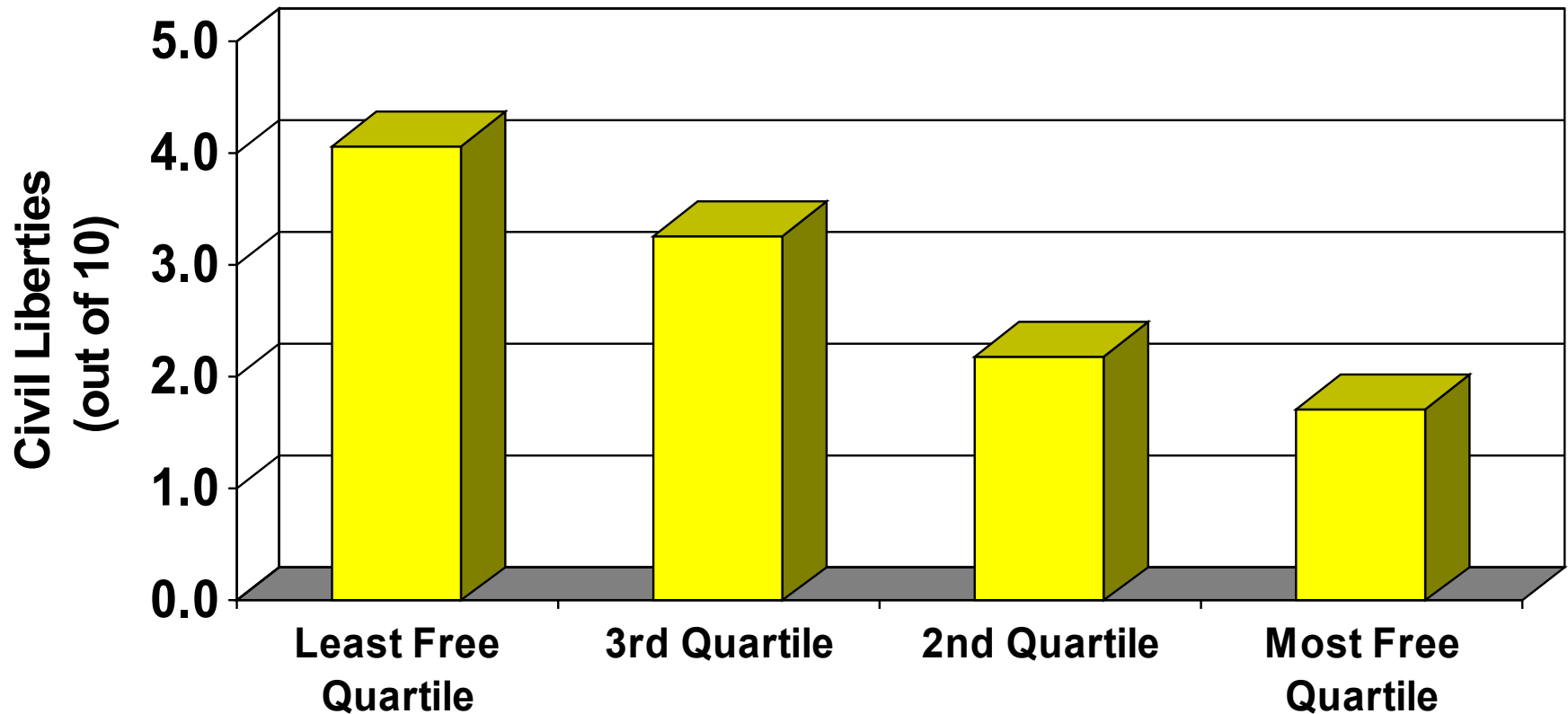


Countries with greater economic freedom tend to have greater political freedom.

Sources: The Fraser Institute; Freedom House, Freedom in the World Country Ratings, 1972 through 2005, available at <http://www.freedomhouse.org/>.

Economic Freedom and Civil Liberties

Lower ratings indicate higher level of civil liberties



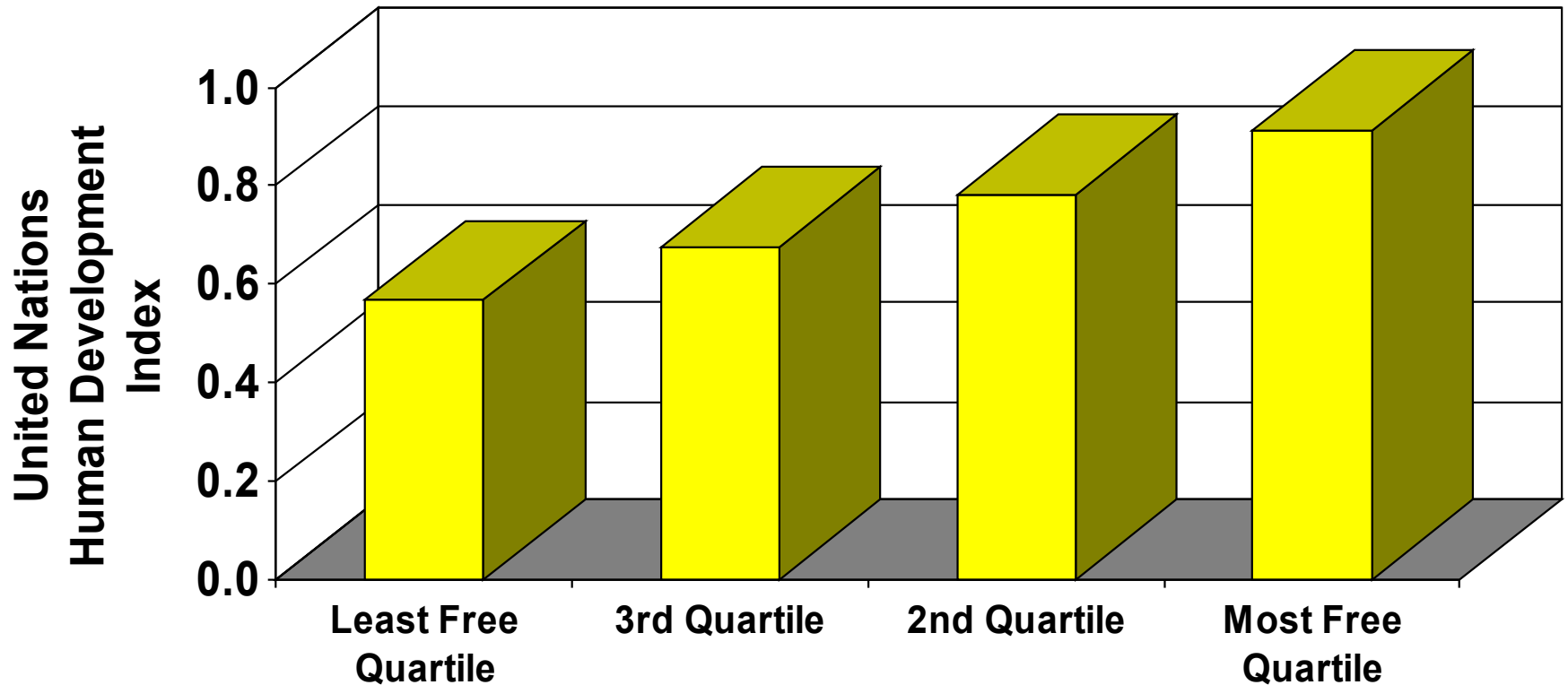
Countries with greater economic freedom tend to have more civil liberties.

Sources: The Fraser Institute; Freedom House, Freedom in the World Country Ratings, 1972 through 2005, available at <http://www.freedomhouse.org/>.

Implications?

- Are economic freedoms and political freedoms necessarily complementary?
- Is it possible to have a “wealthy” society without political freedoms but with economic freedoms?
- Is it possible for a country to curtail political freedoms and still experience growth?
- If so, how long until growth (especially in personal income) requires changes in political freedoms?

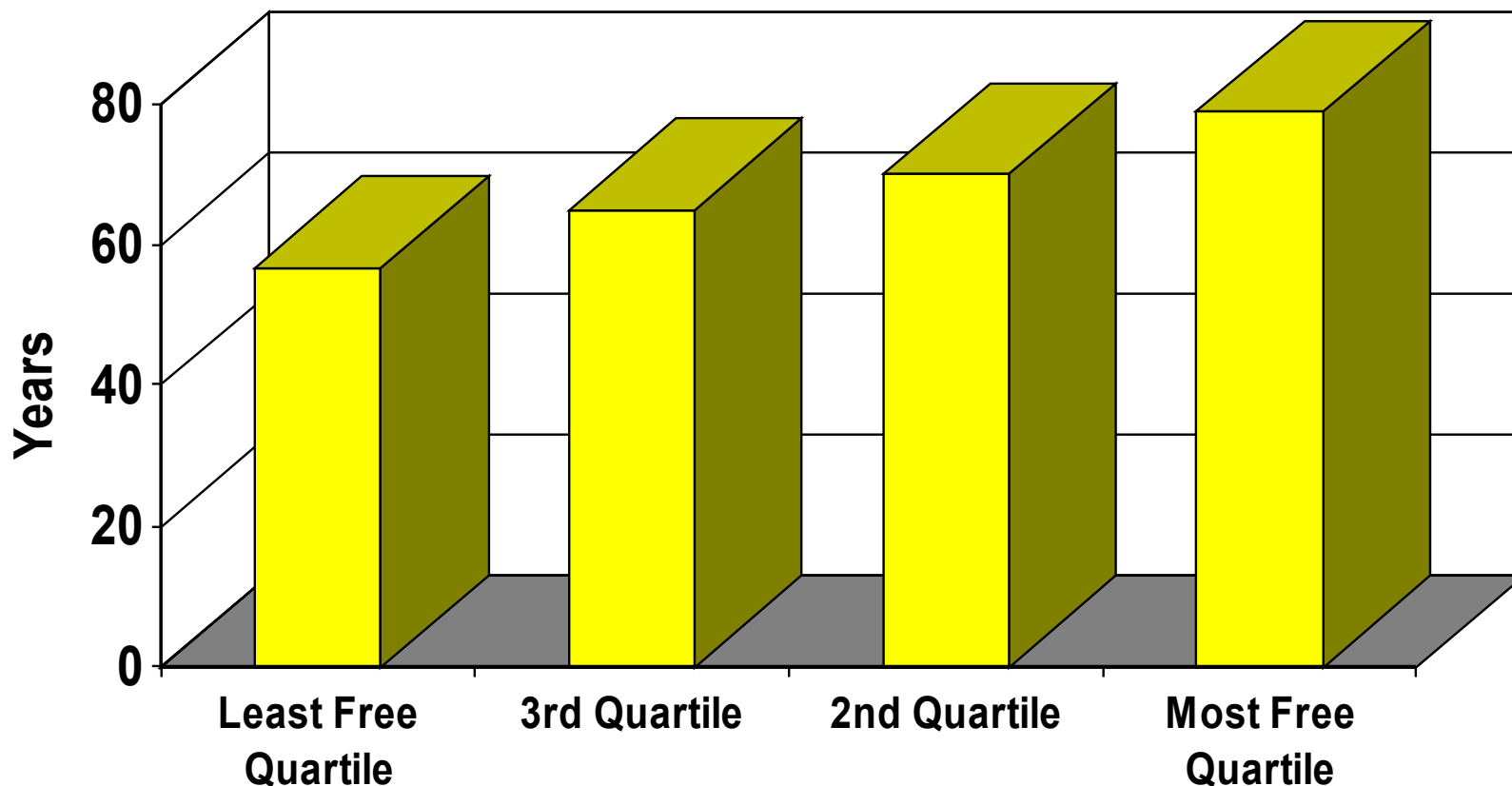
Human Development Index and Economic Freedom



Countries with greater economic freedom have better “quality of life” as measured by UN Human Development Index (includes life expectancy, clean water/food, health care availability, education, etc.)

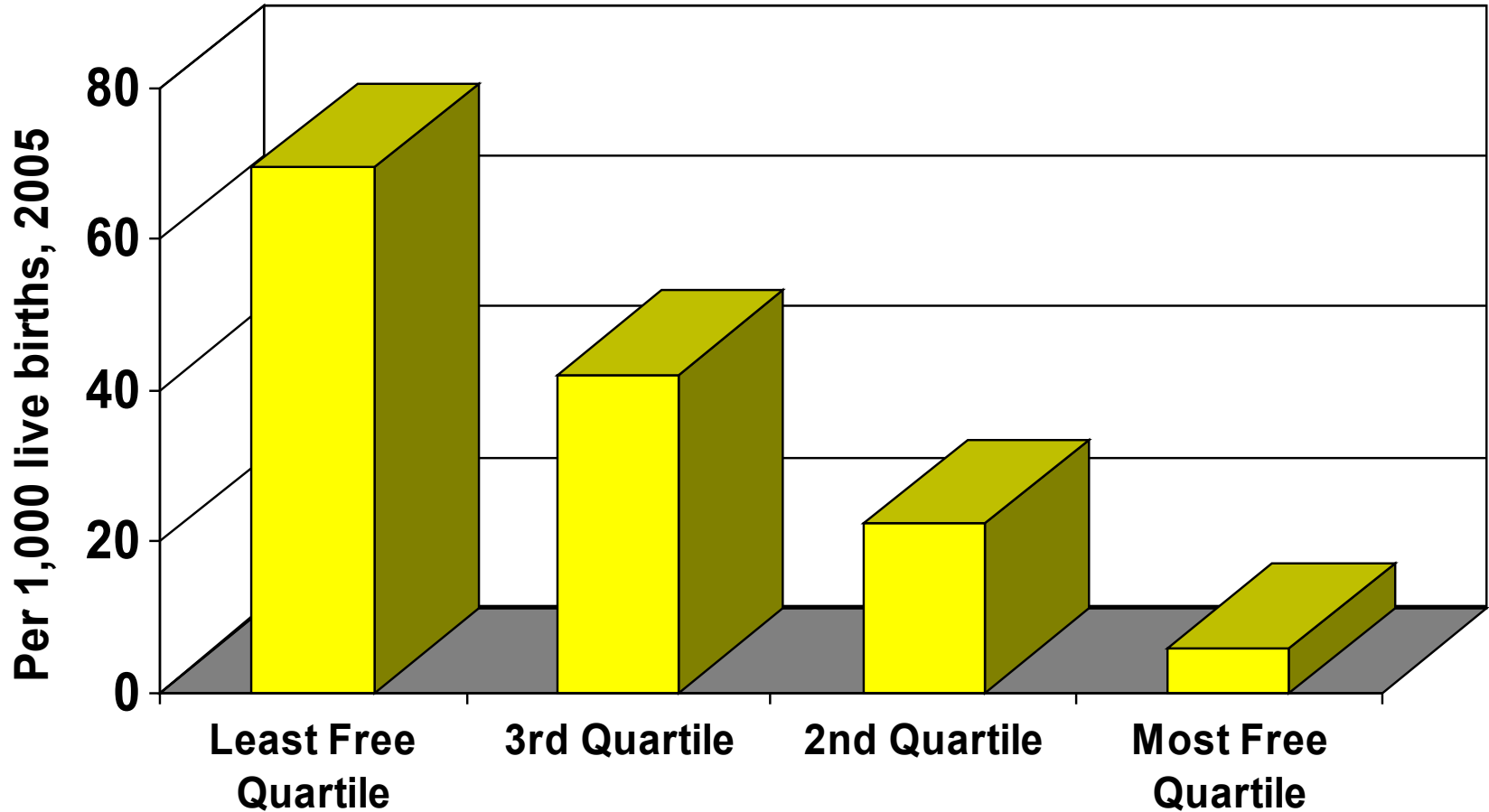
Sources: The Fraser Institute; United Nations Development Programme, Human Development Indicators 2006, available at <http://hdr.undp.org/>.

Life Expectancy at Birth and Economic Freedom



Sources: The Fraser Institute; The World Bank, World Development Indicators CD-ROM, 2007.

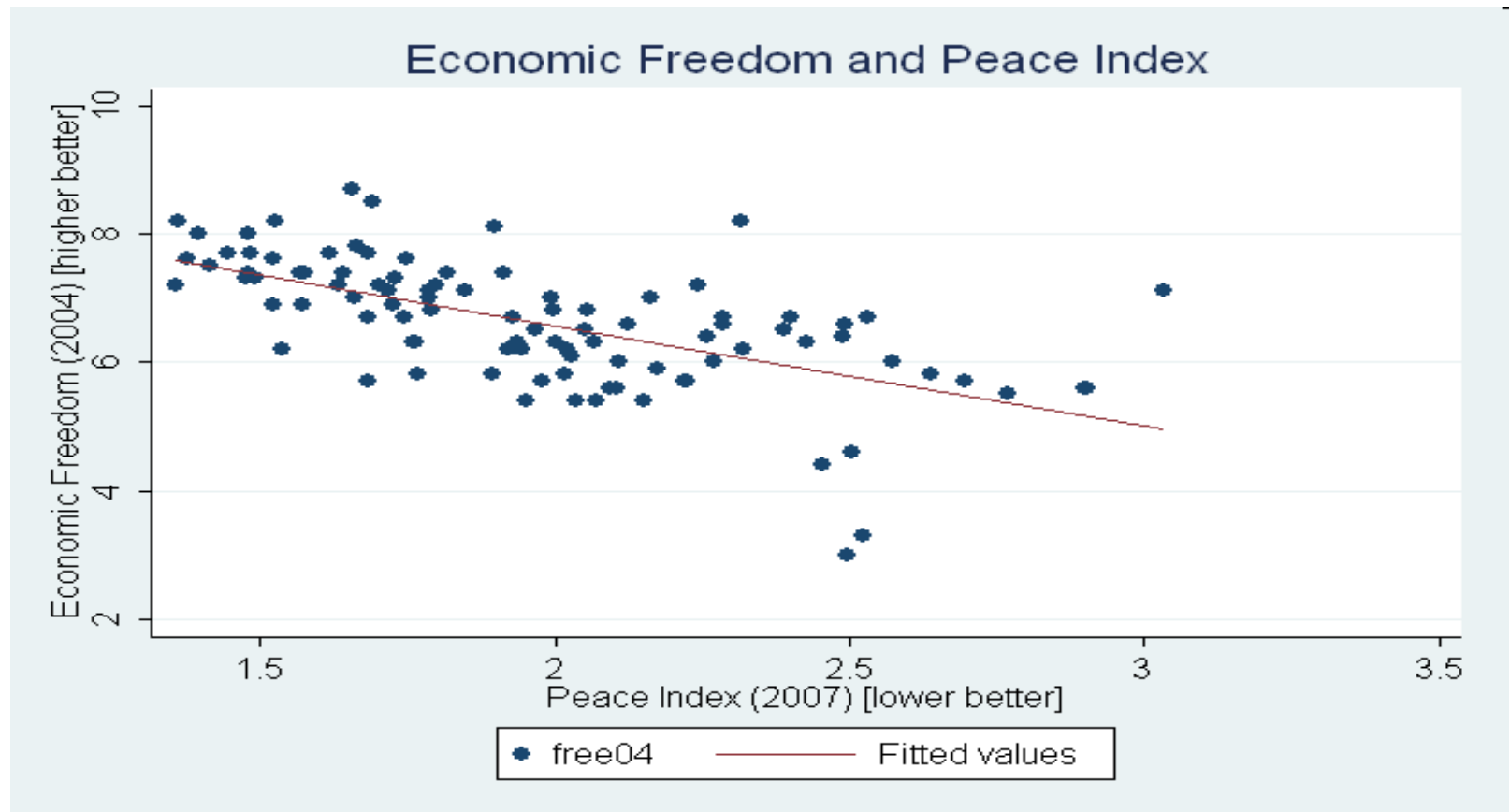
Infant Mortality and Economic Freedom



Perhaps greatest disparity between less and more free (other than per-capita income)

Sources: The Fraser Institute; The World Bank, World Development Indicators CD-ROM, 2007.

Economic Freedom and Peace



Countries that are more free tend to be more peaceful. Is this cause or effect?

Existing Research:

The Impact of Economic Freedom

Google Scholar search for “economic freedom” yields 19,900 hits!!

Economic Freedom and Efficiency

Klein and Luu (2003) – Countries which are more economically free tend to be more efficient

- Countries produce closer to their PPF;
- Countries more likely to recognize true comparative advantage;
- Improvements in economic freedom likely to improve domestic and world economies.

Economic Freedom and Intellectual Property Rights

Depken and Simmons (2004)

- Countries with greater economic freedom tend to protect intellectual property rights better (both home and foreign)
- Enforcing intellectual property rights might hinge more on internal institutions than international arrangements?
 - International arrangements do not necessarily alter internal institutions.

Economic Freedom and Trade

Depken and Sonora (2005)

- Economic freedom increases trade in consumer goods.
- Economic freedom has little to do with how much U.S. imports from other countries;
- Economic freedom has a big impact on how much the U.S. exports to that country.
- Upshot: Economic freedom increases individual choice sets, which include U.S. products.
- Simulations suggest that if the rest of the world had economic freedom at the level of the U.S. (however obtained) the U.S. would have a trade surplus rather than a trade deficit.

Economic Freedom and Entrepreneurship

Ovaski and Sobel (2005) and Clark and Lee (2006)

- Countries with more economic freedom are better suited for entrepreneurship and innovation.
 - Greater freedom correlates with more failures and successes
 - However, greater economic freedom allows a society to diversify the possible sources of (successful) innovation.
 - Reduced economic freedom tends to concentrate “innovation” into the hands of an elite few (not necessarily better), which is more risky.

Economic Freedom and Corruption

Depken, La Fountain and Butters (2007)

- Corruption reduces returns in the formal sector and rewards economic activity in the informal sector.
- Corruption might reduce overall economic activity.
- Corruption likely reduces FDI (usually in formal sector)
- Corruption increases
 - Rent seeking, inefficient government projects, loss of international aid, inefficient uses of international aid, difficulties in creating/maintaining infrastructure (public health issues).
- Corruption is lowest in countries with the greatest economic and political freedoms.
- Corruption increases interest rates on sovereign debt – pecuniary externality to local citizens who have to be taxed more to pay off national obligations.

Spread of Global Economic Freedom

- Global foreign policy has been grounded in the idea that freedom, including economic freedom, spreads among countries – and the loss of economic freedom can likewise spread among countries.
- Sobel and Leeson (2004): Investigate the “contagion” of economic freedom between geographic neighbors and trade partners using more than 100 countries between 1985 and 2000.

Spread of Global Economic Freedom

Empirical Evidence

- Economic freedom spreads through both geography and trade.
- Countries “catch” about 20% of their average geographic neighbors’ and trading partners’ levels and changes in economic freedom.
- The results also suggest freedom does not spread as strongly or as quickly as the domino theory during the Cold War suggested.

Conclusions

Economic Freedom

- Increases incomes
- Increases economic growth
- Improves quality of life
- Increases levels of trade
- Increases efficiency
- Increases entrepreneurship
- Increases property rights protection
- Improves the possibilities for international business