

# **Measuring Economic Freedom and Assessing its Benefits**

**David Henderson**

*James Gwartney, Robert Lawson and Walter Block, **Economic Freedom of the World, 1975-1995**, The Fraser Institute, Vancouver, 1996*

**T**HOMAS CARLYLE, in a memorable and much-quoted phrase, once described economics as 'the dismal science'; and this is indeed an appropriate label, in so far as the subject places a good deal of emphasis on scarcity — on the limitations of economic systems, and hence the inescapability of hard choices. But in another respect economics can be described as a heartening subject, since another of its distinctive messages is that two widely accepted values, prosperity and individual liberty, are not only compatible but mutually reinforcing. This has been part of the representative economist's view of the world ever since Adam Smith advanced so brilliantly the thesis that the wealth of nations would be furthered by what he termed 'the system of natural liberty'.

Within the economic sphere, individual liberty has several aspects. It includes the freedom of people to spend their money as they wish, and to choose their lifestyles, occupations and places of work. For both individuals and business enterprises, it involves freedom to decide how to invest their resources, and which products and services to offer for sale and on what terms. Further and not least, it embraces the right of people and businesses to move freely within national boundaries, and to choose where to live and to operate; and this latter freedom holds good even when, as in federations, there are politically significant geographical divisions. All this enters into the conception both of a free society and of a well-functioning market economy: the two go together. Freedom of action makes it possible for market initiatives to be taken and responses to be made, while these in turn provide the means through which freely chosen and freely exercised preferences can be given effect.

## **The Economic Freedom Index**

This broad conjunction of economic freedom and material prosperity is one of the twin themes of the study under review, which presents, in readable and accessible form, the fruits of an ambitious long-term collaborative research venture. The first

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*David Henderson is a former Head of the Economics and Statistics Department of the OECD in Paris. He is at present a visiting professor at the Melbourne Business School.*

and principal theme of the book is an exercise in systematic measurement of the changing estimated extent of economic freedom across the world over a period of two decades. For 102 countries, and (where possible) for five separate years over the period 1975-95, various measures are developed to show the prevailing extent of economic freedom. These are brought together, in three different illustrative systems of weighting, so as to establish for each country, for as many of the five years as the data permit, an overall Economic Freedom Index. The countries are drawn from all regions of the world, though two notable absentees from the list, because of data limitations, are China and Russia.

Seventeen separate indicators of economic freedom were chosen (though for three of them data were available only for recent years). These are grouped under four headings: money and inflation ('Protection of money as a store of value and a medium of exchange'); government operations and regulations ('Freedom to decide what is produced and consumed'); takings and discriminatory taxation ('Freedom to keep what you earn'); and restraints on international exchange ('Freedom of exchange with foreigners'). In the particular weighting system which the authors prefer, the respective weights under the four headings, expressed as percentages, are 15.7, 34.6, 27.2 and 22.5.

The introduction and the first three chapters of the book, some 90 pages in all, are devoted to explaining the Economic Freedom Index and presenting the main results, while the final (fifth) chapter, of 118 pages in all, gives useful two-page summaries for 58 of the 102 countries (I would have preferred a wider coverage here). Two appendices, amounting together to a further 80 pages, give further details of the underlying data that were used. In the midst of this statistical evidence and commentary for particular countries, and drawing on the results, is Chapter 4, which is just over 20 pages long. This develops the second main theme of the study, namely, the links between the level of economic freedom attained and changes in this level on the one hand, and the past and current growth of output per head in these countries on the other. It thus reviews the connection between freedom and prosperity, as evidenced by what comes out of the main exercise.

Although the final responsibility for the text rests with the three coauthors, they were able to draw on a substantial team effort which goes back several years. The study is described as 'an outgrowth of a series of six conferences jointly sponsored by the Fraser Institute of Vancouver, British Columbia and the Liberty Fund of Indianapolis, Indiana' (p. xiii). A list is given of 62 participants in this series of conferences, drawn from (on my count) 13 different countries, though with a strong preponderance of Americans (42) and Canadians (8). (There is no one in the list from either Australia or New Zealand.) Final publication was by the Fraser Institute, but ten other market-oriented private research institutes around the world, including the Institute of Public Affairs in Australia, are listed as copublishers. The back page quotes tributes to the book from three Nobel prizewinners in economics: Gary Becker, Douglass North, and Milton Friedman who has been an active participant in the whole program and receives a special acknowledgement in the authors' preface.

As one would expect from the list of participating individuals and institutions, the viewpoint of the book, and its treatment of policy issues, is that of classical liberalism: progress is seen in terms of curbing the interventionist activities of governments. Now and then, chiefly in the brief comments on individual countries, the tone becomes rather trying — 'The sooner Bolivian policy makers understand this point and begin to act accordingly, the brighter the future for this troubled economy' (p. 121) — but this hortatory aspect is incidental only. The book is best seen and judged as a contribution to recent quantitative economic history.

Despite the important place which it implicitly holds in the characteristic economists' view of the world, the notion of economic freedom has been given surprisingly little explicit and systematic attention. The program of work that has led up to the publication of this book, as also the book itself and the analysis that it offers, are therefore to be welcomed. Not surprisingly, however, there is room for doubt over both the approach that is taken here and the actual results of the exercise.

### **The Australian and New Zealand Cases**

Some of the reasons for doubt can be illustrated by looking at the numerical results in the particular cases of Australia and New Zealand. For both countries, the overall Economic Freedom Index, taking the weighting system which the authors prefer, is higher for 1995 than for 1975, with the increase for New Zealand (from 4.3 in 1975, out of a maximum of 10, to 8.0 in 1995) being substantially greater than for Australia (from 5.0 in 1975 to 6.8 in 1995). This broadly conforms to what one would expect, since in both countries there have been significant market-oriented changes in policy, which generally speaking have been more far-reaching in New Zealand. However, a closer look at the two series brings out some surprising and questionable features.

For Australia, the timing of the changes in the Economic Freedom Index looks strange. Along with other observers of the Australian scene, my version of events holds that the most notable moves towards liberalisation on the part of federal governments dated from the mid- to late 1980s. The main developments were the floating of the exchange rate at the end of 1983, the radical freeing up of financial markets which accompanied and followed this, the tax reforms of 1986, the substantial deregulation of direct foreign investment in general over these years, the decision of 1988 to set in train a progressive reduction of tariffs, and the readiness as from 1987 to engage in asset sales and privatisation of government-owned enterprises. All these embodied significant changes in the orientation of economic policy. (This view of the past is sketched out further in Henderson, 1995). As compared with this Hawke-Keating period, both the Fraser period from 1975-83 and the first half of the 1990s appear as phases in which the impetus to economic reform was weaker. It is therefore odd to find that the evolution of the index for Australia goes as follows: 5.0 for 1975; 5.5 for 1980; 5.9 for 1985; 6.0 for 1990; and 6.8 for 1995. Of the total increase in the rating of 1.8 points between 1975 and 1995, 1.3 points are thus attributed to 1975-80 and 1980-95, compared with only 0.5 points for the decade of the 1980s, almost all of it attributable to the first five years.

Detailed study of the figures renders the differences between these two views of past events clearer. For one thing, in Australia (and New Zealand too) the authors' rating for 1995 is raised by the inclusion of three new items, two of which do not previously appear while the third is included only from 1990. Hence the overall index as quoted is not consistent over time, and because of this the improvement for 1990-95 may well be overstated. Second, the decision to evaluate policies only in terms of measurable outcomes means that policy changes as such, even when they appear historically significant, do not count. A good instance is the New Zealand Fiscal Responsibility Act 1994, which does not enter into the rating here; and in Australia, the rating for 'taxes on international trade' stays the same for 1980, 1985 and 1990, even though the orientation of trade policies changed markedly. Third, the Fraser Government gets credit for 1980, as compared with 1975, for (i) reducing the variability of inflation, and still more for (ii) apparently establishing, in the period 1978-80, 'freedom from government policies and regulations that cause negative real interest rates'. By contrast, Australia loses marks, as between 1985 and 1990, for a higher rate of growth in the money supply. Fourth, throughout the period, from 1975 onwards, Australia is awarded 10 out of 10 for (allegedly) permitting freely both the ownership of foreign currency and the ownership of a bank account abroad; but as these freedoms effectively date from the abolition of exchange control after the end of 1983, the sequence of ratings here is misleading.

In the case of New Zealand, it is surprising to see that the rating in respect of 'government enterprises' stays the same (at 6 out of 10) for the whole period 1975-90, despite the reforms of state enterprises following the Act of 1986 and the subsequent privatisations (which, however, probably explain the improvement to 8 out of 10 in 1995). More worryingly, there seems to be no allowance in the index for the passage of the Employment Contracts Act 1991, which is arguably the most significant liberalisation to be carried out with respect to labour markets in any country of the world during these two decades.

Three related general morals can be drawn from these specific instances. The first and most mundane is that a lot more work needs to be done on individual countries, with a view to getting facts, figures and history more clearly established. Despite the time and effort put into arriving at the measures presented here, major questions of accuracy, relevance and interpretation remain. To deal with these effectively would mean extending the range of expertise, impressive though it is, that is to be found in the individuals and institutions that have produced the present study. A closer look needs to be taken at particular cases, preferably with the participation of national and international officials as well as people in universities and research institutes, and with a wider geographical spread of first-hand knowledge.

Second, the question of what should enter into an index of this kind remains debatable. One issue, as noted above, is how exclusively the index should reflect actual developments that can be measured, as distinct from statements of policy and intention, or changes that are not easily mirrored in official statistics. A further issue, not surprisingly, is coverage: the present list of indicators makes no explicit reference to freedom of contract in labour markets, or to freedom of choice and the extent of

competition with respect to purchases of health and education services. For these and other reasons there is scope for devising and trying out alternative measures.

Third, the questions of measurement and definition are themselves linked to the more fundamental issue of how economic freedom is to be viewed and defined. In the project of which this book forms part, a good deal of time and thought has gone into exploring these matters, most notably in a number of essays by Alvin Rabushka (Block, 1991). But in my view the whole subject area needs to be treated more fully, with a stronger contribution from both historical and philosophical thinking.

One aspect of clarifying further the notion of economic freedom is to examine more closely some borderline issues and cases, where informed observers who broadly share the same point of view may find themselves in disagreement. Examples of such issues are anti-trust action and merger control, legal protection for patents, insider trading on financial markets, and collective action to improve environmental outcomes. The Fraser Institute program has not, I think, been able to go into such debatable areas, and indeed it is not clear from the present volume how a country would qualify to earn and keep a rating of 10 out of 10 for its Economic Freedom Index.

In the same way, the discussion in Chapter 4 of this book, of the relation between economic freedom and the level and growth rates of income per head, deals with general aspects to the exclusion of more debatable cases and episodes. So far as it goes, the analysis is sound and well presented. The evidence from the country measurements is marshalled so as to bring out two relationships in particular: (i) persistently high freedom ratings go with prosperity, and persistently low ratings with low levels of income per head; and (ii) increases in the Index have been linked to good or improved growth performance, as contrasted with bad or worsening performance in countries where the Index has fallen back.

In a fuller treatment, which it would be unfair to have expected from this study, attention could also be given to differences in growth performance, whether over time or between countries, which may not fit this framework too well. Examples include: the falling away of productivity growth in the OECD countries, as between the period 1950-73 and thereafter; the contrast between growth rates of output per head in the UK and Japan in the decades following World War II; and the sustained high growth rates of South Korea and Taiwan, which at least in the earlier stages — before 1975, the initial date for this study — were achieved in economic systems which in some respects were highly regulated. Also under this heading, it remains to be seen how far the economic reforms of recent years will serve to raise the underlying growth performance of the many countries across the world in which they have been made.

### **Absolute vs Proportionate Change**

Possibly the most useful single feature of the present study is that it enables this process of reform to be presented in comparative and quantitative terms across countries. Since ratings are provided for a series of separate years, a dual presentation can be made for each country: first, of the extent to which reform has been taken during some stage of the period 1975-95; and second, of how far this measure of reform

compares with what could have been realised — the apparent potential for reform — given the initial 'pre-reform' situation of each economy. Both these measures of change, the absolute and the relative, are of interest. By using the second, it is possible to allow for differences in the scope for liberalisation, arising from the fact that at the beginning of their respective reform processes some economies were freer than others. Both measures are therefore shown in Table 1, in which I have drawn on the results of the study to present a picture of my own in which 32 countries are included.

**Table 1**  
**Changes in economic freedom rating for 32 countries, 1975-90,**  
**ranked in order of proportionate change**

Country	Rating		Change	
	Initial (year)	1990s	Absolute	Proportionate (%)
New Zealand	4.1 (1985)	8.0	3.9	66
Argentina	2.5 (1985)	6.3	3.8	51
Ireland	3.9 (1975)	6.7	2.8	46
South Korea	4.0 (1980)	6.7	2.7	45
UK	4.5 (1980)	7.0	2.5	45
Singapore	6.8 (1975)	8.2	1.4	44
Chile	2.8 (1975)	5.8	3.0	42
USA	6.0 (1975)	7.7	1.7	43
Thailand	4.9 (1975)	7.0	2.1	41
France	3.4 (1985)	6.0	2.6	39
Malaysia	5.1 (1975)	7.0	1.9	39
Australia	5.0 (1975)	6.8	1.8	36
Japan	5.2 (1975)	6.9	1.7	35
Czech Republic	2.4 (1985)	4.9	2.5	33
Poland	2.2 (1985)	4.8	2.6	33
Taiwan	4.9 (1975)	6.6	1.7	33
Ghana	2.3 (1980)	4.8	2.5	32
Mexico	3.8 (1980)	5.8	2.0	32
Sweden	3.4 (1980)	5.5	2.1	32
Italy	3.6 (1985)	5.6	2.0	31
Turkey	2.3 (1980)	4.2	1.9	25
Canada	5.9 (1985)	6.9	1.0	24
Indonesia	5.0 (1980)	6.1	1.1	22
Netherlands	5.4 (1980)	6.4	1.0	22
Egypt	2.4 (1980)	4.0	1.6	21
India	3.3 (1975)	4.5	1.2	18
Kenya	3.4 (1975)	4.5	1.1	17
South Africa	3.9 (1975)	4.9	1.0	16
Switzerland	7.1 (1980)	7.5	0.4	14
Brazil	2.3 (1985)	3.3	1.0	13
Nigeria	2.8 (1980)	3.7	0.9	13
Germany	5.9 (1975)	6.4	0.5	12

The first column of the table shows the Economic Freedom Index — again taking the authors' preferred weighting system — for a 'pre-reform' year which can be 1975, 1980 or 1985: in each case, the year that I have chosen is the one in which the country's rating was lowest, and is indicated in the column. The second column shows the rating for the latest year available in the 1990s, and the third column the difference between the two, which is an absolute measure of the estimated extent of reform for the period concerned.

The final column gives the improvement in economic freedom as a percentage of the difference between the initial pre-reform rating and a rating of 10. This allows us to rank the changes in the different countries as a proportion of the level of unrealised economic freedom (according to the Index) prior to the reforms being undertaken. It indicates the achievement as against the potential. Hence in the case of Australia the absolute change in the rating is 1.8; this is divided by 5.0, which is the estimated potential for reform in the initial year of 1975. The result is a figure of 36 per cent.

The main points that emerge from the table are as follows:

- For all 32 countries, the 1990s ratings are higher than those in the first column, in some cases substantially higher: all these countries have taken the path of liberalisation, though in some cases the extent of reform appears as quite modest.<sup>1</sup>
- In the final year, Singapore has the highest rating,<sup>2</sup> closely followed by New Zealand, and with the US and Switzerland third and fourth respectively. Australia appears as tenth.
- In absolute terms, New Zealand appears as the leading reformer, closely followed by Argentina — in both cases despite the fact that the 'pre-reform' year is the relatively recent one of 1985. Other leading countries are Chile, Ireland, South Korea and France. The lowest absolute extent of reform is shown for Switzerland and Germany, though in both these countries the initial rating was a high one. Australia emerges as 17th in this list, right in the middle of the group.
- Generally speaking, and as might be expected, reforms have been taken furthest in those economies that were initially more regulated, so that the ratings for the 1990s, in the second column, show less divergence than those in the first. However, some countries in which the economic system has long been closely regu-

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<sup>1</sup> In a small number of the 70 countries not included in the table, the freedom rating was appreciably lower for the most recent year than for any of the earlier years for which a figure is shown. The list here includes Cameroon, Honduras, Iran, Venezuela and Zaire.

<sup>2</sup> For all the years and with each of the three weighting systems offered, Hong Kong is given the highest rating of all 102 countries covered in the study. Taking the average of all three measures for the most recent year, the leading countries and their ratings are: Hong Kong, 9.0; New Zealand, 8.5; Singapore, 8.2; the US, 8.0; and Switzerland, 7.9. In this listing Australia comes eighth equal, with a rating of 7.4.

lated, such as India, Brazil, South Africa and Nigeria, have so far made only modest moves in the direction of reform.

- In the final column, where differences in the initial situation are allowed for, New Zealand emerges as clearly the leading country, with Argentina an unchallenged though not a close second. New Zealand's lead would appear even greater if account were taken of reforming measures which are not reflected in the Economic Freedom Index, including the Employment Contracts Act and the Fiscal Responsibility Act. Australia's ranking in this final column is twelfth.

### Concluding Comments

For reasons that have been touched on above, too much weight should not be placed on particular figures in this table: there is a lot of scope for debate, rethinking and improvement. Among other aspects, it is possible that the choice of indicators here gives too little weight to areas — such as labour markets, environmental measures, and health and safety regulations — in which the trend of recent policies in some countries may well have been towards, rather than away from, interventionism. In such cases, the extent to which reform has been taken may be overstated. Nevertheless, the picture conveyed in the table seems accurate in general outline, so that the results of the study throw further light on the trend to market-oriented reform which has been such a notable (and largely unexpected) feature of the past 15 to 20 years. In this respect as in others, *Economic Freedom of the World, 1975-1995* makes a contribution to the understanding and interpretation of recent history.

### References

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