

Economic Freedom: A must for incomes and growth

Do countries with more economic freedom grow more rapidly? Do they achieve higher income levels? Do changes in economic freedom affect income growth?

Once, it seems odd now, these questions were debatable. It led to socialist claims about central planning as a prerequisite for economic growth being taken seriously at least by anyone wanting to pass as an advanced thinker.

But those antediluvian times are over. The evidence is in. It required many botched socialist "experiments" and untold human suffering, but now we can answer all the above questions in the affirmative.

First, however, we must know what economic freedom is and how it can be measured. Second, the freedom index must be applied both across a wide range of countries and over a lengthy period of time in order credibly to ascertain the linkage between liberty and prosperity.

A new study, co-published by the Free Market Foundation, *Economic Freedom of the World 1975-1995*, by James Gwartney *et al* is the first to satisfy these requirements. It is an outgrowth of a series of six conferences jointly sponsored by the Fraser Institute of Vancouver and the Liberty Fund of Indianapolis. The sixty two conference participants included three Nobel Prize winners, Milton Friedman, Gary Becker and Douglass North. The study took a decade to complete and examined freedom, growth and incomes in 103 countries.

The index of economic freedom, each measured objectively and quantitatively, has 17 components. They include government consumption expenditures as a percent of GDP, the presence and scale of state operated enterprises, industrial regulation, price controls, levels of marginal taxation, transfers and subsidies between citizens as a part of GDP, the level and variability of inflation, exchange controls, controls or subsidies on foreign trade, and the use of a conscript army distorting free labour market choices. Development economists will debate and analyse these factors, whether they are appropriately measured, and whether the weightings given to each are valid. About these things there will naturally be debate but it will be within a consensus about the necessity of economic freedom for prosperity. The comprehensiveness of the study, both over time and across countries, ensures that its main message cannot lightly be dismissed. The main message comes across in two snapshot charts

(still to come)

(Figures 1 and 2), which answer the first two of the three questions we began with. Countries with the highest level of economic freedom grow most rapidly (at an average of 3.3 per cent per annum per capita GDP). Second, in 1985 dollars, countries with the lowest level of economic freedom achieved in 1994 the lowest level of GDP (\$1650 per capita). What of our third question? Let the authors speak for themselves.

"There were no exceptions – every nation that significantly improved its rating also achieved solid economic growth. On the other hand, economies that moved away from economic freedom were characterised by sluggish growth and economic decline".

And South Africa's position in the world? Two years after the election of 1994 a composite score of 4.9, a rating of 54, was computed for SA (Figure 3). In terms of economic freedom the country is closer to Bangladesh and Pakistan than it is to the Latin American countries of Argentina and Chile, or any of the emerging Asian "tigers" such as Malaysia or Indonesia.

So who is surprised?

Why is economic freedom so important? Why does it require 17 components for its measurement? The crux of the matter is the right to own and exchange property free from intrusions by government. The

intrusions which can impede trade (and hence growth) are embraced by many of the list of 17. Inflation impedes exchange because it discourages complex transactions across time (who wants to receive depreciated currency?). Taxes, subsidies, industrial policy, lavish welfare handouts, all these blunt the incentives of those who would otherwise seek out profitable trading opportunities, and encourage apparently profitable courses of action which would otherwise have been left alone as value-subtracting rather than wealth-creating activities.

If an economy's institutions are consistent with economic freedom then it is easier for people to cooperate, to specialise and to trade with each other from positions of comparative advantage. Gains from trade and entrepreneurship will be realised. Conversely if property owners are not insulated from the power of the state to grant privileges to special interest groups (whether trade unionists, industrialists seeking special favours, empire building bureaucrats, or welfare recipients) then trade will be restrained and transaction costs will rise. Uncertainty about the potential of realising the gains from trade will reduce the incentives of individuals to engage in productive activities.

And if the implications of this study are ignored? If we now know that movement toward economic freedom generates growth, what if we continue to make political decisions, to retain or, for that matter to extend the area of economic unfreedom in the SA economy? The evidence presented in the study is quite consistent. Bearing in mind our reluctance to privatise, our desire to increase welfare, our high tax rates, the ever widening powers of NEDLAC, labour laws, foreign exchange controls, and the unconquered burden of inflation the answer to that question makes for gloomy reading. Countries that remained "persistently unfree" over the study period, all had low incomes. In countries where economic freedom actually "regressed", none was able to achieve a persistent, positive growth rate.

The challenge for S African policy makers is to encourage the further emergence of a profit-seeking economy to replace the rent-seeking economy of the racist past where huge resources were dissipated in the pursuit of non-market returns. The danger is that one group of rent-seekers simply replaces another. Our level of economic freedom will be little changed if we do not in fact regress as well.

The developing countries of the world are those in which profit-seeking dominates rent-seeking. Japan is rich because it is profit-seeking. India is poor because it is rent-seeking. The non-developing countries are those in which rent-seeking dominates profit-seeking. Profit-seeking activities and institutions are those that increase the size of the economic pie. Individuals who seek profits make money by producing more goods and services for consumers, the ultimate arbiter. Rent-seeking activities and institutions are about redistribution, larger chunks of a given economic pie. Individuals who pursue rents make money by taking a bigger helping of what has already been produced.

Under white supremacy rent-seeking became a feature of the South African way of life. Just think of the hold white farmers and white trade unions had on governments before and after 1948.

But parasitic behaviour is not a monopoly of a particular race or form of government. Now, under majority rule, we have the makings of the same old story. Only, the recipients of the artificially contrived transfers are different.

Of course, a different, more optimistic, scenario is possible. But President Mandela will have to prove that his fine words to German businessmen were not just rhetoric for gullible foreigners, who aren't really that naive anyway. He might make a start by convincing COSATU that he is not simply a disarming figurehead for an emerging worker state.

This Briefing Paper was written by Henry Kenney and Duncan Reekie and first appeared in Business Day in June 1996.