

## ADAM SMITH AWARD REMARKS

# The Consequences and Causes of Economic Freedom\*

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### Abstract

This article discusses the history of the development of the Economic Freedom of the World (EFW) index, reflects on what we have learned from the research using the index, and speculates on the direction of the next wave of research looking at the determinants of economic freedom.

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### I. Introduction

I first attended APEE in 1993, so this meeting represents the twenty-seventh consecutive meeting that I have attended. The Adam Smith Award winner at that first meeting I attended was Gordon Tullock, and I can't help but wonder what insult Gordon would have for me today about joining him on this distinguished list.

In fact, as I look at the other Adam Smith Award winners such as Elinor Ostrom, Arnold Harberger, Harold Demsetz, Armen Alchian, Douglass North, Vernon Smith, and James Buchanan, among so many others, I expect future generations of APEE attendees will point at my name and play the old “which of these things doesn't belong with the others” game. With that said, I also see names like Larry White and Pete Boettke on the list—so perhaps I'm not so out of place after all!

More seriously, I have many people I'd like to thank tonight. My wife, Tracy, and daughter, Keri, are here tonight and they share in

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\* This article has been adapted for print from the author's 2019 Adam Smith Award acceptance speech. The Adam Smith Award is the highest honor bestowed by the Association of Private Enterprise Education. It is given to recognize an individual who has made a sustained and lasting contribution to the perpetuation of the ideals of a free market economy as first laid out in Adam Smith's *Wealth of Nations*.

this award. They were the ones wondering when Daddy was coming home from the office all those early years when the economic freedom index was being developed. Keri, as many of you know, is working toward her PhD in economics at West Virginia University—and I hope one of you will hire her in a couple of years!

I have several former students here tonight: Will Luther, Lauren Heller, Todd Nesbit, Lynn MacDonald, and others like Ann Zerkle, Jayme Lemke, Andy Fodor, and Kate Sheehan, who I know wanted to be here tonight but couldn't. Thank you for sharing this moment with me. You could take away all the kudos and fancy awards, and I would still consider myself a great success for having played a small part in your educations. I am really proud of you all.

Of course, I was a student, too. Randy Holcombe and Bruce Benson, who himself was a winner of this award, are regulars at APEE. I was honored to stand at a podium like this to introduce my mentor and second father, Jim Gwartney, as an Adam Smith Award winner in 2004. Words can't convey what I owe Jim. I wouldn't be here; heck, I wouldn't be anywhere without Jim's gentle prodding and support. I hope my teachers are as proud of me as I am of my own students.

## **II. The Birth of the Economic Freedom of the World Index**

Let me turn my attention to the reason for this award: the Economic Freedom of the World (or EFW) index. The EFW index was conceived as a result of a 1984 Mont Pelerin Society meeting session in which George Orwell's book *1984* was being discussed. The question for the session was whether Orwell's dystopic depiction of the future had come true. Some discussants at the meeting thought Orwell was clearly wrong, as democracy and human rights were well protected, at least in the Western nations that concerned Orwell. Others, most notably Michael Walker, the founder and then-executive director of Canada's Fraser Institute, countered that while that might be true of political and civil liberties, economic liberties are under increasing attack.

According to Walker, economic life was becoming increasingly Orwellian. Further, he argued, even our political and civil liberties were not out of the woods just yet. Walker quoted Milton Friedman, who wrote this in *Capitalism and Freedom* (1962, p. 9):

Historical evidence speaks with a single voice on the relation between political freedom and a free market. I know of no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organize the bulk of economic activity.

Among the participants at this meeting was Milton Friedman himself, who, along with Michael Walker, noted that the debate on the floor about whether economic freedom was growing or eroding suffered from a critical lack of empirical data. The debaters employed little more than isolated anecdotes to make their points. As a result of this experience, Michael Walker and Rose and Milton Friedman organized a meeting sponsored by Liberty Fund to discuss the prospects for creating some kind of measure of economic freedom.

This first meeting ultimately led to a series of six meetings. The participants at these early meetings included a veritable who's who of classical-liberal scholars including Armen Alchian, Peter Bauer, Gary Becker, Arthur Denzau, Stephen Easton, David Friedman, John Goodman, Herb Grubel, Ronald Jones, Richard Rahn, Henri LePage, Henry Manne, Charles Murray, and Douglass North, among many others.

At the fourth conference, held in Sea Ranch, California, in 1990, James Gwartney, Walter Block, and I presented a prototype index for seventy-nine countries, which was published in 1992 (Gwartney, Lawson, and Block 1992). A revised version of this index was finally released to the public four years later in 1996 as *Economic Freedom of the World: 1975–1995* (Gwartney, Lawson, and Block 1996). A selection of Milton Friedman's "Foreword" (pp. vii–viii) in the first volume is worth reprinting here:

Freedom is a big word, and economic freedom not much smaller. To talk about economic freedom is easy; to measure it, to make fine distinctions, assign numbers to its attributes, and combine them into one overall magnitude—that is a very different and much more difficult task, as we found out when we started on this quest . . . .

For many of us, freedom—economic, political, civil—is an end in itself not a means to other ends—it is what makes life worthwhile. We would prefer to live in a free country even if it did not provide us and our fellow citizens with a higher standard of life than an alternative

regime. But I am firmly persuaded that a free society could never survive under such circumstances. A free society is a delicate balance, constantly under attack, even by many who profess to be its partisans. I believe that free societies have arisen and persisted only because economic freedom is so much more productive economically than other methods of controlling economic activity . . . .

. . . the actual correlation between the indexes and the level and rate of economic growth documented in some of the extraordinarily informative graphs in the book (e.g., Exhibit S-2) is most impressive. No qualitative verbal description can match the power of that graph.

Jim Gwartney and I continued the effort after 1996 with annual updates and revisions published by the Fraser Institute. Joshua Hall joined as a full coauthor with the 2010 report, and my O’Neil Center colleague Ryan Murphy joined the team this past year (Gwartney et al. 2018).

### **III. The EFW Index’s Impact**

Slowly but surely, the EFW index took off in the literature and has now become a go-to variable for scholars doing empirical work in many areas. Back in 2014, Josh Hall and I decided to look at this emerging literature using the EFW index (Hall and Lawson 2014). We identified 402 articles in the Social Sciences Citation Index citing one or another edition of the EFW index. Of these, 198 articles used the EFW index and/or one of its areas or components as an independent variable in an empirical (i.e., regression) model.

Our next step in the analysis was to identify whether the EFW variable used was correlated in a normatively good or bad way with the dependent variable. Dependent variables like growth, investment, peace, human rights, and the like are clearly good, while variables like income inequality, war, and human rights violations are clearly bad—at least in the eyes of most people.

If the EFW variable(s) correlated positively with good dependent variables or negatively with bad dependent variables, we coded the result as “good” and vice versa. The results were determined to be “mixed or uncertain” when they were contradictory, insignificant, or if the dependent variable was not obviously good or bad.

The bulk of the papers we looked at focused on various macroeconomic variables such as GDP growth, income levels,

poverty, productivity, investment spending, and so on. Many papers, especially those in finance and other business disciplines, looked at firm-level performance measures by country. But there were some odd dependent variables used, like telephone lines per capita, numbers of supermarkets, biodiversity, and number of magazines. Particularly gratifying was the growing number of papers studying important topics like war, human rights, and gender equality.

What's the punch line? Two-thirds of the articles, 134 out of 198, found the EFW independent variable(s) to be correlated in a good way with the dependent variable; 28 percent (fifty-six articles) were mixed or uncertain; and just 4 percent (eight articles out of 198) found the EFW variable to be correlated with a bad outcome. I repeat: just 4 percent. A large body of scientific evidence speaks almost with a single voice: economic freedom correlates with good things.

“Well, that's great, but how do you get more economic freedom?” we might ask. Indeed, while we have a strong body of empirical scholarship demonstrating the possible beneficial *consequences* of economic freedom, there is far less known theoretically or empirically about the *causes* of economic freedom.

Ben Powell, Ryan Murphy, and I have recently set our eyes on this literature. Our current working paper on this topic has identified nearly seventy papers that use the EFW index (or the change in the EFW index) as a dependent variable (Lawson, Murphy, and Powell 2018). The studies in our review employed an incredibly diverse array of independent variables. In order to gain some tractability in this review, we grouped them into twelve categories:

- foreign aid and intergovernmental organizations
- crises
- democracy
- political rights, human rights, and civil liberties
- history/deep roots
- inequality
- ideology
- migration
- natural resources and geography
- income and growth
- economic freedom
- other

For each paper, we coded the direction of the effect of the independent variables and tried to summarize the results for each category. We were able to calculate the average marginal effect on economic freedom of four of the aforementioned explanatory variables: aid, democracy, political/human rights, and inequality. In these areas, the explanatory variable was sufficiently standardized that we can get a reasonable apples-to-apples comparison across studies.

#### *A. Estimating the Impact of Aid on Economic Freedom*

Seven of the studies in this group provided enough information to calculate an average marginal effect of aid on economic freedom. Two of the studies found large negative effects while the remaining five found small positive effects. The average effect of aid on economic freedom was  $-0.106$  but with such a high standard error that we shouldn't place much confidence in the result.

#### *B. Estimating the Impact of Democracy on Economic Freedom*

A total of ten papers were summarized. These papers all used Polity IV as the measure of democracy. While all the results are positive except for one, and the average was  $0.22$ , the standard error was very high, again leaving us with little confidence in the result.

#### *C. Estimating the Impact of Political/Human Rights on Economic Freedom*

Although there were many papers that used Freedom House's Political Freedom and Civil Liberties measures as explanatory variables, only three reported the necessary descriptive statistics for us to compute the standardized marginal effects. These papers all do agree, however, that political freedoms and civil liberties are positively related to economic freedom with an average effect size of  $0.230$  and a low standard error of just  $0.065$ . This combined with the fact that all except one paper discussed found positive and significant results leads us to place a high degree of confidence in this result.

While it is common to refer to the political freedom and civil liberties ratings as democracy, the modest disagreement between the results reinforces our view that formal democratic procedures related to voting and competitive elections may be less critical for the development of economic freedom than the more broadly liberal political regime characterized by constitutional protections for speech, religion, assembly, and so on.

In any case, the combination of these findings for formal democracy and for political/human rights leads me to conclude that

those of us who favor economic freedom need *not* fear democracy or political freedom. Yes, democracy has its problems as identified by public choice scholars, many of whom have been associated with this association or are in the room today. But it is a gross error to conclude from our study of public choice that autocratic regimes are the answer. There has been a tendency for *some*—*some* I say, not all, or even most, but *some*—classical liberals to apologize for or brush away the brutality of countries like Chile or to advocate for the so-called Singapore model because those autocratic regimes have encouraged economic freedom.

I am here to tell you that (1) this is wrong and (2) it won't work. First, shutting down people who disagree with you is flat out wrong, even if those voices are advocating socialism, fascism, or some other tyranny. Freedom of speech, assembly, and political participation is a required component of *any* classical liberal vision for a free society. *Socialists* may have no problem sacrificing human rights to the almighty pedestal of central planning, but we classical liberals are supposed to be better than them. Second, how many autocrats, except perhaps Pinochet or Lee Kwan Yew, have ushered in economic freedom for their countries? Exactly. For every Pinochet, there are dozens of tin-pot dictators who have ruined their nations. Any sober empirical analysis tells us that autocracies are the enemy not only of civil liberties but also of the economic freedom that we cherish so much, and that is the basis for our prosperity.

#### *D. Estimating the Impact of Inequality on Economic Freedom*

One of the most interesting results of our survey was associated with the impact of inequality on economic freedom. Although only four papers were found on this topic, all four agree that higher levels of inequality, whether measured in terms of income or wealth, have negative effects on economic freedom. The mean marginal effect was  $-0.252$  with a miniscule standard error of  $0.016$ . This suggests that a one standard deviation higher degree of inequality is associated with about a quarter standard deviation lower level of economic freedom. While not a huge effect, this strikes us as quite meaningful.

While only based on four papers, the consistency and strength of these results suggests something of a dilemma for advocates of economic freedom. If inequality is in fact detrimental to economic freedom, and if government-driven income redistribution reduces inequality, it could be the case that income redistribution, which is per se contrary to economic freedom, could indirectly contribute to

greater economic freedom by reducing inequality. I'd hesitate to draw this conclusion at this point based on the limited evidence available, but this is certainly an area for further research.

Economic freedom is just one dimension of human freedom in a broader context. I am thrilled that the Fraser Institute and Cato Institute, under the direction of Ian Vásquez and Tanja Porčnik (2018), have created a Human Freedom Index that combines economic and political and civil liberties into a single index. As mentioned, it was this very topic of how economic freedom fits into the overall freedom project that led Milton Friedman and Michael Walker to start the EFW index in the first place. It wasn't until many years into our project, though now about a decade ago, that anyone really investigated this relationship.

In a paper I did with the estimable J. R. Clark that was published in the *Journal of Economic Behavior and Organization* (Lawson and Clark 2010), we found that just as Hayek (1944) had argued in *The Road to Serfdom* and Friedman (1962) had argued in *Capitalism and Freedom*, essentially no countries have been able to sustain political and civil liberties without "something comparable to a free market," to use Friedman's language. That economic freedom is a necessary, though perhaps not sufficient, condition for political and civil freedom is an idea that has been around for a long time, but is only just now beginning to get the empirical scrutiny that it deserves. Our *democratic* socialist friends who promise political liberalism and civil liberties while controlling economic resources are selling snake oil. The data tell us that you can get and keep political and civil freedom only if you maintain some semblance of a market economy, and if you move toward *real* socialism, you will inevitably move toward political repression if not outright tyranny.

The EFW index is not done. Jim Gwartney, Josh Hall, and Ryan Murphy and I are still working to improve its quality and coverage. Recently, with the tremendous help of Rosemarie Fike, we added an adjustment to the property rights score to account for differential legal treatment of women in the economy. In the next year, we are looking at ways to add new variables to beef up the property rights area and our measure of the size of government, to get annual data back to 1970 and perhaps beyond, and to add more countries. This is first and foremost a scholarly project designed to measure economic freedom as best we can, but it certainly is gratifying to think that the EFW index may have played and will continue to play some role in making the world a freer and more prosperous place.

Before closing, I do want to say a few additional things about APEE. In 1992, I was fresh out of grad school in my first job at Shawnee State University in Portsmouth, Ohio. There were only two economists, the other one was a Marxist, and my department chair was a radical sociologist whose main job was running the faculty union. My teaching load was nine courses per year, with at least seven different preps. And I was paid \$32,500, which is about \$60,000 in today's terms. Portsmouth is one of the poorest and most economically depressed cities in Ohio. In short, this was a crap job.

After a year or two, I was seriously questioning my career choice. I even briefly accepted an offer to move to a think tank in a better location with better pay, but ultimately changed my mind. And APEE was a big part of the reason.

#### **IV. Conclusion**

As I mentioned, in April of 1993, I went to my first APEE meeting at the invitation of my old Ohio University professor Richard Vedder. At APEE, I found 150 or so kindred spirits, teachers and researchers of economics, who gave me the strength to keep at it. I left that first meeting knowing that so long as I could make it through the next fall and spring semesters, I could go to the next APEE meeting to recharge my batteries.

Today, I am so thrilled to see a larger, younger, less male, and even more enthusiastic crowd here. APEE is special. We are a family. Like any family, we even have our own inside jokes and old family rituals like when Jack Soper would ask about when APEE would move its accounting to an accrual basis or when Fr. Kekiessen would stand up to invite us to Guatemala. J. R. Clark, to whom I owe so much for bringing me into the leadership role at APEE, has been known to launch into an occasional "Band of Brothers" speech. We have our unofficial mantras: "Work Hard and Play Hard." I'm pretty sure Ed Stringham and Ben Powell coined that one.

I'm looking at you younger folks out there, and I challenge you to keep APEE going strong for the next generation and the generation after that. And I hope to see one of you up here to accept this award in the future.

Keep working hard and playing hard.

Thank you.

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