What Have We Learned from the Economic Freedom of the World Index?[1]

James Gwartney
Florida State University

When you have a co-author, such as Bob Lawson, introducing you and who expects to continue working with you in the future, he can really make the introduction sound good. I really appreciate and am deeply honored to be the recipient of this year=s Adam Smith award. Reviewing the list of people who have won this award in the past many of them are my heroes: Of course, people like Jim Buchanan and Doug North, but also Armand Alchain, Harold Demsetz, Vernon Smith and so on. It=s hard to imagine my name being added to that list. I am deeply honored by it.

My co-authors deserve a big share of this award. I=ve co-authored so many things. I guess that is the secret to getting things done B work with a lot of smart co-authors. Many of them are hereCRick Stroup, Russ Sobel, and Bob Lawson, as well as Michael Walker with whom I have worked closely on a number of projects. It=s a special honor to receive this award at the same time Mike will be receiving the Thomas Jefferson Award for his contribution to economic freedom and good government.

I would also like to express my congratulations to the Association of Private Enterprise Education for the growth of this organization. I believe that the first annual meeting I attended was no more than half this size, maybe not even that large. Jeff Clark has done a fantastic job with this organization over the last 14 years and it has become the leading organization in the area of economic

[1]The address that Professor Gwartney made on accepting the Association of Private Enterprise Education=s Adam Smith Award in Nassau in the Bahamas, April 2004.

education and free enterprise economics. I congratulate Jeff for that achievement.

Also, I would be remiss if I didn=t mention another person who has contributed so much to any achievements that I might have made: my wife Amy. We have been married 41 years and she is still my best friend. When we came to the Bahamas the immigration form asked why you were coming here and one of the options to check off was honeymoon, and we both decided it would be appropriate to check that option. Amy is my helper, chauffeur, and proofreader. I feel like some of the things I write should say Aif there are any remaining errors, they are the responsibility of my wife Amy.@ But that would hardly seem an appropriate way to express one=s gratitude.

As many of you know, I spent two years working for the government at the Joint Economic Committee. Please forgive me for that shortcoming. I went to Washington being very cynical and skeptical and expecting things to be bad, and it turned out to be even worse than I had expected. While I was there, among the responsibilities that Amy had was that she was my unpaid intern. That led to an interesting event. Bill Clinton gave me a call one time and said he heard that I was sleeping with my intern and would like me to join one of the largest clubs in Washington DCCfederal government workers who are sleeping with their interns. I explained to him, AMr. President, my intern is my wife. Thus, I am merely sleeping with my wife.@ He hung up on me at that point.

In any case, after-dinner speeches are typically too long and the speaker nearly always tells you more than you really wanted to know. I told Jane Shaw early on that my plan was to avoid both of these mistakes.

I would like to think a little bit with you a this evening about what we=ve learned from the Economic Freedom of the World (EFW) project. When we set out on this project 15 years ago, our objective was to develop to the fullest extent possible a comprehensive and objective measure of economic freedom. We recognized that if we could develop an accurate measure of economic freedom it would allow us to investigate more directly a large number of unsettled questions. I am delighted that many of the papers that will be presented at this conference will be using the index to tackle many of these issues.

A great deal of research has already been conducted in this area and we have learned quite a number of things. I was tempted to show a few slides, but I thought that a blind man explaining graphics might be a bit much. So you=ll have to wait for the slide show tomorrow. Even without the slides, I=d like to emphasize a few things I think we have learned as a result of using the freedom index to analyze economic performance. Most of you are probably familiar with the quintile analysis of the relationship between per capita GDP and economic freedom. There is a strong positive relationship between the two: countries with more economic freedom have higher levels of per capita GDP. The same is true for economic growth: economically free countries grow more rapidly.

However, it is important to look at these relationships for longer periods of time. For example, when you consider economic freedom and per capita income, what really matters is the type of institutional arrangements a country has had over the last several decades. The EFW measure provides us with good data for about 100 countries back to 1980. When you look at the relationship between average EFW ratings from 1980 through 2000 and the 2000 per capita GDP, the results are pretty amazing. About two-thirds of the cross-country differences in per capita GDP are explained by just this one variable. Of course, the EFW index is a comprehensive measure of institutional quality and the consistency of policies with economic freedom. Thus, it registers the impact of many factors operating in unison. Similarly, economic freedom is a major determinant of cross-country differences in economic growth. For example, there is a strong positive relationship between the 1980-2000 average EFW rating and the growth of per capita GDP over that two-decade period. The economic freedom-growth relationship remains strong, even when an extensive set of control variables, including those stressed by Jeffery Sachs, such as tropical location and percentage of the population living within a hundred kilometers of a coastline, are incorporated into the model.

I would also like to mention a couple of other important things that I think we have learned. Free economies have substantially higher investment rates. This is particularly true for private investment. One way of analyzing this relationship would be to break countries into three different categories: those with an average 1980-2000 EFW rating of greater than 7.0, between 5.0 and 7.0, and less than 5.0. These three groups might be thought of as economies that are persistently free, a middle group, and those that are persistently unfree. For countries with EFW ratings above 7.0, private investment averaged about 18% of GDP, compared to 9.6 percent of GDP for countries with EFW ratings of less than 5.0. Thus, the private investment rate in countries in the persistently free category was almost twice that of the persistently unfree group. Of course we know that investment is a major determinant of growth but economic freedom is, in turn, a major determinant of investment, particularly private investment.

The foreign direct investment figures shine additional light on the linkage between economic freedom and private investment. Foreign direct investment is almost entirely private. This category of investment reflects that foreigners think highly enough of an economy to place their funds at risk. The average annual foreign direct investment per worker in the freest economies (EFW ratings of 7 or more) during 1980-2000 was $3,117, compared to $444 for the middle group, and $68 for the less free group. Thus, over the two-decade period, the foreign direct investment per worker of the persistently free economies was an astonishing 45 times the rate for the persistently unfree group. This huge difference illustrates the importance of sound institutions and policies in which people have confidence and expect to remain in place over an extended period of time.

The strong relationship between economic freedom and investment highlights an important point that is generally overlooked by researchers in this area: regression models that include investment along with various measures of institutional quality will systematically understate the impact of economic freedom and sound institutions. This occurs because when investment is included as an independent variable, the indirect effects of institutional factors that affect the level of investment are ignored. Put another way, when institutional factors are a major determinant of investment, the usual methodology excludes their indirect impact through investment.

Economic freedom also influences the productivity of investment. We estimated the impact of a 1 percentage point increase in investment as a share of GDP on the growth of per capita GDP for the three EFW groups. A percentage point change in investment as a share of GDP increased the annual rate of growth during the two decades by 70 percent more for the persistently free (EFW greater than 7) than for the persistently unfree (EFW less than 5) group. The bottom line here: economic freedom not only influences the level of investment; it also influences the productivity of that investment. We were also able to calculate the productivity of government investment. Interestingly, the productivity of government investment was even lower than that of private investment in the unfree group.

In addition to the cross-country differences in levels of economic freedom, changes in EFW also exert a positive impact on long-term growth. We have examined the impact of changes in EFW during the 1980s and the 1990s. In both cases, there was a positive and significant relationship between changes in EFW and long-term growth. The countries that moved toward economic freedom grew more rapidly. Even when the level of economic freedom was initially low, increases in EFW were associated with more rapid growth.

Some have argued that the association between economic freedom and growth may reflect Areverse causality.@ Perhaps, countries that grow more rapidly are more likely to adopt institutions and policies more consistent with economic freedom. This is a reasonable argument and we examined the data in an effort to test its validity. First, we examined the relationship between changes in EFW during the 1980s and 1990s and the growth of per capita GDP during the 1990s. There was a positive and significant relationship between the changes in EFW during each of the decades and growth during the 1990s. This was true both with and without a wide set of control variables. This indicates that changes in EFW are not only associated with higher growth rates, they also exert an independent impact on growth during the subsequent decade.

In order to address the direction of causality, we then reversed the situation and made the growth rate during a decade an independent variable and changes in EFW during the following decade the dependent variable. I anticipated that the relationship would be random, that is, I did not think there would be a significant relationship between changes in growth during one decade (the 1980s) and changes in EFW during the following decade (the 1990s). I was correct about the relationship not being positive, but wrong about the random relation. The data indicates that rapid growth during a decade exerts a negative impact on changes in EFW during the following decade. Put another way, rapid growth during a decade actually reduces the likelihood of an increase in economic freedom during the following decade. Clearly, this undermines the reverse causality theory.

When you think about it, these findings are not too surprising. They suggest that, reforms consistent with economic freedom are more likely to be adopted when things are going bad. If the economy has been a basket case during the last five or ten years, political decision-makers may well be more receptive to constructive reforms. On the other hand, when things are going pretty good and growth rates are relatively strong the pressure for reform is minimal.

Confronted with the evidence on the positive impact of economic freedom on growth and income, some will respond, AOkay, but what about the distribution of income? Won=t markets generate more income inequality?@ The EFW data also facilitate the examination of this charge. The evidence indicates that there is no relationship between economic freedom and income inequality. In fact, in the case of less developed countries, there is a modest tendency for more economic freedom to be associated with less income inequality. The argument that more economic freedom leads to greater inequality is simply a myth. The data do not support that proposition.

How about the overall quality of life? How does economic freedom influence things like environmental quality, life expectancy, and the access to health care? Again, when you look at the relationship between economic freedom and various indicators of quality of life, broadly defined, economic freedom exerts a positive impact on these variables. The environment in economically free countries is cleaner than in those that are less free. The life expectancy at birth is about 20 years longer in the freest quintile of countries than in the least free quintile. Of course, the positive impact of economic freedom on various quality of life measures is largely due to its positive impact on income. But this should not detract from the positive effects.

Today the case for economic freedom is stronger than ever. Without exception the fifteen countries with the highest economic freedom ratings, have both high per capita income levels and attractive growth rates. On the other hand, all of the countries with low levels of economic freedom have low per capita incomes, and many have experienced reductions in per capita real GDP during the last two decades. The only possible exception to this proposition is Israel. Israel is in the bottom third in terms of economic freedom, but its per capita GDP is relatively high. But given the outside aid Israel has received from both private parties and governments over the last several decades, it is something of a special case.

The bottom line is clear: compared to those that are less free, economies with more economic freedom attract more private investment, generate greater productivity from that investment, and achieve both more rapid growth and higher levels of income. But you will never hear this on the nightly news. Instead, the media will try to convince you that markets need direction from government, all of the good jobs are leaving the country, or that people would starve if it were not for government programs. I fear that we are once again falling into the romantic trap of the 1960s. I know that was before many of you were born, but I remember it well. During that era, there was a love affair with government. Government was going to wipe out poverty, trade-off a little inflation for a reduction in unemployment, provide free health care for everyone that needed it, and so on. Government was perceived of as a corrective device. Essentially, it was as if you had the winning run on third base in the bottom of the 9th and you could bring government in as a pinch hitter that would always deliver the game-winning hit. Of course this is mythology, as Jim Buchanan, Gordon Tullock, and the work of the public choice school has shown so convincingly.

Obviously, we have a lot of work to do in terms of economic education and communicating the realities of economic freedom. This is the focus of APEE and I am sure this conference will provide all of us with helpful information and ideas. As we look forward to our meeting here, I am impressed with the quality of the program and I am deeply honored to be chosen as the recipient of the Adam Smith Award. Thank you so much.

James Gwartney is Professor of Economics and holder of the Gus A. Stavros Eminent Scholar Chair of Economics at Florida State University.