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No Relationship between Economic Freedom and Economic Growth: A Note

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Abstract

The purpose of this research note is to re-examine the link between economic freedom and economic growth because the connection has been massively over played in the past 50 years. Answering this question has important socioeconomic policy implications as economic freedom as a means of fostering higher economic growth has been high on the priority list of leading countries like the UK and US. Indeed, virtually every country in the world has embarked on this agenda of increasing economic freedom either voluntarily or at the behest of the World Bank and IMF through Washington Consensus of increasing economic freedom at all costs. The costs of liberalisation and hence increasing economic freedom have been ongoing moral hazard problems, heightened financial instability, unsustainable global debt problems, increased geopolitical risks, greater economic disequilibrium, the rise of protectionism and international social upheaval. A new economic development order needs to be constructed based on solving these issues.

Keywords

Washington Consensus, GDP, Economic Freedom

Thomas Jefferson observed that "a wise and frugal Government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement." [1].

1. Introduction: Economic Freedom and Economic Growth

From 1980 to 2008 and during the "Great Moderation", the world underwent a massive period of economic and financial liberalization that led to greater globalization. That process commenced in the early 1980s in developed countries like the UK and US with Thatcherism and Reaganomics, respectively. Washington

Consensus, at the behest of the World Bank and IMF mapped the economic liberalism developed in the West to emerging economies during 1988 to 1991 with disastrous consequences in terms of global economic and financial stability.

The rationale behind economic and financial liberalization has been that it will result in higher economic growth by allowing a greater role for market forces in allocating capital within the global macro-economy. These theories, though now widely criticised emanated from the 1970s work of McKinnon and Shaw [2].

2. Discussion

Liberalization as part of a wider agenda of Neo-Liberalism has become synonymous with the concept of economic freedom. Thus economic freedom has become incorrectly linked to economic growth. Essentially liberalization has pushed state intervention towards decisions made by individuals or 'rolling back the frontiers of the state' as Thatcher often said. Liberalization is thus interconnected with the idea of Liberalism. Thatcherism and Reagonomics were taken up by the World Bank and IMF, supported by The Chicago School and specified in reform packages for emerging markets and tied to loan availability and 'bail out' conditions.

Washington Consensus highlighted:

1) Fiscal discipline: deficits should be small and subject to monetary discipline.

2) Within public spending: education, health and public infrastructure investment are priorities, while subsidies should be eliminated.

3) Tax system: the tax base should be broad and marginal rates moderate.

4) Interest rates: should be market-determined, and positive in real terms.

5) Exchange rate: should be at a competitive level (whether fixed or flexible), as an essential element of an outward-oriented trade policy.

6) Trade policy: imports should be liberalized; import licenses are the worst (they give rise to corruption), uniform tariffs are preferable if necessary.

7) Foreign Direct Investment is perceived to be good

8) Privatization: private industry managed more efficiently.

9) Deregulation: as in the US starting in the late 1970s.

10) Property rights: matter.

Washington Consensus, a cornerstone of economic freedom was deficient in the sense that it was based upon McKinnon and Shaw's Financial Liberalization theory which tended to assume perfect information flows in markets, perfect competition and relied upon institution-free analysis [3]. The higher interest rates that occurred in many emerging economies directly after liberalization helped contribute towards the adverse selection and moral hazard problems.

Indeed, the Asian Financial Crisis of 1997 has been blamed on the poor sequencing associated with Washington Consensus and the lack of prudential financial regulation and surveillance that allowed "crony capitalism" to thrive. With massive bail outs worldwide, 1997 and 1998 heralded the birth of Moral

Hazard on an unprecedented scale with the bailout of Long Term Capital Management and emerging economies that sent shock waves through the global financial system. The 1997 crisis set the scene for the Global Financial Crisis of 2007 and 2008, which continues today, ten years later because it increased moral hazard and the concept of 'too big to fail' from the perspective of global banks.

Economic Freedom is defined by the Heritage Foundation [4], the source of data for this study as:

"Economic freedom is the fundamental right of every human to control his or her own labor and property. In an economically free society, individuals are free to work, produce, consume, and invest in any way they please". [4].

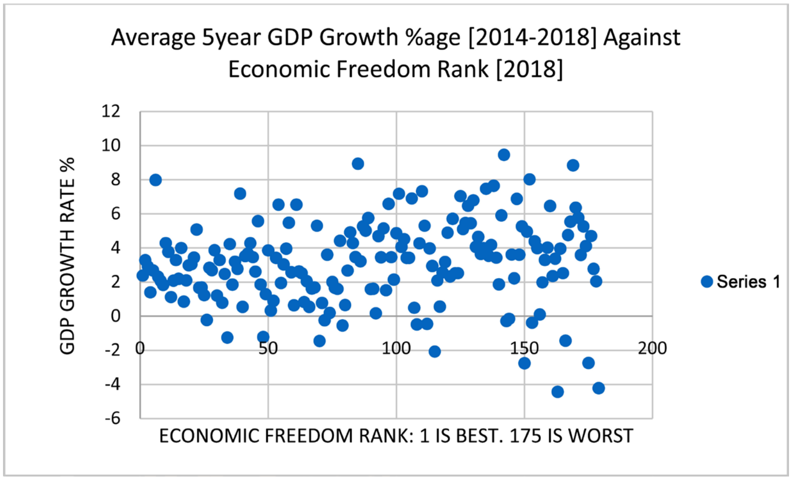
In order to test the relationship between economic growth and economic freedom, the following was estimated for 175 countries:

$$\text{Economic Growth as Measured by GDP Growth \% age } [\text{average over 5 years}] = \alpha + \beta \text{ ECONOMIC FREEDOM } + \varepsilon$$

The slope co-efficient in the chart is only 0.006 [1% significance level, R^2 = 0.18%] indicating a very small relationship between economic growth and economic freedom. Referring to **Figure 1**, the highest ranked economic freedom country [zero] would result in an average growth rate of 2.55%. Replacing 5 year average GDP growth rate with annual growth rate, yields almost an identical outcome of there being no relationship between economic freedom and economic growth. The data is sourced from the World Bank Economic and Social Indicators Database and the Heritage Foundation Economic Freedom Database.

3. Conclusion

From the analysis in this paper, we need to be careful about extrapolating the link between economic freedom and economic growth and turning it into policy on a grandeur scale. Despite this, the World Bank and the IMF have built their agenda on a strong assumed association through Washington Consensus which



Data Source: Heritage Foundation.

Figure 1. No relationship between economic growth and economic freedom.

has led to ongoing moral hazard problems, heightened financial instability, unsustainable global debt problems, increased geopolitical risks, greater economic disequilibrium, the rise of protectionism and international social upheaval. Although the analysis is rudimentary yet robust in this research note, it appears that no such consideration was undertaken by the IMF and World Bank before Washington Consensus bulldozed its way around the developing parts of the globe leading to major economic, financial and social disruption. Arguably this disarray continues today. A new global economic development framework needs to be encompassed by all stakeholders in the global economy, which is close to "melting" point at the beginning of 2019.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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