Freedom as Development: Reflections on James Gwartney’s Contributions to Measuring Institutions

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I. The Great Debate

One of the most hotly contested debates in economics, one that goes back well over a century, is whether decentralized markets with participants largely free to buy, sell, produce, consume, save, invest, and take risks without much government interference is a better or worse economic system than centralized planning with participants obligated to obey the planners’ economic goals and objectives. Today, it is commonly thought, at least in most circles, that some version of the former is preferred to the latter. But the idea that the free market is likely to work better than central planning was not always so widely accepted.

In the 1961 edition of Paul Samuelson’s Principles of Economics textbook there appeared a graph showing the income levels and projected growth rates of the United States and the Soviet Union. In 1960, Samuelson estimated the U.S. economy to be twice the size (presumably measured in per capita terms, but this is unclear) of the Soviet Union. Whatever can be said about that initial estimate, there is little doubt about the inaccuracy of what he expected to happen in the en-

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The graph projected Soviet growth rates that would be must faster than U.S. growth rates such that by as early as the 1980s or almost certainly by 2000 the Soviet Union would be richer than the United States. (Levy and Peart, 2011).

To make matters worse, despite growing evidence being uncovered by some economists such as the University of Virginia’s Warren Nutter, this graph, or rather updated versions of it appeared in the textbook for decades. By the 1970 edition the graph had been updated. The U.S. to U.S.S.R. income ratio was still 100:50; the only thing was the decades on the horizontal axis had shifted ten years forward. By 1980, the ratio was 100:55 but the basic story was the same.

Levy and Peart (2011) do a great job accounting for Samuelson’s own evolving explanations for the inconsistencies between his forecasts and actual Soviet growth. In several editions for instance, he brushed away any such concerns by blaming the poor Soviet performance on “bad weather”.

Even as late as 1989, literally on the verge of the breakup of the Soviet Union itself, Samuelson and Nordhaus (his new co-author) said, “What counts is results, and there can be no doubt that the Soviet planning system has been a powerful engine for economic growth.”

The graph had finally been taken out, but there was no backtracking for Samuelson even until the bitter end. Samuelson and Nordhaus did append their statement with this qualification: “But it has done so in an atmosphere of great human sacrifice…” I guess tens of millions of deaths does count as “great human sacrifice” so they got that one right at least.

All sarcasm aside, the point here is not to bash Samuelson for his errors. Samuelson was far from alone in overestimating the productive capabilities of central planning. Rather the point here is to give the reader a sense of the dominant intellectual environment that prevailed in the 1960s and 1970s and also to reflect on why the best minds in the business were so utterly wrong on this issue.

There are two explanations that come to mind. First, Samuelson may simply have been an ideological Communist. Certainly, the era sported many ideological apologists for the Soviet regime, so maybe Samuelson was one of them. Alas, there isn’t any real evidence of this in Samuelson’s case. To be sure, he was no Milton Friedman, but politically he was a centrist, liberal (in the corrupted American sense of that word) academic. He was a Keynesian who saw a role for an expansive and active state, but he was no “commie”.

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2 This quotation was provided to me by Barkley Rosser at James Madison University.
If not blinded by ideology, what is the second possible explanation for Samuelson’s error? The answer provided by Levy and Peart (2011) is that he was a victim of a bad model of economic growth. The model of growth that Samuelson worked with was based on a production function idea borrowed from microeconomics. The production function, when applied to a nation, posits that national production is a function of resources such as capital and labor. As such, growth in production is the result of expanding capital and labor, that is, investment in physical and human capital. Later models would add technology to this model, but that is not a complication that matters for this story.

So if growth is a matter of investment, and if the Soviet central planners emphasized investment to a greater degree than was the case in the market-driven United States, and there is evidence that they did, then ipso facto the Soviet economy would grow faster.

Doesn’t investment matter? Yes, of course it does. The problem with the production function approach is that it assumes the country is operating at the boundary of its production possibilities frontier. That is, it assumes the country is combining its capital and labor, and investing in new capital, in a way that is maximizing output. The reality of course is that the Soviet economy was a massive waster of resources. They invested in capital like crazy, but most of that investment failed to result in productive output. The reasons for this failure have to do with the inherent institutional flaws (as identified by the likes of Mises and Hayek) of central planning in the absence of market prices. Simply put, the Soviet economy failed ultimately because of a lack of economic freedom.

Before moving on, I want to highlight a final problem with those Samuelson graphs. Not to put to fine a point on it, but frankly Samuelson made it all up. By that I mean only that the graph was drawn entirely based on his theoretical view of the world. There was not one whit of data involved in constructing that graphic. Samuelson existed for the most part in a chalkboard world that ignored empirical reality.

II. James Gwartney

About the time Paul Samuelson is publishing these forecasts for the Soviet economy, young James Gwartney is receiving his education first in a one-room schoolhouse and then at Ottawa University in Kansas where he studied under Wayne Angell, who would later become a Governor of the Federal Reserve System. Eventually, Gwartney found himself at the University of Washington as a
graduate student studying under a very different kind of economist compared to Samuelson, Douglass North. North's study of economic history led him to focus on the central role of institutions, both formal and informal, in determining economic outcomes. Unlike Samuelson's production function approach that saw growth in terms of finding more resources, North's approach suggested that growth is more about finding better institutions. To North, growth is less about expanding the production possibilities frontier than about moving from inside that frontier to a point closer to the frontier. To North, a country with less investment but better institutions could easily outgrow one with more investment but worse institutions. North would win the Nobel Prize in 1993.

In a foreshadowing of things to come, Gwartney's dissertation focused on measuring discrimination in labor markets. He then found his way to Florida State University in Tallahassee in 1968 where he has taught since. Reviewing Gwartney's long and distinguished career as a labor economist and economic educator (his own principles text co-authored first with Richard Stroup and now with the addition of Russell Sobel and David Macpherson is in its 14th edition) is beyond the scope of this paper. Instead, I want to focus on Jim Gwartney's contributions to measuring economic freedom.

III. The Creation of the Economic Freedom of the World Index

At a 1984 meeting of the Mont Pelerin Society, Milton Friedman and others were debating George Orwell's book 1984. The question was whether freedom was growing or worsening (as Orwell predicted in the novel). While most thought civil and political liberties were growing in most places around the world, many thought economic liberties were under increasing attack. Friedman noted the lack of empirical evidence during this debate and afterwards, with help of his wife Rose and the Fraser Institute’s Michael Walker, organized a series of Liberty Fund conferences with the goal of creating some kind of economic freedom measurement.

Jim Gwartney went to the third such meeting in 1989. Many of the participants talked about obtaining a laundry list of dozens and dozens of indicators that they would like to include in an economic freedom index. Gwartney and another participant at this meeting, Walter Block who was then at the Fraser Institute and now is a professor at Loyola University in New Orleans, recognized that such an index might be doable but only for a tiny handful of countries. They decided to
create their own index that used fewer variables but one that could be calculated for many more countries.

As Gwartney’s graduate research assistant, I was tasked with the unenviable job of collecting and organizing the data, which I did beginning in the winter of 1989-90. This was no small feat in the days before the commercial Internet. Our first attempt, which we presented at the fourth meeting in the series at Sea Ranch California in 1990 (Figure 1), contained 11 variables and covered 79 countries. The participants attacked us mercilessly! How could so few variables tell us anything? You’re not including this, that or the other thing, they complained. Despite the criticisms, a casual survey conducted by Friedman himself verified that our parsimonious index resulted in ratings that were fairly close to people’s expectations for many countries. We passed the smell test with Friedman at least.

Figure 1 Participants of the 1990 Meeting at Sea Ranch, CA

A couple of years later, in 1992, we were invited back to California for a sixth and final meeting, one that would focus entirely on our revised index with the goal of publishing it widely soon thereafter. That meeting went a little better than the first, but again we left with a long list of criticisms to consider.

Michael Walker invited us to complete a full revision and he agreed to publish it as a Fraser Institute publication. As bad luck would have it Gwartney’s eyesight
took a serious turn for the worse in 1993-94 while he was teaching in Prague and our plans to publish were delayed until 1996.

The first volume (Gwartney, Block, and Lawson; 1996) presented an index for the years 1975-1995 (in five-year intervals) based on 17 variables covering 102 countries. Milton Friedman’s “Foreword” 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 some thirteen years ago (see Michael Walker’s introduction).*

James Gwartney, Robert Lawson, and Walter Block deserve great credit for having brought this quest to so satisfactory a temporary conclusion—I say temporary because this study of economic freedom for more than 100 countries provides a cornucopia for students of the relation between economic freedom, political freedom, and civil freedom, and for further explorations of the relation between economic freedom and the level and rate of economic growth. The resulting studies will surely make revised editions necessary, both to bring the indexes of economic freedom up to date and to incorporate the additional understanding that will be generated.

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.

It did not require the construction of an index of economic freedom for it to be widely believed that there is a close relation between economic freedom and the level and rate of economic growth. Theoretical considerations gave reason to expect such a relation, and little more than casual observation sufficed to show that what theory suggested, experience documented. We have
not in a sense learned any big thing from this book that we did not know before. What we have done is to acquire a set of data that can be used to explore just how the relation works, and what are the essential connections, and that will enable skeptics to test their views objectively.

To achieve these advantages, it was essential that the measure of economic freedom not beg any questions by depending on outcomes; it was essential that it depend only on objective characteristics of an economy. This may seem obvious but I assure you that it is not. After all, the rate of economic growth or the level of living may be an excellent proxy for economic freedom, just as an auto’s maximum speed may be an excellent proxy for the power of its motor. But any such connections must be demonstrated not assumed or taken for granted. There is nothing in the way the indexes are calculated that would prevent them from having no correlation whatsoever with such completely independent numbers as per capita GDP and the rate of growth of GDP. Yet 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.

Milton Friedman
The Hoover Institution
Stanford University

Each year since then, the Economic Freedom of the World report has been updated, revised and expanded. The most recent edition (Gwartney, Lawson, and Hall; 2013) presents an index based on 43 variables for 152 countries.

IV. The Legacy of the Economic Freedom of the World Index

It is probably too early to tell what the legacy of this project will be, and I am probably not the one to write about it. It is fair to say however that the Economic Freedom of the World (EFW) index has vastly exceeded our expectations in terms of its impact on the scholarly debate.

Economic Freedom and Growth

By a good margin, the EFW index has been used more to study economic growth than any other factor. There have been a couple full survey articles looking
at this literature (Berggren, 2003) and (De Haan, Lundstrom, and Sturm; 2006). The latter authors concluded (p. 170),

Most studies analysing the relationship between economic growth and EF have employed cross-country (or panel) growth models. Table 5 summarizes empirical growth studies in which some EF indicator is taken up as explanatory variable. It is clear from these studies that EF seems to have a positive association with growth. *None of the studies summarized reports that economic freedom is bad for growth.* (Emphasis added.)

What I think of as my best piece of scholarship using the EFW index is the article we published in the journal *Kyklos* (Gwartney, Holcombe, Lawson; 2006). That article made three important contributions to the growth literature. First, it expanded the discussion to include the impact of institutions on investment. Countries with more economic freedom exhibited more growth per unit of investment and attract a higher level of private investment as a share of GDP.

Second, economic freedom exhibits a directly positive impact on economic growth and an indirect impact through increasing levels of investment. Our estimates indicated that a one-unit change in EFW increases long-term growth by approximately 1.5 percentage points in total.

Third, our analysis indicated that poor economic performance is associated with larger future improvements in institutional quality. Thus, the positive relationship between economic freedom and long-term economic growth is clearly not the result of reverse causality.

**The Economic Freedom Literature**

Recently Hall and Lawson (2014) reviewed 402 articles citing the EFW index in various peer-reviewed academic journals. Of these 402 articles, 198 used the index as an independent variable in an empirical study. Over two-thirds of these studies found economic freedom to correspond to a “good” outcome such as faster growth, better living standards, more happiness, etc. Only 8 studies in the sample found economic freedom to be associated with a “bad” outcome such as increased income inequality. The balance of evidence is overwhelming that economic freedom corresponds with a wide variety of positive outcomes with almost no negative tradeoffs.

Here are just a few random samples of findings of papers surveyed in Hall and Lawson’s accounting of the literature.
“Empirical results indicate that capitalism often has a stronger beneficial impact on many aspects of women’s well-being and gender equality in society” (Stroup, 2008).

More economic freedom results in more investment in renewable energy (Brunnschweiler, 2010).

“The result of the analysis is that there is a significant negative correlation between economic freedom and human rights violations.” (Burkhart, 2002)

Higher economic freedom corresponds to better tourism competitiveness (Das and Dirienzo, 2010).

“…countries more favorable to free enterprise have a reduced risk of civil war onsets.” (De Soysa and Fjelde, 2010)

“We report the existence of a strong, positive, statistically significant and economically consequential impact of EFW on growth and the level of income.” (Faria and Montesinos, 2009)

“The regulatory framework and freedom factors have significant positive impacts on telephone lines per capita.” (Gutierrez and Berg, 2000)

Economic freedom is a negative correlate with air and water pollution (Lamla, 2009).

The EFW summary index is positively related to the change in entrepreneurship from 2001-2007 (Larroulet and Couyoumdjian, 2009).

Countries with higher EFW scores are recipients of higher foreign capital investment (Lothian, 2006).

“This empirical analysis examines the interaction of economic freedom and democracy on measures of health, education, and disease prevention in society. The results imply that greater economic freedom consistently enhances these welfare measures, even among more democratic countries. Democracy has a smaller positive influence that disappears for many welfare measures in countries with more economic freedoms.” (Stroup, 2007)

Economic freedom is positively correlated with happiness (Veenhoven, 1999)

“A higher rate of economic freedom reduces the gender wage residual significantly; if the country is ranked one point higher in
the ten-point scale on economic freedom the gender wage residual drops between 1.4 and 4.4 log points. The standard deviation of economic freedom is 1.7, so observed differences in this indicator have a rather large effect on the gender wage residual.” (Weichselbaumer and Winter-Ebmer, 2007)

**Economic Freedom and the Value of Measurement**

One of the most valuable lessons to be learned from the EFW index project is the transformative impact of bringing measurement to bear on a problem. Economists have talked about economic freedom in some sense or another since at least the days of Adam Smith. It wasn’t until a quantitative measurement was available that the kinds of studies we’ve seen in the last few years could be published. After spending nearly 20 years trying to measure economic freedom, I decided to try to use the lessons of measurement in another area.

I confess to being a hopeless cosmopolitan and frequently refer to national borders as “lines drawn on maps by dead white men.” On a personal and political level, I find it an abomination to tell a peaceful human being where they can and can’t live or to prevent her from traveling from place to place. With this motivation in mind, I decided to study and measure how countries limit our freedom to travel.

Lawson and Lemke (2012) created Ease of Travel indexes to measure how restrictive travel visas are around the world. This paper examined travel visa restrictions in 188 countries. The paper presented quantitative measures of the restrictions (1) facing foreign visitors into a given country and (2) facing citizens of a given nation traveling abroad. The analysis showed that countries are more likely to impose visas on foreign visitors when they are more populous, but less likely when they are rich and economically free. Citizens from richer and more populous countries face fewer travel visa requirements when traveling abroad. Also countries are less likely to impose visa requirements on similar nations.

Lawson and Roychoudhury (2013) have a follow-up paper that estimates the impact of travel visas on tourism travel flows. At the aggregate level, a one standard deviation more severe travel visa regime, as measured, is associated with a 30 percent decrease in inbound travel. At the bilateral level, having a travel visa requirement on a particular country is associated with a 70% reduction in inbound travel from that country.
The gains associated with eliminating travel visas appear to be very large. For example, requiring travel visas from residents of over 80% of the countries in the sample, few countries have travel visa regimes as strict as the United States. As an extreme counterfactual, what would happen if the United States opened up tourist travel to all comers without requiring visas? We estimate that if the U.S. eliminated entirely all travel visas, we would see an additional 45-67 million visitors and $90-123 billion in tourist spending annually.

It is my hope that by finally measuring the severity of our restrictive travel policies and then using these measures to estimate their deleterious impact we can raise both academic and public awareness to the issue.

**Economic Freedom and Other Freedoms**

Two of my papers using the EFW index focused on the so-called “other” freedoms. Lawson and Clark (2010) examined the hypothesis put forward by Milton Friedman in *Capitalism and Freedom* and by Hayek in *The Road to Serfdom* that economic freedom is a necessary, but not sufficient, condition for political freedom. Consistent with the Hayek-Friedman hypothesis, using the EFW data and measures of political rights and civil liberties from Freedom House, we indeed found few examples of countries with high degrees of political freedom without relatively high economic freedom. This suggests that people who value political and civil liberties should favor economic liberty, as it is a necessary precondition for the other liberties they care about.

The second paper (Lawson and Carden, 2009) took on Naomi Klein’s thesis from her book *The Shock Doctrine: The Rise of Disaster Capitalism* in which she argues that economic liberalization has been built on the basis of human rights abuses. Citing Chile as her prime example, she accuses free-market advocates of being openly complicit in heinous acts including even torture. This is a serious charge, but one I doubted was true. Using the EFW data and a database of human rights violations from the CIRI Human Rights Data Project, we demonstrate conclusively that economic liberalization has occurred more in countries that exhibit fewer human rights violations. This is precisely the opposite of what Klein argued.

This, once again, illustrates the power of employing empirical data. With her strong progressive ideology as a background and using exactly one data point, Chile, she concocted a narrative that links economic freedom with serious violations of human rights. Sadly for Klein, if you look at all the available data, her thesis fails miserably.
V. Conclusions

What have we learned from our attempt to measure economic freedom with the EFW index? As Lord Kelvin said, “to measure is to know.” Our understanding of what economic freedom actually is has been enhanced by this index. Freedom, economic or otherwise, is a good and it is worth studying on its own merits.

With that said, the biggest impact of the index will no doubt be how it helps us understand how economic freedom can contribute to a better society. Academically, the EFW index has helped us recognize that the input-output production function model of growth is flawed without some deeper understanding of the role of freedom and other institutions like rule of law.

Additionally, the EFW index highlights the importance of using empirical evidence in any debate. Paul Samuelson’s graph would be laughed at today because today we know better from the data. The existence of the EFW index will help guard against another mistake of that magnitude entering our textbooks in the future.
References


