Original scientific paper
UDC: 330.837 : 172.3 :330

Indexes of economic freedom – An outline and open issues*

Aleksandar Kešeljević[1]

Abstract

Authors of the indexes of economic freedom argue that economic freedom is a key link to prosperity and growth. An outline of empirical and theoretical investigation into the relationships between economic performance and institutional environment shows that economic freedom is an important precondition for economic prosperity. Countries that have more economic freedom also tend to have higher rates of economic growth and are more prosperous. Author however in the article argues that economic policy advisers should use indexes of economic freedom with great caution, since they suffer from certain deficiencies with regard to their content. An author presents a detail political-economic analysis of economic freedom, through three pairs of concepts that emphasize and express two different conceptions of understanding of economic freedom, in order to show why presented index of economic freedom cannot be sufficient indicators of economic freedom and prosperity.

Key words: *Institutional environment, economic freedom, indexes of economic freedom, economic performance.*

JEL classification: *O10, 017*

1. In stead of an introduction

The image and the meaning of economic freedom tend to be rather obscured today. In everyday life, economic freedom is less familiar and is paid less heed than civil and political freedom. Towards the end of 1980s, the world underwent significant changes in terms of economic freedom; liberalization, deregulation and privatization became the main guidelines of future development. Since the fall of the Berlin wall

* Received: 10-10-2006; accepted: 04-12-2007

[1] *Assistant, PhD in Economics, University of Ljubljana, Faculty of Economics, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenia. Scientific affiliation: Institutional economics, Comparative analysis of economic systems. Phone: + 386 1 31707005. E-mail: saso.keseljevic@ef.uni-lj.si. Personal website: http://www.ef.uni-lj.si/en/lecturers/lecturer.asp?id=259*

in 1989, the idea of freedom has been sweeping the world to eventually adopt the forms of political democracy and free markets. It seems that in the long run, freedom works and people figure that out. I have no doubt that in future even more people will live in the free world than today. In the shorter run however, the outcome is less predictable and it will depend on our understanding and own interest to learn how good a free society is.

The second chapter will introduce the role of institutions and economic freedom in the growth process. The third chapter will provide a detailed definition of economic freedom and a note on measuring economic freedom. The complexity of economic freedom itself will be presented in the fourth chapter through three pairs of concepts that emphasize and express two different conceptions of economic freedom. The fifth chapter will provide an outline of empirical studies which speak in favor of economic freedom impact on economic performance. In the final chapter author explains why presented indexes of economic freedom cannot be sufficient indicators of economic freedom and economic prosperity.

2. Institutional environment and economic freedom

Adam Smith, the 18th century Scottish philosopher and founder of modern economics, devoted the whole of his Inquiry into the Nature and Causes of the Wealth of Nations to a simple question: Why do some countries prosper? For Smith the answer lies in free exchange, entrepreneurship and in the protection of private property. Smith found that growth depends on two types of factors. In the first part of the equation, he focused on the production factors, that are today in the centre of interest of endogenous growth theory, which works in the neoclassical tradition and focuses on production factors, especially on technological development and human capital (Aghion, Howitt, 1998). In the other, Smith stressed the importance of a proper institutional setting, i.e. an environment that supports growth.

The neoclassical approach conceives of economic growth as a result of capital accumulation, additional employment of labor and technological improvements. From the 1960s to the mid 1980s, the dominant economic theory of what causes economic growth was the Solow growth model (1956). From the policy viewpoint, his theory performed poorly. Neoclassical approach to growth, stressing the role of production factors, only provides an analysis of the necessary conditions for growth – the growth of facilities. But economic subjects will not invest, and will not do business efficiently unless there is an environment in which business can flourish. More recent evidence suggests that growth is determined by a much larger set of endogenously determined variables (Romer, 1986, 1989, 1990; Lucas, 1988). Endogenous growth models have pointed out many other variables that contribute to differences in growth rates, such as knowledge spillovers, technology transfers, R&D funds, and human capital. Yet even these ideas fail to explain the observed patterns of development. His theory implies that institutionally sensible policies can result in a GDP growth rate that is permanently higher.

Exogenous and endogenous models were mainly inefficient in explaining growth. These economic approaches usually neglected institutional dimension and suggested that even if policy in a country is unable to create a favorable institutional environment, movement of inputs will provide economic growth; hence, economic growth seems nearly an automatic process (Prokopijevic, 2002). However, the quantity and quality of production factors are not sole determinants of economic development; it depends to a large extent on the institutional environment as well. A country can easily worsen its economic position despite affluence of production factors, if its institutional environment is inadequate. On the other hand, a favorable institutional environment can attract production factors, thus making up for their scarcity and providing unimpeded development and progress.

This means that policy makers have for too long overlooked institutions that are in fact crucial preconditions for economic prosperity. Powell (2003) and Olson (1996) argued that long-term economic growth mainly depends on the everyday institutional setting for economic activity. North (1990) understands institutions as a set of (in)formal rules of the game in a society. As opposed to the formal rules, the informal ones are more stable and more difficult to change. Pejovich (1990) claims that there are three basic institutions that define the nature of the capitalism: private property rights, the law of contracts and a limited government.

The common feature of all these studies lies in the fact that economic decisions are made within a given institutional framework. It is not hard to argue that all institutions that directly affect economic agents are important, but that equally important are all those institutions that have an indirect effect on activities of all economic subjects. I believe that quality of the institutional framework could be understood through economic freedom and its influence on economic performance:

- Moers (2002) argues that property rights protection, sound legal system, small and supporting state and economic freedom are the cornerstones of economic growth.
- North (1988) emphasizes the relevance of economic freedom for economic progress. In his view, one of the major reasons for the development lag in Spain, Portugal and its colonies in South America, compare to Great Britain and its colonies in North America, was the lack of economic freedom. Spanish and Portuguese government violated economic freedom because they failed to protect private property from governmental expropriation.
- Berggren (2003) points out that institutions that guarantee economic freedom enhance economic growth for several reasons: (i) they promote a high return through low taxation, sound legal system and protection of private property, (ii) they en-

able talent to be allocated to where it generates highest value, (iii) they foster a dynamic economy in which competition can occur because regulations are few, (v) they facilitate predictable and rational decision-making through a low and stable inflation rate, (vi) they promote capital investment where returns are highest.

- Hanke and Walters (2000) argue that presence of economic freedom can fuel investment and spur growth, so no development will meet its goals without that.
- Powell (2003) argues that the institutional framework either hinders or helps in achieving economic growth. The key institutional factor is the degree of economic freedom enjoyed by the people.

The listed scholars are convinced that economic freedom enables faster progress than any other system of "control" of the economic activity. The differences in the evolution of key institutions resulted in a wide variety with regard to understanding and maintaining economic freedom which has an important influence for economic growth because incentives are mainly determined by the institutional framework. This is not to deny the importance of natural resources, technology and skill force. If only resources determined a national economy fate, there would be no difference between North and South Korea, and former East and West Germany. Surely, the state can play a very important development role in any stressed economy as a strategic-oriented, forward-looking and supporting State. I do not challenge that, however I strongly believe in the efficiency of the concept of economic freedom. Private initiative in an environment of well protected property rights and a good legal system, high quality performance of institutions, clear rules of the game, consensus building capacity of the society regarding the importance of economic freedom can bring in significant differences in economic development between particular countries. To analyze the relationship between economic freedom and economic performance, it is first important to define what economic freedom is. Several authors have dealt with the problem, thus I shall present a few results in the next chapter.

3. The concept of economic freedom

Economic freedom is different from political and civil freedom. Political freedom means that citizens are free to participate in the political process on equal conditions, that there exists competition between parties and that elections are fair. Civil freedom deals with the questions of freedom of religion, freedom of assembly and freedom of speech. Economic and civil freedoms significantly differ from political, because they both focused on the individual, whereas political freedom enables political decision-making based on the will of the majority and thus downplaying the will of the individual. Therefore economic and civil freedoms tend to be legitimate, as opposed to political freedom.

One valuable contribution of the distinction between economic, political and civil freedom is that it provides a clearer view on how complex the sheer meaning of economic freedom is; the mere existence of such a distinction gives economic freedom a value of its own. On the other hand, such a division can be misleading, as it implies the question of the hierarchy of different types of freedom; which freedom is a mean to achieve a certain end and which one is and end to itself? For economists economic freedom is often understood as a proximate or intermediate goal, while improved welfare stands as the final goal. Conversely, political freedom may be deemed as an ultimate goal by some societies, whereas others again view civil freedom as the goal to which political and economic freedom are the means. Some authors argue that economic freedom can be a mean to achieve political freedom, as was the case with some transitional countries (Friedman, 1992). Thus, the existence of political freedom is justified by economic freedom, although it was the political changes in these countries that enabled greater economic freedom.

Nevertheless, political and civil liberties usually go hand in hand with economic freedom. Countries that are economically free are also more politically free and have higher levels of civil liberties than countries with less economic freedom (Gordillo, Alvarez, 2003). However Farr, Lord, Wolfenbarger (1998) argue that there is no statistical relationship between economic freedom and political freedom. There are a number of countries that feature severe political restrictions but at the same time allow a considerable level of economic freedom (e.g. South Korea). On the other hand there are also countries with a high degree of political and civil freedom, yet with a relatively lower level of economic freedom (e.g. Sweden).

Political and civil freedoms are usually easily understood, since most people relate them to the freedom of speech and the right to vote. Understanding of economic freedom, however, tends to be more complex and often quite deficient, although this is not to say that economic freedom is not understood. The cornerstones of economic freedom are freedom of exchange, freedom to compete, personal choice and protection of private property. Economic freedom means the absence of government intervention, constraint on the production, distribution or consumption of goods and services. Fundamental function of government should be the protection of private property and the provision of infrastructure for an exchange. This requires government to perform one type of action, refrain from engaging in others. However, the scholars have yet to agree on a single definition of economic freedom. It appears that there is a considerably wide agreement among them today what economic freedom includes (Hanke, Walters, 1997; Gwartney et al., 1996; Johnson, Holmes, Kirkpatrick, 1998):

- security of property rights,
- freedom to engage in voluntary transactions,
- access to sound money,

- freedom to engage in voluntary transactions outside the borders of a nation,
- restrictions in the market and freedom to compete,
- personal choice.

If freedom cannot be measured, we have to concede that it is impossible to define clearly the influence of economic freedom on progress. The first attempt to measure economic freedom was produced by R. Gastil and L. Wright in 1983 and came out in the Freedom House annual report. Gastill and Wright assigned respective countries grades for political and civil liberties and then also assigned each country a score for economic freedom. Friedman's book Capitalism and Freedom (1962) was largely ignored by the establishment in economics until the Mont Pelerin Society meeting in Cambridge, England, in 1984. There they challenged the idea of relationship between economic freedom and economic performance. In 1986 M. Walker of Fraser Institute organized the conference attended by M. Friedman, A. Alchian and A. Lindbeck, which resulted later in a number of studies of the relationship between economic freedom and development. In 1996, J. Gwartney, R. Lawson and W. Block published the first volume of Economic Freedom of the World. That encouraged additional efforts to develop more sophisticated measures of economic freedom. All these attempts have been mainly sponsored by liberal institutes (e.g. Cato Institute, Fraser Institute, Heritage Foundation, Liberty Found, Mont Pelerin Society), which strongly believe that liberalization, deregulation and privatization should be the main guidelines of future economic development. The most comprehensive indexes of economic freedom today are the following three:

- Economic freedom index (Fraser index). The index is divided into five areas and twenty-one components. Each component is measured from 0 (no freedom) to 10 (full freedom)[2].
- Index of economic freedom (Heritage index). Index is divided into 10 categories. Component ratings have been used to give a summary rating. Each component is measured from 1 (full freedom) to 5 (no freedom)[3].
- Freedom house index. Four areas are incorporated in the summary index[4]. Each component is measured from 1 (full freedom) to 7 (no freedom).

Indexes represent an attempt to link the meaning of economic freedom more closely to the analytical framework of contemporary economics. The index methodology is intricate and complex and the field of analysis is vast. Different indexes of economic freedom are valuable indicators of economic freedom, based on objective compo-

[2] We should argue that components of the index and weighing factors have been changed through years. When comparing different editions authors should keep this in mind.

[3] The index uses the same weighing factors for each component.

[4] The index uses the same weighing factors for each component.

nents that can be updated. All indexes are focused on economic liberty, but they also have some different emphases and approaches (more in: Hanke, Walters, 1997; Kešeljević, 2000). The most ambiguous attempt to quantify economic freedom is undoubtedly the Economic Freedom Index. Indexes can identify the extent to which individuals are free to choose for themselves and engage in transactions and have their rightly acquired property protected from invasions by others.

4. The political - economic analysis of economic freedom

In order to offer a more precise and profound understanding of economic freedom, it may be helpful to present the complexity of the issue through three pairs of concepts that emphasize and express two different conceptions of understanding of economic freedom:

a) Subjective or objective economic freedom

This division has to do with the dilemma whether one should protect his freedom and accept it as an objectively relevant fact, or is freedom subjective and only forms a part of an array of an individual's preferences. The same degree of freedom may be understood quite differently by various individuals. In this sense, economic freedom is notably subjective, as it depends exclusively on the individual whether he or she understands a 20 % tax on his or her income as a major or a minor breach of freedom. This conception of economic freedom stresses economic freedom as a subjective category that pertains primarily to the individual and to a lesser extent to the community. This conception of freedom that is based on 17th and 18th century liberalism stresses economic freedom as a subjective category that pertains primarily to the individual and to a lesser extent to the community. In line with the recognition that a completely free choice of values necessarily leads to conflict with others, we should submit that every individual's maneuvering space is restricted. The greater the extent of individual's freedom to form his views and the more stringent restrictions are required. Nonetheless, it is difficult to determine which values are widely acceptable, since the field of freedom implies that there isn't a set of fixed criteria according to which an action could be regarded as a universal violation of society's values, because every society chooses its own values. Such understanding implies that economic freedom is a reflection of certain consent in the society, which gives way to the definition of economic freedom as an objective category. I am convinced that economic freedom is subjective, since the presence of freedom is a precondition for the existence of diversity; without freedom, the concept of freedom itself cannot be subjective.

b) Absolute or relative economic freedom

Absolute freedom is understood in terms of its links with the existence and dignity of any individual as a free and independent human being. The freedom of thought is a fundamental freedom and cannot be abstracted from the freedom of speech and expression. The diversity of opinion is a reflection of human wisdom and intellectual charge in a society, since the clash of opinions is a prerequisite for a profound knowledge (Mill, 1956). On the other hand, the presence of a unified system of education, political systems, public opinion, culture and values in a society tend to restrict individual's freedom of thought. The cultural environment, the interweave of particular members of our society and the desire to assert our freedom fuel the transition from absolute freedom towards relative freedom, as these same factors increase the need for regulation. The freedom to act is more restricted than freedom of thought, since it affects others more directly. Absolute economic freedom of an individual in the sense of total absence of any impediments is not possible, as every individual is restricted by the environment in which he lives and which he affects, as well as by a moral commitment to care for his family and for the society that he lives in. Economic freedom is relative, since the presence of absolute freedom would destroy freedom; therefore the restriction of freedom is in the interest of freedom itself.

c) Collective or individual economic freedom

The question that poses itself is whether freedom pertains exclusively to an individual (individual freedom) or can freedom relate to a community as well (collective freedom). Individuals concede a certain degree of their freedom in order to improve their security, which in turn can be understood as a certain form of collective freedom. An individual can accept given restrictions of his freedom due to his belief that in exchange for a part of consensually conceded freedom; society protects individual's property rights that form the foundation of his freedom. Common authority that can defend people from the invasions by hostile foreigners and from mutually inflicted damage can only be formed by entrusting a part of our freedom to a particular institutional body. The authority over an individual is not absolute; it only exists on the level of exchange, based on which individual may agree to acknowledge the authority. In this case, the social contract is a contract on integration and not on submission (Rabushka, 1991). However in reality the world does not work in this way, since many restrictions by the state are not accepted voluntarily. Therefore, collective economic freedom indicates the extent to which a political economic system actually reflects the preference of the majority. A democratic country may adopt economic policies that lower individual economic freedom, because the politicians often offer voters rents in exchange for support and because the government must respond to popular demands[5]. By accounting for political agreements in a society, we

[5] Democracy facilitates economic growth through the development of an institutional framework that is more compatible with incentives. However, increases in political rights initially increases eco-

are departing from individual economic freedom, which is becoming collective and a reflection of majority, and thus ceases to be exclusively individual.

Our analysis has shown that economic freedom is notably subjective, relative and collective. However, presented indexes of economic freedom are mainly based on the idea of objective, absolute and individual economic freedom. Such an understanding of economic freedom is obviously wrong, but quite expected considering all the problems regarding quantifying economic freedom. I am strongly convinced that such a deficient understanding of economic freedom is one of the main reasons why presented indexes of economic freedom cannot be sufficient indicators of economic freedom and future economic prosperity. I shall refer more to this statement in the next two chapters.

5. An outline of the empirical investigations in the importance of economic freedom for economic prosperity

The aim of economic policy is to increase national income, human well-being and sustainability. The key question is how these goals are obtained. Based on theoretical conclusions, we may rightfully expect a positive relationship between economic freedom and well-being and economic growth; but does empirical evidence substantiate this effect? Table 1 and Table 2 present the relationship between economic freedom (Fraser index) and economic performance, measured by GDP per capita in purchasing power parity (Table 1) for 121 countries, and between economic freedom (Fraser index) and GDP growth rate per capita (Table 2). It seems that economic freedom might be an important explanatory factor of well being and prosperity.

Table 1: Relationship between economic freedom and economic performance measured in GDP per capita PPP (2003)

Economic Freedom Index	Bottom quintile	4Th quintile	3Rd quintile	2Nd quintile	1St quintile
GDP per capita (in $)	2409	5062	6404	13789	25062

Source: Own calculations, World Bank indicators, Economic freedom of the world.

nomic growth, which in turn tends to slacken once a certain level of democracy is attained. Democracy hinders individual economic freedom by intensifying the redistribution of resources by interests groups (Prokopijevic, 2002; Spindler, 1991).

Table 2: Relationship between economic freedom and economic performance measured in GDP growth rate (1990-2003)

Countries ranked by Economic Freedom Index	Growth rate of GDP per capita (%)
bottom quintile	0,91
4th quintile	1,38
3th quintile	1,18
2nd quintile	1,87
top quintile	2,35

Source: Own calculations, World Bank indicators, Economic freedom of the world.

However, statistical correlation, graphs and tables naturally do not imply a casual connection between economic freedom and economic performance. One of more serious problems of such an analysis is that it only points to the fact that two variables, in this case economic freedom and economic performance, are related. But this relationship or its strength might be a result of the so called indirect impact of other variables that have an impact on economic performance and also on economic freedom. Economies are not rich solely because of good institutions, including economic freedom. Numerous other factors have contributed to relative and absolute success of a given economy. To isolate the impact of economic freedom on institutional quality a regression analysis is needed to be done. There are a vast number of authors which all similarly found out that economic freedom does make a significantly positive contribution to well being (Table 3). Different model specifications could serve as an instrument for testing the robustness of economic freedom.

Economic freedom has many positive influences on many aspects of human well-being like: lower unemployment (Gwartney and Lawson, 1997; Grubel, 1998)6, higher life expectancy (Esposto and Zaleski, 1999), lower infant mortality (Grubel, 1998)7, more equal income distribution (Berggren, 2003, 201; Scully, 20028), lower poverty

[6] This finding is not without controversy. Higher economic freedom may generate higher unemployment in previously protected sectors and undermine the political and economic role of trade unions.

[7] Higher economic freedom (e.g. lower tax burden) can on the other hand lead to lower quality of the public health system that may have been more efficient in the previous period.

[8] The empirical evidence indicates that economic freedom reduces income inequality by increasing the share of market income going to the two lowest income quintiles and lowering the share going to the highest income quintile (Scully, 2002). The finding is not without controversy, since Berggren (2003) has concluded the opposite. Income distribution can be polarized with economic freedom since we are differently prepared for changes and challenges, and particularly if different redistribution mechanisms (that would, logically, restrict economic freedom) are missing.

(Grubel, 1998) and better ecological consequences (Norton, 1998)9. It seems that economic freedom is associated with many economic benefits.

Table 3: Economic freedom and economic performance - An outline

Studies	Dependent variable	Independent variable	Effect
De Haan and Sturm (2000, 2001), Adkins, Moomaw and Savvides (2002)	Growth	Level of the EF index	Not significant
Easton and Walker (1997), Scully (2002), Cole (2003), Powell (2003), Gordillo and Alvarez (2003)	Growth	Level of the EF index	Significant, positive
Hanke and Walters (1997), Farr, Lord, Wolfenbarger (1998)	GDP per capita	Level of the EF index	Significant, positive
Heckelman and Stroup (2000)	Growth	Level of a version of the EFI with different weights	Significant, positive
Gwartney and Lawson (1997)	GDP per capita, growth rate	Level of economic freedom index	Positive, significant
De Haan and Sturm (2000, 2001), Adkins, Moomaw and Savvides (2002), Cole (2003)	Growth	Change in the EF index	Significant, positive

There is obviously a great amount of literature linking economic freedom to economic performance and other socio-economic indicators. Is seems that economic freedom does make a positive contribution to well being. Empirical results make this relationship obviously clear. Countries that have the most economic freedom tend to have higher rates of long term economic growth and are more prosperous than those that have less economic freedom. More economic freedom means higher levels of individual well-being and stronger long-term economic growth than in countries that have less economic freedom.

[9] Economic freedom does not necessarily increase ecology-oriented mentality, just the opposite. Current environmental standards (e.g. Kyoto agreement) do limit economic freedom in order to protect the environment.

However, there have been also many accusations against the virtues of economic freedom. Economic downturn in the 1990s in several transition countries raised the question whether too much economic freedom caused economic crisis. Table 4 present the strength of the relationship between economic freedom (Fraser index) and economic performance, measured GDP per capita in purchasing power parity and economic growth in selected transition economies (for years 1990, 1995, 2000-05). The relationship between economic freedom and GDP per capita in PPP is relatively strong (around 0,52), while the relationship between economic freedom and economic growth is less strong (0,33). Weaker growth and economic freedom correlation can easily be rationalized. During transition due to extensive restructuring economic growth in many economies was very volatile, while economic freedom has been slowly but steadily progressing. But in all three cases the relationship indicates that higher economic freedom is related to better economic performance in transition countries.

Table 4: Correlations

		Fraser index	Real growth rate	GDP per capita PPP (2005)
Fraser index	Pearson Correlation	1.000	.328**	.516**
	Sig. (2 tailed)	.	.001	.000
	N	112	110	112
Real growth rate	Pearson Correlation	.328**	1.000	-.089
	Sig. (2 tailed)	.001	.	.371
	N	110	136	136
GDP per capita PPP (2005)	Pearson Correlation	.516**	-.089**	1.000
	Sig. (2 tailed)	.000	.371	.
	N	112	136	140

** Corelation is significant at the 0.01 level (2-tailed).
Source: Own calculations

Kešeljević and Redek (2006, 2006a) investigated the importance of economic freedom for economic performance in 24 transition economies (excluding Serbia and Montenegro, Georgia and Moldova due to a lack of data). Panel data analysis was performed on a data set spanning from 1995 to 2004, for the 24 transition economies. Authors have considered several possible econometric specifications. Heritage index exhibits stronger relationship to economic performance, but has compared to Fraser index weaker relationship to economic growth (Kešeljević, Redek, 2006, 2006a). Thus, empirical investigation into the relationship between economic performance and economic freedom in transition countries have showed that countries that have more economic freedom also tend to have higher growth and are more prosperous than those that have less economic freedom. Nevertheless, the situation differs significantly between transition countries. Transition countries, once politically and economically homogenous, have taken divergent paths of political and economic development. Many countries have taken the path of higher economic freedom and consolidated democracies (e.g. Czech Republic, Estonia, Slovenia). The Transition and Economic Freedom annual reports however indicate that some transition countries (e.g. Belarus, Albania, Uzbekistan) have not taken decisive steps towards greater economic freedom in terms of opening their economies, attracting FDI and lowering taxes. Restrictions in the banking sector were expanded, the entrance of foreign banks was hampered, credits were reallocated with state assistance, and corruption was tolerated. Therefore, the causes of trouble could not be excessive liberalization; they could be more easily found in the continued lack of economic freedom (corruption, stringent regulation, unsound institutions). This implication undoubtedly requires further research, but it is consistent with the initial idea that more (less) economic freedom means higher (lower) levels of economic well being.

However, some authors still argue that level of economic freedom does not have a significant effect on economic growth (e.g. De Haan and Sturm, 2000, 2001; Adkins, Moomaw and Savvides, 2002). It means that the relationship between economic freedom and economic performance could sometimes be weaker and less significant than economic theory should predict. These inconsistencies imply that we are either dealing with an improper use of the indexes, or that understanding of economic freedom by indexes of economic freedom may be incomprehensive and incomplete.

The first issue deals mainly with the fact that indexes of economic freedom at a particular point of time do not reveal how long the level of freedom has been present. The immediate impact of economic freedom is likely to be smaller, so we expect a lag between the time when institutional arrangements and policies become more consistent with economic freedom and when they begin to exert their primary impact on economic growth. Consequently, the authors should rather use the variable “change in economic freedom index” in their analysis to point out that the effect of economic freedom on economic growth depends not only on the absolute level of economic freedom index during any given period, but also on the direction and magnitude of the change in the index over that period[10]. Obviously, economic freedom needs time to blossom in ways that could eventually lead to higher levels of economic well-being. The second issue deals with the possibility that presented indexes of economic freedom tend to suffer from certain deficiencies. I shall refer more to this in the next chapter.

[10] Cole (2003) for example argues that adding the variable “change in the economic freedom” into the model caused that the explanatory power of the previous model with the variable “level of economic freedom” increases from 69,5 to 74,1 percent. Farr, Lord and Wolfenbarger (1998) similarly showed that past level of economic freedom is significantly related to the current level of real per capita GDP.

6. Why indexes of economic freedom cannot be sufficient indicators of future economic prosperity?

The relationship between economic freedom measured by presented indexes and economic prosperity could sometimes be less significant and weaker. The main reason lies in the fact that indexes of economic freedom presented so far tend to suffer from certain deficiencies with regard to their content and improper use and may therefore be insufficient indicators of economic freedom and prosperity. I believe that researches should not use the economic freedom indexes without necessary precaution and bearing in mind the following four issues:

a) Subjectivity problem and institutional shortcomings

Some regulations and state interventions remained hidden from the public that lacks sufficient economic knowledge to grasp completely the meaning of economic freedom. In transition countries for example the majority of the population does not understand what a life in a world of freedom should be like, as they are only familiar with the central planning system. However, the problem is much deeper, since the same degree of economic freedom may be understood quite differently even among the people with sufficient economic knowledge. It is a relation between the degree of freedom and the value of this freedom as perceived by an individual. A detail political-economic analysis of economic freedom, through three pairs of concepts, has shown that economic freedom is notably subjective.

Nevertheless, presented indexes of economic freedom are mainly based on the idea of freedom as an objective category. Such understanding implies wrongly that economic freedom is a reflection of certain "political" consent in the scientific community and (western) society concerning the object of measurement and dimensions of economic freedom. Presented indexes of economic freedom obviously entail rules that are set externally and as such do not allow different interpretations and perception of economic freedom among different individuals, countries and cultures with regard to their distinctiveness (e.g. norms, habits, political system, education). Indexes regard economic freedom in terms of its relations exclusively to the market as an institution, despite the fact that it would be more sensible to rank countries according to how their citizens perceive economic freedom. I strongly believe that such an understanding of economic freedom greatly depends on the institutional, social and cultural aspects since every individual is restricted by the environment in which he lives. As such, presented indexes cannot be sufficient indicators of economic freedom and consequently of future economic performance.

b) Problem of non-consistent division

The division that poses itself is whether freedom pertains exclusively to an individual (individual freedom) or whether freedom can relate to a community as well (collective freedom). A detail political-economic analysis of economic freedom have shown that economic freedom is notably collective, since the majority has a right to create the form of political-economic system that it deems most appropriate. The main problem is, that certain parts of the indexes of economic freedom may be understood as measures of influence on the individual (e.g. marginal tax rate) and others as measures of influence on the entire population (e.g. average tax rate). Nevertheless, presented indexes of economic freedom are mainly based on individual approach (individual freedom), because freedom is strongly connected with the existence of individual, as a free and independent human being.

Among presented indexes of economic freedom only the authors of Freedom House index understand that economic freedom can be severely influenced by political process. Nevertheless, none of the indexes do make a clear distinction between society which has reached a wide consensus in society regarding relatively high level of taxation, and society without it. Indexes of economic freedom would assign both countries the same level of economic freedom in spite of the fact that society with wide consensus should be ranked higher, since absolute individual freedom cannot be guaranteed due to the right of the democratically elected majority. Presented indexes of economic freedom do not understand economic freedom as a notably collective category, and therefore cannot be sufficient indicators of economic freedom and future economic prosperity.

c) Problem of choice

Differences in policy conclusions depend largely upon the choice of economic freedom indicator. For example, Sweden takes quite different places on economic freedom indexes lists. In view of the Fraser Index authors, taxes do not stand against economic freedom if there is a consent regarding their imposition, which puts Sweden in 2003 to a high (yet still modest) 24th place[11]. In contrast, authors of the Heritage Index believe than any tax constitutes a restriction of economic freedom, which puts Sweden among the less economically free countries. Freedom House Index however, does not account for taxes and transfers directly; thus, it is not surprising

[11] Did Sweden introduce restrictions to economic freedom before or during generating welfare, to become able to (re)distribute it later? If the relation between economic freedom and economic growth exists, does this imply that economic freedom causes growth, or is it the other way around? There is also the possibility of inverse relationship, which argues that economic growth may in turn enhance economic freedom. The relationship is not surprising since countries that experienced a higher level of economic well being in response to more economic freedom are likely to liberalize their economies even more. This development however is to be observed just in rare cases. Some countries have entered the path of deep and systematic de-liberalization after increasing economic freedom in one period of time (e.g. Greece in 1970s, Malaysia in the late 1990s, non-Baltic States of the former Soviet Union in the 1990s). Gwartney, Lawson and Holcombe (1999) found that economic growth is not capable of predicting future increases in economic freedom in a significant manner. Gordillo and Alvarez (2003) similarly argue that there is no statistically significant causality working from growth to freedom.

that their calculations list Sweden among the countries with the highest level of economic freedom in the world. I do agree that Sweden should score a high grade in some areas of index of economic freedom. However, a country that redistributes income to such an extent can definitely not be regarded as one of the most economically free countries in the world.

In my view, the problem is that indexes of economic freedom often fail to account for the entire tax system, neglecting numerous tax relieves and exemptions from the taxable base. Social security contributions are also often omitted from the indexes calculations. In my view, these should be regarded equally to any other levy, regardless of its purpose. Using different indexes of economic freedom, with regard to their different methodology and content, may therefore lead to inconsistent economic policy suggestions.

d) Problem of aggregation

It is difficult to make a blanket statement as to weather or not economic freedom is important for growth, if the result largely depends upon the method of aggregation. Indexes of economic freedom are usually composed of sub-indexes. As with respect to any composite index, when a great number of separate variables are combined, we may wonder what the influence of the components is. Economic freedom does matter for growth; however specific types of economic freedom are more important for growth than others. Because of that some indexes have weighted components equally (Heritage index, Freedom House index) and some have not (Fraser index). Researches should bear in mind that weighing factors (e.g. for Fraser index) have been changed through the years. Many authors argue that economic freedom is in general beneficial to growth, but not all economic freedoms have equal effect, and some may also have counteracting effects (e.g. Carlsson and Lundstrom, 2002; Ayal and Karras, 1998).

I believe these results are more useful than results that rely on aggregate or composite indexes of economic freedom. Relying upon ad-hoc aggregations of the freedom measures into overall index can mislead us, because we could see that not every type of freedom measured in indexes is equally important for economic progress. There is always a question of selection of variables for the index; some authors might think that some important variables are not included in a composite index and others might think that some of the freedoms are inappropriate for the inclusion in an overall measure. Researchers should focus especially on those components of economic freedom index, which contribute significantly to growth and to those that hamper it. Nevertheless, more detailed analysis should be made before any final policy conclusions are drawn. Following this path of research, I expect to find a considerable scope for improvement in presented indexes and consequently in more consistent economic policy suggestions in the future.

7. Conclusion

When countries have an institutional framework based on economic freedom, it enables their citizens to enjoy the fruits of their labor. The private sector has very high motivation to follow its own interest, maximizing profits and thus contributing to long run success of an economy. Such an environment has been classified as an environment of economic freedom. Economic freedom means the absence of government intervention, constraint on the production, distribution or consumption of goods and services. The cornerstones of economic freedom are freedom of exchange, freedom to compete, personal choice and protection of private property.

Indexes of economic freedom (Fraser Index, Heritage index, Freedom House Index) measure the degree to which the policies and institutions of countries are supportive of economic freedom. They identify the extent to which individuals are free to choose for themselves and engage in voluntary transactions with others and have their rightly acquired property protected from invasions by others. Indexes can be seen as quality measures of the institutional environment and one of the most comprehensive, concise, and up to date measurement of the world economies. They can be used as a tool for helping policy makers to develop the most appropriate institutional framework which will underpin lasting and stable economic growth. Overview of the studies into the relationships between economic performance and economic freedom indexes showed that countries that have more economic freedom also tend to have higher growth rates and income levels.

However, the relationship between economic freedom measured by different indexes of economic freedom and economic performance could be sometimes weaker and less significant than the economic theory predicts. The fact is that presented indexes of economic freedom tend to suffer from certain deficiencies, since they are mainly based on the idea of absolute, individual and objective economic freedom. A detail political-economic analysis of economic freedom through three pairs of concepts, that emphasize and express two different conceptions of understanding of economic freedom, have shown that economic freedom is collective, since the majority has a right to create the form of political and economic system that it deems most appropriate in the society. By failure to account for political agreements in a society, which strongly determines the final outcome of liberalization policies, presented indexes do not make any significant distinction between societies with different levels of consent regarding specific economic policy measures. Economic freedom is also relative, since the presence of restrictions of freedom is in the interest of freedom itself. Finally, economic freedom is notably also subjective, because it is more sensible to rank countries according to how their citizens perceive economic freedom. Indexes do not pay any attention to different cultures, norms and values, which all undoubtedly have powerful influences on understanding of economic freedom.

To be exact, this means that different numbers being ascribed by indexes of economic freedom to particular countries are not levels of economic freedom; they are just the consequence of a specific definition of economic freedom. Researchers should be also aware that not every type of economic freedom measured in indexes is equally important for economic progress and that the effect of freedom on economic growth largely depends on the direction and magnitude of the change in the economic freedom index over longer period.

These are the main reasons why presented indexes of economic freedom cannot be sufficient indicators of economic freedom and of future economic prosperity. Therefore, researches should not use indexes without due attentiveness, and policy advisers should keep an eye on mentioned issues as well.

References

Adkins Lee, Moomaw Ronald, Savvides Andreas (2002) “Institutions, Freedom and Technical efficiency”, *Southern Economic Journal,* Vol. 69, July, pp. 92-108.

Aghion, P.; Howitt, P. (1998) *Endogenous Growth Theory,* Massachustets : The MIT Press.

Ayal Elizier, Karras Georgios (1998) “Componenets of Economic Freedom and Growth”, *Journal of Developing Areas*, Vol. 32, No. 3., Spring, pp. 327-338.

Berggren Nicolas (2003) “The Benefits of Economic Freedom: A Survey”, *The Independent Review,* Vol. VIII., No. 2, Fall, pp. 193-211.

Berlin Isaiah (1992) Dva koncepta svobode. In Rosanvallon Pierre. ed., Zbornik sodobni liberalizem, Ljubljana: Studia Humanitatis.

Carlsson Frederik, Lundstrom Susanna (2002) “Economic freedom and growth: Decomposing the effects”, *Public choice,* Vol. 112, September, No. 3-4, pp. 335-344.

Cole H. Julio (2003) “The Contributions of Economic Growth to World Economic Growth 1980-1999”, *Cato Journal,* Vol. 23. No. 2, Fall, pp. 189-198.

Easton Steven, Walker Michael (1997) “Income, Growth and Economic Freedom”, *American Economic Review,* Vol. 87, No. 2, pp. 328-332.

Esposto Alfredo, Peter Zaleski (1999) “Economic freedom and the quality of life”, *Constitutional Political Economy,* 10, no. 2, pp. 185-197.

Farr Ken, Richard a. Lord, J. Larry Wolfenbarger (1998) “Economic Freedom, Political freedom and Economic well-Being: A Causality Analysis”, *Cato Journal,* Vol. 18., No. 2, pp. 247-262.

Friedman Milton (1992), Odnos med ekonomsko in politično svobodo. In: Rosanvallon Pierre. ed., Zbornik sodobni liberalizem, Ljubljana : Studia Humanitatis.

Gordillo Vega Manuel, Alvarez Arce Jose (2003) "Economic Growth and Freedom: A Causality Study", *Cato Journal,* Vol. 23., No. 2, pp.199-215.

Grubel Herbert (1998) "Economic Freedom and Human Welfare; Some empirical evidence", *Cato Journal,* Vol. 18., No. 2., Fall, pp. 287-304.

Gwartney James, Lawson Robert, Block Walter (1996) *Economic Freedom of the World 1975-1995,* Vancouver : Fraser Insitute.

Gwartney James, Lawson Robert (1997) *Economic Freedom of the World 1997, Annual Report.* Vancouver : Fraser Institute.

Gwartney James, Lawson Robert (1999) *Economic Freedom and the Environment for Economic Growth,* Vancouver : Fraser Institute.

De Haan Jakob, Sturm Jan (1999) *On the relationship between economic freedom and economic growth*, Groningen : University of Groningen.

De Haan Jacob, Sturm Jan Egbert (2000) "On the Relationship Between Economic Freedom and Economic Growth", *Public choice,* Vol 95, No. ¾, pp. 363-380.

De Haan Jacob, Sturm Jan Egbert (2001) "How Robust is the Relationship Between Economic Freedom and Economic Growth?", *Applied Economics,* Vol. 33, No. 7, pp. 839-844.

Hanke Steve, Walters Stephen (1997) "Economic Freedom, Prosperity and Equality: A Survey", Vol. 17, No 2, pp. 1-29.

Heckelman Jac, Stroup Michael (2000) "Which Economic Freedoms Contribute to Growth", *Kyklos,* Vol. 53, No. 4, pp. 527-544.

Johnson T. Bryan, Holmes R. Kim, Kirkpatrick Melanie (1998) *1999 Index of Economic Freedom,* New York : Heritage Foundation.

Kešeljević Aleksandar (2000) *Economic Freedom,* Ljubljana, Faculty of Economics.

Kešeljević, Redek (2006a) "Does Economic Freedom Enhance Economic Growth in Transition Countries?" In: *An Enterprise Odyssey: Integration or disintegration,* 15-17 June 2006, Zagreb, Faculty of Economics and Business.

Kešeljević, Redek (2006) "Institutional reforms, economic freedom and economic performance in transition economies". V: *From transition to sustainable development : the path to European integration : [CD ROM with full papers]*. Sarajevo: School of Economics and Business, 2006.

Lucas, R. (1988) "On the Mechanics of Economic Development", *Journal of Monetary Economics,* Amsterdam, pp. 3-42.

Mill John Stuart (1956), *On Liberty,* New York: Macmillan Publishing Company.

Moers, L. (2002) *Institutions, Economic Performance and Transition,* Tinbergen Institute Research Series 269.

North C. Douglass (1988) *Institution, Economic Growth and Freedom: An Historical Introduction, Freedom, Democracy and Economic Welfare,* Vancouver, Fraser Institute.

North, D. (1990) *Institutions, Institutional Change and Economic Performance,* Cambridge : Cambridge University Press.

Norton Seth (1998) "Poverty, Property Rights and Human Well Being: A Cross National Study", *Cato Journal,* Vol. 18, No. 2, Fall, pp. 233-245.

Olson Mancur (1996) "Big bills left on the sidewalk: why some nations are rich and other are poor", *Journal of Economic perspectives,* vol 10, pp. 3-24.

Pejovich, S. (1990) *The Economics of Property Rights,* London : Kluwer Academic Publishers.

Powell Benjamin (2003) "Economic Freedom and Growth: The Case of The Celtic Tiger", *Cato Journal,* Vol. 22., No. 3, Winter, pp. 431-448.

Prokopijevic Miroslav (2002) "Does growth improve economic freedom?", ICER, Torino. pp. 1-57.

Rabushka Alvin (1991) *Philosophical Aspects of Economic Freedom. Economic Freedom: Toward a Theory of Measurment,* Vancouver, Fraser Institute.

Romer, P. (1986) "Increasing Returns and Long Run Growth", *Journal of Political Economy,* 94, Chicago, 1002-37.

Romer, P. (1989) Capital Accumulation in the Theory of Long Run Growth, In Barro R., ed.: Modern Business Cycle Theory, Cambridge : Harvard University Press, p. 51-127

Romer, P. (1990) "Endogenous Technical Change", *Journal of Political Economy,* 98, Chicago, pp. 71-102.

Scully W. Gerald: (2002) "Economic Freedom, Government Policy and the Trade off Between Equity and Economic Growth", *Public choice*, 113, 1-2, pp. 77-96.

Solow, R. (1956) "A Contribution to the Theory of Economic Growth", *Quarterly Journal of Economics,* 70, New York, pp. 65-94.

Spindler Zane (1991) "Liberty and development: A further empirical investigation", *Public choice,* Vol. 69, pp. 197-210.

Indeksi ekonomske slobode – pregled i otvorena pitanja

Aleksandar Kešeljević[1]

Sažetak

Autori indeksa ekonomske slobode tvrde da je ekonomska sloboda ključna za brži ekonomski napredak. Pregled empirijskih i teoretskih istraživanja potvrđuje da je ekonomska sloboda važan uvjet za brži ekonomski napredak. Države koje imaju više ekonomske slobode postižu brži ekonomski napredak. Autor želi posebno istaknuti da je potrebno indekse ekonomske slobode upotrebljavati oprezno zbog određenih slabosti u vezi njihovog sadržaja i primjene. Zbog toga je sama ekonomska sloboda u radu prikazana kroz tri aspekta, koji prikazuju dva potpuno različita načina razumijevanja same ekonomske slobode. Takva političko-ekonomska analiza jasno je pokazala zašto indeksi ekonomske slobode ne mogu biti pouzdan indikator ekonomske slobode i budućeg ekonomskog prosperiteta.

Ključne riječi: *Institucionalna okolina, ekonomska sloboda, indeksi ekonomske slobode.*

JEL klasifikacija: *O10, 017.*

[1] *Asistent, doktor ekonomskih znanosti. Sveučilište u Ljubljani, Ekonomski fakultet, Kardeljeva ploščad 17, 1000 Ljubljana, Slovenija. Znanstveni interes: Institucionalna ekonomija, komparativna analiza ekonomskih sistema. Tel.: + 386 1 31707005. E-mail: saso.keseljevic@ef.uni-lj.si. osobna web stranica: http://www.ef.uni-lj.si/en/lecturers/lecturer.asp?id=259*