POLITICAL FREEDOM AND ECONOMIC FREEDOM:
How Political Rights and Civil Liberties Affect Open Markets

Morgan Shields

This paper was written for Dr. Lightcapís Senior Seminar course.

Introduction

Famous economist Milton Friedman has claimed that democracy and capitalism are inherently linked. This association of economic freedom and political freedom is important to understand and assess for multiple reasons. These reasons can be approached from both a business and economic perspective and also from a political perspective. From a business perspective, multinational corporations (MNCs) and business leaders, who are looking for countries to invest in, should be interested in the association. When looking for a market, if the association is strongly enough correlated, MNCs should be able to look at the political freedom of a country and automatically assume that if the political freedom in that country is high, the economic freedom in that country is also high. This association, if strong enough, provides a powerful argument “...for pursuing an expansion of global trade” (Griswold, 2004: 1)

From a political perspective this association is important in cases such as Iraq ŉ instead of invading the country and democratizing it, what if instead we had pushed for a free-trade agreement? Would this have had the same, if not better, effect on creating a democracy in the country? If the association is strong enough, there might be implications for this. If the relationship is strong enough, there could also be implications for countries that are in the process of democratizing. While building a democracy in a country, one must also build enough economic freedom to maintain that democracy. Nation building must consist of both political and economic freedom simultaneously ŉ if the association is strong enough.

If the association that this paper is trying to test holds true, it is also important for anyone who has an interest in enhancing and protecting democracy. It is important to understand the association between democracy and economic freedom because democracy is a multifaceted and complex system that is not simply a political (government) system—it is an economic system too. This paper tries to make the case that the association between democracy and economic freedom is strong enough to allow for these assumptions on the part of economists, business leaders, and world leaders.

Literature Review

In his classic work, Capitalism and Freedom, Milton Friedman (2002, 7) discusses the very subject of democracy and economic freedom. He starts
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out in his first chapter by saying that, “It is widely believed that politics and economics are separate and largely unconnected...” While the masses may not believe that the two factors are linked or even think about the connection, according to Milton Friedman these two factors are not at all disconnected. Friedman (2002, 8) believes that you cannot have one without the other. He states that “Economic arrangements play a dual role in the promotion of a free society. On the one hand, freedom in economic arrangements is itself a component of freedom broadly understood, so economic freedom is an end in itself. In the second place, economic freedom is also an indispensable means toward the achievement of political freedom”.

Friedman (2002, 9) believes that economic freedom (capitalism) leads to and maintains political freedom (democracy). Economic freedom is important for democracy because it is “Viewed as a means to the end of political freedom, economic arrangements are important because of their effect on the concentration or dispersion of power. The kind of economic organization that provides economic freedom directly, namely, competitive capitalism, also promotes political freedom because it separates economic power from political power and in this way enables the one to offset the other.”

The reason that economic freedom leads to and maintains political freedom, according to Friedman (2002, 13) is because:

Fundamentally, there are only two ways of co-ordinating the economic activities of millions. One is central direction involving the use of coercion ñ the technique of the army and of the modern totalitarian state. The other is voluntary co-operation of individuals - the technique of the market place... Exchange can therefore bring about co-ordination without coercion. A working model of a society organized through voluntary exchange is a free private enterprise exchange economy - what we have been calling competitive capitalism.

Therefore, “So long as effective freedom of exchange is maintained, the central feature of the market organization of economic activity is that it prevents one person from interfering with another in respect of most of his activities” (pg. 14).

Economic freedom allows for political freedom because (as we have all heard) money is power ñ what a free market and economic freedom does is to remove “...the organization of economic activity from the control of political authority....It enables economic strength to be a check to political power rather than a reinforcement” (pg. 15). When kept separate from political power, economic power serves as a check and balance to government and those in power.

Another economist, Jagdish Bhagwati (2007, 93) states that “Globaliza-
tion promotes democracy both directly and indirectly. The direct link comes from the fact that rural farmers are now able to bypass the dominant classes and castes by taking their produce directly to the market....In turn, this can start them on the way to becoming more independent actors, with democratic aspirations, in the political arena.” In his work, Jagdish Bhagwati (2007, 3) defines globalization as “...economic globalization [which] constitutes integration of national economies into the international economy through trade, direct foreign investment (by corporations and multinationals), short-term capital flows, international flows of workers and humanity generally, and flows of technology...”

Bhagwati’s (2007, 94) theory is straightforward—it states that “...Globalization leads to prosperity, and prosperity in turn leads to democratization of politics with the rise of the middle class.” Bhagwati (2007, 94) cites historical cases to backup his opinion that economic globalization leads to and helps to maintain political freedom— he cites Russia and China. He states that:

The strong belief that economic prosperity, engineered through globalization as also the fostering of economic freedoms and associated use of markets rather than central planning, will promote democracy has also been at the heart of a different impassioned debate, contrasting the Russian and the Chinese experience. Russia under Gorbachev opted for glasnost (political freedom and democracy) before perestroika (economic restructuring, including an end to autarky); China opted for economic change while keeping democratization firmly away. China’s success and Russia’s astonishing failure have led many to think both that democratization should follow, not preceded, economic reforms, and that...the prosperity and the middle classes that follow the success of economic reforms will indeed lead to democratization down the road.

Economists such as Bhagwati and Friedman have long hypothesized that capitalism and democracy are inherently linked. There have also been other economists and social scientists that have looked into this linkage. In the next section of this paper, several of these previous studies on the relationship between democracy and capitalism will be discussed and analyzed further.

Previous Studies

There have been several studies done already on the association of political freedom and economic freedom. These studies have mainly dealt with (1) the effect that political freedom has on economic growth, (2) studies pertaining to political freedom and GDP, and (3) studies pertaining to the different economic and democratic effects between developed and developing countries.

In an interesting paper, Feng (1997, 398) asserts”...that democracy is likely to have a significant indirect effect on growth through its impact on politi
cal stability.” He states that his findings suggest that:

Democracy tends to have a positive effect on economic growth by inhibiting extra-constitutional political change and favouring constitutional political change. Democracy provides a stable political environment which reduces stability; democracy offers flexibility and the opportunity for substantial political change within the political system. Together with the positive indirect effects on growth of democracy through investment and education, this juxtaposition of macropolitical certainty and micropolitical adjustability may be regarded as the ultimate basis for sustainable economic growth and expansion (pg. 414).

Niclas Berggren (2003, 205) agrees, “Free markets are conducive to growth, which is why measures such as privatization, freedom to establish new businesses, freer pricing, more flexible contract laws, and less regulation of domestic and international trade and of capital transactions are important.” He also states “An impartial and strong judicial system that protects private-property rights and upholds contracts and agreements is central for a strong economic development” (pg. 205).

In an interesting study done by David Lake and Matthew A. Baum (2003, 333), the authors focus on democracy’s direct effect on growth and its indirect effect on life expectancy and secondary education. At the beginning of their study they focus on the relationship between democracy and economic growth. They note that, while there have been many studies dealing with democracy and its affect on economic growth, there is very little consensus among scholars as to the relationship between these two variables. They argue that “…there are important indirect effects of democracy on growth that are manifested through public health and education.” Their conclusion was that the effect of democracy on economic growth is both subtle, indirect and in the case of their study is dependent on the level of development in the country. Similarly, David Helliwell (1994, 233) did a study about the empirical linkages between democracy and economic growth. He conducted a cross-sectional study on 125 countries for the years 1960-1985. He measured democracy and growth of GDP per adult. His conclusion was (1) there seems to be a “…fairly strong influence from GDP per capita to the level of political rights and freedoms” and (2) that “The data surveyed...support[s] strongly the notion that countries at higher income levels are more likely to have democratic forms of government” (pg. 244). Once again, it appears that income level and the level of development matters in these studies. Uk Heo and Alexander C. Tan (2001, 469) also did a study involving developing countries. They tested 32 developing countries by doing a causal analysis of economic growth and democracy using a simple Granger test to determine that “...it is as likely that economic growth causes democracy as that democracy causes economic growth” in...
developing countries.

Now that the literature and previous studies have been reviewed, in the next section of this paper, the theory and hypothesis will be derived and discussed.

Theory and Hypothesis

While there have been plenty of studies done on democracy and economic growth, there have been limited studies done on specific indicators of economic freedom and their relationship to democracy. The previous literature and studies that have been reviewed in this paper have dealt mainly with: (1) democracy and its effect on economic growth, (2) economics effects on freedom, (3) democracy’s effect on GDP, and (4) economic growth and democracy's effect in developing countries. This study differs from these previous studies in several areas. First, it is not testing for economic growth and democracy, but is testing for an association between democracy and economic freedom. Second, the study I am conducting does not deal with economic growth, but with economic freedom. Finally, this study does not divide developing and developed countries from each other, but tests both. The theory is that as democracy increases, economic freedom also increases.

The general hypothesis is that as the level of political freedom in a country increases, the openness of the markets also increase. In particular, that countries with high civil liberties and political rights have low mean tariff rates, low non-tariff trade barriers, low compliance costs of importing and exporting, low foreign ownership/investment restrictions, and low capital controls.

Dependent Variable

The dependent variable for this study is economic freedom\(^2\). What is economic freedom? For purposes of this study, economic freedom is the presence of open markets in a country. I have defined open markets with five key indicators, listed and defined below.

In their book, Joseph E. Stiglitz and Andrew Charlton (2005, 126) discuss how to open up markets. One of the ways they suggest is to lower tariff rates ñ tariff rate levels are an indicator of the openness of a countryís market. Because tariff rates when high limit the amount of trade coming in and out of a country (limiting economic freedom). Stiglitz and Charlton also refer to non-tariff trade barriers as indicators of how open a countryís market is. They state that “It is not surprising that as tariffs have come down, non-tariff barriers have assumed increasing importance. Trade agreements may do little to alter protectionist sentiment ñ and the politics of special interest. They do, however, change the form that such protection can take”. Thus, for a country to have a more completely open and free market they must not only have limited
amounts of tariffs, but also limited and low non-tariff trade barriers. Tariffs are in essence taxes on trade, non-tariff trade barriers on the other hand are put into four broad categories by Stiglitz and Charlton (2005, 127)

...(1) dumping duties, which are imposed when a country (allegedly) sells products below cost; (2) countervailing duties, which can be imposed when a country subsidizes a commodity; (3) safeguards, which can be imposed temporarily when a country faces a surge of imports; (4) and restrictions to maintain food safety or avoid, say, an infestation of fruit flies.

Thus, two of the five indicators I have chosen to represent the openness of the markets are mean tariff rates and non-tariff trade barriers. Mean tariff rates are measured on a scale from 0 to 10 for each country. As the mean tariff rate increases, the assigned rating is lower. The rating declines towards 0, the higher the mean tariff rate approaches (Economic Freedom of the World 2008 Annual Report). Non-tariff trade barriers are measured by using the Global Competitiveness Report’s survey. The Global Competitiveness Report is published annually by the World Economic Forum, which is an independent international organization that deals with shaping global, regional, and industry agendas.

The compliance cost of importing and exporting is based on the World Bank’s Doing Business data. This rating is based on (1) the time it takes to import a good and (2) the time it takes to export a good. The rating is based on a 0 – 10 point scale, where the longer it takes a country to import/export a product, the closer the rating is to zero (Economic Freedom of the World 2008 Annual Report). This data represents the time it takes to import and export a good from a country. This is an indicator of how many barriers a country places on trade. As the time decreases to import and export a product in a country, the more open its markets are.

Foreign ownership/investment restrictions are also a good indicator of the level of the openness of the markets of a country because it shows how much regulation the government places on foreign businesses in the country. The fewer the restrictions the more open the market. Foreign ownership/investment restrictions are based on a 1 to 7 point scale. Where foreign direct investment being encouraged and happening often in a country is a rating of 7 and it’s being prohibited being a rating of 1. (Economic Freedom of the World 2008 Annual Report).

Capital controls are also a good indicator of the openness of a country’s markets because they represent government policy and restrictions placed on (1) local firms purchasing foreign assets and (2) foreign firms purchasing local assets. Data for capital controls is based on a 0 - 10 scale which represents
the percentage of capital controls not levied as reported by the International Monetary Fund report of 13 different types of capital controls (Economic Freedom of the World 2008 Annual Report).

Independent Variable

The independent variable for this study is democracy (political freedom) as defined by political rights and civil liberties. According to Anthony Arblaster (2002, 9), “At the root of all definitions of democracy, however refined or complex, lies the idea of popular power, of a situation in which power, and perhaps authority too, rests with the people. That power or authority is usually thought of as being political...” Thus, political rights and civil liberties are the indicators used for this study. Data for these indicators of democracy were taken from the Freedom of the World Index, as calculated by Freedom House. Freedom House’s data methodology states that “The Survey rates political rights and civil liberties separately on a scale of 1 to 7, with 1 representing the most free and 7 the least free” (Methodology: Freedom of the World Index). Political rights are rated in 8 areas: (1) whether or not the head of state or government is elected through free and fair elections, (2) whether the legislative representatives are elected through free and fair elections, (3) whether there are free electoral laws, equal campaign opportunities, fair polling and honest tabulation of ballots, (4) whether the voters are able to endow freely elected representatives with power, (5) whether the people have the right to organize in different political parties, (6) whether there is a significant opposition vote, (7) whether the people are free from domination by the military, totalitarian regimes, etc, and (8) what the level of self-government and autonomy is of cultural, ethnic, religious and military groups (Methodology: Freedom of the World Index). Civil liberties are assessed by the levels of 4 broad categories: (1) freedom of expression and belief, (2) association and organizational rights, (3) rule of law and human rights, and (4) personal autonomy and economic rights.

Control Variables

The tests that will be run will also include control variables. Control variables are used to ensure that the effect of the variable does not significantly influence or change the results of the test (Monroe). The control variables for this test are: (1) real gross domestic product per capita (cgdp), and (2) the government’s share of gross domestic product (cg). The reason that these two variables have been chosen is that they can obviously affect the results of the test. The wealth of the nation is important to control for because in most previous studies the results have been divided between developing and developed countries and level of economic wealth. By controlling for this particular aspect, we can find how much the wealth of the nation actually affects the correlation between political freedom and economic freedom. The other variable,
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government share of gross domestic product, will help to control for the gov-
ernment’s level of consumption and spending as it pertains to the total wealth
of the country. These variables have been chosen because they influence the
results, as can be seen by previous studies. The question is how much will
they affect this particular study? By controlling for them, their influence on the
correlation between political and economic freedom can better be understood
and assessed.

Research Design

Relations of the above-mentioned variables (independent, dependent and
control) have been analyzed using SPSS 17. Bivariate studies have been run
and partial correlations controlling for both real gross domestic product per
capita (cgdp) and the governments share of gross domestic product (cg). The
study that was done was a cross-sectional study for the year 2002 for 93 coun
tries. The data for the independent, dependent and control variables were
collected from: the Penn World Tables, the Economic Freedom of the World
Report, and the Freedom of the World Index. The study conducted looked like
the following diagram:

In the next section of the paper, the results of the study have been placed in
several tables and will be analyzed and discussed further.

Empirical Analysis

The first correlations that were run were done for the association of civil
liberties and the open market indicators (mean tariff rates, nontariff trade bar-
riers, compliance costs, foreign ownership/investment restrictions, and capital
controls). All coefficients should be negative in sign. This means that an
increase in oneis civil liberties should lead to a decrease in mean tariff rates,
etc. The results of that study are found in Table 1.
For the association of civil liberties with the economic indicators, 100% of my bivariate correlations are significant in the hypothesized direction, and were remarkable. 60% of the bivariate correlations were stronger than -.5. When the control variables were applied, while there was some change in the strength of the relationships, all relationships remained strong and in the same (hypothesized) direction. Thus, for this study the conclusion can be made that while the wealth of the country and the government’s level of consumption do have some influence on the level of economic freedom in a country (which was expected), its effects are not significant enough to discard the initial results.

Table 2 shows correlations between political rights and the open market indicators. Again, all coefficients should be negative in sign.

The results for the association of political rights and economic indicators were very similar to that of civil liberties. 100% of my bivariate correlations are significant in the hypothesized direction, and were remarkable. Furthermore, as with the previous study, 60% of the relationships where stronger than -.5.
Also, once again, when the control variables were applied, while there was some change in the strength of the relationships, all relationships remained generally strong and in the same (hypothesized) direction. Thus, for this study the conclusion can be made that while the wealth of the country and the government’s level of consumption do have some effect on the level of economic freedom in a country (which was expected), it is not the only significant factor. It is not surprising that these two control variables did have some influence on the results. Previous studies have already stated that they do have an influence. What is surprising is that their influence on the results was never so significant as to change the results dramatically enough to throw out any of the indicators and the relationship that were tested.

As can be seen from the study, the strongest relationship exists between compliance cost of importing and exporting and the two democratic indicators. Why is this? Compliance cost deals with the level of time it takes to import and export a product from a country. This involves the effects of tariffs, licensing fees, bank fees, and time for administrative red tape cutting. In some respects, this particular indicator involves other indicators tested too (i.e., tariff rates), while incorporating other aspects of open markets (i.e., institutional fees). Political rights involve the freedom of citizens from economic oligarchies, which is an economy controlled by a few elites or government. Civil liberties involve the ability of persons to establish and run private business and the assurance that the private business sector is not going to be unduly influenced by government. Thus, the strong relationship between democracy and this particular aspect of open markets is understandable. The theoretical rational for this strong relationship is that compliance costs would be lower as the government involvement in the economy lessens. Without the red tape of government involved, the time it would take to import and/or export goods would be lessened.

The weakest relationship (while still significant) was between the democratic indicators and the level of foreign ownership/investment restrictions. This could be due to the fact that in a democracy the people (that includes business people) are responsible for electing the officials and giving those officials the power - perhaps people are still skeptical of foreign ownership and investment within their economy. Trade unions (an indicator of civil liberties) could also want to limit foreign ownership within their economy.

While all relationships are significant for both political rights and civil liberties, the largest difference between the two is when the relationships were measured for non-tariff trade barriers. The relationship between civil liberties and non-tariff trade barriers is -.142 stronger (at -.644) than the correlation between political rights and non-tariff trade barriers (at -.502). The reason for this could be due to the fact that particular industries (such as the agricultural
industry) would in fact want some nontariff trade barriers such as safeguards, import restrictions and subsidies. Political rights include the ability to elect and provide power to officials. This includes lobbying, etc. Civil liberties include the freedom of groups to establish private business and conduct that business with limited government involvement. Thus there is a stronger relationship between higher civil liberties and low nontariff barriers than between political rights and nontariff trade barriers.

Nontariff trade barriers are not the only indicator that saw a stronger relationship between it and civil liberties instead of political rights. All of the indicators in fact had a stronger relationship with civil liberties than political rights. Political rights (as mentioned earlier) deal with the ability of individuals to elect and endow their officials with power. Civil liberties on the other hand deals with the ability of individuals to form civic organizations and private businesses, the freedom to organize, travel, choose a vocation and conduct yourself with limited government involvement. While political rights are significantly correlated with open market indicators, civil liberties are more strongly correlated. This is partly because civil liberties more clearly represent individual freedom — the freedom to do business and engage in commerce without restriction from the government.

Conclusion

The original question asked was whether or not the level of political freedom could help to explain the level of economic freedom (openness of the markets) in a country. The results of the study do show that the association is significant for each variable tested. What this indicates is that political leaders, world leaders, and businessmen can assume that in most cases, the level of democracy also reflects the level of economic freedom in a country. More specifically, civil liberties in a country are more strongly correlated with free market indicators than political rights. This could be because civil liberties include the rights of individuals to form private businesses without the undue influence of government. Civil liberties also include things such as freedom of employment, freedom to choose your vocation, right to form civic and business organizations (this includes trade organizations and unions). Political rights deal with the ability of individuals to elect and endow their officials with power. Thus, civil liberties more directly deal with the right of people to conduct transactions freely in the marketplace (the very definition of economics).

It is interesting to note that according to the iEconomic Freedom of the World 2008 Annual Report” by the Cato Institute (the study that my economic indicators came from), the United States’ overall economic freedom summary index score and rank has been in decline since 2000. The index score and ranking is derived from not only the measures that I selected for this study
but from five major categories: (1) size of government, (2) legal structure and security of property rights, (3) access to sound money, (4) freedom to trade internationally and, (5) regulation of credit, labor, and business. In 2000, the United States was ranked 2nd of the 141 countries rated with a summary index score of 8.55. By 2006, the United States overall rating was 8th and its summary index score was down to 8.04. According to the study in this paper, if the United States economic freedom is in decline, perhaps the USís civil liberties are also in decline? With bills like the USA PATRIOT Act and Homeland Security Act signed into law in 2001 and 2002, some believe that in the post-9/11 world of fighting terrorism, civil liberties are in decline. According to Russell Hardin (2004, 94) “...it seems likely that the rate of invention of new techniques for surveillance will far outrun the rate for new techniques to controlling the use of surveillance.” In his paper he discusses how the scales of terrorism experienced is not balanced with the restrictions and violations placed on civil liberties of the citizens of the United States. With the links between democracy and economic freedom found in this study, this decline in civil liberties that is cited by Russell Hardin may be linked to the decline in economic freedom (as measured by the Cato Institute). If the United States hopes to climb back up the ranks to 2nd in economic freedom, they should look at increasing their civil liberties first.

Bibliography


University Press.


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APPENDIX A:
Correlations Between Economic Indicators

<table>
<thead>
<tr>
<th></th>
<th>Nontariff Trade Barriers</th>
<th>Compliance Cost</th>
<th>Foreign Ownership/Investment Restrictions</th>
<th>Capital Controls</th>
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<tr>
<td>Mean Tariff Rate</td>
<td>.524**</td>
<td>.623**</td>
<td>.241*</td>
<td>.473**</td>
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<tr>
<td>Non tariff Trade Barriers</td>
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<td></td>
<td>.681**</td>
<td>.467**</td>
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<tr>
<td>Compliance Cost</td>
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<td>.406**</td>
<td>.439**</td>
</tr>
<tr>
<td>Foreign Ownership/Investment Restrictions</td>
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<td></td>
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<td>.465**</td>
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N=93

**, Correlation is Significant at the 0.01 Level
*, Correlation is Significant at the 0.05 Level
APPENDIX B:  
Correlations Between Democracy Indicators

<table>
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<th>Political Rights</th>
<th>Civil Liberties</th>
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<td></td>
<td>.889**</td>
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</tbody>
</table>

N=93  **. Correlation is Significant at the 0.01 Level

APPENDIX C:  
List of Countries Tested:

List of Countries Tested:

Algeria  Denmark  Israel  New Zealand  Sri Lanka
Argentina  Dominican Rep.  Italy  Nicaragua  Sweden
Australia  Ecuador  Jamaica  Nigeria  Switzerland
Austria  Egypt  Japan  Norway  Taiwan
Bangladesh  El Salvador  Jordan  Pakistan  Tanzania
Belgium  Estonia  Kenya  Panama  Thailand
Bolivia  Finland  Latvia  Paraguay  Trinidad & Tob.
Botswana  France  Lithuania  Peru  Tunisia
Brazil  Germany  Luxembourg  Philippines  Turkey
Bulgaria  Ghana  Madagascar  Poland  Uganda
Cameroon  Greece  Malawi  Portugal  Ukraine
Canada  Guatemala  Malaysia  Romania  United Kingdom
Chad  Honduras  Mali  Russia  United States
Chile  Hong Kong  Malta  Senegal  Uruguay
China  Hungary  Mauritius  Singapore  Venezuela
Colombia  Iceland  Mexico  Slovak Rep  Zambia
Costa Rica  India  Morocco  Slovenia  Zimbabwe
Croatia  Indonesia  Namibia  South Africa
Czech Rep.  Ireland  Netherlands  Spain

(Endnotes)
1 The results of the Economic Growth “Granger causes” democracy in 34% of the thirty-two developing countries in their sample. In contrast, the Democracy “Granger causes” economic growth is 31% (pg. 468).
2 See Appendix A for the association of economic factors with each other.
3 See Appendix B for the Correlation between political rights and civil liberties.
4 See Appendix C for the list of countries analyzed.