

TAKING FREEDOM'S NUMBER

A REPLY TO ALEXANDER

Reliance on Australia's high ranking in a recent Economic Freedom Index obscures the reality of our political economy, argues **William Coleman**

We live in an age of the numerical mystique.

An age when the most trivial act of enumeration appears to cast some charm on a subject ('Nineteen things not to do in Japan'). An age ravenous for 'league tables' that supposedly rank everything from universities to penitentiaries.¹ An age in which, in consequence, any judgement of the 'best' is relished. (Readers will recall *Euromoney's* award in 2011 of the Best Finance Minister of the Year to Wayne Swan.) An age that gulps down wide-eyed the 'quantifications' of the 'annual cost' of anything—obesity, domestic violence, whatever—that are turned out by pay-to-play consultancies and then repeated with a cardboard earnestness by a feckless media.

An age, then, that is in the tight grip of the mythology of positivism; one that stoops low in the face of Kelvin's dictum—'When you cannot express it in numbers, your knowledge is of a meagre and unsatisfactory kind', but forgets Jacob Viner's parodifying jape—'When you cannot express it in numbers . . . well, go and express it in numbers anyway!'.²

Viner's point is that you can't always do it with numbers. Contrary to the pretensions of the numerical mystique, measurement is sometimes straight-out impossible.

A simple illustration is any attempt to measure whether a consumer is better off this year relative to last. If the cost of the basket that Bob bought this year (at this year's income and prices) is such that he could not have bought it at last year's income and prices; and if the basket he bought last

year (at last year's incomes and prices), he could not buy this year; then we simply cannot tell if Bob is better off or worse off this year relative to last. It is impossible. No computation of Bob's 'real income' in this circumstance can do the trick. No manipulation can transmute the base mettle of the facts we have in hand into the truth we wish to know.

Similarly, all attempts at 'league tables' expose themselves to the danger of attempting the impossible. An illustration: consider devising a 'league table' of the liveability of Sydney, Melbourne and Canberra based on a survey of individual judgements. Let each person surveyed have their own ranking of the three. In 1785 Condorcet noticed, and in 1951 Kenneth Arrow proved, that the rankings in such an exercise may be such that for *any* of the three cities one cares to nominate as the most liveable, a majority will agree upon one of the remaining two cities as being more liveable than the one nominated. So which city is 'the most liveable' according to respondents? There is no answer. This league table cannot exist.

A slightly different example: consider the concept of 'equality'. Imagine that the top 10% are receiving a larger share of total income than before and the bottom 10% receive a larger share too. Has inequality increased or decreased? Any inequality 'measure' will cough up an 'answer'



William Coleman is editor of *Only in Australia: The History, Politics and Economics of Australian Exceptionalism* (Oxford: Oxford University Press, 2016).

in an instant and—tellingly—different measures will provide different answers. The moral is that before any rational measurement is possible, some serious thinking must first be done: thinking about what equality means, and wherein lies the value that we are reaching for by this word ‘equality’.

The point of such cases where measurement is a hopeless quest is to underline that the frailties of positivism are not just a matter of incompetence; it is not just a matter of ‘getting the ninnies out’ and all will be well with positivism. And yet, going in the other direction, incompetent measurement may in fact be the worst besetting sin of the numerical mystique of our times. Measurement is a craft requiring a long apprenticeship.

The various frailties of the numerical mystique were put in mind by my reading David Alexander’s review of *Only in Australia: The History, Politics and Economics of Australian Exceptionalism* in the Summer 2016-2017 issue of *Policy*.³

The marvel

Only in Australia begins by asserting that Australia is an outlier among comparable Anglophone countries by virtue of its adherence to an egalitarian, collectivist and *dirigiste* bent in policymaking. Alexander’s flat repudiation of this contention turns on his dazzling claim that ‘if Australia is an outlier among our peers, it is an outlier on the more liberal side rather than the collective’ (p.54).

He bases this claim on the Economic Freedom Index (EFI), produced by the Heritage Foundation in partnership with *The Wall Street Journal*, that in his words ‘assiduously ranks countries of the world on various criteria of economic liberalism’ (p.54). Although he acknowledges in passing that ‘[o]ne can quibble the methodology’, Alexander nonetheless unquestioningly relies on the fact that the most recent version of the EFI ranks Australia as fifth most economically free out of 178 countries.⁴

That Australia is an outlier of (economic) liberalism is a marvel not previously noticed by any investigator, apart perhaps from Alexander.⁵ If the EFI’s ranking is taken seriously then The Centre for Independent Studies would have good cause to dissolve itself in a lather of self-congratulation.

So I propose to turn a steady eye towards this revelation.

The augury

The defects of the Economic Freedom Index (EFI) begin at the beginning. It does not attempt any consideration of the meaning of freedom. It simply expresses an allegiance to the ‘absence of constraint’ formulation before nominating ten ‘components’ of freedom (Property Rights, Freedom from Corruption, Fiscal Freedom, and so on) and giving each a score out of 100.⁶ This is evidently an exercise in ‘measurement without theory’, and unsurprisingly yields several conceptually inadequate measures. Let me illustrate.

‘**Monetary freedom**’. In the EFI, this is a matter of the absence of inflation: the lower inflation, the higher the score. But inflation is only obscurely related to freedom, as Milton Friedman unreservedly allowed. The postwar experience of Russia is a lesson enough. Under Stalin prices fell; under Brezhnev they were stable; under perestroika they began to climb; and in 1993—the year Yeltsin introduced the post-Soviet constitution—annual inflation hit 874%. When was Russia the more free, economically and politically?

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‘**Government spending**’. In the EFI, the lower government spending as a percentage of GDP, the higher the score. This produces profoundly unconvincing results. Thus the country ranked highest (that is, most economically free) on this component is the Democratic Republic of the Congo.⁷ Such worthless outcomes are the product of the intellectual poverty of the notion that there is a simple negative relationship between freedom and any ‘government spending’ share, regardless of other factors which drive different spending between rich and poor countries.

Such a notion ignores massive evidence that certain government activities are income elastic (community libraries, nicely guttered roads, environmental clean ups), with the effect of

pushing up the government spending share for high income countries, regardless of how free or unfree they are.⁸

The notion also ignores that in many rich countries a significant portion of government spending consists of social security payments arising from contributory social insurance schemes. In such schemes the more you have paid to the government over your lifetime, the more the government pays you in retirement. Australia, of course, has the reverse system; the more you pay in, typically the less you are paid out. This Australian-style welfare system reduces the government spending share, but that is hardly in the service of economic freedom: it is all in the service of making the middle class the cash cow of a welfare class and creating the high effective marginal tax rates that so burden Australians. The EFI appears to include in government spending payouts from contributory schemes; and the OECD certainly does in their data that Alexander cites without any qualification in another of his proofs that Australia is a low government spending country.⁹ A better measure would be simply government *consumption* as a percentage of GDP. Rather than low, Australia's ratio is dead on the world average.¹⁰

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And there are other categories of government spending which are difficult to construe as hostile to freedom; government debt interest, for example. To renounce billions of debt interest, as Argentina has, will improve Argentina's 'score' on government spending, but will not serve economic freedom.

The divining rods

The defects of the EFI extend beyond conceptual crudities to ineptitudes in procedure.

'**Freedom from Corruption**'. Remarkably, the EFI scores Australia better on 'corruption' than the UK. This unlooked for judgement is wholly based on a

2015 survey by Transparency International (TI) of *perceptions* of corruption across countries. In the same year Transparency International 'defended the decision by its American chapter . . . to give Hillary Clinton its Integrity Award'.¹¹ I guess Transparency International (America) *perceived* the Clinton Foundation to be transparent. I suppose that, similarly, TI's hundreds of survey respondents *perceived* Australia to be less corrupt than the UK. But I dare anyone appraised of current Australian reality—her unions an *opera bouffe* (without the laughs) of sleaze, fraud and extortion; and a former NSW minister for Mineral Resources presently imprisoned—would not judge Australia to be less corrupt than the UK.

'**Property Rights**'. Australia is scored 90, meaning 'corruption is nearly non-existent and appropriation is unlikely'. You might wonder at that. You might wonder that only two countries are scored higher (that is, better) on corruption. You might wonder still more at Australia being judged as stronger on property rights than the United States (which is scored at only 80). APR Energy—the current owner of General Electric's former turbines business—would surely more than wonder given that the ANZ Bank has seized four of its gas turbines under the rubric of Australia's Personal Property Security Act (PPSA). APR had leased these turbines to a firm that 'unbeknown to APR and in breach of the lease agreement included the hired turbines under a blanket lien for a loan with ANZ'.¹² APR is now taking formal action under the Australia-US Free Trade Agreement against what it describes as 'expropriation'. It protests:

The PPSA is offensive to the universally accepted principles of common law right to title and ownership of property, denies the parties due process in connection with the taking of their property, and makes Australia an outlier in the commercial world.

The doubtfulness of Australia's supposedly sturdy attachment to property rights is further underlined by the attraction of governments to taxing 'economic rents', as any tax on the pure rent

from an asset is indistinguishable from expropriation of part of that asset.

‘Labour freedom’. Here Australia is—quite ludicrously—scored as having more labour freedom than the UK or Canada. If any formal refutation was required one could cite the World Economic Forum’s 2014 Global Competitiveness Report that ranked Australia 132nd out of 144 countries in terms of wage determination flexibility, and 136th in hiring and firing flexibility.¹³ But I prefer to proceed more directly, and ask where is this fabled labour freedom that is presumably the envy of the UK and Canada? Is it in the 935 pages of legislation that govern ‘labour freedom’ in Australia? Or is it in the Coles’ Store Team Agreement that was approved overwhelmingly by members of the relevant union, but nevertheless vetoed by the Fair Work Commission? Is it in the abortive 2014 deal between Toyota and its workers? As one analyst recorded,

Toyota planned to put the new deal to a ballot of all employees which, given the chronic unprofitability of Toyota Australia . . . was almost certain to be passed. The Australian Manufacturing Workers Union opposed and sought to stop the ballot . . . Justice Bromberg ruled that the ballot of employees could not go ahead.¹⁴

‘Monetary freedom’. Curiouser and curiouser. On this ‘component’ the EFI ranks Australia as tenth from the top; that is, only nine countries have lower inflation. The US is ranked 96th and the UK 102nd. So Australia is deemed to have lower inflation than the UK or US. Lower inflation? This leaves me acutely perplexed. My calculation of the average of inflation of 2015, 2014 and 2013 that is used by the EFI puts Australia’s inflation above the US or UK, and very much in the middle of the global pack.¹⁵

I leave it to those initiated into the arcania of the EFI to illuminate this mystery: and I leave it to readers as to whether any explanation that can turn Australia from a relatively high inflation economy into a relatively low one is worth anything.¹⁶

‘Financial Freedom’. In a case of leaving the best to last, the EFI ranks Australia as no less than equal first in the world. This is, indeed, a wonder that ‘passeth all understanding’. It passes understanding how the EFI could judge that ‘regulation of financial institutions is minimal’ when Australia’s ‘authorised deposit taking institutions’ circle in a Saragossa Sea of permits, licenses and ‘prudential standards’; are confined within a ‘four pillars’ regime that still sits like stone after a quarter century; are subject to the stern scrutiny of the Foreign Investment Review Board, the Credit and Investment Tribunal, the Reserve Bank of Australia (RBA), the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investment Commission (ASIC), and the Australian Competition and Consumer Commission; and while ASIC successfully ‘pressures’ the banks to leave off no-interest loans, APRA publicly ‘demands’ banks to moderate investor lending, just as the RBA caps banks’ bonds holding at no more than 30% of the total.¹⁷

But as Edmund Burke once said, some follies baffle argument.

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The magic pudding

From this gypsy stew of ten ingredients Australia emerges as fifth ‘Overall’. How this overall rank emerges is itself something of a riddle. Australia’s rankings in the ten components range from 160th to equal firsts, with an average rank of 42; and in only one of the ten components does Australia receive a rank exceeding five. So what cookery transforms these ten ranks into fifth ‘Overall’?

The process is as irrational as it is simple. The ‘scores’ of the ten components are averaged to produce an ‘Overall Score’. That’s it. I don’t need to observe that a rational weighting schema does not just ‘add up and divide by N’. In seeking a rational measure of Bob’s living standards, one does not just add the quantities that Bob consumed of milk,

laundry powder, cigars, salt, and headache tablets, and divide by five.

But the problem of averaging the components is made worse by the EFI's component scores being tainted by 'spurious cardinalisation'. By this I mean the taking of a potentially meaningful set of rankings (first, second, third) and attributing to each rank a meaningless absolute number. Thus a ranking of countries by the strength of property rights is potentially meaningful, but how can one meaningfully assign an absolute number to each rank? Yet the EFI does so for all ten components. It works out its cardinalisations so that the top scoring country for each component scores near 100 and the bottom country scores zero, or nearly so. But, critically, the median score varies substantially from component to component; from as low as 35 (for property rights) to as high as 79 (for fiscal freedom). The consequence is that for property rights a high ranking country's score is considerably in excess of the typical score; 95 is a long way from 35. Thus the upshot of the EFI's cardinalisations is that there is a big payoff in terms of the Overall Score for a country being highly ranked on property rights and little payoff for being high for fiscal freedom. And Australia is near top for property rights (ninth), and near bottom for fiscal freedom (160th). So Australia's Overall Score spuriously benefits.¹⁸

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To pursue this point, we may imagine preserving the rankings for property rights and fiscal freedom, but swapping the cardinalisations. So let's score Australia for property rights as the EFI scores the country that is ranked ninth on fiscal freedom; and let's score Australia for fiscal freedom as the EFI scores the country ranked 160th on property rights. The average of Australia's ten scores is now changed; and, by the logic explained above, is now reduced to 76.1; and Australia's Overall ranking falls from fifth so that it is now squeezed in between UK (ninth) and the US (11th). Thus

Alexander's claim, based on the EFI, that Australia is an outlier of economic liberalism can be refuted solely by this 'technical' rearrangement of arbitrary cardinalisations.

What is to be done?

The EFI, regrettably, sheds no light on the reality of Australia's political economy; rather it obscures it. The nature of that reality is best uncovered by the kind of scholarly examination of the distinct strands of Australian life that is undertaken in *Only in Australia*.

But nothing in the above demonstrates that a quantitative gauge of freedom must be inherently flawed. In fact, I wish to float the possibility that there may exist a rational measure of freedom. To convey the germ of the possibility, we can conceive of paying a sum of money in order to be free of the legal constraints that an economy imposes. The larger the maximum sum we are willing to pay, the less the freedom. The idea might be operationalised as economic theory can evaluate the shadow price of legal constraints on economic activity, and a massive general equilibrium model could compute them. Such an ambitious and intricate project will surely present a legion of intellectual problems. Their treatment would require a host of talent labouring patiently up a twisted path. It does well to recall that the familiar 'national accounts' (GDP, and so on) was the fruit of three Nobel laureates (Simon Kuznets, James Meade and John Hicks), who had the benefit of the brilliant intellectual bequests of Irving Fisher, Etienne Laspyeres and Hermann Paasche. If our world is fortunate enough to be blessed with the insight, expertise and scholarly acumen of the likes of these, a fascinating project is at hand.

Until then, substitutes should be refused.

Endnotes

- 1 On the fatuities of university rankings, see Malcolm Gladwell, 'The Order of Things: What College Rankings Really Tell Us', *The New Yorker* (14 February 2011), 321.
- 2 Robert K. Merton, David L. Sills and Stephen M. Stigler, 'The Kelvin Dictum and Social Science: The History of an Idea', *The Journal of the History of Ideas* 20:4 (1984), 319-331.

- 3 David Alexander, 'Hold the Pessimism', *Policy* 32:4 (Summer 2016-2017), 53-57.
- 4 I use the self-described '2016' Index, although most of the data it draws upon pertains to the period 1 July 2014 to 30 June 2015.
- 5 See 'Dissecting the Platypus Model' by Julie Novak (*Policy* 27:1, Autumn 2011, 25-30) for an appraisal of Alexander's position.
- 6 <http://www.heritage.org/index/book/methodology>
- 7 This is the same Democratic Republic that recently announced that no elections would take place at the end of the current president's term of office in December 2016.
- 8 Originally formulated as Wagner's Law, the income elasticity of government spending to GDP was later corroborated by a great friend of liberty, Alan Peacock. See Alan T. Peacock and Jack Wiseman, *Public Expenditure in the United Kingdom* (London, Oxford University Press, 1961).
- 9 The offending series is 'General government spending, as a share of GDP'. The same defect afflicts the OECD's data on tax to GDP ratios: they include social security contributory schemes.
- 10 <http://data.worldbank.org/indicator/NE.CON.GOVT.ZS>
- 11 https://en.wikipedia.org/wiki/Transparency_International
- 12 Paul Garvey, 'US FTA claim could cost taxpayers \$260 million', *The Australian* (4 October 2016).
- 13 Klaus Schwab and Xavier Salai-i-Martin write, 'Australian businesses, year after year, have named the restrictive labor regulations the most problematic factor for doing business in their country by a wide margin'. See *The Global Competitiveness Report 2014-2015* (Switzerland: World Economic Forum, 2014).
- 14 Phil Lewis, 'Australia's Industrial Relations Singularity', in William Coleman (ed), *Only in Australia: The History, Politics and Economics of Australian Exceptionalism* (Oxford: Oxford University Press, 2016).
- 15 The EFF's inflation measure is a weighted average of the three most recent available years; the most recent year is weighted by 0.665, the preceding year by 0.245, and the year before that by 0.09. Using these weights, World Bank data, and the years 2015, 2014 and 2013, I obtained a weighted inflation rate of 0.61 percent for the UK, 0.62 percent for US and 1.8 percent for Australia. (In 2015, 94 countries recorded a lower weighted rate of inflation than Australia.)
- 16 Australia's consumer prices increased by 29.7% between 2005 and 2015; US consumer prices by 21.4%.
- 17 'Minimal' financial regulation is also impossible to square with Australia's massive compulsory saving scheme ('superannuation'), which takes 9.5% of all workforce earnings and inters them for decades in a labyrinth of tax privilege and penalty—a scheme the likes of which few other countries have. See Adam Creighton's chapter, 'We Are All Capitalists Now', in Coleman (ed), *Only in Australia*.
- 18 So instead of Australia being scored at 90 for being ranked ninth in property rights, it gets 95.3; which is the score of the country that is ranked ninth in fiscal freedom (Turkmenistan). And instead of Australia scoring 63.2 for being ranked 160th in fiscal freedom, it is scored at 15; that being score of the country that is ranked 160th in property rights (Laos).