

Economic Freedom Watch

Wolfgang Kasper

Civilisation cannot prosper without economic freedom and other liberties, yet in Australia economic freedom is no longer seen as the foundation of prosperity.



Free is a four-letter word rarely mentioned in polite political society—at least not in the sense of freedom as ‘individual autonomy and self-responsibility’ and ‘small, rule-bound government’. When an Australian politician mentions the word ‘free’, expect it to mean free lunches and other illusions!

Civic, economic and political freedom

‘Freedom’, wrote the philosopher Immanuel Kant in 1775, ‘is that fundamental value which enlarges the usefulness of all other human faculties’. He considered freedom one of the ‘ultimate justifiers’ of human actions, one of the yardsticks by which we judge the behaviour of others.

The Centre for Independent Studies (CIS) states in its terms of reference that its ‘major concern [is] with the principles and institutions underlying a free and open society’ and then lists, among other things, ‘the right to property [and] an economy based on free markets’. In other words, the civic, political and economic aspects of freedom are seen as closely linked.

Is this correct? Can’t one combine political freedom, founded on electoral democracy, with pervasive economic planning and coercive redistribution—a ‘third way’? Alternatively, is it not feasible to repress civil and political liberties yet operate a free economy, as they are trying to do in China?

Lessons of history

History has shown time and again that—in the long term—economic and civil/political liberties are

intimately linked and that advances in economic freedom tend to spearhead progress on the latter front.

In (western) Europe, economic liberties paved the way for overcoming a state of tyranny and economic near-stagnation—the normal state of humanity for most of history.¹ In feudal times, different laws applied to different classes of people, and the nobility enjoyed privileges over the less powerful. Merchants could not operate properly in those circumstances, so they created the ‘Law Merchant’ which acknowledged all as equal before the law. Disputes were sorted out expediently according to universal rules, mostly within the merchant community.² In the great medieval trading cities, such as Nuremberg and Amsterdam, merchant guilds fostered and enforced a legal order which granted the merchants and many producers economic freedom. This attracted enterprising people from the feudal hinterland. Over time, however, the guilds in many cities became pressure groups which exploited their economic and political power to protect their interests. Economic freedom was degraded. The rulers and pressure groups interfered and caused great costs to new producers and competitors. Innovative merchants and enterprising investors decamped and the great trading cities suffered a bout of ‘Eurosclerosis’, often lasting centuries. Tragically, the institutions rigidified just when world trade shifted during the first wave of globalisation, in the Age of Discoveries.

Wolfgang Kasper is Emeritus Professor of Economics, The University of New South Wales, and Senior Fellow at The Centre for Independent Studies.

In some instances, openness and migration were upheld. Inter-jurisdictional competition forced some rulers to institute limitations on their own power, for example in the *Magna Carta* or when the Netherlands cast off Spanish dominion.

Religious persecution was another major reason why people with valuable knowhow, capital and enterprise moved among jurisdictions. Where the sovereigns guaranteed religious freedom, migrants created new wealth and enriched cultural life—for example in Ferrara in Italy and the early Ottoman Empire, where refugee Jews from post-*reconquista* Spain produced an economic and cultural renaissance. Later, refugee Huguenots founded leading-edge industries in Prussia, the Netherlands and England because enlightened rulers offered them guarantees of economic and religious freedom. The resulting prosperity gave the governments additional revenue—and the means to expand by conquest.

Rulers acted increasingly as political entrepreneurs, as they discovered that protecting private property, commercial contracts and equality before the law were good for prosperity—and their own power. It did not matter that liberties were often granted and protected reluctantly. The Enlightenment was mainly driven by base competition among power-hungry rulers. Yet, slowly and painfully, political, legal and judicial innovations gave rise to an entrepreneurial bourgeoisie who challenged the old political order, further promoting freedom. As Europe opened to the New World, the process accelerated. Some colonies became pacesetters in instituting formal guarantees of freedom, which inspired the Europeans to claim more freedom and constitutional guarantees for themselves.

Eric Jones described this evolution as the ‘European miracle’: the dynamics of competition among jurisdictions in producing freer and more secure institutions and the subsequent economic and cultural flourishing. Eventually, this led to rule-bound, limited government, constitutions, democracy and free, open economies.³ The process still unfolds. The essential ingredient has always been openness. The makers and enforcers of the rules get the right signal only if

mobile, enterprising people with assets are able to flee repression and are attracted by freedom-supporting regimes.

Economic freedom has not been an exclusively Western pursuit. China’s Han dynasty are still the world record holders in tax reform. They reduced taxation to 3% of crop yields, down from the 50% that the preceding, short-lived Qin emperors had levied. One early Han emperor declared that the principle of good government was to rule unobtrusively (*wu wei er zhi*). It is not surprising that the Han Empire flourished culturally and economically, and lasted for over 400 years.

Subsequent Chinese regimes unfortunately relied on the principle that control is better. From the Ming onwards, the Chinese world was closed and there was little individual freedom and no guarantee of property. The magistrates and officials treated the people as ‘fish and fowl’, as milch cows. As a closed, unfree economy, China—up to 1500 the civilisation with the world’s most accomplished science, technology and organisational knowledge—went into economic and civic decline.

But European history repeated itself in the Far East from the 1960s onwards. War and revolution had shattered China’s cultural and political orbit. In one small, poor East Asian country after the other, autocratic rulers emerged who

offered guarantees of economic freedom to traders and investors, attracting foreign investment and mobilising domestic resources. Some of these formerly destitute economies have now caught up with the first world.

Opportunistic political powerbrokers—Lee Kuan Yew, Generals Chiang in Taiwan and Park in South Korea—introduced institutions that limited their own power, at least most of the time. They did so not out of enlightenment, or love of freedom, not even at American bidding, but out of sheer self-interest in economic growth as a source of military power and political legitimacy. Within a generation, the sons and daughters of the emerging middle class were fighting for political freedom, challenging autocracy and crony capitalism. Communist China became the world record holder in privatisation, with 600 million peasants

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gaining *de facto* control over their own land as the Peoples Communes vanished. Rural productivity rose dramatically and sullen, Mao-uniformed state slaves turned into enterprising and fairly cheerful citizens.⁴

Time and again, economic freedom has thus paved the way for enhanced political and civil freedom.

Economic freedom underpins all freedom

In his celebrated book *Capitalism and Freedom*, Milton Friedman showed that the coercive powers of government remain limited only if citizens enjoy secure private property rights and the freedom to truck and barter, travel and relocate.⁵ Economic freedom is both an essential component of overall freedom and the condition that enables citizens to acquire the material means to ensure their political and civic freedom. Poor people cannot marshal the resources to take on autocratic authorities, or to fight for their freedom in the courts. A free society requires citizens of property, who are inspired by the practical experience of free markets to defend overall freedom.

Government is always problematic for individual freedom, as people attempt to shirk their contributions to government programmes and make excessive claims on the benefits. Coercion, command and control are therefore necessary parts of all political action.⁶

By contrast, free markets allow individuals to cooperate voluntarily because it is mutually beneficial. They try out different ideas and resources to practice informed, creative interaction and experience daily what they can achieve without top-down guidance and coercion. Only when markets are pervasively controlled and politically guided will people subordinate themselves passively to central directives, claim socialised provision and lose their creativity. This was the problem with the decline of the guild-ridden European cities and the Chinese Empire; now it is the tragedy of the welfare state.

The freedom of the individual of course stops where its exercise infringes the freedom of others. Therefore, we need constraining rules (institutions) to avoid and sort out inevitable conflicts in orderly ways. Most rules are discovered by experience and are obeyed

spontaneously—most of the time anyway (ethical norms, customs, conventions, work practices, and professional self-regulation). Violations attract spontaneous sanctions: tut-tut, tit-for-tat, ostracism, and so on. But these rules do not always suffice. Therefore, we need ‘external institutions’—legislation and regulation—backed by formal enforcement. This is the classical protective role of government. No modern state, however, has the means to monitor and enforce more than a very small fraction of its legislation and regulations if the citizens refuse to obey voluntarily.⁷

The institutions of capitalism

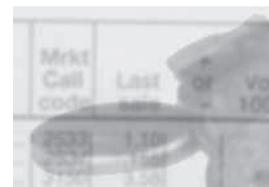
Government must also protect economic freedom, namely to claim, earn and exclusively hold private property and to enter into contracts by which to use or dispose of our property (including our labour and talents). Proper economic freedom requires unbiased, objective protection of the rights—and enforcement of the obligations—that derive from contracts, as well as the equality of all contracting parties before the law. It also requires

governments to protect competition from prevalent tendencies to self-destruct. Poor protection of economic freedom causes decline and poverty, as we have seen in Russia and Africa.

Economic freedom is less important to the rich, the established and the well-connected than the young, the new entrepreneurs, and the economically and politically weak. They need secure property titles and rely on cheap and expedient protection of their property. Without this, they cannot make use of their assets. The Peruvian economist Hernando de Soto has shown in numerous case studies that the poor in the third world own much wealth, but cannot utilise it effectively unless the government formalises and protects property titles.⁸ Genuine social justice starts with secure property rights and enforceable contracts for all.

Free markets oblige us to compete ceaselessly. The asset-rich often perceive this as a threat. After all, property rights are not an unadulterated

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pleasure. In a changing marketplace, asset values depend on whether the owners employ their property, again and again, to search for and test new knowledge. Such innovation is risky and discomfiting. It imposes high costs. We never know whether what we find will be embraced sufficiently by our fellow citizens to pay the knowledge-search costs. People with the means therefore often employ their wealth to seek political protection of their current socioeconomic positions from competition. Rulers, vote-seeking parliaments and power-seeking bureaucrats naturally oblige, catering to the organised and powerful, but degrading economic freedom. This is the world's oldest profession.

Rent-seeking—crony capitalism—produces injustice, economic stagnation, political instability, and social conflict. It also destroys popular support both for democratic government and capitalism. Karl Marx even predicted a world revolution because of the growing monopolisation of the economy and the cosy relationship of the rich with the rulers. He was of course wrong—up to now anyway—because openness, international competition, innovative entrepreneurs, and political self-correction (institutional reform) have undermined political rent creation. But the struggle for economic freedom continues.

Social democracy's creeping encroachment and globalisation

History has not ended. Despite its glaring material successes and economic progress spreading to most third world countries, capitalism remains under attack. The attack frequently comes with the blandishments of manifold rights that promise a 'third way'.⁹ In Australia, as in many other affluent democracies, economic freedom is no longer seen as the essential foundation of prosperity. Vote-seeking politicians, judges who tout social justice and administrators habitually brush economic freedom aside; many citizens applaud because freedom imposes uncomfortable responsibilities and risks. Yet our civilisation cannot prosper without economic and other liberties.

Modern, populist electoral democracy—and the political agents to whom we entrusted the collective

protection of the institutions—has rarely been equal to the task. This is not to attack democracy—the least imperfect means of government yet discovered—but to search for improvements in how to protect a competitive, free economy. What institutions could bind our elected representatives, so that power is less likely to corrupt them? How to remind them that we are the principals and our interest should come first?

Economic freedom is rarely taken away in one fell swoop. As Friedrich Hayek showed in the *Road to Serfdom*, freedom is normally curtailed by salami tactics, almost imperceptibly. If no-one watches, the degrading of economic freedom becomes a political habit, which meets with little resistance as people acquire habits of dependency on government. In our age, the redistributive welfare state probably poses the main danger to economic and political freedom, which is often diminished out of good intentions. Roger Douglas put it well when he quipped about the 'bloody damage done by the bleeding hearts'.

Socialised welfare and interventionism politicise markets and make them dysfunctional. The profit-loss signals, which coordinate free people effectively, are overlaid with more and more 'static noise', so to speak, and the motivation to risk and perform is destroyed. The visible hand causes 'market failures'. Thus, the recent Ansett collapse was not, as commentators claimed, a market failure, but the product of political intervention by two incompetent governments.

Globalisation is now putting a high premium on economic freedom. Highly talented people with knowledge, capital and an entrepreneurial spirit are now fairly free to move elsewhere and have the information about where their assets promise to earn the highest returns. This puts a big onus on those who cannot easily move between countries—unskilled workers and the unions, land owners, and government administrations.

The rulers may react to the challenge of international mobility by offering conditions that attract mobile capital and enterprise, leading to prosperity. Or they may persist with political rent creation and redistribution, sowing the seeds of economic decline. This is why governments must—again—focus on the

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protection of the simple tenets of economic freedom. Of course, this is contentious, at least to those who know no history and who are indifferent to the costs of degrading economic freedom.

Measuring economic freedom

Because it is the most transparent, I prefer the Fraser Institute's *Index of Economic Freedom of the World*, which is published annually. Unfortunately, all international comparisons are published with a time lag of three to four years and coverage is of course limited by the availability of internationally comparable data.

The Fraser Index correlates positively with economic growth (Graph 1 below). Free economies also enjoy relatively high levels of income, good job creation (low unemployment), a low incidence of absolute poverty, longevity, low child mortality, and numerous other 'goods'.¹⁰

Graph 2 (overleaf) shows that Australians lost much economic freedom in the wake of the impatient, confounded and aborted Whitlam 'revolution'. Much ground was recovered under successive Hawke governments, who implemented many ideas of the 'dries' in and outside parliament and whose reforms culminated with the tariff cuts of the early 1990s.

Despite reform of the economic institutions, we have never again been able to surpass the economic freedom standards set in the USA (indicated by the shaded background). Since Keating's 'tea break in reform', and with Howard's increasingly opportunistic handouts, the progress to economic freedom almost stalled during the 1990s. The 'dry cause' is now all but history.

If one compares Australia's overall economic freedom with that of other countries, it becomes apparent that we enjoy a relatively good legal structure and reasonably free conditions to operate a business. What greatly detracts from Australian freedom rankings, however, is the regulation of labour markets and the non-enforcement of the rule of law in industrial relations, as well as the excessive size of government.¹¹

As of 2001, we may even have had some backsliding, so that we may now be hardly ahead of where we stood in 1990.

In some important respects, things have of course continued to improve. Inflation has remained under control, federal and state deficits were being reduced until the pre-election spending spree of 2001, and labour market reform, though pusillanimous, can be counted as having enhanced economic freedom in Australia. Tax reform has probably been a mixed blessing, with the shift from income taxes to the

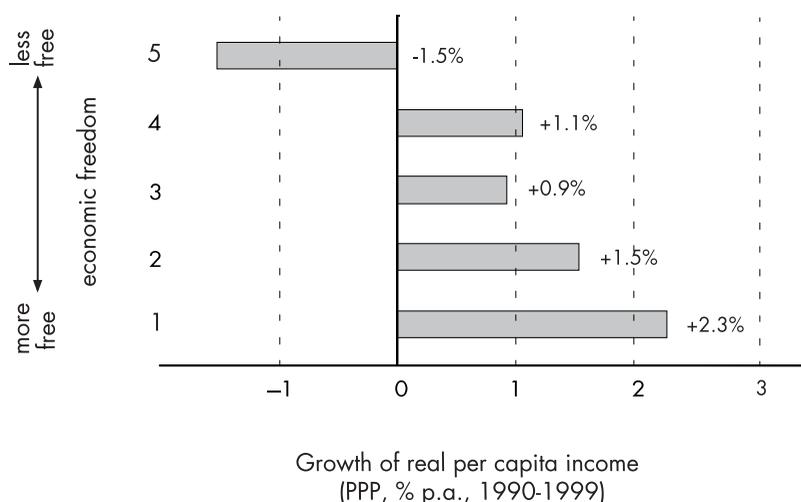
GST marking an advance, but the automatic quota allocation of GST revenues to the states, irrespective of their conduct, was a setback to inter-jurisdictional competition.

These improvements have, however, been balanced by numerous recent violations of the simple, fundamental rules of a free market economy.

Elected parliaments sometimes expropriate private property (for example, NSW commercial fishing licenses), although outright confiscation is rare these days. Indeed, with taxes confiscating a major share of private incomes and wealth, how can government effectively protect private property? It is nowadays much more common for parliaments to inflict regulatory expropriation; that is, they degrade the value of private property for

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**Graph 1. Economic Freedom and Prosperity
Grading on Economic Liberties**



the sake of promoting collective goals. 'Regulatory takings' may well be justified, but property owners should be compensated for their loss out of taxes. Mabo and the confusing administrative follow-up have had enormous consequences for the security of land tenure, and hence agricultural productivity and mineral exploration.

Australian parliaments and governments violate equality before the law, for example when electorally important groups and well-connected industries receive huge handouts, particularly before elections. The states engage in fiscally irresponsible 'subsidy wars' and secretive deals, which corrupt politics and market forces.

Welfare for capital owners erodes the self-responsibility that is essential for a free society and a functioning market economy. When National Textiles went broke, the federal government assumed partial responsibility for particular businesses' liabilities, setting itself up for almost automatic claims for workers' compensation, as became evident after the recent Ansett failure. Is it now to be normal that bankrupt firms, which may just have paid out handsome directors' fees, are no longer held responsible for their losses?

All market interventions have unexpected side effects. Thus, West Australians can now ponder the consequences of the former Liberal state government's 'clean petrol' legislation, which is likely to lead to a costly petrol monopoly throughout the State.

Despite half-hearted attempts to reform labour market regulation, many Australians do not have the freedom to exploit their own talents and labour. Australian employers know that most court rulings are not enforced by the police if these go in their favour and against privileged unions. This is why industrial relations are the biggest blot on Australian freedom ratings.

In recent years, international conventions have increasingly limited this country's sovereignty to determine its own affairs. International cooperation should not be pursued for its own sake—as if it were a goal, rather than simply a means to some higher ends. Diplomatic deals should not empower national and state administrations to limit our economic freedom further; for example under the Kyoto Protocol. Though not yet ratified and highly controversial, Kyoto is already being used by Australian governments to make energy—one of our key competitive international advantages—more expensive. The overseas competition applauds! The Australian government is now participating in a welcome new round of trade liberalisation, but the price—at the insistence of European Union regulators—will be that Australian farmers may have to accept freedom-destroying environmental regulations.

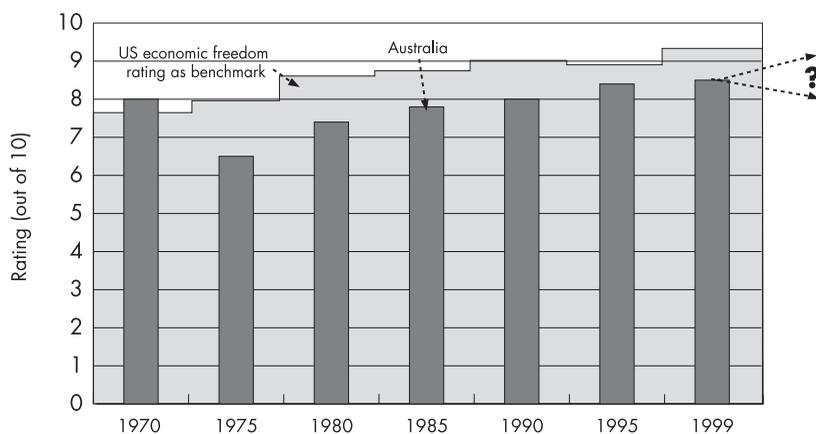
All these influences taken together suggest that economic freedom may well have deteriorated in recent years. This has to remain speculation because no-one in Australia has updated estimates of economic freedom speedily and systematically to the present.

Mounting an Economic Freedom Watch

Those well-known international comparisons of economic freedom serve to advertise the importance of secure

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**Graph 2. Economic Freedom
in Australia 1970-1999**



property rights, non-discrimination and free contracts. However, the political feedback from these international comparisons is weak since they are typically three or four years out of date. I therefore see a benefit in documenting and assessing the thousands of petty and not-so-petty interventions that degrade economic freedom, as well as reforms that promote it. Informed, prompt assessments of the impact on economic freedom seem the best means of preventing the sins against economic freedom from falling into the abyss of habitual political oblivion.

This is why CIS now proposes to mount an Economic Freedom Watch. It will be a regular and systematic exercise to monitor internationally accepted quantitative and qualitative criteria of economic freedom. We intend to prepare and publish short, regular analyses of economic freedom based on published statistics and short-term forecasts, as well as subjective evaluations of criteria which cannot be measured statistically. The evaluations—as well as the overall reports—will rely on a circle of respected, informed experts. An *Index of Economic Freedom* and its key components will be updated three times a year, explaining which actions have promoted—or detracted from—economic freedom.

We hope that this will gradually build up an understanding of economic freedom among policymakers and thereby help to enhance economic literacy in this country. The exercise is to remind politicians and judges—as well as the media and the electorate—of the unintended and mostly deleterious side effects of their actions on economic freedom.

In global competition, standstill means backsliding, particularly for Australia which is a frontline state vis-à-vis the new industrial countries of East Asia. In these insecure times, we could reap enormous benefits if only we protected our freedom from elected parliaments, the group egotism of lobby groups, and appointed judges. It is a major national task to cultivate free economic institutions better and to foster international trust in Australian protections of freedom, which investors and producers can enjoy here when they work with us.

We invite readers to communicate to us actions of parliaments, the executive and the judiciary that have, in their opinion, had a particularly positive or negative impact on economic freedom. Contact wkasper@cis.org.au

Endnotes

- ¹ Prior to 1820, real per capita incomes rose at a glacial pace, maybe 0.1 or 0.2% p.a., as any additional output was soon matched by population increases, the famous 'Malthusian trap'. Since 1820, Western per capita incomes have risen nearly 20-fold. See A. Maddison, *The World Economy: A Millennial Perspective* (Paris: OECD, 2001), 46.
- ² Jane Jacobs, *Systems of Survival* (New York: Random House, 1992).
- ³ Eric Jones, *The European Miracle* (Cambridge: Cambridge University Press, 1981/87). Earlier writers were well aware of what I would call the 'Eric Jones effect', for example Adam Smith (*An Inquiry Into the Wealth of Nations*, 1776), Immanuel Kant (*Idea of a Universal History From a Cosmopolitan Point of View*, 1784), Edward Gibbon (*The History of the Decline and Fall of the Roman Empire*, 1987), and Max Weber (*General Economic History*, 1923). See also: P. Bernholz, M.E. Streit and R. Vaubel (eds), *Political Competition, Innovation and Growth* (Berlin-New York: Springer, 1998).
- ⁴ Wolfgang Kasper, 'The Sichuan Experiment', *Australian Journal of Chinese Affairs*, no. 7, (1982), 163-172.
- ⁵ Milton Friedman, *Capitalism and Freedom* (Chicago-London: University of Chicago Press, 1962).
- ⁶ On this see, W. Kasper and M. E. Streit, *Institutional Economics* (Cheltenham: E. Elgar, 1998), 287-293
- ⁷ O. Kimminich, (in a German language publication), found that government can enforce no more than 3 to 7% of what it legislates if people do not comply voluntarily. See 'Institutionen in der Rechtsordnung', in *Institutionen und Technische Zivilisation*, ed. E. Pankoke (Berlin: Duncker-Humblot, 1990), 90-118.
- ⁸ Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).
- ⁹ Strictly speaking, there is a difference between a freedom and a right: Freedom is an innate quality, and the burden of proof rests on those who wish to curtail it. A right is a claim for which the claimant bears the burden of proof.
- ¹⁰ M. Nahan, 'Prospering From Freedom's Bounty', *IPA Review* (June 2001), 3-4.
- ¹¹ J. Buckingham and H. Hughes, 'Australia's Economic Record', *Policy* 17:3 (Spring 2001), 61-63.

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