The Rosetta stone of development economics:

Economic freedom and how much money you can make from it

Marshall L. Stocker

What is 'Socially Responsible'? In 1970, the late Milton Friedman, the Nobel laureate economist, wrote that 'the social responsibility of business is to increase profits'. In contrast, NGO Oxfam's Website uses 'socially responsible' as an adjective to describe manners, values, and decisions, without defining what exactly it is. Tellingly, Oxfam's career page provides the most concrete description for those seeking 'an ethical career, where the emphasis is less on income than on social responsibility and a warm feel-good glow'.

Rather than a 'warm feel-good glow', an advocate of economic and individual freedom should argue that socially responsible conduct is that which allows one to improve his/her living standards at no coerced expense to anyone else. By extension, socially responsible economic policies create an environment for individuals to improve their lot without a coerced expense to others. This begs the question, are policies that promote capitalism socially responsible?

To answer this question, in the late 1980s, economists set out to create the Rosetta stone of development economics: an objective measure of economic freedom. The group defined economic freedom as secure rights to property, freedom to engage in voluntary transactions (domestically and internationally), freedom from government control over contractual terms, and freedom from governmental expropriation by confiscatory taxation or unanticipated inflation. Using this definition, the Fraser Institute annually publishes the Economic Freedom of the World (EFW) survey, an ordinal ranking and numerical score of economic freedom for 130 countries.

Early studies using the EFW survey showed that high levels of economic freedom correlated with higher per capita income, higher real per capita GDP growth and longer life expectancies. Later, low unemployment rates and child participation in the work force were tied to high levels of economic freedom. As for poverty, countries with the highest level of economic freedom recorded per capita incomes for the poorest 10 per cent of citizens that were eight times those of the poorest 10 per cent in countries with the least economic freedom.

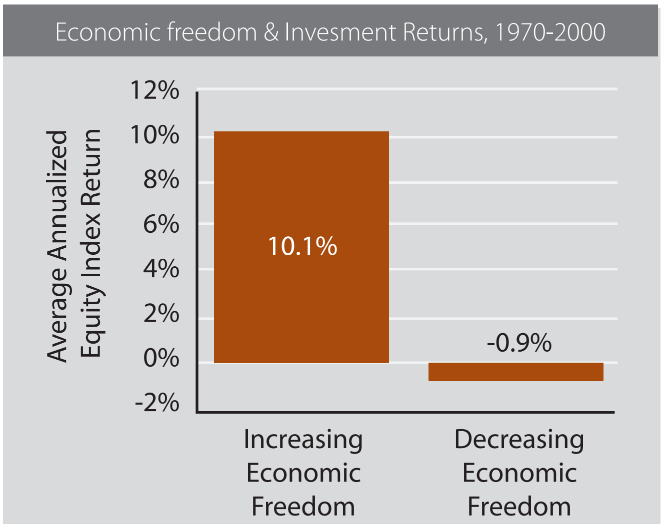
By 2004, the academy had spoken. Empirical evidence overwhelmingly confirmed what classical liberals had for years proffered: the absence of government interference in private economic transactions, a strong rule of law to enforce contracts and property rights, a sound money supply, the freedom to trade internationally, and a government of limited size were conditions necessary for economic prosperity. Simply, the empirical evidence unquestionably demonstrates: life is better in a market-based economy than a highly regulated social-democratic economy.

If economic freedom is good for a country's citizens, what about for those who stoke the fire of free-market economies—capitalists? 'Equity Returns and Economic Freedom,' published in *Cato Journal* in 2005, demonstrates that the same increase in economic freedom associated with improved socio-economic well-being also provides investors with above-average investment returns. Countries that underwent economic liberalisation, shifting from centrally planned economies to free-market economies experienced an annual equity return 11 per cent greater than those countries whose governments moved to exercise greater control over their domestic economies during the years 1970–2000.

Rather than the ethical investment fad of a few years ago, investments made on the basis of economic freedom are both proven to be ethical—they encourage policies which improve standards of living—and proven to be wise investments.

Consider Estonia. After completing comprehensive economic reforms that included privatisation of state-owned enterprises, development of capital markets, price control liberalisation, balancing of the fiscal budget and implementation of the flat-tax, Estonia is now reaping the reward of improved socio-economic well-being. Inflation has dropped from nearly 1000 per cent in 1992 to 4 per cent in 2005. Though

Marshall L. Stocker, *is vice president of Sanderson & Stocker, Inc. He manages World Freedom Select, an investment in economic freedom.*



SOURCE: Stocker, M., (2005) 'Equity Returns and Economic Freedom,' *Cato Journal*, 25:3, page 583

unemployment initially increased as a result of shrinking government bureaucracy, its year 2000 peak of 13.6 per cent is steadily declining to less than 10 per cent today. Per capita gross domestic product (GDP) grew more than 9 per cent in 2005. Since the Tallinn stock market opened in 1996, the index of Estonian stocks has increased by 21.4 per cent per year, while the American S&P 500 index increased a paltry 7.2 per cent per year. For investors, this result should be of little surprise. For during this period, Estonia recorded the largest increase of any country in its economic freedom ranking, having moved from the 75th freest country to the 12th freest country. Meanwhile, the United States' level of economic freedom has decreased! If Estonia's economy continues to grow 6 per cent faster than the USA's, Estonia's per capita GDP will equal that of the USA's in the year 2022, the approximate year in which today's Estonian children will finish their university studies.

Now consider Venezuela. There, economic freedom has decreased dramatically as nationalisation programmes have weakened private property rights and bureaucratic interference in labour markets and the monetary system has increased. No surprise, then, that in 2005 Venezuela had the worst performing equity market in the world, down 35.5 per cent from the year's high. As for socio-economic well-being, the *Financial Times* reported that government price controls identical to those imposed by the former Soviet Union have led to food shortages. As bad, since Chavez took office in 1999, the murder rate has tripled.

Convinced that increases in economic freedom correlate with investment returns and improved socio-economic well-being? Then watch Indonesia closely. President Yudhoyono has already cut the size of government by radically reducing fuel subsidies. During his September 2005 visit with investors in New York City, Yudhoyono pledged to introduce legislation establishing equal treatment for foreign and local investors, as well as to reduce the number of days to start a business from 150 to 30, cut the corporate income tax from 30% to 27% in 2007, and continue to slash onerous economic regulations. Expect the salutary increases in socio-economic well-being to follow.

With a free economy, Australia is socially responsible. Once ranked 20th and bested by Guatemala, Malaysia, and Japan in 1975, Australia rose to the 8th freest economy in 2002. As countries race to adopt the socially responsible policies of economic freedom, Australia has been edged out by Ireland, Iceland, and Luxembourg and now stands as the 11th most economically free economy in the world. Yet, for investors, Aussie land is home to both Dr Jekyll and Mr Hyde. With the 9th best legal and property rights system in the world and 7th best economic policy environment as measured by the absence of onerous regulations, Australia remains weighed down by a bloated government funded by punitive tax rates.

Mr Hyde appears when Australian government consumption as a share of total economic consumption is measured at 23.3 per cent, greater than its northern communist neighbour, China's 21.8 per cent. The Australian government's one-for-you, one-for-me top marginal tax rate of 45 per cent serves to discourage investment and productivity. Thus, true Australian advocates of social responsibility should dispatch with the chase to secure a 'warm feel-good glow' and instead shrink the size of government. The empirical evidence shows clearly that this will improve living standards across the board.

It is seventeen years since the Berlin Wall fell and market-based economies are no longer questioned in favour of the once trumpeted centrally-planned economy. Today, supporters of free-market economies now face a litany of vaguely defined 'socially responsible' programmes such as 'fair trade', 'sustainable business', and 'debt relief'. Fortunately, empirical evidence suggests that free-marketeers stay the course. So capitalists should doff the rock star blue-tint glasses, ignore the politicians' grandiose proposals, and focus on making profits. By seeking to profit from the economic institutions that reduce poverty, capitalists make the world better off. The evidence shows it.