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Driving Growth Through Economic Freedom and the Rule of Law

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Article at a glance

- Economic freedom drives economic growth through innovation.
- While both economic freedom and the rule of law create incentives for accelerated economic growth, economic freedom has a greater effect because it intensifies market competition that leads to improved efficiency and productivity.
- In order to continue fostering growth, economic institutions must be flexible enough to adapt to technological innovations that develop as a result of economic freedom.

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Introduction

Economic freedom contributes to economic growth by fostering competition among actors, leading to increased innovations, efficiency, and ultimately, productivity. Economic freedom also allows investments to be more efficient, leading to growth. The rule of law, as understood as the protection of private property and contractual rights, can protect economic freedom and contribute to growth as well.

Still, the question remains of how to describe economic institutions that make the exercise of economic freedom possible. This article sets out to describe the different component of economic freedom and explain how they relate to both economic growth and the rule of law. Then, it addresses what is necessary for good economic institutions to foster growth on the basis of economic freedom.

Economic Freedom

Before embarking upon a discussion about the relationship between economic freedom and economic growth, it is necessary to more precisely define the notion of economic freedom. The first question associated with economic freedom is one about their character. Are economic freedom exclusively negative freedom, i.e., do they mean only freedom from state coercion? Or do they include positive freedom as well? To put it differently, should the state also act – not just refrain from acting – in order to establish and preserve economic freedom? Further, what is the relationship between the rule of law and economic freedom? Is the rule of law a broader concept than economic freedom, or vice versa? Is there any overlap between these two notions? In order to give answers to the above questions, it is necessary to define the scope and contents of the notion of economic freedom.

Freedom from Government Intervention

The first type of economic freedom refers to the freedom from government intervention, which is manifested in the size of the government. Indicators of this size, i.e. indicators of the level of government intervention include the size of public spending, the amount of transfers and subsidies, the share of public state-owned enterprises in terms of employment and public investment, as well as the top marginal tax rate used for income taxation.[1] The smaller size of the government, the bigger freedom form government intention.

Government intervention is often accompanied by legal barriers to entry for private sector actors. Therefore, the very participation of the public sector in production and investment entails the crowding out of the private sector. Private sector activities, however, are typically more productive than public sector activities because the private sector has incentives to maximize returns, not political effects. Thus, public sector activities can decelerate productivity and economic growth.

Taxation, excluding the public expenditure spent on the supply of public goods, constitutes violation of private property rights that is not based on breaching of law – even the highest tax rates are set by law. At the analytical level, however, it is difficult to separate the tax burden necessary to enable the provision of public goods, which is conducive to growth, from the tax burden necessary to finance coercive redistribution, such as transfers and subsidies.

One needs to be careful when examining the relationship between freedom from government intervention and economic growth. For example, the sheer size of public spending does not provide information on which portion of public spending is used on the supply of public goods that produce an increase in the productivity of investment or business projects, thereby increasing their returns. However, such an increase in returns would not occur in the case of transfers and subsidies because they distort incentives by lowering expected rates of return and increasing the rates of return on those business endeavors undertakings that are not necessarily the most productive on the market.

There is some overlap between economic freedom from government intervention and the rule of law, if the rule of law is understood as the protection of private property rights against violation by the

public sector. It is apparent, however, that this type of economic freedom includes more elements than the rule of law observed in that manner. The key difference relates to the freedom to perform economic activities. The ability to freely embark on business undertakings is important because it is the main precondition for competition on the market: the greater the economic freedom of this type, the tougher the competition. Market competition, in turn, creates strong incentives for improving efficiency, thus increasing productivity, which fosters economic growth. In this respect, economic freedom clearly has stronger and broader effects on economic growth, and on boosting it, than the rule of law alone.

A specific segment of the rule of law – the protection of contractual rights – does, however, affect competition since there can be no exchange where there is no protection of contractual rights. However, even when the protection of contractual rights as a component of the rule of law is perfect, lack of freedom of market entry prevents the creation of unrestricted and sustainable competition, and that decelerates economic growth. In other words, the rule of law is a necessary but not sufficient condition for increasing efficiency and accelerating economic growth.

Freedom to Have Secure Private Property Rights

The second type of economic freedom refers to the legal structure and security of private property rights, predominantly in the sense of their security from expropriation by private predators, although certain components of this economic freedom also point to security from expropriation by the state, regardless of whether this expropriation is based on law or not. This freedom includes assessments of judicial independence, impartial courts, protection of intellectual property rights, lack of military interference in the rule of law and political processes, and finally, the power and integrity of the legal system and the trust of the public in it.

To the largest extent, this indicator of economic freedom, since it indicates the freedom from expropriation, points to the level of the rule of law that overlaps with universal protection of private property and contractual rights in the manner in which that protection was looked at in the previous section. That is why the effect of this type of economic freedom on economic growth is very close, if not identical, to the effect of the rule of law.

Freedom to Access Sound Money

The third type of economic freedom includes access to sound money by economic agents. It is measured by indicators of monetary stability in the country, the freedom of economic agents to have bank accounts in their own country denominated in foreign currency, and the ability of actors to open bank accounts in other countries. This type of freedom also concerns the freedom of each economic agent to enter into as many free, voluntary market transactions as possible, with as many economic agents as possible.

Without sound money as the main medium of exchange in order to cut back transaction costs of market exchange, the level of such exchange falls dramatically. That has negative effects on economic growth because of the decline in efficiency and productivity. Furthermore, with fewer exchanges, the incentives for research and development of new technologies also weakens, which further leads to the deceleration of productivity and economic growth. Indeed, in terms of its effects on economic growth, this type of economic freedom has a lot of similarity to the proper protection of contractual rights as a component of the rule of law.

Fr**eedom of International Exchange**

The fourth component of economic freedom comprises freedom related to international exchange, i.e. exchange with economic agents located out of the country. This type of economic freedom is assessed by the amount of tariff and non-tariff barriers to trade reflected in foreign trade regulation, the share of foreign trade in the domestic output, the existence and margin of "black market" exchange rate of foreign currencies to the official one, and control of international capital flows. Broadly speaking, this freedom refers to the freedom to trade, which has two main consequences.

With freedom to trade, the division of labor becomes broader, so the issue of social division of labor is no longer raised for one country. Instead, division of labor is elevated to the international level, which deepens the opportunity to exploit economies' comparative advantages. This type of economic freedom also implies the introduction of a new type of competition – international competition – which increases the pressure on competitors in one country and strengthens incentives for productivity and efficiency in order for actors to remain competitive at the international level.

A special segment component of this component of economic freedom is the freedom to invest capital internationally. More freedom and exposure to the operation of the international capital markets increases competition among investment projects, which enables the transfer of capital to the countries offering the most productive business projects in the global market. That fuels economic growth as well.

Freedom in transactions

The fifth type of economic freedom refers to the freedom from government regulation of transactions in three markets: the financial capital market, the labor market, and products market, i.e. general business regulation.

Economic freedom in the financial capital market increases freedom in the process of financial intermediation. This freedom is measured by five indicators: the percentage of deposits held in privately owned banks, whether domestic banks face competition from foreign banks, the share of loans approved to the private sector, how widespread is interest rate control that results in a negative real interest rate, and how widespread is general interest rate controls on deposits and loans alike. Practically speaking, this boils down to the freedom to negotiate financial deals, i.e. to freely borrow and lend money.

Freedom in the labor market are shown by means of five indicators: the impact of the minimum wage on the equilibrium one, the complexities of hiring and firing procedures, the share of the labor force whose wages are set through centralized collective bargaining, transfers to the unemployed that reduce incentives for job searching, and the existence of compulsory enlistment in armed forces. Freedom in this market generates incentives to owners of labor to invest in their own human capital, since they can expect higher returns on their investment in such a free market. This also leads to an increase in productivity, since investment in human capital brings about more productive utilization of physical capital.

Indicators of general business regulation boil down to the extent to which entrepreneurs are in a position to autonomously set prices for their own products; administrative procedures for starting a business; general legal barriers to entry for new competitors; work hours that an entrepreneur spends on interactions with civil servants implementing general business regulations; the costs of starting a new business; and irregular payments, which is a euphemism for corruption.

Distinctions between Economic Freedom and the Rule of Law

Economic freedom affect economic growth in two ways: directly, by creating incentives for increasing productivity, either through increased efficiency with given technology or through technological progress , and indirectly, through an increase in investment. In terms of the rule of law, the lack of universal protection for private property and contractual rights constitutes a substantive constraint on economic freedom by inhibiting or disincentivizing investment and trade. As such, the rule of law and the protection of private property and contractual rights constitute an important prerequisite for private investment-driven economic growth and high productivity. It is supplemented by relevant supply of public goods, both in terms of the type of public goods and in terms of their quantity and efficiency of their provision.

Economic freedom, however, constitute one step beyond the rule of law when it comes to creating incentives for accelerated economic growth. The greatest difference can be seen in those components of economic freedom that intensify competition and

strengthen incentives created by that competition on all participants in the market due to stronger competitive pressure. More competition leads to stronger incentives for efficiency and productivity, which leads to economic growth. Without economic freedom, the rule of law alone will not accomplish this.

It is justified to view competition in the market as the main driver of economic growth, particularly in those countries that already have achieved - strong rule of law, that is, protection of private property and contractual rights.[2] When there are no other possibilities for major improvements in the rule of law, an increase in economic freedom, i.e., intensification of competition and its pressure to competitors is the key source of productivity increases and thus economic growth.

The freedom of economic agents to enter any industry is essential if economic freedom is to lead to economic growth. Irrespective of how well private property and contractual rights are protected, if there is no freedom of entry for new competitors, competition will not be free and efficiency will not be maximized, i.e. economic growth will be slowed down.

What are Good Economic Institutions?

Good economic institutions that foster economic growth have three main features. One is the rule of law, which means good protection of private property and contractual rights. The better the protection of private property and contractual rights, the higher the investment rate and productivity, which leads to an increase in the economic growth rate.

The second feature of good economic institutions is related to the efficiency of the public sector in the provision of public goods. Part of the decline in the rate of return on business projects is caused by the tax burden, which is used to finance supply of public goods. However, that can be compensated by increased productivity due to the spillover effects of public goods. The higher the efficiency in the provision of public goods, the larger the difference between the increase in the rate of return from productivity growth and the reduction in productivity caused by the tax burden necessary to ensure supply of public goods.

The third feature of good economic institutions has to do with economic freedom and boils down to those institutions that establish and maintain freedom of entry for new competitors and thus enable a free competition among competitors on the market. Competitive pressure creates strong incentives for all participants in the market to increase their efficiency and to raise the level of technology they use through technological and business innovations. Strong competitive pressure creates incentives for all participants in the market to also produce precisely the goods that the market needs, offer them at the lowest affordable prices, and produce them at the lowest affordable costs per unit of product. Competition also creates incentives for all those participants in the market who cannot meet the requirements of efficiency to exit the activity and go bankrupt, thus making it possible for the production factors utilized by them to be allocated to the market participants who are more efficient. Strong competitive pressures also create incentives for technological investment in order to improve the position of participants in the market. In turn, these investments result in technological progress and innovations that bring about growth in productivity - not only for the economic agent who is the innovator, but also for all those who are affected by the diffusion of technological innovations.

Good economic institutions evolve over time as innovation occurs. However, technological innovation is often faster than institutional innovation. Therefore, since technological innovations are ongoing, institutional reform is the task ahead of all countries, even those which are institutionally very well developed.

In some countries, there is a lot of space for institutional reform, thus opening the question of priorities and sequencing for institutional reform.

Conclusion: Prioritizing and Sequencing Economic Institutional Reform

It is possible to say that the priority for economic institutional reform is the rule of law. In all likelihood, what should come first is the prevention of violation of property rights by the state based on law, such as excessive compulsory redistribution of value in favor of government cronies or predators. The reason to prioritize the prevention of these actions is the fact that this does not require a lot of resources.

Following that protection should be strengthening the segment of the rule of law related to an efficient judicial system that is capable of not only punishing, but also achieving deterrence through punishment of violations of property and contractual rights by the private sector. It is probably only then when an acceptable level of the rule of law has been secured that the issue of public sector efficiency can be dealt with, that is, the issue of reducing the tax burden necessary for the given level of public good supply, such as supply of the rule of law.

In terms of economic freedom, what is most important is institutionalizing the freedom of entry for new competitors, thus securing strong competitive pressure felt by all the participants on the market.

Institutional reforms are to a large extent related to the introduction of new formal rules of behavior for economic agents that level the playing field where economic agents make their decisions. However, formal rules do not matter if they are not applied or their application is not probable. That puts specific tasks before institutional reform, such as the building of authorities that will efficiently implement rules, and this building requires resources and time. It is not enough to simply transfer the formal rules of behavior from one country to another.

The existence of high-quality economic institutions, such as strong and universal protection of private property rights, is crucial at lower levels of institutional development. However, it is also necessary to pay attention to the ability of economic institutions to quickly adapt to new situations, predominantly those arising from technological progress and business innovations. If such flexibility, which opens up the space for institutional innovations, is not ensured, incentives to economic agents to take decisions beneficial to economic growth become weaker. This relates in particular to those institutions that should ensure economic freedom and the existence of strong competitive pressure on the market, since that is the key driver of economic growth in circumstances with high levels of institutional development.

In conclusion, the rule of law is a necessary, but not sufficient, precondition to economic growth, because economic freedom goes beyond the rule of law to bring about innovation and increased productivity through market competition. Owing to technological progress brought about by competition and economic freedom, economic institutions must remain flexible enough to adapt to new technological and business needs as necessary.

Notes

[1] The indicators of all components of economic freedom are based on: Gwartney, J. i Lawson, R. (2003), The concept and measurement of economic freedom, *European Journal of Political Economy*, Vol. 19, pp. 405–430

[2] Aghion, P. i Griffith, R. (2005), *Competition and Growth: Reconciling Theory and Evidence*, Cambridge, Mass. and London: The MIT Press

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