Is "economic freedom" strictly free market capitalism? A decompositional analysis of the Economic Freedom of the World index

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The Frasier Institute's *Economic Freedom of the World* is often taken as a metric of market capitalism. This paper argues that the index is an amalgam of measures capturing free markets and good governance, and analysts should remain cognizant of this conceptual conflation when using the index to develop policy prescriptions. Implicitly, the "economic freedom" literature suggests that countries embrace an "Anglo-Swiss" policy model, although the rich world offers alternative models that maximize good governance but not liberalization. Factor analyses suggest that the index's Legal System & Property Rights component is more closely related to outside governance metrics that do not imply market liberalism than other "economic freedom" constituent measures.

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The Frasier Institute's *Economic Freedom of the World* (EFW) (Gwartney and Lawson 2008) is a well-cited annual assessment of countries' "economic freedom." Its index is generally accepted as a measure of market capitalism and is often used as an empirical basis for evaluating the effects of *laissez faire* policies. I argue that this index is not strictly a measure of market capitalism, but rather an amalgam of at least two distinct, though related, concepts: economic liberalism and good governance. The conflation of these two concepts presents problems for the practice of using the EFW to evaluate market capitalism's effects.

The paper begins with a review of the EFW and its reception in the scholastic literature. Analysts often accept the index's nominal definition as a measure of free market capitalism. Four of the five sub-indices that generate countries overall "freedom" scores are very much in line with this project's libertarian conception of "economic freedom", but its Legal Structure & Property Rights component is argued to be distinct in both its content and empirical incidence. There are good reasons to see this fifth component as a different facet of a country's economic environment, even if it is empirically coincident with *laissez faire*.

I then discuss the EFW's use as a set of guidelines that developing countries are implicitly advised to adopt if they wish to emulate rich countries. While the rich world is both relatively liberal and well-governed, the advanced (post-) industrial economies exhibit different mixtures of both, and prescribing reforms that maximize both liberalism and governance is tantamount to recommending that countries embrace an Anglo-Swiss model of capitalism. Alternative models exist, and policy-makers have reason to entertain them.

Through both exploratory and confirmatory factor analysis, I show that the Legal Structure & Property Rights component is more closely related to outside measures of good governance that do not directly imply liberalization. These findings suggest that the Legal

Structure & Property Rights sub-index does not measure market capitalism, but captures the good governance often found in advanced market economies.

The maximization of good governance is not the same as maximizing economic liberalism, and analysts should keep these two policy initiatives conceptually separate. A failure to distinguish them ignores important concerns about reform sequencing, obfuscates their individual contributions to economic welfare, and fails to consider the possibility that governance and liberalism can work at cross-purposes in countries' pursuit of development. Analyses of the EFW should remain cognizant of the mixture of concepts implicit in its empirical specification of "economic freedom", particularly when using the index to devise policy prescriptions.

1. The EFW Index: Background, Composition & Reception

The EFW is a regularly-published, well-cited index that measures countries' level of "economic freedom". Its authors define such freedom as occurring where an economy is characterized by "personal choice, voluntary exchange, freedom to compete, and security of privately owned property" (Gwartney and Lawson 2008: xxi). It is rooted in a libertarian conception of "economic freedom" often associated with Chicago School economics. Analysts generally accept this frame. I argue that its Legal Structure & Property Rights component is conceptually distinct from the EFW's other constituent measures.

1.1: Background

The EFW locates its beginnings in the 1984 meetings of the Mont Pelerin Society (Walker 1996), an academic society whose members were strong advocates of the broad-based globalization, privatization and deregulation reforms that took place in the 1970s through early-1990s (see Yergin and Stanislaw 1998; Harvey 2005). A basic tenet of Mont Pelerin scholars' views was that the strongly interventionist policies adopted by governments after WWII (like Keynesianism or Import Substitution Industrialization) were counterproductive and undesirable (Yergin and Stanislaw 1998). This focus on reducing government intervention is as a central policy concern, and the EFW's focus on limited government is animated by this view.

According to Walker (1996), the project was motivated by the notion that then-extant attempts to assess "freedom" empirically (e.g., Wright 1982; Gastil and Wright 1988) understood its economic dimensions to be too reliant on political processes, and failed to recognize "the right of people to pursue their economic activities free from arbitrary control and interference by the state and other individuals", even if that state is democratic and its interferences a product of popular will (Rabushka 1991: 61). In effect, the EFW was considered a redress to then-current discussions of economic freedom that, in the opinion of its contributors, over-emphasized democracy and the policy expressions of popular will. An alternative, libertarian view of "freedom" was present in the EFW's evolution, whereby its authors held that there exist "protective rights … that provide individuals with a shield against others who would invade and/or take what does not belong to them." (Gwartney and Lawson 2003: 407). Such freedoms, according to Gwartney and Lawson, are negative, and run contrary to "positive" freedoms that emphasize people's rights to things like basic necessities (food or shelter), minimal income or essential services (like health care) (e.g., the conceptions of "freedom" offered by Sen 1999). "If A has a positive right to housing, for example, this logically implies that A has the right to force B to provide them housing. But in a negative rights context, A has no right to the labor of B or any other individual since B owns himself." (Gwartney and Lawson 2003: 407). This sentiment of negative freedoms being economic freedom is apparent in the index's current formulation.

1.2: What is Meant by "Economic Freedom" Precisely?

To see what is meant specifically by "economic freedom", it is useful to see how the concept is measured. Economic freedom scores represent the average of five sub-indices, each of which is intended to capture some constituent aspect of the overall concept. The index has undergone many revisions since its introduction in 1996, and its current formulation is summarized below in **Table 1**:

[Insert Table 1]

Four of the five sub-indices rate countries as being "free" to the extent that governments limit their attempts to steer domestic activities, and accept whatever economic outcomes emerge from private activity. The first three sub-indices' suggestion of limited government intervention in the economy is reasonably straightforward: less government taxes and government-directed economic allocation, reduced government-imposed restrictions on international transacting, or less regulation all directly imply a government that is taking a more "hands-off" approach to economic management. The Access to Sound Money component can also be understood as reflecting limited government in many senses as well. Money supply growth is often understood as an implicit tax on money holders (e.g., Sumner 2004). Easing restrictions on access to foreign-denominated bank accounts is a straightforward case of deregulation. The sub-index's use of low and invariant inflation as a marker of freedom could be debated, although the matter is bracketed here (also noted in Heckelman and Stroup 2000).[2]

These sub-indices suggest a particular kind of freedom, whereby non-state actors' decisions are not affected by government prerogatives. It does not see decision-making

[2] Low (or at least controlled) inflation is often understood as a policy goal, like economic growth or low unemployment. There are cases when inflation could conceivably be aggravated by liberal policy, for example in the case of internationally-transmitted inflation or currency pressures to trade- and external finance-dependent economies.

pressures stemming from non-state actors – like threatening dismissals to unionizing employees, business' coordinated or collusive extrication of rents, or tying the provision of health care to employment – as eroding private, voluntaristic choice. In fact, efforts to ease these sorts of decision-making pressures would likely hurt a country's EFW freedom score, even if they were backed by popular political will. Here, "economic freedom" is a function of maximizing non-state actors' discretionary power in the disposal of the assets they own.

If these constituent measures of "freedom" are accepted as ideals that policy-makers are being specifically advised to embrace, then the index can be understood as providing commentary on the effectiveness of major pro-market reform initiatives of the late-20th century. They bear great semblance to the tenets of the "Washington Consensus" (Williamson 1990) (De Haan, Lundström et al. 2006), and involve reforms that were pushed by the 1989 Brady Plan (Edwards 1995), post-Soviet collapse "shock therapy" (Kolodko 2000; Aslund 2002) or early-1990s IMF conditionality (Polak 1991). As such, the EFW defines "economic freedom" along the same lines as the broad-based, late-20th century movement that is often described as "neoliberalism" (Harvey 2005), or more blandly by its contemporary observers as "reform" (Edwards 1995; Rodrik 1996; Yergin and Stanislaw 1998).

The fifth sub-index, the Legal Structure & Property Rights component, is often treated as constitutive of "economic freedom" on the grounds that it represents a structural condition required for markets to work well. Below, I argue that this sub-index is conceptually distinct. However, most analyses do not strongly distinguish this sub-index from other EFW constituents.

1.3: EFW Index in Policy Analysis

The EFW frames its discussion of "freedom" in terms of unfettered private markets *versus* over-reaching interventionist governments, and those who analyze the EFW data appear to accept this frame. Scholars explicitly treat the EFW as a measure of "free markets" (Doucouliagos and Ulubasoglu 2006), a "market economy" (Berggren 2003), "liberalization" (De Haan, Lundström et al. 2006), "neoliberal" economies (Tures 2003) or some cognate concept that suggests *laissez-faire* capitalism.

The EFW is widely used in scholastic analyses of the relationship between market capitalism and macroeconomic performance, in part because the data is more strongly rooted in transparent and objective (rather than more opaque and subjective) measures of liberalism relative to competing indexes of market capitalism (De Haan, Lundström et al. 2006). The literature (reviewed in Berggren 2003; De Haan, Lundström et al. 2006) principally concentrates on the statistical relationship between EFW overall freedom scores and some metric of macroeconomic performance (like economic growth, poverty or longevity). Much of it focuses on methodological concerns involved in assessing these relationships, for example on matters related to statistical controls (especially the use of sensitivity analysis), assessing Granger causality or instrumentation. Where studies treat the validity of EFW as a measure of "freedom" in the sense of free markets or market capitalism, the index's self-description is accepted at face value.

Some studies have sought to decompose the EFW, recognizing the possibility that "freedom" does not represent a unitary theoretical construct. Two strategies are often employed in such analyses: (1) the assessment of EFW constituent sub-indexes' individual relationships with economic outcomes in isolation or net of each other or (2) the use of exploratory factor analysis to assess differences in the underlying constructs captured by these measures.

Studies that have attempted to parse out the individual relationships between EFW constituent indexes and macroeconomic outcomes have focused on economic growth and produced mixed results. Ayal and Karras (1998) find Access to Sound Money measures to often predict growth rates reasonably well, and some evidence that free trade and small government measures could be important. Carlsson and Lundström (2002) and Berggren and Jordahl (2005) suggest that the index's Legal Structure & Property Rights and Access to Sound Money are strong predictors of growth. Justesen (2008) argues that small government and deregulation are most important.

Claudill, Zanella and Mixon (2000) attempt to disaggregate and reconstitute the EFW via exploratory factor analysis. Their analyses result in a reconceptualization of the EFW as involving four factors – Free Enterprise, Stable Domestic Money, Government Size and International Monetary Freedom – a relatively model recasting of the index. This analysis does not consider the potential for a serious governance component to the EFW because the Legal System and Property Rights sub-index had not yet been formulated when the study was conducted. A similar factor analysis on current data would ultimately find results similar to those of Claudill and colleagues because that study was data-driven, restricted to the EFW data and without outside governance measures that do not necessarily imply liberalism. As liberalism and governance are related empirically, factor analyses pick up on the reasonably strong correlation between the Legal Structure & Property Rights component and other EFW sub-indices. Outside governance measures can help clarify these questions because they expose the Legal Structure index to a test for discriminant validity (Campbell and Fiske 1959) – tests for a substantial difference between what it is supposed to measure (economic liberty) and outside measures intended to capture a different concept (good governance).

1.4: The Legal Structure & Property Rights Component

The Legal Structure & Property Rights sub-index is somewhat distinct conceptually. Its constituent measures are not concerned with limiting government intervention, but are included on the grounds that they constitute an essential "protective function" that provides "the foundation for both economic freedom and the efficient operation of markets" (Gwartney and Lawson 2008: 6). These are not the negative freedoms that constitute the index's purported underlying concept of freedom, but rather a "positive" freedom whereby governments provide essential services that secure people's need for contract enforcement, order and conflict resolution. Ultimately, they involve taxation, government appropriation and the exercise of government power, all of which suggest less private determination over economic outcomes. Its inclusion of a criterion evaluating the absence of military influence in rule of law and politics is an explicit nod to the political freedoms captured by earlier studies of economic freedom from which the EFW attempted to differentiate itself.

This sub-index can be understood as part of a broader policy initiative that need not imply more market capitalism. Instead, it can be understood as part of an initiative that stresses "good governance", reform packages that concentrate on making governments accountable, orderly, professional and non-corrupt (Burki and Perry 1998; Evans and Rauch 1999; Glaeser, LaPorta et al. 2004). Governance and liberalism often coincide empirically, as the world's wealthier countries are generally both better-governed and more liberal. However, dramatic reforms in governance or liberalization need not involve commensurately dramatic reforms in the other, and the maximization of one does not imply the maximization of the other. Indeed, there are reasons to believe that they are two distinct steps in a sequence, and many analysts have argued that good governance should be secured before going too far with liberalism. If governance and liberalism are not separated conceptually, these possibilities will not even be entertained.

Early advocates of free market reform often saw illiberal markets as a cause of government corruption (e.g., Krueger 1974). The basic idea was that governments' intervention created opportunities for public officials to profit from clientelism and corruption, and that liberalization's removal of these opportunities would ultimately decrease the severity of official malfeasance. As such, free market capitalism was seen as a cause of better governance.

There were at least two reasons to question this proposition. First, the emerging East Asian economies, which were often held up as exemplars of market liberalization's capacity to spur development, had governments that played relatively strong roles in steering their economies (Rodrik 1996; Bruton 1998). The region's strong export orientation notwithstanding, scholars argued that the key to the Asian Miracles laid not in hands-off governance but effective governance that would intervene in private affairs (Wade 1990; Evans 1995). Comparative researchers showed that alternative forms of capitalism, some of which did not minimize state influence and power, existed across the advanced industrialized world, and could generate competitive industries and favorable macroeconomic outcomes (Hall and Soskice 2001). The subsequent success of China, which has often maintained many vestiges of government intervention while experiencing phenomenal development, also lends credence to the notion that a strong but effective government can generate good macroeconomic performance.

Second, many analysts argued that liberalization efforts often failed where governance was poor. Stiglitz (2002), for example, cites the Soviet Union's corrupt and incompetent transition government as a cause for the apparently poor payoffs of its rapid liberalization. Latin America, where liberalization was embraced most wholeheartedly but whose governance problems persisted, experienced lackluster economic performance over the past twenty years (Rodrik 1996; Cohen and Centeno 2006).

Burki and Perry (1998) express a core sentiment underlying this view, that governance institutions – the “rules that shape the behavior of organizations and individuals of organizations and individuals” – were required to resolve what then seen to be key problems not addressed by globalization and “first-generation” Washington Consensus reforms: edifying of quality public services that are essential to making private sectors competitive, containing of the volatility that appears to inhere in contemporary liberal financial markets, or addressing the inequality and economic vulnerability that can be exacerbated in liberal systems. Whereas liberalization alone was once seen by many to be key to overcoming economic underdevelopment, concentrating too much on reducing government runs the risk of losing productive forms of government involvement in the economy. Furthermore, if a strong government presence is required in particular areas for markets to work well, like contract enforcement and so on, does the introduction of market forces make sense in their absence? Finally, even a limited government can do a lot to damage a development effort, and improving some facts of economic governance not related to limiting intervention [like better bureaucracies (Evans and Rauch 1999) or political stability (Alesina, Ozler et al. 1996)] could help explain countries economic fortunes.

A key issue here is whether governance constitutes similar or different policy concerns from the advancement of market capitalism. It is logically conceivable for a government to have a small and completely mismanaged government, or a large and well-run one. Below, I offer empirical tests of this question, which show that, although liberalization and good governance are related, they constitute different concepts, and the EFW’s Legal System & Property Rights index pertains to the latter.

2. Methods

The analysis sets forth two goals. First, it attempts to show that the rich world, whose embrace of market capitalism serves as a basis for advising other countries to liberalize, does not maximize liberalism and good governance across the board. While both good governance and free markets are present in healthy doses in wealthy countries, much of the OECD resists several forms of liberalization. My attempt to classify these liberalization-governance variations is pursued through complete-linkage hierarchical cluster analysis, which works to differentiate groups by progressively agglomerating individual observations into groups by collecting them according to farthest Euclidian (L2) distances between groups (see Kaufman and Rousseeuw 1990; Everitt, Landau et al. 2001; StataCorp 2007) . In other words, it collects observations into groups by iteratively aggregating them to produce maximally-different groups in a multidimensional space (defined by the variables used in the cluster analysis).

Second, I examine the degree to which economic liberalism and governance can be treated as two distinct concepts, and attempt to determine whether the EFW's Legal Structure & Property Rights index bears a closer relationship to the former or latter. Towards these ends, it employs exploratory and confirmatory factor analysis. Warner (2008: Ch. 18) provides an overview and comparison of these two factor-analytical methods. In addition to not addressing the implications of governance factors (due to their then-absence in the EFW), Claudill, Zanella and Mixon's (2000) use of exploratory factor analysis is a data-driven exercise, and vulnerable to Type I error (the analyst's identification of factors that may not exist empirically). Such analyses, according to Warner, are vulnerable to "over-interpretation" (p. 814), rooted in the analyst having mistaken exploratory factor analysis' findings as real-world categories. Confirmatory factor analysis provides a somewhat stronger method for assessing measurement models, which employs *a priori* data categorizations based on theory and tests the significance of these *a priori* grouping's ability to predict relationships among variables. In other words, confirmatory factor analysis exposes data groupings to the possibility of being rejected.

I analyze the EFW's publicly-released 2008 data, and concentrate on countries' mean scores for 1995 to 2006. Missing data from 1996 to 1999 were interpolated linearly before calculating these means. To assess whether the EFW is substantially discrepant from other governance measures that do not directly imply market capitalism, I include outside data from Kaufmann, Kraay and Mastruzzi's (2007) *Governance Indicators* (GI). The GI is comprised of six composite indices designed to capture various aspects of "good governance." They are detailed in Table 2 below.

[Insert Table 2]

The GI Rule of Law and Control of Corruption indices were deemed *a priori* to have too much conceptual overlap with measured used to construct the EFW Legal System & Property Rights sub-index. To avoid stacking the deck by including measures of similar underlying constructs, it was excluded from the factor analyses. The decision is taken to be conservative, as both indices are highly correlated with the EFW Legal System sub-index and hence have a likelihood of pushing analytical results towards identifying the latter as a governance-related factor. The GI Regulatory Quality component was deemed to provide a commentary on policy rather than governance, and specifically concentrates on the empowerment of the private sector. My intent is to distinguish strongly between policy (specifically, liberalism) and more strictly non-policy economic governance metrics.

3. National Models of Capitalism

The EFW's annual reports emphasize the fact that the world's richest countries are also its most liberal ones. This relationship is presented as a reason for encouraging developing countries to liberalize (Gwartney and Lawson 2008). The basic idea underlying this prescription is that poor countries can become wealthy by emulating rich ones, a contestable proposition that has been criticized by many scholars (reviews in Chirot and Hall 1982; Hettne 1995; Easterly 2001). I bracket these concerns, and instead propose that the rich world offers a variety of national economic models that embrace liberal markets to varying degrees (see also Hall and Soskice 2001).

Table 3 (below) presents the pairwise correlations between logged per capita GDP (drawn from the World Bank's 2008 *World Development Indicators*), the five EFW sub-indexes and the six GI governance indexes. With the exception of the EFW's Size of Government indicator, these indexes' strong correlations with per capita GDP (>0.500) suggest that rich countries tend to be both liberal and well-governed.

[Insert Table 3]

The negative relationship between the Size of Government measure and other indicators could be the product of Wagner's Law, a propensity for wealthier economies to have larger government budgets relative to GDP (see Peacock and Scott 2000). For present purposes, this discrepancy is treated as non-problematic because the construct is thematically similar to the basic underlying concept of "freedom" as reduced government (i.e., face validity is strong). Smaller government can be treated as a form of limited government, even if the wealthy do not embrace it.

All of the other measured indicators have strong relationships. Note that the GI governance indexes are highly correlated with each other, and with the EFW Legal System & Property Rights index. Curiously, the GI's relationship with other EFW indicators seems slightly stronger than the relationships among EFW indicators. This observation is possibly a product of wealthy advanced economies being generally well-governed, but having a propensity to pick-and-choose their forms of liberalism.

A variation in rich countries' adoption of liberalism is suggested by cluster analyses. Figure 1 (below) presents a dendrogram describing the results of a cluster analysis that used average annual scores for EFW and GI indicators in 21 OECD countries. The purpose of cluster analysis is to identify distinct groups of countries that show similar combinations of liberalization policies and governance characteristics within groups, but distinct combinations from other groups. Countries linked by lower-order branches in this chart are deemed to be more similar in terms of their liberalism-governance profiles.

[Insert Figure 1]

The cluster analysis sorts these 21 OECD countries into five sizeable groups. The first, which will be termed the "Anglo-Swiss" model, comprises all of the English-speaking OECD and Switzerland. The second group (the "Continental" model), includes most of the Northern European Union members, although France and Sweden are demarked as a "Franco-Swedish" variant of the model. Mediterranean European countries constitute a fourth group, and Japan is identified as a unique case.

To discern the character of these groups, Table 4 (below) presents the median EFW and GI scores for 1995 – 2006.

[Insert Table 4]

The Anglo-Swiss countries are the world's "freest" countries, with overall EFW scores that are significantly higher[3] than other regions depicted in the table. These standout scores are not the product of sound money, freer trade or a stronger legal system, which are statistically indistinguishable from Continental economies. Access to Sound Money is similar across all countries, although the Mediterranean barely misses the Pr=0.05 threshold. The defining characteristic of these economies is their relatively small governments and strong embrace of deregulation, both of which are significantly higher than in other regions.

The Continental model of capitalism offers an alternative to the Anglo-Swiss model. As a group, they are significantly less liberal, but marginally better-governed (though not significantly so). Whereas the Anglo-Swiss countries simultaneously secure good governance and liberalism, the Continental models eschew government reduction and deregulation while maximizing good governance. The Franco-Swiss variant of the Continental model's defining characteristic appears to be very large governments, but they are otherwise similar to Continental countries.

The Mediterranean OECD and Japan is more weakly governed and less liberal. Japan is generally better-governed and less open to trade, while the converse is true for the Mediterranean.

Thus, when policy-makers are advised to embrace "economic freedom", they are implicitly being asked to follow an Anglo-Swiss economic model. Presumably, embracing this model pays off in clearer gains in economic welfare. Exploring such relationships lies outside of

[3] According to pairwise t-tests for differences in group means. Here, "significant" differences are those whose t-tests suggest a probability of greater than 95% that group means are different.

the concerns of this paper. In all likelihood, there are different benefits involved in pursuing the Anglo-Swiss strategy versus the Continental models – maximizing liberalism and governance *versus* maximizing governance but setting limits to markets' reach. The point being made here is that, if we do not differentiate liberalism from good governance, we cannot explore these differences. We end up lumping all of the rich world's policy strategies into a common category called "freedom". These comparisons suggest that a choice ultimately presents itself to policy-makers: whether to go "all the way" with liberalism or seek to limit it once it reaches some minimal level. The developing world need not hold up the English-speaking OECD as the only model to pursue development. Europe offers an alternative model that merits consideration.

4. What Concept Does the Legal System & Property Rights Sub-Index Capture?

Given the possibility that liberalism and governance represent distinct agenda, even if they are both found in good measure among the rich countries, the next question to be addressed concerns the EFW's Legal System & Property Rights sub-index. Does it represent good governance or free market capitalism? One way to address this question is to ask whether high Legal System scores are more often found in liberal or well-governed countries. This question can be addressed via factor analysis. The analyses presented below find that a strong legal system and secure property rights are found in both liberal and well-governed countries, but that the measure seems more closely related to good governance.

4.1: Exploratory Factor Analysis

The purpose of exploratory factor analysis is to reduce a larger set of variables into a smaller range of factors denoting common underlying concepts. Table 5 summarizes the results of the exercise. Each row represents a factor, a unique underlying concept that these indicators collectively capture. The first column lists each factor's variance, is the variance accounted for by its corresponding factor. The second column represents proportion of total variance captured by a given factor. Column Three lists the cumulative count of the proportion of variance captured by these factors. The figure exceeds 100% because unreported additional factors registered negative variance scores. These models can over-fit data, and then compensate later with negative variance-scoring factors.

[Insert Table 5]

Table 6 gives the rotated factor loadings, which are transformed loadings that help establish clearer differences among factors:

[Insert Table 6]

The results can be interpreted as follows. Two underlying factors can be construed as explaining the majority of variation found in the five EFW and three GI indicators measured here. Factor 1 appears to correlate positively with both EFW and GI indicators, suggesting an amalgam of liberalization and good governance. Conventional rules-of-thumb hold that a factor loading of 0.7 constitutes a strong relationship, although some argue that lower thresholds are acceptable (Raubenheimer 2004). Factor One appears to be very strongly determined by governance variables (at a stringent cutoff of 0.8), including the EFW Legal System & Property Rights index. However, other EFW measures are also strongly associated with this first factor, particularly its Freedom to Trade component. I interpret this result as an indicator that signals general economic development, which depends very strongly on good governance and less so on the presence of liberalism. In this case the EFW Legal System index behaves very much like a governance indicator.

A second factor, which explains roughly 17% of the variation present in the data, captures liberalism more strictly and *exhibits little relationship with the Legal Structure & Property Rights index.* I take this factor to represent market capitalism separated from governance concerns. It may be the economic libertarianism that lies at the core of policy thinking that motivates the larger "economic freedom" enterprise, and it does not involve the legal system or property rights.

Such an analysis is exploratory and suggestive. The fact that free trade also seems to be related to good governance (albeit much more weakly) makes the case for the Legal System indicator's uniqueness still somewhat weak. Confirmatory factor analysis enables us to directly test *a priori* specified categorizations of the data. I turn to this method next.

4.2: Confirmatory Factor Analysis

Figure 2 presents a graphical depiction of the model being tested. Two latent concepts (denoted by circles) are theorized to be captured by the EFW and GI empirical measures (denoted by boxes): Liberalism and Governance. The arrows from the latent to measured variables denote the relationship between observed measurements and their underlying, latent theoretical constructs. The coefficient of these measures is denoted by lambdas (λ). The dotted line from the Liberalism latent measure to the EFW Legal System & Property Rights index represents its use in one model, in which that measure is taken to be related to both Liberalism and Governance. Each measured variable (in boxes) in the model has an error term that is not drawn in the model for the sake of legibility. The curved line between Liberalism and Governance, labeled with phi (φ), measures a relationship between the Liberalism and Governance constructs.

[Insert Figure 2]

Table 7 (below) shows the results of two models. The first model considers the Legal System & Property Rights measure that signals both Liberalism and Governance. The second takes that measure to capture Governance only.

[Insert Table 7]

Model One assesses both the Liberalism and Governance construct, and considers the EFW Legal System & Property Rights index to be a potential predictor of both. Its model fit meets the standards set by Hu and Bentler (1999): an standardized root mean square residual (SRMR) below 0.09 and Bentler's Comparative Fit Index (CFI) of 0.96 or higher.

Factor loadings for both the Liberalism and Governance latent variables are reasonably similar and significant, except for the Legal System measure, which registers an insignificant, negative coefficient for Liberalism. I test the effects of removing the relationship between Liberalism and the Legal System & Property Rights indicator in Model Two. Other factor loadings seem to be minimally affected. SRMR and CFI statistics remain adequate. The BIC fit statistic suggests a better model fit suggesting that a better fit for the data after adjusting for the number of parameters employed in the model.

Both models suggest a strong relationship between Liberalism and Governance. They can reasonably be construed as two facets of an overall "development" process. However, the analysis makes it clear that this larger process involves two distinct components.

5. Conclusion

The EFW advocates policy-makers' embrace of "economic freedom" on the grounds that it is a defining characteristic of the world's richest countries, and marshals the support of an index measuring "freedom" in support of that proposition. The notion that the world's richest countries are the "freest" is true, but some care should be taken when considering what "economic freedom" means in empirical, rather than nominal, terms. Free markets, fair courts and a strong legal system are all present in these objects of emulation, but lumping these concepts together imparts the impression that they are all expressions of a single policy project.

They are not. "Economic freedom" is an amalgam of two distinct concepts: free markets and good governance. Attempting to maximize both is not an act of emulating the entire rich world, but rather one that emulates primarily the English-speaking rich world. By separating free markets from good governance, we can see that alternatives models of capitalism exist. Indeed, much of the European Union has secured world-class governance while embracing liberalization more haltingly.

Of course, whether or not the Continental European model should be emulated is a matter of debate. The net benefit of pursuing either of these models of capitalism, or other ones, is an empirical question. The main point is that, if we do not distinguish free markets from good governance, such questions will not even be entertained. Governance and liberalism may have different effects on different policy goals, and an exploration of these differences may provide very useful information that can shape countries' policy priorities.

Aside from the fact that the rich world offers distinct models of capitalism, there are other reasons to keep questions of free markets separate from those of good governance. First, there are issues related to reform sequencing. If a strong and fair legal system does represent a structure requirement necessary for markets to work well, does it make sense to liberalize an economy in their absence? The "liberalization first" strategy was employed in both Latin America and the transitioning Soviet Union, and rendered disappointing results in many respects.

These policy failures may suggest that dangers lurk in treating governance and liberalism as part of a common policy package.

Second, there are instances in which liberalism and good governance could work at cross-purposes in the pursuit of macroeconomic goals. There may be instances in which too much democracy, political stability or bureaucratic control could mitigate the benefits of market liberalization. The EFW was originally rooted in the view that political liberalization could ultimately undermine development if it led to populist policies that destroy incentives to invest and produce. Likewise, there are conceivable circumstances in which policy-makers may deem it important to pursue specific initiatives, even at the cost of sowing political discontent or overriding bureaucrats.

Likewise, too much liberalism could hurt macroeconomic gains that accrue as a result of a well-managed government. Unpopular liberalization policies can disrupt political order too much, or a penchant for overruling or neglecting a bureaucracy in the interests of short-term policy objectives may cause problems that hurt development over the long-term. In addition, there are circumstances in which markets really need government oversight – the 2007 global financial crisis being an obvious potential example. Where countries lack effective governments, they may be at the mercy of private (and often foreign) markets, which can lead to trouble when these markets' interests diverge from those relative to general economic welfare.

The data presented here suggest that – to the extent we can equate the rich world's policy strategies with good policy for others – some measure of free markets and good governance is probably desirable, but these programs are not identical and should not be treated as such. Those who engage the EFW should remain cognizant of the conceptual conflation that exists in its strategies to measure “freedom”, and take care to parse these separate issues when using the EFW as a basis for making policy prescriptions.

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Figure 1: Dendrogram of Cluster Analysis of EFW and GI Indices in OECD, 1995 - 2006

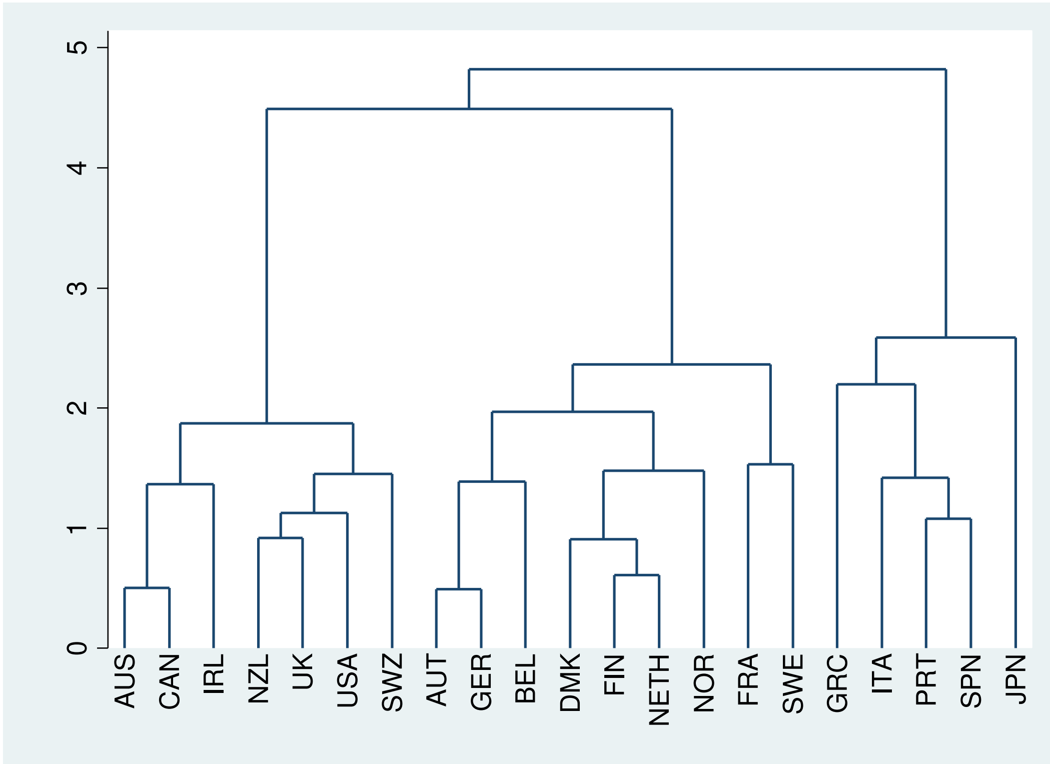
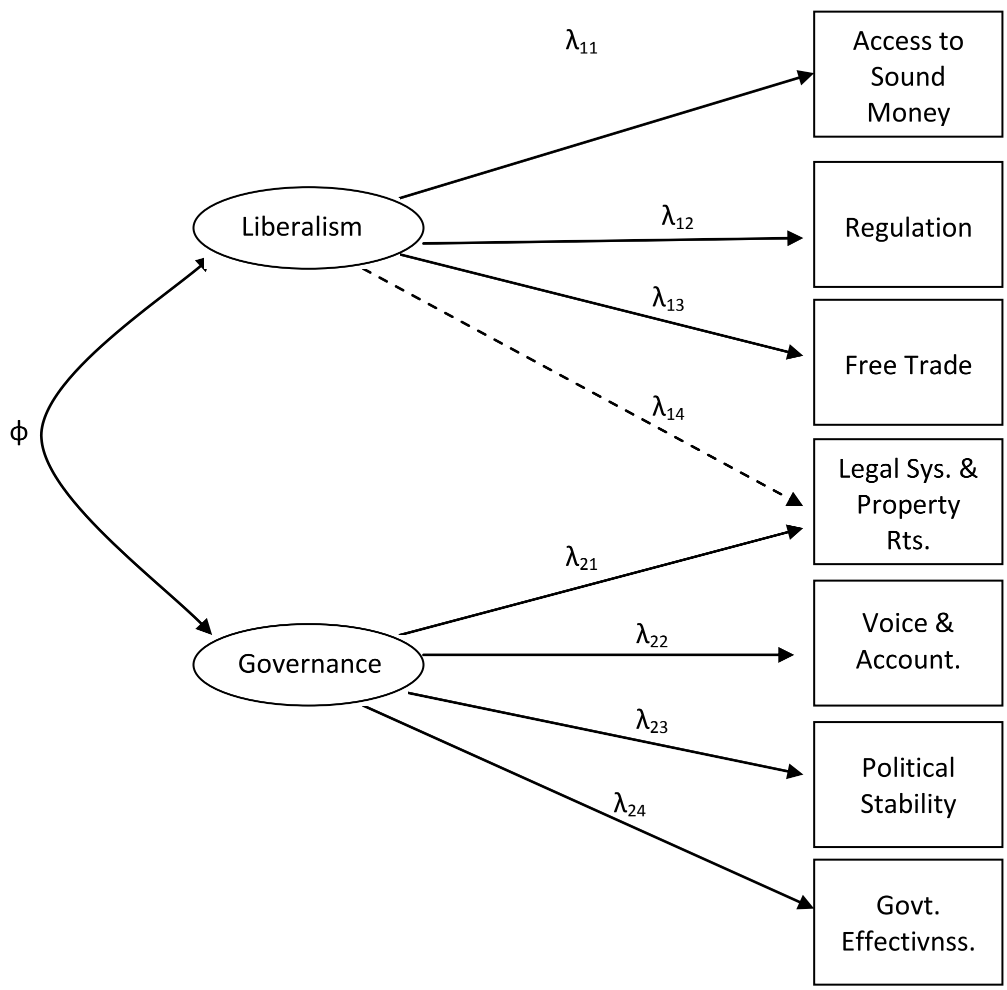


Figure 2: Diagram of Confirmatory Factor Analysis Model



(error terms not shown in diagram)

Table 1: Constituent Sub-Indices of EFW

Component	***Conditions that Enhance "Freedom"***
Size of Government Expenditures, Taxes and Enterprises	Low government consumption, transfers, subsidies, investment and enterprise ownership, and low taxes.
Freedom to Trade Internationally	Low and invariant tariffs, low regulatory trade barriers, formal market-determined exchange rates, relatively large trade sectors, low capital market controls
Regulation of Credit, Labor and Business	Private banking, openness to international banking, private sector-directed credit, low interest rate controls, minimum wages, regulatory compliance costs, prevalence of centralized collective bargaining, price controls, need to pay bribes or military conscription.
Access to Sound Money	Low and invariable inflation, low growth in M1 money supply, no restrictions on foreign currency bank accounts
Legal Structure & Security of Property Rights	Independent judiciary, impartial courts, protection of property rights, no military interference in politics or courts, rule of law, legal enforcement of contracts, low regulation on real estate

Source: Gwartney and Lawson (2008)

Table 2: Governance Indicators IV Indices: Nominal Definitions

Indicator	***Definition***
Voice & Accountability	Citizens' ability to participate in selecting government, freedom of expression, freedom of association and free media
Political Stability & the Absence of Violence	Likelihood that government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism
Rule of Law	Agents have confidence in and abide by rules of society, particularly in contract enforcement, property rights, police, courts and likelihood of crime and violence
Control of Corruption	Public power is not exercised for private gain, and state is not captured by elites or private interests
Government Effectiveness	Quality of public services, civil service and degree of independence from political pressures, quality of policy formulation and implementation, and credibility of government commitment to such policies
Regulatory Quality	Ability of government to formulate and implement sound policies and regulations that permit and promote private sector development.

Source: Kaufmann, Kraay and Mastruzzi (2007)

Table 3: Pairwise Correlations, EFW & GI Indicator Annual Means, 1995 - 2006, 148 Countries

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
(1)	*Per Capita GDP (log)*	1.000											
(2)	*EFW Govt. Size*	-0.141	1.000										
(3)	*EFW Sound Money*	0.577	0.169	1.000									
(4)	*EFW Free Trade*	0.745	0.009	0.608	1.000								
(5)	*EFW Regulation*	0.529	0.231	0.630	0.638	1.000							
(6)	*EFW Legal Structure*	0.778	-0.201	0.626	0.682	0.654	1.000						
(7)	*GI Voice*	0.686	-0.078	0.607	0.686	0.583	0.766	1.000					
(8)	*GI Pol. Stability*	0.703	-0.131	0.628	0.690	0.600	0.845	0.780	1.000				
(9)	*GI Rule of Law*	0.817	-0.160	0.691	0.725	0.649	0.943	0.849	0.862	1.000			
(10)	*GI Contr. Corr.*	0.791	-0.170	0.654	0.704	0.672	0.926	0.817	0.829	0.966	1.000		
(11)	*GI Govt. Eff.*	0.833	-0.154	0.680	0.754	0.671	0.929	0.859	0.841	0.968	0.966	1.000	
(12)	*GI Reg. Quality*	0.778	-0.037	0.705	0.825	0.688	0.862	0.896	0.810	0.915	0.890	0.932	1.000

Table 4: Mean EFW and GI Scores by OECD Clusters

Group	EFW Overall	Size of Govt.	Sound Money	Free Trade	Regulation	Legal System	Voice & Acct.	Pol. Stability.	Government Effectiveness
Anglo-Swiss	8.14	6.57	9.56	7.98	7.71	8.86	1.43	1.11	1.94
Continental	7.53	4.39	9.49	8.15	6.74	8.89	1.48	1.22	2.00
Franco-Swedish Continental Variant	7.12	3.19	9.67	7.93	6.60	8.22	1.35	1.07	1.84
Mediterranean	7.02	5.41	9.35	7.61	5.84	6.90	1.13	0.69	1.07
Japan	7.26	5.67	9.64	6.41	6.68	7.90	0.93	1.12	1.28
Total	7.58	5.26	9.51	7.89	6.88	8.39	1.36	1.06	1.75

Table 5: Factor Analysis of EFW and GI Variables, 128 Country Means, 1995 - 2006

Factor	Variance	Proportion	Cumulative
Factor1	4.716	0.8601	0.8601
Factor2	0.939	0.1713	1.0314
Factor3	0.102	0.0187	1.0501

Table 6: Rotated Factor Loadings for Factor Analysis in Table 5

	Factor 1	Factor 2	Factor 3	Uniqueness
EFW Size of Government	-0.1999	0.5832	0.0417	0.6182
EFW Sound Money	0.6384	0.4467	0.0603	0.3893
EFW Free Trade	0.7383	0.2874	0.1130	0.3595
EFW Regulation	0.6284	0.5305	0.1130	0.2154
EFW Legal Structure	0.9528	0.0372	-0.0217	0.0752
GI Voice & Accountability	0.8411	0.1271	0.2321	0.2226
GI Political Stability	0.8827	0.0885	0.1181	0.1990
GI Government Effectiveness	0.9664	0.1023	0.0182	0.0554

Table 7: Confirmatory Factor Analysis, Liberalism and Governance

		Estimate	Std Err.	Z-Value	Estimate	Std Err	Z-Value
λ_{11}	Freedom → Sound Money	0.764	0.073	10.526	0.763	0.073	10.517
λ_{12}	Freedom → Regulation	0.766	0.073	10.525	0.773	0.072	10.666
λ_{12}	Freedom → Free Trade	0.835	0.069	12.017	0.830	0.070	11.911
λ_{14}	Freedom → Legal System	-0.189	0.138	-1.367			
λ_{21}	Governance → Legal System	1.116	0.148	7.522	0.939	0.062	15.166
λ_{22}	Governance → Voice	0.863	0.066	13.121	0.865	0.066	13.180
λ_{23}	Governance → Pol. Stability	0.870	0.066	13.423	0.865	0.066	13.102
λ_{24}	Governance → Govt. Eff	0.982	0.060	16.447	0.986	0.059	16.589
e_1	Sound Money	0.417	0.058	7.158	0.417	0.058	7.132
e_2	Regulation	0.413	0.059	7.022	0.403	0.058	6.984
e_3	Free Trade	0.303	0.048	6.290	0.311	0.049	6.360
e_4	Legal System	0.104	0.020	5.146	0.117	0.017	6.924
e_5	Voice	0.255	0.032	7.992	0.252	0.031	8.050
e_6	Pol. Stability	0.243	0.033	7.448	0.252	0.034	7.454
e_7	Govt. Eff.	0.035	0.013	2.707	0.027	0.012	2.267
ϕ	Governance ←→ Liberalism	0.912	0.026	34.812	0.903	0.026	34.241
	Model Chi-Sq (df)	39.323 (12)			41.558 (13)		
	SRMR	0.019			0.021		
	CFI	0.973			0.972		
	BIC	-20.643			-23.406		