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23 September 2011

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The Frasier Institute's *Economic Freedom of the World* is often taken as a metric of market capitalism, and relationships between the index and macroeconomic outcomes are presented as signaling the consequences of free markets. This paper warns analysts that the index may be conflating three distinct concepts: free markets, good governance and price stability. Analysts should remain cognizant of this conceptual conflation when using the index to develop policy prescriptions.

Word Count: 5,562 (excl. tables and figures)
JEL Codes: P10; P51
Keywords: Economic Freedom, Neoliberalism, Capitalism, *Laissez Faire*, Governance, Measurement, Economic Policy, Economic Development

The Frasier Institute's *Economic Freedom of the World* (EFW) (Gwartney, J. Hall, and Lawson 2010) is a well-cited metric "economic freedom." Many analysts have used the index to assess the effects of *laissez faire* policies. I argue that the EFW is not strictly a measure of market capitalism, but rather an amalgam of at least two distinct though related but distinct concepts: economic liberalism and good governance. The conflation of these concepts could present problems for analysts who use the EFW to evaluate *laissez-faire* policies' effects.

The paper begins with a review of the EFW and its use in the scholastic literature. It then discusses the possible conceptual blending implicit in the index's measurement. Using confirmatory factor analysis, I show that its *Legal Structure and Property Rights* component lacks discriminant validity from "governance quality", a concept developed to condition orthodox free market reform prescriptions (reviewed in Burki and Perry 1998). Finally, I show via cluster analysis that, while the rich world is both relatively liberal and well-governed, the advanced postindustrial economies exhibit different mixtures of both. Prescribing reforms that maximize both liberalism and governance is tantamount to recommending that countries embrace an Anglo model of capitalism. Alternative models exist, and policy-makers have reason to entertain them.

A failure to distinguish the EFW's conceptually distinct components 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 this conceptual blending when using the index to devise policy prescriptions.

1. The EFW Index's Content and Meaning

The EFW's authors define economic freedom as occurring where an economy is characterized by "personal choice, voluntary exchange, freedom to compete, and security of privately owned property" (Gwartney et al. 2010:v). Discussions of "economic freedom" are often employed in debates about the desirability of policies that prioritize unfettered private markets *versus* government interventionism (for reviews, see Berggren 2003; De Haan, Lundström, and Sturm 2006). Scholars explicitly treat the EFW as a measure of "free markets" (Doucouliagos and Ulubasoglu 2006), a "market economy" (Berggren 2003), "liberalization" (De Haan et al. 2006), "neoliberal" economies (Tures 2003) or some cognate concept that suggests *laissez-faire* capitalism. I argue that the EFW is an amalgam of *laissez-faire* and at least one other concept. The index's *Legal Structure & Property Rights* component is conceptually distinct from the EFW's other constituent measures, and signals the importance of "governance" (Burki and Perry 1998) concerns.

1.1: 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]

The index is taken to capture a particular kind of freedom, whereby non-state actors' decisions are not affected by government prerogatives. 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 promarket reform initiatives of the late-20th century. They bear great semblance to the tenets of the Williamson's (1990) "Washington Consensus" (De Haan et al. 2006), and involve reforms that were pushed by the 1989 Brady Plan (Edwards 1995), post-Soviet collapse "shock therapy" (Kolodko 2000) 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; Centeno and Cohen forth.) or "market reform" (Edwards 1995; Rodrik 1996; Yergin and Stanislaw 2002).

The literature that employs this index 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. When studies treat the EFW as a measure of "freedom" in the sense of *laissez-faire* policy, they are taking the index's self-description at face value.

Three of the five sub-indices clearly rate countries as being "free" to the extent that governments limit their attempts to steer domestic economic activity, and accept whatever economic outcomes emerge from private activity. Their suggestion of limited government intervention is reasonably straightforward: less government taxes and government-directed economic allocation (the *Size of Government* index), reduced government-imposed restrictions on international transacting (the *Freedom to Trade* index), or less regulation (the *Regulation of Credit, Labor and Business* index) 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 some senses. Money supply growth can be 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 is more problematic (also noted in Heckelman and Stroup 2000) because inflation is a policy outcome – like growth or unemployment – and not a policy itself. 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. The issue is bracketed henceforth.

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 <u>related</u> to *laissez-faire,* but remains conceptually distinct. However, most analyses do not strongly distinguish this sub-index from other EFW components.

Previous Efforts to Deconstruct the EFW. 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.

Caudill, Zanella and Mixon (2000) attempt to disaggregate and reconstitute the EFW via exploratory factor analysis, which reconceptualizes the EFW as involving four factors – Free Enterprise, Stable Domestic Money, Government Size and International Monetary Freedom – a relatively modest recasting of the index. It does not render categories that probe the ultimate validity of the index's use as a metric of free market capitalism. Their analysis did not consider potential problems with the *Legal Structure* component because it had not yet been developed when the study was conducted. A study like that of Claudill and colleages on current data would probably lead to substantively similar results in any case. A factor analysis that only uses EFW data fails to 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 (like good governance).

The Legal Structure and 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 because they constitute an essential "protective function" that provides "the foundation for both economic freedom and the efficient operation of markets" (Gwartney et al. 2010:5). 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.

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 signaling the concept of "good governance", reforms that concentrate on making governments accountable, orderly, professional and non-corrupt (Burki and Perry 1998; Evans and Rauch 1999). 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 governance concerns should be addressed before going too far with liberalism (Roland 2001; Staehr 2005). If governance and liberalism are not separated conceptually, these possibilities will not even be entertained. Below, I argue that, although liberalization and good governance are related, they constitute different concepts, and the EFW's *Legal System & Property Rights* index pertains more closely to the latter.

So What? At first glance, one might dismiss the importance of distinguishing governance from liberalism in discussions involving economic freedom and policy. After all, if someone believes that freer markets are necessary for the development of an effective market economy, and has no objection to forms of intervention that do make markets possible, then what is the big deal?

There are several problems with a failure to distinguish between the two concepts. The first involves questions as to what drives the relationship between growth and "economic freedom." Insofar as the EFW's authors are concerned – and many researchers who share their views – "economic freedoms" constituent are part of a larger common process that governments should seek to maximize. However, if previous studies that stress the importance of the *Legal Structure* or *Sound Money* sub-indexes are right (Ayal and Karras 1998; Carlsson and Lundström 2002; Berggren and Jordahl 2005), then questions arise as to which post-Cold War reforms actually improved the world's growth rates during the 1990s and 2000s. The world's governments embraced free market reforms in the late-1980s and early-1990s, but also democratization and governance reform. In a separate paper (Cohen 2011), I show that only the *Legal Structure* index and inflation rates predict growth rates after 1995. Once countries removed their most egregious forms of market interference, there appear to be no further benefits to market liberalization (i.e., "freedom" net of governance and price stabilization. Researchers who fail to appreciate the differences between liberalism and governance implicit in the EFW may miss these possibilities in studies that link "freedom" to other macroeconomic outcomes.

When we bundle governance, *laissez-faire* and price stabilization into one concept, we impart the impression that they all have the same economic consequences, and should be implemented as a single, holistic reform program. There are reasons to doubt that their economic consequences are all the same, and that they should be implemented all at once. The conceptual conflation involved in the EFW communicates policy choices in a way that obfuscates either problem. Analyses that do not differentiate between the EFW's constituent concepts cannot begin to engage the issue of reform sequencing empirically. Furthermore, bundling these concepts does not allow us to assess whether there are different returns to free markets *versus* better governance, nor to engage the possibility that governance and liberalism can work at cross-purposes (e.g., too much democracy yields excessive public spending and fiscal imprudence, over-liberalization can produce political effects that make the political system more unequal, and so on). The EFW imparts an economic worldview that presents all the world's leading economies as following the same set of policy principles, and they do not.

2. Methods

The analysis sets forth two goals. First, , it establishes that the EFW's implicit suggestion that countries maximize liberalism – rather than governance - is advising them to emulate the national economic policies of the Anglo OECD, and not all rich countries. Second, it probes the EFW's *Legal Structure and Property Rights'* discriminant validity from outside measures intended to capture good governance. I examine 138 countries using data from the EFW (Gwartney et al. 2010) and the World Bank's *Governance Indicators* (GI) (Kaufmann, Kraay, and Mastruzzi 2009). I use countries mean EFW and GI scores for the 1995 – 2008 period, using linear interpolation to estimate scores in years in which either the EFW or GI were assessed.

First, the analysis 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 (Kaufman and Rousseeuw 1990; Everitt et al. 2011). 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).

To test whether the *Legal Structure* index measures free markets or governance quality, I use confirmatory factor analysis. Warner (2008: Ch. 18) provides an overview of this method, and compares it with the exploratory factor-analytical method used by Caudill, Zanella and Mixon (2000). In addition to not addressing the implications of governance factors (due to their then-absence in the EFW), Caudill, 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.

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 (2009) *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]

In the factor analysis, 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. All three measures involve assessing the degree to which governments are non-corrupt and secure an orderly, rule-bound economic environment. To avoid stacking the deck in favor of not finding differences between the *Legal Structure* index and GI measures, the GI *Rule of Law* and *Control of Corruption* indices were 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 et al. 2010). 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 in several corners of the literature (for reviews, see Chirot and T. D. Hall 1982; Easterly 2002). 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 P. A. Hall and Soskice 2001). Recommending that countries *maximize* their conformity to free market principles is not recommending that they use policies characteristic of all rich countries, but rather those used in the English-speaking subset of the OECD.

Table 4 (below) presents the pairwise correlations between 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 suggest that liberalism and governance quality occur in tandem. Such a finding suggests that they are indeed part of the same general policy package.

[Insert Table 4]

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 (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, and thus enjoys strong face validity. 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 individual GI indicators' 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 20 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 countries into five sizeable groups. The first, which will be termed the "Anglo" model, comprises the English-speaking OECD countries and Switzerland. The second group (the "Continental" model), includes most of the Northern European Union members, although France and Sweden stand out as a variant of this policy model. Mediterranean European countries and Japan appear as a third cluster.

To discern the character of these groups, Table 4 (below) presents the median EFW and GI scores for 1995 – 2008.

[Insert Table 4]

The Anglo countries are the world's "freest" countries, with overall EFW scores that are significantly higher[1] than other regions depicted in the table. This group's standout scores are not the product of sound money or free trade, which are statistically indistinguishable from Continental economies. 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. Interestingly, the Anglo cluster has significantly <u>lower</u> *Legal System* scores than the remainder of the OECD.

The Continental model of capitalism offers an alternative to the Anglo model. As a group, they are significantly less liberal but significantly better-governed. Whereas the Anglo countries seek to maximize liberalism, the Continental models eschew government reduction and

[1] 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.

deregulation while maximizing good governance. The Franco-Swiss variant of the Continental model's defining characteristic appears to be very large governments and weaker governance quality, but they are otherwise similar to Continental countries.

The Mediterranean OECD and Japan is more weakly governed and more tightly regulated.

Thus, when policy-makers are advised to embrace "economic freedom", they are implicitly being asked to follow an Anglo economic model. Presumably, embracing this model pays off in clearer gains in economic welfare. In all likelihood, there are different benefits involved in pursuing the Anglo 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.

Such a lumping process can shape our understanding of real world policy dilemmas. The overall EFW index of distressed European countries like Greece, Italy, Spain or Portugal suggests that their economies are suffering because they are illiberal. However, a closer look at the deconstructed index reveals that their public sectors are generally less far-reaching than other European countries (as indicated by their higher – or "freer" – *Size of Government* index). They are slightly more closed to trade and have a greater penchant for regulation. However, their governance scores are markedly lower as well. So exactly what is ailing Europe's southern countries? Is it that their markets are less liberal, or that their governments are generally less accountable, stable, professional and free from corruption? While answers to these questions cannot be established here, the fact remains that we cannot even begin to contemplate them if we fail to differentiate between good-quality governance and free markets, which is what happens when you rate countries based on one metric that encapsulates both concepts.

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 economically 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.

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 3 (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 3]

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): a 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* 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.

Both models suggest a strong relationship between liberalism and governance. They can reasonably be construed as two facets of an overall "development" process. The analysis suggests that the *Legal System* measure pertains to the latter. It is a governance quality measure, not a measure of liberalism.

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 at least two distinct concepts: free markets and good governance, not to mention a possible third factor – inflation – lurking in the *Sound Money* component. 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 2008 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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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, Hall and Lawson (2010)

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)
(1)	*EFW Size of Government*	1.000										
(2)	*EFW Legal Structure*	-0.239	1.000									
(3)	*EFW Sound Money*	0.060	0.635	1.000								
(4)	*EFW Freedom to Trade*	-0.052	0.584	0.634	1.000							
(5)	*EFW Regulation*	0.108	0.623	0.570	0.555	1.000						
(6)	*GI Voice*	-0.150	0.742	0.615	0.573	0.557	1.000					
(7)	*GI Political Stability*	-0.178	0.837	0.578	0.570	0.585	0.788	1.000				
(8)	*GI Govt. Effectiveness*	-0.217	0.918	0.693	0.645	0.610	0.835	0.821	1.000			
(9)	*GI Rule of Law*	-0.227	0.935	0.691	0.607	0.596	0.839	0.856	0.973	1.000		
(10)	*GI Control of Corr.*	-0.225	0.908	0.668	0.584	0.601	0.817	0.819	0.970	0.971	1.000	
(11)	*GI Regulatory Quality*	-0.107	0.868	0.745	0.728	0.651	0.858	0.817	0.955	0.942	0.927	1.000

Table 4: Mean EFW and GI Scores by OECD Clusters

Group	Overall EFW	Size of Govt.	Sound Money	Free Trade	Regulatn	Legal System	Voice	Political Stability	Govt. Effectnss	Rule of Law	Control Corruptn.	Reg. Quality
Anglo	8.11	6.57	9.54	7.82	7.99	8.69	1.43	0.99	1.77	1.69	1.89	1.60
Continental	7.50	4.06	9.52	7.93	7.18	8.93	1.54	1.23	1.96	1.83	2.15	1.57
France & Belgium	7.22	4.06	9.62	8.05	6.91	7.54	1.30	0.81	1.64	1.35	1.38	1.17
Spain, Portugal & Japan	7.29	5.77	9.56	7.24	6.64	7.37	1.16	0.78	1.25	1.22	1.21	1.09
Greece & Italy	6.83	5.64	9.32	7.28	5.76	6.34	1.00	0.62	0.77	0.75	0.52	0.89
Total	7.59	5.35	9.52	7.74	7.21	8.22	1.36	0.97	1.64	1.53	1.68	1.40

Table 5: Confirmatory Factor Analysis, Liberalism and Governance

		Estimate	Std Err.	Z-Value	Estimate	Std Err	Z-Value
λ_{11}	Freedom → Sound Money	0.810	0.075	10.875	1.277	0.119	10.839
λ_{12}	Freedom → Regulation	0.721	0.078	9.237	0.798	0.095	9.324
λ_{12}	Freedom → Free Trade	0.769	0.076	10.086	0.955	0.086	10.036
λ_{14}	Freedom → Legal System	-0.105	0.111	-0.950			
λ_{21}	Governance → Legal System	1.032	0.122	8.470	1.650	0.113	15.616
λ_{22}	Governance → Voice	0.846	0.069	12.243	0.772	0.063	12.289
λ_{23}	Governance → Pol. Stability	0.865	0.068	12.629	0.771	0.061	12.564
λ_{24}	Governance → Govt. Eff	0.972	0.063	15.545	0.949	0.061	15.616
e_1	Sound Money	0.344	0.058	5.879	0.863	0.146	5.892
e_2	Regulation	0.480	0.069	6.932	0.573	0.083	6.921
e_3	Free Trade	0.409	0.063	6.468	0.642	0.100	6.495
e_4	Legal System	0.104	0.020	5.146	0.376	0.061	6.163
e_5	Voice	0.284	0.038	7.516	0.233	0.031	7.565
e_6	Pol. Stability	0.253	0.035	7.119	0.205	0.029	7.032
e_7	Govt. Eff.	0.054	0.016	3.388	0.047	0.015	3.184
ϕ	Governance ←→ Liberalism	0.873	0.035	25.204	0.867	0.035	24.981
	Model Chi-Sq (df)	43.198 (12)			44.17 (13)		
	SRMR	0.023			0.023		
	CFI	0.964			0.964		
	BIC	-15.929			-19.884		

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

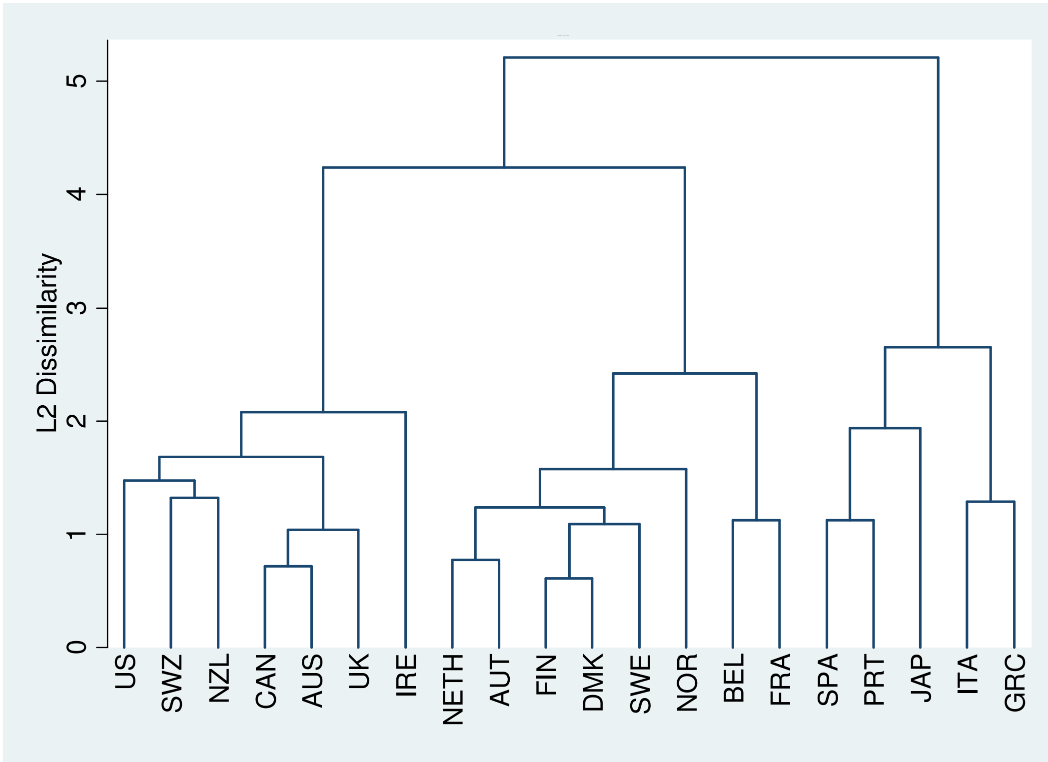

Figure 2: Diagram of Confirmatory Factor Analysis Model