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FREEDOM AND PROSPERITY

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FREEDOM AND PROSPERITY

My topic is the economic dimension of freedom. Conceivably freedom and prosperity could be at odds. In that event most of us would prefer to live in a free country – a country with civil and political freedoms – even if it meant accepting a lower standard of living. Happily, economics teaches us that freedom and prosperity are not only compatible but mutually reinforcing.

Historically, many prominent writers and thinkers detested the teachings of economics, as well as liberal ideas generally. Indeed the much-quoted description of economics as "the dismal science" was coined by Victorian writer Thomas Carlyle in a debate over slavery with the economist and philosopher John Stuart Mill. Mill opposed slavery whereas Carlyle campaigned to maintain it. Carlyle wanted a hierarchical social order: he also campaigned against democracy and the spectre of feminism. From Adam Smith to Mill, the classical economists were among the leading reformers of the Victorian age whereas Carlyle, Ruskin, Kingsley and Dickens were among the reactionaries.¹ The elitism of many of the literati hasn't changed much down the years.

As the slavery example illustrates, freedom – economic, political and civil – is an end in itself, not a means to an end. We would abhor slavery even if it were a more productive economic system. But economic freedom is also an indispensable means of achieving other freedoms. Milton Friedman cites the case of British citizens who could not spend a vacation in the United States after World War II because of exchange controls. Their freedom was no less restricted than that of US citizens unable to visit the Soviet Union because of their political views. While the first restriction was ostensibly an economic limitation on freedom and the other a political limitation, the practical results were essentially the same.²

In another example that is relevant to the debate about compulsory superannuation in New Zealand, Friedman points out that US citizens who are compelled by law to devote

¹ See Terry Arthur, 'Economics, slavery and Victorian reformers', *Economic Affairs*, Vol 21, No 2, June 2001.

² Milton Friedman, *Capitalism and Freedom*, University of Chicago Press, Chicago, 1962, p8.

around 10 percent of their income to a particular form of retirement saving are being deprived of a corresponding part of their personal freedom.³ New Zealand apple growers who, until last month, were prohibited from freely selling their produce to a willing overseas buyer – and a few years ago even to a New Zealand buyer – were similarly deprived of a basic freedom. Indeed the ability to trade on mutually acceptable terms with anyone around the world is ultimately an issue of morality and freedom. So-called globalisation is not a phenomenon engineered by governments: it is simply what happens when people are free to invest, trade, derive cultural enjoyment and, increasingly, work in other countries around the globe.

Clearly it is possible to have economic freedom without civil or political freedoms. Hong Kong as a British colony was one of the freest economies in the world with a great deal of civil freedom but no political freedom. Nevertheless, economic freedom is a necessary if not sufficient condition for political freedom – there are no examples of politically free countries that have not relied essentially on private enterprise economic arrangements. Economic freedom tends to facilitate political freedom, as events in China and other Asian countries are slowly demonstrating. Over the long term, democracy (political freedom) is necessary to guarantee economic freedom and prosperity, since authoritarian regimes are poor at providing security of property rights, especially at times of transition.

Fundamentally, there are only two ways to coordinate the economic activities of large societies. One is central direction involving the use of coercion – the technique of central planning and totalitarian regimes. The other is the voluntary cooperation of individuals – the technique of the market place.

A free private enterprise economy rests on voluntary cooperation. Willing buyers enter into transactions with willing sellers that both parties believe will make them better off. Cooperation is achieved without coercion. Absent fraud or monopoly, consumers, renters, investors and workers are protected from coerced bargains by competition among other parties wanting to deal with them.

³ *Loc cit.*

Adam Smith postulated over two hundred years ago that, as if guided by an invisible hand, market competition and the pursuit of self-interest (profit) produce unintended benefits for the wider public. Smith also highlighted the importance of a high degree of individual liberty and economic freedom for prosperity:

Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes and a tolerable administration of justice; all the rest being brought about by

the natural course of things.⁴

Economic freedom is about freedom of action and exchange and security in person and in rightfully owned possessions. It includes the freedom of people to spend their money as they wish, and to choose their lifestyles, occupations and places of work. For both businesses and individuals it involves freedom in making decisions on investments, products and trading partners. Freedom of contract is a core aspect of economic freedom.

Economic freedom cannot exist without private property. Individuals are economically free if property that they have legally acquired is protected from invasions or intrusions by others, and if they are free to use, exchange or give away their property so long as their actions do not violate other people's similar rights.⁵ If people are not free to sell the property they have in their own labour they are not free. Private property allows people to come together for mutually beneficial exchanges. The institution of private property is also critical for the existence of political and individual freedoms.

Since the fall of communism there has been little dispute that prosperity depends on the existence of private property. People look after what is theirs; they have confidence to invest in the expectation of future returns. With common ownership there are weak incentives to be productive and tendencies to waste and pollute. Recent history has shown that market economies not only out-perform centrally planned economies but are environmentally cleaner, safer and healthier as well.

The relationship between economic freedom and prosperity is not quantifiable in a straightforward way. In recent years, however, a number of researchers have constructed measures of economic freedom across countries and through time and related them to measures of economic performance. The best known of these projects are those undertaken by the Fraser Institute in Canada and the Heritage Foundation in association with the *Wall Street Journal* in the United States.

⁴ Adam Smith, *The Wealth of Nations* [1776] 1973, University of Chicago Press, p xl.

⁵ *The Economist*, January 13, 1996, p 19.

The initial Fraser Institute study used 17 measures of freedom in four broad areas. As summarised by *The Economist*, these were:

- *Money and inflation* Does government protect money as a store of value and allow it to be used as a medium of exchange? This measure includes the volatility of inflation; monetary growth relative to the potential growth capacity of an economy; and citizens' rights to hold foreign-currency accounts at home and bank accounts abroad.
- *Government operations and regulation* Who decides what is produced and consumed? The measures of this include public spending as a share of gross domestic product (GDP); the size of the state-controlled sector; price controls; freedom to enter markets; and controls on borrowing and lending rates.
- *'Takings' and discriminatory taxation* Are you free to earn, and to keep your earnings? Measures of this include subsidies and transfer payments as a share of gross domestic product (GDP); the level and impact of marginal tax rates; and whether there is conscription.
- *International exchange* Are you free to exchange goods and money with foreigners? Measures of this include taxes on international trade; any differences between an official exchange rate and a black-market one; the actual size of a country's trade relative to the size that might be expected; and restrictions on capital flows.⁶

The study rated 102 countries for five separate years over the period 1975-95 on each of these measures on a scale of 0-10, where zero means that a country is completely unfree and 10 means it is completely free. The results showed an increase in absolute measures in economic freedom for most countries, reflecting the worldwide moves towards economic stabilisation and liberalisation since the late 1970s. The expected relationship between the relative rankings of countries and their economic performance was borne out: in the words of *The Economist*:

... the conclusion from this research could scarcely be more striking:

⁶ *Op cit*, p 20.

the more economic freedom a country had in that period, the more economic growth it achieved and the richer its citizens became.⁷

Six countries that had persistently high rankings throughout the 1975-95 period (Hong Kong, Switzerland, Singapore, the United States, Canada and Germany) were all in the top 10 in terms of gross domestic product per head in 1993-95. By contrast, no country with a persistently low rating was able to achieve even a middling income.

Some specific cases are noteworthy. Ireland is a country that has moved rapidly up the rankings of economic freedom and has enjoyed commensurate improvements in economic performance. The East Asian countries, including Japan, also occupy relatively high positions, contrary to beliefs that their economies have been heavily state-directed. Japan is losing ground, however: in the Fraser Institute's survey it is in 20th position for 1999, down from 9th in 1990. One factor in this fall is the growth in government spending in Japan, from below 20 percent of GDP in the late 1960s to around 46 percent today, according to the latest Organisation for Economic Cooperation and Development (OECD) figures.

Since the initial studies were carried out more work has been done to improve the data and methodologies. Clearly there is room for debate over the weight to be applied to the different measures of economic freedom. David Henderson has suggested that the measures may not be fully capturing important trends, such as increased intervention in some economies in labour markets, restrictive environmental policies and health and safety regulations.⁸ A point emphasised by the researchers is that it takes time for improvements in economic freedom to be translated into better economic performance: individuals and companies have to believe that the changes will last before they alter their behaviour in productive ways.

Some people have questioned why New Zealand's economic performance hasn't been better, given the moves to free up the economy. On the Fraser Institute rankings, New Zealand was in 11th place in 1990 and second in 1995, and was still in third position on the basis of 1999 data in the latest survey. Several comments are relevant.

⁷ *Op cit*, p 19.

First, prior to 1984 New Zealand was one of the most repressed economies in the OECD, and the legacy of the distortions, business practices and attitudes of that era was bound to affect its economic performance for many years. The transition to a freer economy was inevitably painful, as in the former Soviet Union and Eastern bloc countries. It was made more difficult by the 1987 sharemarket crash and by the failure of the 1980s Labour government to implement a fully coherent programme, with fiscal, labour market and welfare policies being key weaknesses.

However, as predicted by the economic freedom methodology, economic growth improved sharply in New Zealand after the second wave of reforms in 1990-91 produced a more consistent economic framework, and remained strong through the mid-1990s. Other indicators of economic performance also improved. Some of this improvement has been sustained: for the 1990s as a whole, average per capita incomes grew by 1.7 percent per annum in real terms, twice the 0.8 percent rate recorded over the last three decades on average. Nevertheless, there have been few further moves towards greater economic freedom in recent years, and with the changes in the opposite direction since the change of government in 1999, combined with ongoing liberalisation elsewhere, New Zealand's ranking is likely to fall in future years. Given the need for investor confidence that a general shift toward economic freedom will be maintained and enhanced, this stalling and reversal of policy is likely to have undermined growth. In addition, factors such as the Asian crisis and droughts have affected the economy's performance. Also it is likely that New Zealand needs to have superior policies to those of other countries to offset its disadvantages of size and location if it is to match their economic achievements.

Economic research has not only established strong links between economic freedom and prosperity; it has also shown that freer economies tend to have more equal distributions of income.⁹ More importantly, since a focus on poverty makes more sense than a preoccupation with inequality, studies have shown that growth is good for the poor.¹⁰

⁸ David Henderson, *Agenda*, Vol 4, No 2, 1997, p 216.

⁹ See Brian T Johnson, Kim R Holmes and Melanie Kirkpatrick, *1999 Index of Economic Freedom*, Heritage Foundation and *Wall Street Journal*, pp 12-15.

¹⁰ See David Dollar and Aart Kraay, 'Growth is good for the poor', Development Research Group, The World Bank, March 2000.

In addition, open and competitive markets punish prejudice and reduce discrimination – to a trader the colour of a person's money is more important than the colour of their skin.¹¹ Thus minorities stand to gain more from free markets than from political processes where majoritarian politics will always dominate.

Of course it cannot be too strongly stressed that economic freedom does not mean an absence of government. Markets can only operate within a framework of laws laid down and enforced by governments – we need governments as rule-makers and umpires to protect individual and commercial freedoms. Among other things, market liberals want governments to protect property rights, promote competition, provide a monetary framework, step in to fill gaps where the market can't work or fails, look after the interests of people unable to make decisions for themselves, and provide a social

¹¹ A powerful case has been made by Alvin Rabushka for markets being the most potent agent for racial harmony and collective politics often being divisive and destructive (A Rabushka, *A Theory of Racial Harmony*, Columbia, SC, University of South Carolina, 1974).

safety net, including underwriting access to services such as health and education. These are important functions: the consistent liberal is not an anarchist. Moreover, the role of the state can never be spelled out once and for all in terms of specific functions – new problems and new circumstances will always arise.

Far from reflecting an anti-government mentality, the liberal concern is that by trying to do too much the state has actually grown weak and is often unable to discharge effectively its core functions such as national defence, law enforcement, the provision of public amenities or protection of the environment. Only by doing less can the state do more, and in the process undo the damage it has done to self-reliance, enterprise and even the family by its clumsy interventions.

The widespread use of the market reduces the strain on the social fabric by minimising the number of issues on which political decisions are required. Political decisions are inherently divisive – as in Michael Cullen's 'We won, you lost, eat that!' – and tend to impose conformity and one-size-fits-all solutions. Milton Friedman has pointed out that the market is a form of proportional representation – each person can vote, as it were, for the icecream flavour of their choice; they don't have to accept what the majority wants. By contrast, Friedman notes that the use of the political form of proportional representation tends towards fragmentation and ineffectiveness and weakens the state's ability to perform its key functions.¹²

The best label for the economic viewpoint that I have been outlining is liberalism. Historically it has encompassed ideas such as personal freedom and responsibility, representative government, reduction in the arbitrary power of the state, open markets and free international trade. In the United States the meaning of the term 'liberal' changed in the 1930s when it took on connotations of welfarism and state paternalism with the policies of the New Deal. The value of the term may have been damaged beyond repair in that country, but it has retained its integrity to a greater degree elsewhere. It should also be said that liberalism is not to be confused with conservatism – the liberal viewpoint is open to ongoing changes in social institutions, and in

¹² Friedman, *op cit*, p 23.

particular is opposed to conserving state-conferred privileges.

It follows that liberal doctrines have not been consistently associated with political parties of the left or right, either historically or in the modern era. In France and in the United States, liberal ideas were initially associated with the political left. Karl Marx was no purveyor of liberal ideas in general, but he favoured free trade and shared similar views to John Stuart Mill on the role of the state in education. Both thought that government financing of education need not imply government schools. As Marx put it:

'Elementary education by the state' is altogether objectionable. Defining by general law the financial means of the elementary schools, the qualifications of the teachers, the branches of instruction, etc, and ... supervising the fulfilment of these legal specifications by state inspectors, is a very different thing from appointing the state as the educator of the people! Government and church should rather be equally excluded from any influence on the school.¹³

In similar vein Mill wrote:

A general State education is a mere contrivance for molding people to be exactly like one another ... in proportion as it is efficient and successful, it establishes a despotism over the mind ... An education established and controlled by the State should only exist, if it exists at all, as one among many competing experiments ...¹⁴

Mill favoured "a law rendering education compulsory, combined with State aid to those unable to defray the expense".¹⁵ Both Marx and Mill were supporters of what we would today call school choice – competition between government and private schools and equal funding for both. The Business Roundtable supports school choice and for some reason is sometimes called 'new right'. The left-wing teacher unions oppose school choice. Make sense of that if you can.

In the modern era, moves towards economic liberalism have been initiated from both sides of the conventional political divide. Governments with left-wing credentials in

¹³ Karl Marx, *Critique of the Gotha Programme*, written in 1875 though first published only in 1891. The text quoted here is from p 42 of an edition published in Moscow in 1947 by the Foreign Languages Publishing House. The italics are in the original – Marx was quoting from the text of the Programme.

¹⁴ John Stuart Mill, *On Liberty* [1859] 1956, Bobbs-Merrill Educational Publishing, Indianapolis, p 129.

countries as different as China, Mexico, Australia, New Zealand, Sweden, Spain and Ireland have carried through liberalisation measures. In the United Kingdom and the United States there has been a broad continuity of policies between administrations such as those of prime ministers Margaret Thatcher and Tony Blair and presidents Reagan and Clinton. It is certainly not the case that parties of the 'right' are naturally more inclined to liberal ideas: Britain under Edward Heath, Spain under Franco and the former nationalist regime in South Africa all maintained tightly regulated economies. In

France not long ago, the prime minister of the then government of the right, Edmond Balladur, said in an interview: "What is the market? It is the law of the jungle, the law of nature. And what is civilisation? It is the struggle against nature".¹⁶

What is the outlook for liberal economic ideas? Certainly it seems better than in 1889 when the Fabian Sidney Webb wrote:

The steady increase of government regulation of private enterprise, the growth of municipal administration, and the rapid shifting of the burden of taxation directly to rent and interest mark in treble lines the statesman's unconscious abandonment of the old Individualism, and our irresistible glide into collectivist Socialism ... No nation, having once nationalised or municipalised any industry, has ever retraced its steps or reversed its action. No failure of any experiment in such 'collectivisation' is anywhere recorded.¹⁷

Exactly 100 years later the major collectivist experiments of the 20th century came to an end with the fall of the Berlin Wall, and those experiments do not look likely to be repeated in most parts of the world. Since the end of the 1970s there has been a remarkable shift in OECD countries and many others in the direction of liberalisation. A relatively open international regime for trade and investment seems here to stay. Since around 1993, government spending has been falling as a share of national income in most OECD countries and many have lowered taxes and eased regulation. Privatisation continues around the world.

Yet at the same time, as David Henderson has noted, public opinion in many countries remains hostile to markets and supportive of extensive government roles and powers of an anti-liberal nature.¹⁸ Some governments have sought a 'third way' between socialism and the market economy. Support for protectionism, nationalism and collectivism is still strong. In New Zealand we have seen recent moves to greater state ownership and control in accident insurance, banking, electricity, airlines and rail passenger services, and the establishment of a state superannuation fund, as well as many moves to greater economic regulation. Internationally there have been anti-globalisation protests on a

¹⁶ Quoted in David Henderson, *The Changing Fortunes of Economic Liberalism: Yesterday, Today and Tomorrow*, Institute of Public Affairs and New Zealand Business Roundtable, 1999, p 48. This study has been republished by the Institute of Economic Affairs, with a new preface by the author.

¹⁷ *The Economist*, January 28, 1989, p 55.

large scale, and some have interpreted the terrorist attacks on the United States as a backlash against the liberal ideas that America stands for. As one writer put it, criticism of American values:

... unites the Islamic terrorist, the anti-globalization street protesters, the resentful right, and the literary left. They hate the culture of markets and liberalism. They hate the Enlightenment and modernity. They hate reason, science, technology, individualism, pluralism, tolerance, progress and freedom. And to be more specific, they hate Wall Street, Hollywood, McDonald's, Starbucks, Microsoft, Ralph Lauren ads, and the casual joy of American freedom. These people share H L Mencken's definition of Puritanism: "The haunting fear that someone, somewhere, may be happy."¹⁹

None of us can know for sure how the conflicts of visions, clashes of ideas and the influence of apparently practical but mistaken 'do-it-yourself' economics will play out precisely over the period ahead. Nevertheless, economic research is continuing to demonstrate the clear links between economic freedom and prosperity, and governments are under pressure to achieve the improvements in standards of living that good policies and institutions make possible. I tend to share the optimistic view of Milton Friedman, probably the most influential economist of the last 50 years, about the prospects for economic liberalism. Friedman concluded his memoirs, written with his wife Rose in 1998, with the following reflections:

Judged by practice, we have, despite some successes, mostly been on the losing side. Judged by ideas, we have been on the winning side. The public in the United States has increasingly recognised that government is not the universal cure for all ills, that governmental measures taken with good intentions and for good purposes often, if not typically, go astray and do harm instead of good. The growth of government has come to a halt, and seems on the verge of declining as a fraction of the economy. We are in the mainstream of thought, not as we were 50 years ago, members of the derided minority.

So we close this book full of optimism for the future. Our children and grandchildren will live in a country that continues to advance rapidly in material and biological well-being, and that gives its citizens ever wider freedom to follow their own values and tastes, so long as they do not interfere with the ability of others to do the

¹⁸ Henderson, *op cit*, p 81.

¹⁹ David Boaz, 'Attacks on American Values', Cato Institute, October 1, 2001.

same.²⁰

Let's hope that Friedman's optimism proves justified for New Zealand too.

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Milton and Rose D Friedman, *Two Lucky People: Memoirs*, University of Chicago Press, Chicago, pp 588-89.