

## **How to Handle Economic Freedom: Reply to Lawson**

**JAKOB DE HAAN\* AND JAN-EGBERT STURM\*\***

### **IN HIS COMMENT ON THE ECONOMIC FREEDOM SURVEY ARTICLE**

we wrote with Susanna Lundström (De Haan et al. 2006), Lawson (2006) criticizes five elements of our article:

1. Our use of the term “zealots”
2. Our remarks on the role of government in the construction of the economic freedom index
3. Our discussion of the composition of the economic freedom index
4. Our criticism of empirical growth models that include both the level and the change in economic freedom
5. Our endorsement of a modeling approach wherein researchers run many specifications

In this reply, we briefly deal with each of these issues.

As Lawson points out, we cite Martin Paldam (2003) to convince skeptical readers that the economic freedom indicators provide valuable information and should be used more often in empirical research. Indeed, the change in the economic freedom indicator can be used as a proxy for the institutional changes and policies generally supported by the IMF. The economic freedom index, therefore, helps us to examine whether the IMF is right when it imposes conditions on loans to member states. This and other highly relevant issues can be fruitfully approached using the economic

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\* University of Groningen, Groningen, The Netherlands 9700AV.

\*\* KOF—Swiss Institute for Business Cycle Research, ETH, Zurich, Switzerland 8092.

freedom index. So we endorse Lawson's view that "With the creation of the EFW index we now are in a position to begin to address the problem of economic organization as scientists should by measurement of reality and testing of various hypotheses" (Lawson 2006, 400).

Why then, has the index not been used more often? We suspect that this may be due to the pro-free market position of institutes like the Fraser Institute and the Heritage Foundation, which publish the indexes. We argue that this is not a good reason to neglect the indexes, for reasons expressed in the passages we quoted from Paldam. We fully agree with Paldam when he refers to Lawson and others as a group of eminent scholars.

As to our criticism of the way government taxes are taken up in the economic freedom index, let us repeat what we wrote in our survey: "Of course, taxes always distort prices, but that in itself does not make it necessary to include the level of taxation in an index of economic freedom. To extreme libertarians, like Rothbard (1970), the state obtains its revenue by coercion, known as taxation, whereas private persons and groups obtain their income voluntarily by selling goods and services to others or by voluntary gift. To Rothbard, taxation is theft, pure and simple" (De Haan et al. 2006, 164). Lawson affirms that taxation is coercion and hence an incursion on economic freedom. In our view, that interpretation goes too far, as economic freedom also implies that government has an important role to play, notably in securing property rights. However, Lawson is right, of course, that the index does elsewhere capture these freedom-enhancing effects of government.

On the composition of economic freedom, we have a more substantial disagreement with Lawson. The development of the economic freedom index shows that even when one agrees on the general definition of economic freedom, there are still many options when it comes to constructing an index. In Lawson's analogy, there is not a unique recipe for a cherry pie. However, there is an interesting discussion of the proper ingredients. Various authors have pointed out that many of the candidate ingredients, which are supposed to reflect a particular dimension of economic freedom, have a low correlation with other ingredients and with the aggregate index. This may suggest that the various elements of economic freedom may not be measuring the same thing. In other words, there are many proxies for the latent variable economic freedom. In our view, this calls for using latent variable techniques both when it comes to clustering particular elements of economic freedom as well as aggregating these elements into (one or more) aggregates. In our view, the current clustering of the various elements of the economic freedom into five categories, like size of government and sound money, is rather arbitrary. In our view, it makes more sense to use, for

instance, factor analysis to decide on the number and composition of the various categories. These can then, in turn, be employed in empirical growth models to check to what extent different dimensions of economic freedom may differently affect income growth. Our favored approach implies that we share Lawson's skepticism of studies that examine the relationship of the individual elements of economic freedom and economic growth. We thank Lawson for offering us the opportunity to point this out.

We also disagree with Lawson on the issue of using both the level and the change in economic freedom. We all agree that Lawson's equation (1) does not make theoretical sense: the level of economic freedom at the end of the sample period cannot explain economic growth experienced over the sample. It would rather indicate that causality runs the other way. We also all agree that the change in economic freedom may impact economic growth. However, such possible impact is something that should be tested for, using appropriate econometric modeling approaches that take the problem of model uncertainty into account, such as the Extreme Bounds Analysis that we apply in much of our research. We also agree that equations (2) and (2') are mathematically equivalent. This, however, also implies that both specifications suffer from the same kind of multicollinearity problems and hence that it does not matter econometrically which specification is estimated (the estimation results clearly show this). If, however, the estimate for  $\beta_1$  is larger than that for  $\beta_0$ , (i.e.  $\gamma_0 < 2\gamma_1$ ) the danger of having estimated an equation with reverse causality problems (as in equation (1)) is substantial and not to be neglected. We hence disagree with Lawson's statement that "including the level of EF at the end of the period is not a problem so long as you control for the level of EF at the beginning of the period, thus in effect converting the end of the period variable into a change in EF measure" (403). It depends upon the estimation results. Column (3) of Table 6 in our paper actually shows a negative estimate for  $\beta_0$  and a high and significant estimate for  $\beta_1$  (or, in Column (2) of the same table, an estimate of  $\gamma_0$  which is significantly less than twice the estimate of  $\gamma_1$ ). As we are not interested in the effect of growth on institutional reform in our paper, we (at least to a certain extent) circumvent this reverse causality problem by allowing into the specification only either economic freedom at the beginning of the period or the change in economic freedom. When we include only the level of economic freedom in the regression it has no significant impact (see column (4) in our Table 6). The only reason that it is significant in column (2) of Table 6 is that in that column the change in economic freedom is included. Hence, equation (1) of Lawson and his preferred specification (2') that includes both the change and the initial level of

economic freedom are statistically equivalent. If equation (1) is to be considered nonsensical, then—given the estimation results—Lawson’s proposed equation is as well, and for the same reason.

Finally, we do not agree with Lawson’s criticisms concerning our favored modeling strategy, the Extreme Bounds Analysis (EBA). Lawson (405) states, “My criticism is this: what has happened to theory? For example, standard economic theory says that investment is an important factor for growth. We know then that failing to include investment in a regression will result in biased estimates of the remaining parameters. Why should we pay any attention to such an obviously misspecified model?” If Lawson feels, like we do, that a good case can be made to include investment, then there is no reason not to do so. In fact, in our papers on the relationship between economic freedom and economic growth we always included investment in the so-called M-vector of the EBA, i.e. it is included in *all* regressions (see, for instance, De Haan and Sturm 2000). Likewise, we always include initial income and often also a human capital variable. At the same time, the inclusion of these variables has been criticized by other authors. Fortunately, the EBA is flexible enough to deal with this: if the researcher feels—on theoretical or empirical grounds—that a particular variable should not be included in the M-vector she can easily move it to the Z-vector.

## CONCLUSION

Even though our reply might suggest otherwise, there are many issues on which Lawson and we agree, like the usefulness of the economic freedom index, the need for solid research on the relationship between this index and economic growth, and the importance of academic debate. We believe this exchange is a good example of academic debate as a discovery procedure.

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### ABOUT THE AUTHORS



**Jakob de Haan** is Professor of Political Economy, University of Groningen, the Netherlands. He is also director of SOM, the research institute and graduate school of the faculties of Management and Organisation and Economics of the University of Groningen. He is editor of the *European Journal of Political Economy* ([Link](#)), and President of the European Public Choice Society ([Link](#)). His email address is [Jakob.de.Haan@rug.nl](mailto:Jakob.de.Haan@rug.nl).



**Jan-Egbert Sturm** is Professor of Applied Macroeconomics and director of KOF—Swiss Institute for Business Cycle Research both at the ETH Zurich, Switzerland ([Link](#)). He is also a member of the European Economic Advisory Group at CESifo, Munich ([Link](#)). His email address is [sturm@kof.ethz.ch](mailto:sturm@kof.ethz.ch).

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