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Role of economic and political freedom in the emergence of global middle class

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ABSTRACT

The study examines the role of the economic freedoms such as regulatory efficiency, open markets and limited markets, political freedom and rule of law in the growth of the global middle class through international business activity in 34 emerging markets during the period of 1994–2011. The analysis suggests that some dimensions of freedom are more critical than others in making these markets attractive locations for international business and this in turn leads to domestic growth and thus growth of the middle class in these countries. The results also reveal the existence of a feedback loop, whereby the growing middle class becomes a driving force for further expansion of international business activity and economic growth.

1. Introduction

A vibrant middle class is widely recognized as a key to a stable and prosperous society. The many benefits of a strong middle class are sometimes referred to in the context of middle class values that seem to transcend nation state boundaries such as a focus on the future, savings, ownership and responsibility for property, and a strong desire to create a world of promise for the next generations (Ren, 2013; De Koning, 2009). Hence, because of these emphasized values, the concept of the middle class remains a beacon for growth.

Middle class is an important group of consumers for multinational businesses. In search for quality of life, they want higher quality products and services (Banerjee & Duflo, 2007). For many years, the business world was paying attention only to industrialized economies of North America, Western Europe and Japan (Cavusgil & Kardes, 2013a). However, the growing middle class in emerging markets is now a topic that is rightfully receiving increasing attention. Of primary interest is the high growth rates of emerging economies and the potential of further growth that is expected to outpace that of highly developed economies (Mouawad, 2013; Court & Narasimhan, 2010; Scott, 2014). The middle class consumers in these markets are expected to buy smartphones and tablets at a higher rate than in the United States and Western Europe (Scott, 2014) where adoption is more widespread. Air travel in emerging markets such in Istanbul, Dubai, Jakarta, Bangkok, and Singapore are reporting double digit growth and are outpacing Western airport growth as defined by numbers of travelers (Mouawad, 2013). In the area of pharmaceuticals, demand for medicines in emerging economies is expected to grow more quickly than in industrialized economies (PWC Global, 2014). The broadening of consumption choices coupled with increasing awareness and acceptance of global brands will continue to strengthen these economies through this growing engine of consumption (Steenkamp & de Jong, 2010). The emerging middle class in these economies have the potential to be a significant economic force in the coming decades, and potentially replacing Japan, North American and Western European economies as the leading drivers of the global economy.

A first step in understanding the middle class in emerging markets is of course to define the middle class. Therefore, the various approaches researchers have used to measure the middle class is first presented and compared. A definition is then selected that best fits the goal of our research question, namely, the focus on a rising per capita GDP which translates into the ability to make discretionary consumption choices. An important contribution of this article to the literature is the empirical estimation of this growing middle class during an approximate 20 year period beginning 1994 for a comprehensive group of 34 emerging countries.

What is causing this seemingly sudden growth of middle class in emerging markets? Each country is unique, yet there are common drivers contributing to the growth of the emerging middle class. This question of what contributes to the growth of the middle class remains as a topic of interest among researchers. Harvey (2005) describes the middle class as the professional

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managerial segment that emerged from market liberalization reforms. Economic, legal and political systems of emerging economies can expose multinationals to significant risks and losses, negatively affect their operations, and thus reduce their profitability. In contrast, positive changes in economic, legal and political institutions and practices can affect a market's attractiveness favorably for multinational businesses and can connect its economy to the global market, and consequently avail its benefits (Robock, 1971). Similarly, Cavusgil and Kardes (2013b) suggest that country-specific factors such as political instability, corruption, ease of doing business, openness to foreign investors, protection of property rights, factors that are generally associated with political economy, should be carefully and seriously analyzed by foreign investors. This study proposes to exactly do that; it examines the developments in various dimensions of economic freedom, rule of law, and political freedom in emerging markets and assesses their impact for enhancing international business activity.

Each country included in the analysis has a unique culture and history. However, there has been a general moving away from totalitarian political systems, centrally planned economic systems, and corrupt legal systems with no or little property rights into freer systems that are identified as emerging democracies with market economies and more transparent rule of law with stronger enforcement of property rights. However, anomalies naturally exist within countries as to the pace and sequence of reforms. In China, for example, while substantial limits to individual political freedom continues, major economic reforms started in 1980s and China's legal system is also gravitating toward one that is consistent with Western countries. The Soviet Union collapsed in 1991, which lead to significant democratic and economic reforms in Central and Eastern Europe. Communism has also collapsed in several Southeast Asian, African and some Latin American nations. In addition, several countries in Latin American and Southeast Asian countries with right-wing totalitarian governments have started to be replaced with democratically elected ones. It is also noteworthy that while these changes have been positive for development of international business, in the last 10 years there are some signs of reversals and set-back in Latin American and Russia. As such, a neat lock-step linear process toward greater freedoms does not exist within the changing economic, legal and political systems of emerging countries.

In this context, there is continuing interest in better understanding origins of an emerging middle class and its impact for further international business activity. Additional empirical research is needed to help clarify these complex questions. What is the impact of enhanced freedoms for the growth of international business, economic growth and the rise of the middle class? Which freedoms are more important in this economic development process? How does growing middle class, once in place, loop back to affect continued international business activity? This research therefore seeks to shed light on these relationships.

2. Freedoms, international business, economic growth and emerging middle class

It is often argued that a country's economic development is related to its political, economic and legal systems. Despite the long debate over the question of this relationship in the literature, it has not been possible to give an unambiguous answer. Certainly, innovation and entrepreneurship are considered engines of economic growth (Grossman & Helpman, 1994). In particular, innovations in production and business processes lead to increases in the productivity of labor and capital, which boosts economic growth rates (Lewis, 2004). Innovation is also seen as the product of entrepreneurial activity. It is the entrepreneurial activity that commercializes innovative new products and implements new improved processes.

It has also been suggested that the economic freedom typically associated with a market economy generates greater incentives for innovation and entrepreneurship. In such economies, individuals are free to try to make money out of a new product by starting a business and existing businesses are free to improve their operations through innovation (Hayek, 1989). A study that involved more than 100 countries provides the empirical evidence supporting this argument for a strong relationship between economic freedom and economic growth (Gwartney, Lawson, & Block, 1996). They found that the more economic freedom a country had, the more economic growth it achieved and the richer its citizens became. The reforms toward more economic freedom often involve a number of steps such as deregulation, privatization, and liberalization. Deregulation removes legal restrictions to the markets, operations of companies, and establishment of new ones. The result is *regulatory efficiency*. Through privatizations, the ownership of state-owned enterprises changes into private individuals, who have more powerful incentives for profits (Zahra, Ireland, Gutierrez, & Hitt, 2000). This reduces government spending and consequently the need for taxation. In fact, Cebula and Mixom (2012) found that reduced fiscal freedom leads to a reduced rate of economic growth. The result is *limited government*, which is another important element of economic freedom. Lastly, liberalization involves reductions in tariff and non-tariff trade and investment barriers, so that there are reduced barriers to the free flow of capital, products and services across the borders, leading to *open markets*, the third dimension of economic freedom considered in this analysis.

Rule of law is considered as another requirement for a business environment conducive to innovation and entrepreneurial activity, thus economic growth (Murphy, Shleifer, & Vishny, 1993; Maskus, 2000). A consistent legal system is expected for a well-functioning market economy. In particular, this entails strong enforcement of property rights, and contract enforcement in an environment free of corruption and organized crime. Without such protection from the legal system, businesses and individuals run the risk that the profits from their innovative efforts are expropriated, either by criminal elements or by the state. Corruption increases inefficiencies in government expenditures, distorts relative prices, and hampers economic growth (Ghalwash, 2014; Aidt, 2011). The final dimension of the political economy of a country considered is its political system. The relationship between economic system and economic development is clear as outlined above. Similarly, freedom from corruption results in greater efficiencies and economic growth. However, debate still surrounds what kind of political system best supports a functioning market economy with a strong legal system (Hirschman, 1994; Przeworski & Limongi, 1993). Nearly 20 years ago, Barro (1996) found a weak and slightly negative impact of democracy on economic growth conditional on maintenance of the rule of law, free markets, small government consumption, and high human capital. Democracy is associated with the highly developed Western countries. Yet there are examples of totalitarian regimes that have fostered a market economy, stronger property rights protection, and have experienced significant economic growth such as China, South Korea, Taiwan and Singapore. However, totalitarian regimes elsewhere in Africa, Asian, and Latin America did not witness such growth. In the former socialist systems in Eastern Europe "individuals were being rewarded according to their political positions, not to their economical productivities" (Salgür, 2013). In addition, a socialist system has shown to produce less self-reliance which hinders the entrepreneurial spirit (Bauernschuster, Falck, Gold, & Heblich, 2012). Such reward structures result in market inefficiencies and result in a misallocation of valuable human capital. Given this, it