



A distributional analysis of the benefits of economic freedom



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ABSTRACT

Using US state-level economic freedom measures, we investigate the extent that changes in economic freedom affect US State income growth. More importantly, we study how this effect differs across income quintiles, allowing us to address the particularly timely question of who benefits from increases in economic freedom and who does not. Our results indicate that while increases in economic freedom positively contribute to income growth, the strength of this effect differs across quintiles.

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1. Introduction

There has been a great deal of academic research produced in the last two decades about economic freedom. As defined by Gwartney et al. (1996) “Individuals have economic freedom when (a) property they acquire without the use of force, fraud, or theft is protected from physical invasions by others and (b) they are free to use, exchange, or give away their property as long as their actions do not violate the identical rights of others.” The idea is not new, economies generally work best when the exchange of goods and services are allowed to happen within the market without undue external interference. With less external inference there is greater capacity for economic growth as more economic agents enter the market place. However, there is still some debate concerning whether the benefits of economic freedom are distributed equally in society. This work uses US state-level data in its attempt to add clarity to that discussion and proves particularly timely in light of growing concern over the increasing divide between the rich and poor in the United States.

At the international level, Gwartney et al. (1996) were the first to attempt to create an index of how well individual countries implemented the ideals of economic freedom. The authors created the Economic Freedom of the World (EFW) index in 1996. In its current form, the index has 23 components, which have five major areas (the size of government, legal structure and security of property rights, access to sound money, freedom to trade internationally, and regulations of credit, labor, and business). Each component and subcomponent is ranked with scores ranging from a low of 1 to a high of 10, with a higher number representing greater economic freedom. A great deal of controversy surrounds this index (as well as other freedom indices) due to the

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components selected to create it. In addition, each component in the index is equally weighted. It is debatable whether this measure (and others like it) accurately captures economic freedom at the state or country level. This controversy is explored in papers such as Berggren (2003), De Haan and Sturm (2000), Leschke (2000), Sturm et al. (2002), Gwartney and Lawson (2003), Heckelman and Stroup (2000, 2005), and De Haan et al. (2006). More recently, Rode (2012) uses cluster analysis to evaluate the effectiveness of such measures.

Despite the controversies, the index has been widely used to investigate the relationship between economic freedom and a range of macroeconomic variables. The most widely researched area has been whether economic freedom is a positive contributor to economic growth. Studies by De Haan and Sturm (2000), Justesen (2008), and Williamson and Mathers (2011) are just a few exploring this relationship. As well, there has been work on the relationship between economic freedom and equity returns in both developed markets (see, Easton and Walker, 1997 and Gwartney et al., 2006) and developing markets (see Smimou and Karabegovic, 2010). De Haan and Sturm (2003) also examine the impact of freedom in developing countries. They conclude that political freedoms are somewhat influenced by economic freedom. Additionally, Johnson (2011) measures the performance of banks during the economic crisis of 2007–2009, investigating the role of country-level economic freedom. The author finds that banks in countries with higher levels of government economic freedom had significantly higher returns. However, banks performed only marginally better with higher financial freedoms. Further, Sufian and Habibullah (2011) examine bank inefficiency and economic freedom in China and draw mixed results about the relationship.

Concerning the relationship between economic freedom and inequality, Berggren (1999) and Scully (2002) find, with various levels of confidence, that economic freedom does not increase income inequality and in fact, helps to reduce it. Carter (2006), however, points out serious and fundamental flaws in the econometric interpretation of the results of these two papers. After a more careful analysis, Carter concludes that increases in economic freedom are associated with increasing inequality. In more recent work, Bergh and Nilsson (2010) find that greater inequality is linked to trade liberalization and certain types of economic freedoms.

For studies like ours, of state-level economic freedom in the United States, the most commonly used dataset comes from the “Economic Freedom of North America” index.¹ This index contains annual data for all US states and Canadian provinces beginning in 1981. The index has been used to investigate the relationship between state-level economic freedom and a number of economic variables such as entrepreneurship (Kreft and Sobel, 2005) migration (Ashby, 2007), economic growth (Compton et al., 2011), corruption Apergis et al. (2012), and employment growth (Garrett and Rhine, 2011).

Most related to the subject of this paper are the works of Ashby and Sobel (2008) and Bennett and Vedder (2013) since their works examine economic freedom in the United States as opposed to internationally. The latter use the index with an OLS fixed effects model and find a nonlinear inverted U-shaped relationship between economic freedom and the Gini coefficient. Ashby and Sobel (2008) investigate the relationship between economic freedom and income distributions at the state level. Their results are interesting in that they found a significantly positive relationship between the change in economic freedom and income growth at all levels of the income distribution (they consider the bottom, middle, and upper income quintiles). In addition, the authors state that reductions in state minimum wages and tax burdens would result in higher income levels, income growth, and a greater share of incomes going to the bottom quintile of the distribution.

Our paper is most similar to that of Ashby and Sobel (2008) and adds to it in several ways. Their paper uses a cross-sectional approach to examine the influence of freedom on several factors related to the income distribution and income growth from the early 1980s to the early 2000s. Of the issues examined by Ashby and Sobel the one that is most closely related to our work is their study of how freedom affected the twenty-year cumulative percentage growth of incomes across various income quintiles.² Our paper examines mean income growth across quintiles for a similar time period (1980–2004), but rather than using a cross-sectional approach that compares two points in time, we use a dynamic panel methodology based upon five-year averages of data created from annual observations. As will be discussed in the following section, this methodology has a number of benefits over cross-sectional approaches, particularly with respect to issues related to endogeneity and omitted variable bias. Ashby and Sobel also calculate impacts of economic freedom for only the lowest, middle, and highest income quintiles while this work examines the impact across all five income quintiles.

Although Ashby and Sobel found that economic freedom has benefits across the income distribution, their results were not conclusive and there are some potential reasons to think that freedom’s positive effects may not be shared across income quintiles. The driving premise of economic freedom is that economic agents and economies as a whole will function efficiently without redistributive government intervention. If we assume that these redistributive activities are from those in the highest income quintiles to those in the lowest, a decrease in such activities will necessarily leave those at the bottom with less income. However, a primary argument of proponents of economic freedom is that the savings in income by those at the top will ultimately positively impact those at the bottom also. Mainly, this action will be seen through greater economic activity with a subsequent increase in economic opportunities and job creation across all income quintiles.

This reasoning can fail under various scenarios. Assuming that a government decreases the amount of redistributive activities from the highest to the lowest income quintile, it must also be assumed that corresponding gains to those in the higher income quintiles are used to create jobs and promote economic growth (domestically).³ If the loss of transfers to those at the bottom is

¹ See Karabegovic et al. (2003).

² Ashby and Sobel also used as dependent variables the absolute mean income levels within quintiles, the shares of income held by the lowest and highest quintiles, and the ratio of the highest to the lowest quintile’s income shares.

³ There is no reason to believe that spillovers cannot occur, thus lessening potential gains to domestic low income residents.

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