The Role of Government to Create "Effective Freedom" — The Fundament for Economic Development

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***Abstract*—Fundamentally, there are only two ways of coordinating the economic activities of millions. One is central direction involving the use of coercion, so called the technique of the army and of the modern totalitarian state. The other is voluntary co-operation of individuals - the technique of the market place. As Milton Friedman, has mentioned in his public speeches, the government solution to a problem is usually as bad as the problem and very often makes a problem worse. In this paper, we are going to discuss the role of government to create a framework for the whole economy so that economic agents can benefit the most.**

***Index Terms*—Economic freedom, economic freedom index, economic growth, government.**

I. Introduction-Description of Economic Freedom

A common objection to totalitarian societies is that they regard the end as justifying the means. Liberals disagree with this statement and argue that appropriate means are free discussion and voluntary co-operation, which implies that any form of coercion is inappropriate.

Basically, individuals can be considered as economically free 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 their property to another as their actions do not violate the identical rights of others [1].

Economic freedom is the fundamental right of every individual to control his/her own labor and property. In an economically free society, people are free to choose whether they want to work or not, produce, invest etc. The success of every individual depends on their own labor and initiative, their personal effort and ability. Institutions do not discriminate either or in favor of people to any factor unrelated to individual merit, government decision making is characterized by openness and transparency. The allocation of resources for production/consumption is based on the open competition so that every individual gets the chance to succeed.

It is important to distinguish economic freedom from political and civil liberties. Political liberty means that citizens are free to participate in the political processes (vote, lobby, and choose among candidates), elections are fair and competitive, and alternative parties are allowed to participate freely. Civil liberty encompasses the freedom of the press and the rights of individuals to assemble, hold alternative religious views, receive a fair trial and express their views without fear of physical retaliation [1].

The key ingredients of economic freedom are personal choice, free competition and protection of private property.

II. Government as a Rule-Maker

When we are talking about what should be the role of government, first of all we must sign that it must do something that the market cannot do for itself, namely, to determine, arbitrate and enforce the rules of the game.

Discussion economic freedom, people see a critical relationship between individuals and government. Generally, state action or government control that interferes with individual autonomy limits economic freedom, but the goal is not simply an absence of government coercion. The government has its exclusive role in this layout. It can provide a legal structure and a law-enforcement system that will protect the property rights of owners and enforce contracts in an evenhanded manner [1].

When governments substitute taxes, government expenditures, and regulations for personal choice, voluntary exchange, and market coordination, they reduce economic freedom.

It is important to distinguish the day-to-day activities of people from the general customary and legal framework within which these take place. The day-to-day activities are like the actions of the participants in a game when they are playing it; the framework, like the rules of the game they play. And just as a good game requires acceptance by the players both of the rules and of the umpire to interpret and enforce them, so a good society requires that its members agree on the general conditions that will govern relations among them.

The basic roles of government in a free society are: to provide a means whereby we can modify the rules to mediate differences among us on the meaning of the rules, and to enforce compliance with the rules on the part of those few who would otherwise not play the game [1].

The need for government in these respects arises because absolute freedom is impossible.

"Freedoms" can conflict and when they do, one's freedom must be limited to preserve another's.

"The right to swing my fist ends where the other men's nose begins" – Oliver Wendel Holmes, Jr.

My freedom to move my fist must be limited by the proximity of your chin. The major problem in deciding the appropriate activities of government is how to resolve such conflicts among freedoms of individuals.

In summary, the organization of economic activity through voluntary exchange presumes that we have provided, through government, for the maintenance of law and order to prevent coercion of one individual by another, the enforcement of

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contracts voluntarily entered into, the definition of the meaning of property rights and the provision of a monetary framework.

In an economically free society, the fundamental function of government is the protection of private property and the enforcement of contracts. When a government fails to protect private property, takes property itself without full compensation or establishes restrictions that limit voluntary exchange, it violates the economic freedom of its citizens. Institutional arrangements that restrain trade, increase transaction costs, weaken property rights, and create uncertainty will reduce the realization of gains from trade and also the incentive of individuals to engage productive activities.

III. Measuring "Freedom"

"Full employment" and "economic growth" have in the past few decades become primarily excuses for widening the extent of government interventions in economic affairs.

"Economic Freedom" considers that the countries which keep their economies more or less "free" will have opportunity to boost their growth, others argue, that state control, if intelligently applied, can do the same. We are not going to detract the latest postulate but to prove that economic freedom matters a lot [1], [2].

First of all, economic freedom is the issue that affects incentives, productive effort, and the effectiveness of resource use.

If we accept the intuition underlying the basic macroeconomic model for GDP, we expect that any factors that would likely increase consumption, investments, government spending, or net exports will probably have a positive relation to GDP. Let's discuss around the topic and find out if economic freedom can increase above mentioned parameters [3].

There are several common indexes which measure economic freedom, such as Index of Economic Freedom by the Wall Street Journal and Heritage Foundation, Index of Economic Freedom by Fraser Institute, Index of Doing Business or Global Competitiveness Index.

In this paper, we will use an index calculated by the Wall Street journal and Heritage Foundation. The reason is simple, it gathers 10 different components in four broad categories which are found in other indexes too, so picture will be drawn quite objectively.

For analytical understanding and presentational clarity let's briefly discuss the main concept of understanding and measuring each component of the overall index.[1]

As it was mentioned, it consolidates 10 different economic freedoms which are divided into four broad categories (see Table I). Each of them is graded on a scale from 0 to 100. Scores on these components of economic freedom, which are calculated from a number of sub-variables, are equally weighted and averaged to produce an overall economic freedom score for each economy. After having an overall score of the index for the country, each country is classified to one of the five categories: 1. Free; 2. Mostly Free; 3. Moderately Free; 4. Mostly Unfree; 5. Repressed.

TABLE I: Categories and Components of Economic Freedom Index by the Wall Street Journal and Heritage Foundation

Categories of Economic Freedom Index	Components of Economic Freedom Index
The Rule of Law	Property Rights
	Freedom from Corruption
Government Size	Fiscal Freedom
	Government Spending
Regulatory Efficiency	Business Freedom
	Labor Freedom
	Monetary Freedom
Market Openness	Trade Freedom
	Investment Freedom
	Financial Freedom

RULE OF LAW. Property Rights — this component by its content is a qualitative assessment of the extent to which a country's legal framework allows individuals to freely accumulate private property. People should be secured by clear laws that are enforced effectively by the government. The criterion of measurement of this component is determined and varies from 0 to 100. 0 point is drawn if private property is outlawed and all property belongs to the state, people do not have the right to sue others and do not have access to the courts. Opposite to these, 100 points are drawn when private property is guaranteed by the government. The court system enforces contracts efficiently and quickly, the justice system punishes those who confiscate private property unlawfully and there is no corruption or expropriation.

Freedom from Corruption—Corruption leads to insecurity and uncertainty into economic relations, it leads to increasing costs and disfigures resource allocation.

The score for this component is derived directly from Transparency International's Corruption Perceptions Index (CPI)[2], which measures the level of perceived corruption in 175 countries [4].

GOVERNMENT SIZE. Fiscal Freedom — component measures the burden of taxes (marginal and the overall level of taxation) as a percentage of GDP.

The component score is derived from three quantitative sub-factors:

- *The top marginal tax rate on individual income;*
- *The top marginal tax rate on corporate income;*
- *The total tax burden as a percentage of GDP.*

These numerical variables are weighted equally as one-third of the component score.

Fiscal freedom scores are calculated as follows:

$$fiscalfreedom_{ij} = 100 - \alpha(factor_{ij})^2 \quad (1)$$

In equation (1) $fiscalfreedom_{ij}$ represents the fiscal

[1] For detailed measurement methodology of the index visit the link - http://www.heritage.org/index/book/methodology

[2] http://www.transparency.org/research/cpi/overview

freedom in country I for factor j; $factor_{ij}$ represents the value (a percentage expressed on a scale of 0 to 100) in country I for factor j; α is a coefficient set equal to .03. The minimum score for each sub factor is zero, which is not represented in the printed equation but was utilized because it means that no single high tax burden will make the other two sub-factors irrelevant [4].[3]

Government Spending—component captures the burden imposed by government expenditures, which includes consumption by the state and all transfer payments related to various entitlement programs.

We cannot assume an optimal level of government spending for each country as it depends on many factors such as culture or the level of economic development. Though, one thing is clear, excessive government spending that causes chronic budget deficits and the accumulation of public debt is one of the most serious drags on economic dynamism.

Due to its complexity government spending has a one of the major impacts on economic freedom.

The equation used for computing a country's government spending score is:

$$GE_i = 100 - \alpha(Expenditures_i)^2 \tag{2}$$

The scale for scoring government spending is non-linear, which means that government spending that is close to zero is lightly penalized, while levels of government spending that exceed 30 percent of GDP lead to much worse scores.

In the equation (2) GE_i represents the government expenditure score in country I; $Expenditures_i$ represents the total amount of government spending at all levels as a portion of GDP (between 0 and 100); α is a coefficient to control for variation among scores (set at .03). The minimum component score is zero [4].[4]

REGULATORY EFFICIENCY. Business Freedom — component measures whether the regulatory environment promotes efficient operation of businesses. The quantitative score is based on 13 sub-factors, all of which are weighted equally, using data from the World Bank's Doing Business report:

- Starting a business – procedures (number);
- Starting a business – time (days);
- Starting a business – cost (% of income per capita);
- Starting a business – minimum capital (% of income per capita);
- Obtaining a license – procedures (number);
- Obtaining a license – time (days);
- Obtaining a license – cost (% of income per capita)
- Closing a business – time (days);
- Closing a business – cost (% of estate);
- Closing a business – recovery rate (cents on the dollar);
- Getting electricity – procedures (number);
- Getting electricity – time (days);
- Getting electricity – cost (% of income per capita).

Each of these sub-factors is converted to a scale of 0 to 100, after which the average of the converted values is computed. The results represent the country's business freedom score.

Equation for calculating each sub-factor is as follows:

$$factorscore_i = 50\, factor_{average} \,/\, factor_i \tag{3}$$

So according to the equation (3) $factorscore_i$ is based on the ratio of the country data for each sub-factor relative to the world average, multiplied by 50. For example, on average worldwide it takes 18 procedures to get necessary licenses and country "**X**" needs just 10 procedures. Ratio is 18/10=1.80 and 1.80 multiplied by 50 equals 90, so the score for country **X** is 90.

Labor Freedom—is a quantitative measure of the legal and regulatory framework of a labor market. The regulations vary from country to country and in many cases they can be even ridiculous. The most common ones are: regulations concerning minimum wages, laws inhibiting layoffs, severance requirements and measurable regulatory restrains on hiring and hours worked, plus the labor force participation rate as an indicative measure of employment opportunities in the labor market.

Labor freedom component is calculated by equally averaging the below mentioned sub factors:

- Ratio of minimum wage to the average value added per worker;
- Hindrance to hiring additional workers;
- Rigidity of hours;
- Difficulty of firing redundant employees;
- Legally mandated notice period;
- Mandatory severance pay;
- Labor force participation rate.

Like it was in the equation (3), for converting sub-factors into 0 to 100 scale there is used the same concept:

$$factorscore_i = 50\, factor_{average} \,/\, factor_i \tag{4}$$

Monetary Freedom—The score for the monetary freedom component is based on two sub-factors:

- The weighted average inflation rate for the most recent three years;
- Price controls.[5]

The weighted average inflation rate for the most recent three years serves as the primary input into an equation that generates the base score for monetary freedom.

$$WeightedAvg.Inflation_1 = \theta_1 Inflation_{it} + \theta_2 Inflation_{it-1} + \\ + \theta_3 Inflation_{it-2} \tag{5.1}$$

$$MonetaryFreedom_i = 100 - \alpha\sqrt{WeightedAvg.Inflation_i} - \\ - PCpenalty_i \tag{5.2}$$

θ_1 through θ_3 (thetas in equation 5.1) represent three numbers that sum to 1 and are exponentially smaller in

[3] http://www.heritage.org/index/book/methodology

[4] In most cases, the index uses general government expenditure data that includes all levels of government such as federal, state and local. In cases where data on general government spending are not available, data on central government expenditures are used instead.

[5] Price Controls means price stability without microeconomic intervention.

sequence; $inflation_{it}$ is the absolute value of the annual inflation rate in country "*X*" during year ***t*** as measured by the Consumer Price Index; ***α*** represents a coefficient that stabilizes the variance of scores and the price control penalty is an assigned value of 0-20 penalty points based on the extent of price controls. The square root functional form is chosen to create separation among countries with low inflation rates [4].

MARKET OPENNESS. Trade Freedom—measures the extent of tariff and non-tariff barriers that affect imports and exports of goods and services. The trade freedom score is based on two inputs:

- The trade-weighted average tariff rate;
- Non-tariff barriers (NTBs).

Different imports entering a country can face different tariffs. The weighted average tariff uses weights for each tariff based on the share of imports for each good.

$$TradeFreedom_i = 100(Tariff_{\max} - Tariff_i)/(Tariff_{\max} - Tariff_{\min}) - NTB_i \quad (6)$$

$TradeFreedom_i$ in equation (6) represents the trade freedom in country "X"; $Tariff_{max}$ and $Tariff_{min}$ represents the weighted average tariff rate (%) in country *i*. The minimum tariff is naturally zero percent, and the upper bound was set as 50 percent. An NTB penalty is then subtracted from the base score. The penalty of 5, 10, 15, 20 points is assigned. For example penalty of 20 points is drawn, if NTBs are used extensively across many goods and services and/or act to impede a significant amount of international trade and 0 points if NTBs are not used to limit international trade.

Restrictive rules that hinder trade vary widely, the categories of NTBs considered in the penalty include quantitative restrictions (such as import quotas, export limitations etc.), price restrictions (antidumping duties, tariff rate quotas etc.), regulatory restrictions (licensing, labeling, advertising, media regulations etc.), customs restrictions (advance deposit requirements, customs classification procedures etc.), direct government intervention (subsidies, competition policies, exclusive franchises) [4].

Investment Freedoma—In an economically free country, there would be no constraints on the flow of investment capital. Individuals and firms would be allowed to move their resources into and out of specific activities, both internally and across the country's borders, without restriction.

This index evaluates a variety of regulatory restrictions that typically are imposed on investment, such as national treatment of foreign investment, foreign investment code, restrictions on land ownership, sectoral investment restrictions, expropriation of investments without fair compensation, foreign exchange controls, capital controls.

Financial Freedom—is an indicator of banking efficiency as well as a measure of independence from government control and interference in the financial sector. The index scores an economy's financial freedom by looking at five broad areas:

- The extent of government regulation of financial services;
- The degree of state intervention in banks and other financial firms through direct and indirect ownership;
- Government influence on the allocation of credit;
- The extent of financial and capital market development;
- Openness to foreign competition.

An overall score differs from 0 to 100 e.g. 0 if the system is repressive, private financial institutions are nonexistent and 100 when government interference is negligible.

IV. "Economic Freedom" and Economic Development

After discussing the measurement technique of economic freedom, we can analyze its relationship with economic development. As it was mentioned above if we accept the intuition underlying the basic macroeconomic model for GDP, we expect that any factors that would likely increase consumption, investments, government spending, or net exports will probably have a positive relation to GDP growth, so improving economic freedom is expected to have a positive relation to GDP.

Let's discuss the relationship between economic freedom index components and economic development.

The most essential component for economic freedom is "property rights". It is impossible to promote small and medium businesses (SMEs) without efficient rule of law which protects private property rights. If one cannot freely dispose the property, he/she owns it will decelerate the incentives to produce and realize innovative start-ups.

The other component is corruption. It is often understood as the abuse of public office for private gains. As a result of corruption, the public at large loses confidence in the government's ability to manage the economy in the interest of people.

Most researches find that corruption lowers private investment, thereby reducing economic growth. In fact, corruption adversely affects the quantity of productive public investment by displacing public funds from public investment towards unproductive activities [5].

Fiscal freedom simply is a measure of the tax burden imposed by the government. A high taxation burden directly affects the incentives of the individuals to refrain from doing business. It also reduces investment level within a country.

Though it is difficult to identify an optimal level of government spending, volumes of research have shown that excessive government spending that causes chronic budget deficits and the accumulation of public debt is one of the most serious drags on economic dynamism.

Every individual who is going to invest or start a new business is seeking for a place where it can be done in the easiest way. Business freedom is the factor, which really matters to individuals all over the world. Simply, if I live in a country, where I have to have 20 procedures for starting business what takes 3-6 months to be done, it will push me to seek for a country with less restrictions e.g. Georgia, where an average time of starting a new business is 15 minutes. If a country has a high level of Business Freedom it will give an opportunity to interest thousands of investors from all over the world to invest in this country, so its importance is quite substantial.

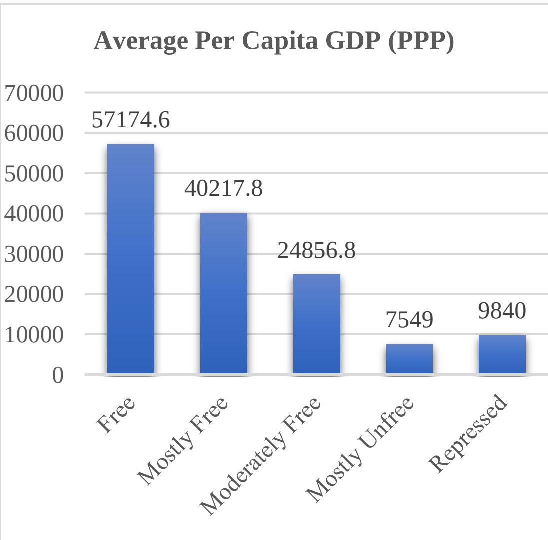
Labor freedom is the component, which stimulates proper resource allocation. It is essential that country's economy has high level of labor freedom, so that employers on the one hand are free in negotiating with employees and on the other hand employees can chose on their own. Every regulation on labor market such as e.g. regulations concerning minimum wages can easily boost corruption or jump to shadow economy, what leads country's economy to recession [5].

Monetary freedom consists of two main sub-factors: the weighted average inflation rate for most recent three years and price controls. For economic agents, price stability is one of the most important issues to plan their future entrepreneurial plans. In a modern world, most central banks are managing monetary policy by targeting future inflation rate. The main reason of this policy is to build a sustainable economic environment for economic agents. Stability is the main factor for developing business and this factor is directly concentrated on this issue.

What is the meaning of open markets? Why do countries trade between each other? The answer is comparative advantages. "X" country can produce "M" goods at a lower opportunity cost than "Y" country, while the "Y" country can produce "N" goods at a lower opportunity cost than "X" one. It gives them opportunity to trade between each other and both of them benefit. If one implies any barriers (tariff or non-tariff) it will lead both countries to inefficiency and ineffectiveness.

Nowadays, there is no rationally thinking economist that would rather think to put restrictions on investment flows. Investments lead country's economy to innovations, stabile flows of foreign currency and sustainable economic growth.

Everything what was mentioned above is vain without financial freedom. If the financial system within a country, (banking sector or capital market) is not developed enough, it will be a substantial obstacle for economic agents. First of all, it is necessary for credit allocation, so that economic agents have access to loans, also banks can freely extend loans, accept deposits and conduct operations in foreign currencies [5].



SOURCES: http://www.heritage.org/index/ranking; http://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD

Fig. 1. Average per capita GDP of top countries from each category of economic freedom index.

On the basis of above mentioned arguments, we can assume economic freedom as one of the most essential factors for economic development. For better understanding and illustrating what is the difference between development level of the "Freest" and "Repressed" economies, see the Fig. 1.

In Fig. 1 it is calculated average of per capita GDP (PPP) of top 5 countries of each category from world's freest economies to repressed ones.

V. Conclusion - Effective Level of Freedom and the Role of Government

Economists argue about what is the effective level of freedom? There is no single answer to this question. We cannot assume that "golden score" is any specific level and it does not need any changes. The best answer would be that it varies from country to country and depends on many factors such as geographical environment, traditions, the level of economic development etc. In a modern world, there is no example, what would give us a single reason to say that specific level of economic freedom is gained and enough, that it does not need to be modified and developed time to time. World economic environment is changing day to day, so adjustments are needed in all sectors of economy. The effective level of economic freedom is country's position, when it gains most benefits from economic activities, when there is high level of competition on the market and people control the fruits of their own labor.

And the other question is about the role of government. Many economists argue that government should not take any activities in the market place and that it must be diminished absolutely, but we do not agree with that postulate. If there would be simply an absence of government coercion it'd rather cause a chaos and inefficiency. The point of government coercion should be creation of a mutual sense of liberty for all. It must provide a proper framework for the whole economic system, so that every individual at the same time is protected by the law, can benefit from his/her own effort and initiative and is not able to harm other economic agents. Government coercion is justified if it is directed for promoting and strengthening property rights, fiscal and monetary freedom, business and labor freedom, trade and investment freedom and of course diminishing corruption. As Adam Smith, has mentioned many years ago, "the only fair is laissez-faire", maybe in exceptional cases we can approve government interventions in the market place, but it should be strictly limited and unavoidable. Government's core functions are maintaining defense, keeping order or promoting education. It should keep economy open and free and not act in ways that distorts it. Economic freedom is the only thing that stimulates open competition, and competition creates progress.

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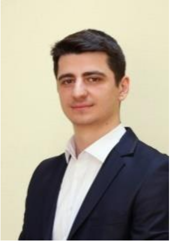

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Vakhtang Chkareuli has won different scholars for short-term visits on international scientific events, and a PhD scholar. Also, he is a winner of Dora Plus scholarships for visiting PhD students at the University of Tartu.

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