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Leave Size of Government Out of the Measurement of Economic Freedom—Put Quality of Government In

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LINK TO ABSTRACT

Ryan Murphy's approach is popular in many debates about social-economic questions. I am glad that Murphy's statistical results (Murphy 2022) differ only immaterially from my results for the years 2010–2012, with a different sample of nations (Ott 2018). At some points he is perhaps too pessimistic about my measurement of economic freedom, but let me first say a few words about two fundamental issues: the *conceptualization* and the *measurement* of economic freedom.

Conceptualization of economic freedom

Freedom is usually defined and interpreted as the actual possibility to choose. This possibility depends on two dimensions: the opportunity to choose and the capability to choose (Sen 1999). The opportunity is a characteristic of the social environment and depends on the absence of inhibitions and the availability of options. When using the word 'freedom,' options and inhibitions are supposed to be *man-made*. Capability is a characteristic of individuals. It is not unusual to ignore capabilities and to concentrate on opportunities in the definition of freedom. The combination of capabilities and opportunities in one concept is difficult to handle.

1. World Database of Happiness, Erasmus University Rotterdam, 3062 PA Rotterdam, Netherlands.

It is not realistic, however, to define opportunities exclusively in a negative way, as just the absence of inhibitions, or exclusively in a positive way, as just the availability of options. Options and inhibitions always go together; they are always intertwined and complementary. Legislation and policies create combinations of inhibitions and options simultaneously.

Specific institutional arrangements facilitate and regulate specific types of freedom in different domains, like going to school, getting married and divorced, religion, and political participation. An interesting outcome of empirical research is that different types of freedoms in nations are correlated.[2] This is not self-evident because different types of freedom have different priorities for different groups of people. We may conclude that individual freedom is an actual phenomenon and cultural standard in different domains.

Economic freedom is in my view about the opportunity to choose in economic decisions, like buying and selling goods and services, hiring and firing staff, international trade, and starting and maintaining a business. The Fraser Institute, however, rejects this concept of freedom as the opportunity to choose and prefers a more specific concept, as expressed in different formulations in the annual *Economic Freedom of the World* reports. In many reports, and in the first sentence of the Executive Summary of the annual report of 2021, we find the following formulation:

> The index published in Economic Freedom of the World measures the degree to which the policies and institutions of countries are supportive of economic freedom. The cornerstones of economic freedom are personal choice, voluntary exchange, freedom to enter markets and compete, and security of the person and privately owned property.

In the annual report of 2016, Chapter 1, page 1, we find an interesting additional explanation:

> Conceptually, economic freedom is present when economic activity is coordinated by personal choice, voluntary exchange, open markets, and clearly defined and enforced property rights. People are economically free when they are permitted to choose for themselves and engage in voluntary transactions as long as they do not harm the person or property of others. The Economic Freedom of the World (EFW) measure might be thought of as an effort to identify how closely the institutions and policies of a country correspond with the ideal of limited government, where the government protects property

2. Well-known types of freedom in this context are global freedom by political rights and civil liberties, press freedom, personal autonomy, and freedom to make life choices. The first three are measured by Freedom House and the last one is measured by the Gallup World Poll. See also Veenhoven 2008.

> rights and arranges for the provision of a limited set of "public goods" such as national defence and access to money of sound value, but little beyond these core functions. To a large degree, a country's EFW summary rating is a measure of how closely its institutions and policies compare with the idealized structure implied by standard textbook analysis of microeconomics.

This idealized structure is a structure with many consumers and producers, each of them without substantial market power, who operate in a rational way on the basis of adequate information. The differences between this concept and the usual concept of freedom, as the possibility or opportunity to choose, are very modest at first sight. The individual possibility or opportunity of personal choice is always a key point. There is, however, a lot of attention for inhibitions by government activities, while options created by governments, and options and inhibitions created by other agents, get less attention. In view of the conceptualization, one would at least expect some appreciation for antitrust legislation.

The representatives of the Fraser Institute, Murphy included, argue, however, that they use the concept of economic freedom in a *formative* way, meaning that the constituent dimensions define what it is, and that they are free to decide what these dimensions are. The implication is that there is never any inconsistency between the concept of economic freedom and measurement, because the meaning is implied in the measurement. Validity issues are irrelevant in this approach.

Everybody is free to do that, but I believe it is still an interesting and informative exercise to look at the validity of the measurement by the Fraser Institute, assuming that economic freedom is about the opportunity to choose in economic decisions, without specification of the origin of limitations or options.

The measurement of economic freedom by the Fraser Institute, if interpreted as the opportunity to choose, is reasonable—but better without size of government

The Fraser Institute has selected five items to measure economic freedom. Three of them are assumed to contribute to economic freedom: *rule of law and protection of property*, *sound money* and *freedom to trade internationally*. The other two items, *regulation* and *size of government*, are assumed to diminish economic freedom. We can assess the validity of this measurement, assuming that economic freedom is about the opportunity to choose, even if the Fraser Institute prefers a more specific meaning. We can have a look at the convergent validity, the underlying observations or content validity, and the predictive validity in view of previous research.

The Cronbach's alpha (CA) is—or can be used as—a statistical measure for the convergent validity of the measurement. This CA is high if the items used measure the same phenomenon. The CA of the measurement of Economic Freedom by the Fraser Institute is very reasonable, but higher if we leave out the size of government as one of the items.[3] The reason is that the size of government has a positive correlation with the first three positive items, instead of a negative one as assumed.

Murphy is somewhat pessimistic about my application of the CA, because I seem to apply this measure in a formulaic way. It is indeed important to apply this measure carefully. As a general rule we may say that 0.7 is reasonable and that 0.8 is good, but it is necessary to compare the CA of different sets of items, and to combine information about the differences with additional information about the underlying observations, and with information about the predictive validity. I should have been more explicit at this point.

We can specify this outcome by having a look at the underlying observations, occasionally denoted as content validity. The item *size of government* is the average of four sub-items: *government consumption as a percent of national consumption*, *transfers and subsidies*, *government enterprises*, and *top tax rate*. The first two items have a positive correlation with the three positive items: *rule of law and protection of property*, *sound money*, and *freedom to trade internationally*. This is not consistent with the assumption that the *size of government* has a negative correlation with economic freedom, as measured with these positive items.

The conclusion is that we can improve the measurement of Economic Freedom (as the opportunity to choose!) by leaving out the *size of government* as an item. Leaving *government consumption* and *transfers and subsidies* out of *size of government* is less appropriate, since these sub-items are more representative for the actual size of government than the more specific items *government enterprises* and *top tax rate*. Reversing the sign of *size of government* from negative to positive is less appropriate, since the selection of the sub-items is disputable.

This conclusion is supported by a higher predictive validity if we leave size out. In previous research we find that different types of freedom have a positive mutual correlation (Veenhoven 2008), and we find a positive correlation between freedom in nations and average happiness (Ott 2018). If we leave out the *size of government* in the measurement of economic freedom, we see that the correlation

3. The CA with size of government is 0.66 with size of government and 0.85 without size of government. (Ott 2018, data 2010–2012; 127 nations). With the data used by Murphy (2022), this is 0.67 and 0.83 respectively for the years 2000–2019 with 152 nations.

between Economic Freedom and other types of freedom and average happiness goes up.[4] This is consistent with, and predicted by, previous research. Predictive validity is, just like the convergent validity, not a simple recipe to be applied in an axiomatic way. Predictive validity can be low because previous research may have produced disputable results. There are no indications, however, that the research results just mentioned are disputable.

Another result of previous research is that the correlation between the *size of government* and average happiness depends heavily on the quality of governments (Helliwell and Huang 2008; Ott 2010a). This correlation is positive if the quality of governments is good. This is a trivial but important conclusion. Interesting examples are presented by the Nordic countries, with high levels of government quality, government consumption and taxation, happiness, and economic freedom.[5] Employers in these countries may even lay off employees without substantial limitations or conditions. The 'secret' of these countries is that their governments organize many provisions free of charge, like education, health care, training, and care for children and the elderly. In this way they optimize their investments in human capital.[6] Their income tax is high, and their governments are relatively big, but they achieve high levels of employment and productivity with high levels of happiness. The correlation between *size of government* and happiness is negative if the quality of government is bad. Governments which are oversized as a result of corruption, rent-seeking, and patronage are regrettable examples.

Conclusion and discussion

The Fraser Institute prefers a more specific interpretation, but the conclusion is that its measurement of economic freedom, if interpreted as the opportunity to choose, is very reasonable. The measurement can be further improved by leaving out the *size of government*. Just reversing the sign is less appropriate, because the selection of sub-items is inadequate.

The relation between economic freedom and the *size of government* depends

4. The positive correlations of economic freedom—size of government included—with global freedom, personal autonomy, and press freedom, as measured by Freedom House, are 0.51, 0.57, and 0.50. Without size of government these are 0.59, 0.66, and 0.59 respectively. The correlation with happiness goes up from 0.46 to 0.55. Murphy (2022) pays no attention to these differences.

5. The Nordic countries always ranked high on the Ease of Doing Business index compiled by the World Bank (**link**).

6. The Nordic countries avoid the negative impact of inequality on the education and training of poor people, women, and young people (Jensen 2021). This is, as explained by Andersen (2021), an effective way to mitigate a fundamental market failure.

on the *quality of the government*. It is therefore also an attractive option to substitute the *size of government* as an item of economic freedom with the *quality of government*. The World Bank presents excellent data about this quality, with the Worldwide Governance Indicators (Kaufmann and Kraay 2021).

Putting items in an index is also a way to create more attention for issues. There are arguments to pay more attention to the quality of governments than to their size. One argument is that size as such is usually irrelevant for the quality and availability of goods and services to be delivered. The quality of government is more important. Intelligent governments can organize goods and services themselves, but may also do so with legislation, in cooperation with private organizations. Another argument is that it is easier to improve the quality of governments than to change their size. Attention to the quality is also more productive, because there are usually many practical and non-controversial options to improve this quality (Ott 2010b).

The quality of governments also deserves more attention in view of the current worldwide problems, like climate change, pandemics, and aggression by dictators. Our discussions about freedom are interesting, but I am sure we are all equally motivated to put an end to dictatorships and bad governments in general.

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