



## **U.S. National Security Strategy: Is There an Empirical Relationship Between Economic Freedom and Political Freedom?**

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### **Introduction**

One of the major concerns for current foreign policy leaders in the United States is the impact of failed states. This view is reflected in the text of the most current *U.S. National Security Strategy of the United States*, (March 2006). The strategy says clearly, "The goal of our statecraft is to help create a world of democratic, well governed states." Furthermore, "It is the policy of the United States to support democratic movements and institutions in every nation and culture." One of the essential tasks in the strategy to accomplish these goals is to increase global economic growth through free markets and free trade. Economic freedom in turn, will empower individuals to then demand political freedom. A case in point of this phenomenon is China, where U.S. leaders hope that greater economic prosperity will cause the Chinese people to demand greater political freedom. The increasing number of organized protests occurring throughout China would seem to support this approach.

Notwithstanding the unambiguous language in the National Security Strategy, the question remains open as to whether the belief that the relationship between economic and political freedom has any empirical basis. This research is important because it calls into question one of the basic tenets of U.S. foreign policy. For instance, the nature of the relationship between economic freedom and political freedom has great ramifications for U.S. foreign aid. In an effort to create democracy, is aid money better spent on building political or economic institutions, or both? This study aims to put that relationship to the test.

Section II of this study reviews the current literature on the relationship between economic freedom and political freedom. This review will survey the various competing explanations on the relationship between economic and political freedom as well as identify other, outside, causal factors for the two phenomena.

Having surveyed the relevant literature, Section III will then harness the extant body of knowledge to define the interdependent variables as well as the control variables for the study. Section IV will present the quantitative results of the hypothesis testing along with a discussion of some of the methodological issues and considerations.

Finally, Section V will provide a conclusion that discusses some of the impacts of the results of this study for policy makers.

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## Literature Review

Seymour Lipset (1959) addresses what he refers to as the “social requisites” of democracy. He divides these requisites into the broad categories of economic development and political legitimacy. Important to this paper is the distinction that Lipset does not study the emergence of democracy so much as the maintenance of “stable democracies.” Lipset draws the strong conclusion that stable democratic countries, particularly in the West, exhibit high levels of economic development along with a number of other variables. Lipset never explicitly addressed economic freedom as a variable, but he does observe that a relatively large middle class can act as a check on political leadership. More broadly, the presence of a large number of independent “intermediary organizations and institutions” can constrain dictatorial tendencies of the state. In a cultural vein, Lipset identifies a high level of Protestantism, with its focus on individual responsibility, as a frequent characteristic of stable democracies.

Friedman (1962) makes no explicit reference to Lipset’s work, but explores similar ideas. Friedman expands beyond Lipset’s focus on economic development to explore the relationship between economic freedom and democracy. He begins his book with the bold declaration that economic freedom leads to political freedom. He specifically states, “history suggests that capitalism is a necessary, but not sufficient precondition” for economic freedom. He justifies this statement with his observation that he knows of “no example in time or place of a society with a large measure of political freedom that has not used something comparable to a free market.”

Friedman provides a definition of political freedom as the “absence of coercion of a man by fellow man.” He further states that the preservation of this freedom requires the elimination of concentration of power and the presence of a system of checks and balances. This idea is consistent with Lipset’s argument of the necessity of independent intermediate organizations.

Friedman characterizes economic freedom as the absence of undue government influence in the markets. Friedman argues that this absence of government influence prevents the government from using control of the markets as a source of coercive power. Despite his aversion to government influence in markets, Friedman says that the government has some critical role in a free market, principally to enforce contracts and maintain law and order.

The direction of causation, or at least correlation, in Friedman's 1962 theory is very straightforward. Economic freedom is a necessary precondition for political freedom. However, later statements by Friedman make the relationship more complex. Dawson (1998) notes that Friedman stated in a 1997 Wall Street Journal article that “In general, the relationship between economic freedom and political freedom is that initial growth in one tends to promote the other.” Friedman’s statement suggests that the direction of causation between economic freedom and political freedom is either unclear or the variables are interdependent.

Later articles reinforce Lipset’s observation of the relationship between economic growth and the development of democracy. In their summary of this vein of research, Prezeworski and Limongi (1993) note the widespread belief among scholars that some amount of economic development must be extant for democracy to develop. In contrast to this unanimity on the relationship between economic development and democracy, the authors point out that the theories on which aspects of development matter most are less consistent, however.

Lipset (1993) readdresses his 1959 article with a focus on which analyzing the “factors and processes affecting the prospects for institutionalization of democracy.” One category of factors affecting the emergence of democracy is the relationship between the economy and the polity. Lipset concludes that the elimination of the government from the marketplace reduces the opportunities for “nepotistic networks” and rent-seeking behavior by government elites. In keeping with Friedman’s ideas as well as his 1959 article, Lipset argues that reduction of these behaviors

prevents the government from using economic resources to coerce its citizens. In keeping with his previous work, Lipset also introduces a number of what he determines to be critical cultural factors such as religion and political culture. In fact, he argues, "cross-national historical evaluations of the correlates of democracy have found that cultural factors appear even more important than economic ones." With respect to this paper, Lipset notes in his conclusion that there are simply too many historical contingencies to generalize on a formula for the development of democracy. For example, one important contingent factor is the presence of a visionary leader such as George Washington or Gorbachev. Nevertheless, he does acknowledge that the factors he identifies can influence the probability that democracy can take hold.

Robert Barro (1996) expands upon Lipset's ideas on the relationship between economic growth and democracy. He concludes that economic growth is a critical intermediate step between economic freedom and political freedom. By controlling for all factors except for GDP, Barro demonstrates the weak direct effect of the attributes of free markets on democracy. In contrast, he determines the strong effect of improvements in the standard of living on democracy, particularly per capita GDP, infant mortality rate, and male and female primary school attainment.

John Dawson (1996) claims to have conducted the very first empirical test of Friedman's 1962 hypothesis of the relationship between economic freedom and political freedom. As quoted above, Dawson relies upon Friedman's later remarks concerning the actual interrelationship of the two variables for his hypothesis, rather than Friedman's original unidirectional relationship. The results of Dawson's analysis support Friedman's theory of the interrelationship between the two types of freedoms and do determine the absence of a single direction of causation. Despite the interrelationship, Dawson does conclude that increases in economic freedom show a greater effect on both economic growth and political freedom than do changes in political freedom on growth and economic freedom. Dawson's results discount the intermediate role of economic growth for the two freedoms, thereby contradicting the aforementioned work of Barro.

Farr, Lord, and Wolfenberger (1998), heretofore referred to as FLW, research similar ground as Dawson, with a stated purpose of distinguishing a direction of causation between economic freedom, economic growth, and political freedom. The authors conclude that economic freedom and economic development in the form of GDP have a strong interdependent relationship. Specifically, past economic growth appears to Granger-cause an increase in economic freedom. Additional tests determine that economic growth has a strong correlation with political freedom, but economic freedom does not have the same correlation with political freedom. These results are similar to those of Barro and contradict Dawson. The authors conclude that the uncertain relationship among the three variables raises the possibility of omitted variables, particularly social and cultural factors.

Vega-Gordillo and Alvarez-Arce (2003) readdress the study by FLW to determine more specifically the mutually reinforcing relationship between economic and political freedom. The authors vary the FLW study only in econometric technique. This new technique yields the result that economic freedom and political freedom are indeed interdependent and mutually reinforcing, while also supporting FLW's conclusions on the positive effect of the two freedoms on economic growth.

Many of the aforementioned works directly address or suggest the role of cultural and social factors in influencing the development of economic and political freedom. Francis Fukuyama addresses these factors in two articles (1989, 1992). His 1989 article challenges the economically deterministic approaches of Marx and others for political phenomena. Instead, Fukuyama (1992) argues that scholars should consider ideological and cultural factors as well. He argues that these factors must combine in the appropriate "state of consciousness" of the people for freedoms to flourish. Where other authors appear to analyze economic freedom in absolute terms, Fukuyama does so in comparison with socialism. He states that while capitalism is neither necessary nor sufficient for democracy to flourish, it is "very helpful." In Fukuyama's words, capitalism is

empirically simply the most efficient form of economy for the development of democracy, specifically to allow the cultural factors to take effect. In addition to the cultural factors, Fukuyama also argues that the quality of leadership as well as a state's geopolitical position also influence the probability of democracy taking hold successfully.

As noted by Lipset (1993), there are a very large number of theories on the causes of democracy. This high number of potential control variables becomes so large as to be un-testable. While their study does not directly, address the relationship between economic freedom and political freedom, Pickering's and Kisangani's (2006) research into the relationship between foreign military intervention and development does provide some useful control variables for democratization. These authors' choice of control variables manages to cover a wide variety of potential causal factors while still keeping the number of variables small.[1] As a result, this study simply borrows from the work of Pickering and Kisangani, rather than attempt to control for each and every of the myriad competing explanations for democratization.

Despite the numerous studies addressed above, the relationship between economic freedom and political freedom is still inconclusive. With that in mind, the study goes forward with a hypothesis derived from Freidman's updated theory.

Hypothesis: Economic freedom and political freedom develop interdependently

## **Research Design**

The study tests the interdependence of political and economic freedom by treating the two phenomena as endogenous variables in a simultaneous-equation model. The testing draws upon pooled data by state by year, with the only limitation being data availability. This method, rather than simple time-series or cross-section method has a number of advantages. First, it simply provides the greatest amount of data. Additionally, it automatically eliminates sampling bias due to regional effects, type of regime, and other geo-political factors.

*Endogenous Variables.* The source for the variable of economic freedom (ef) is the Fraser Institute's Economic Freedom of the World 2008 Annual Report. This report gives scores for economic freedom by state on five-year averages from 1970 to 2000, then yearly scores thereafter through 2006. The source for operationalization of political freedom (pf) is the Polity IV Data Series v 2007. This database provides an aggregate score reflecting regime type for most of world's states. 130 states have data for political and economic freedom, although not all have data on both variables for all years. The study includes only cases that have values for both economic and political freedom. This decision results in 1360 cases, vastly surpassing the requirement for a large sample.

*Exogenous Control Variables.* As noted earlier, Fukuyama (1989, 1992) argues that certain social (in this case religious) and cultural factors may be more likely to aid in the development of capitalism. Fukuyama is most explicit that the presence of a large proportion of Protestants in a state's population contributes to the development of free markets. In light of these factors, this study will employ a dummy variable for those states whose population is at least 51% protestant (prot). The source for this data is the World Christian Encyclopedia (Barret, Kurian, and Johnson, 2001). We code a country as protestant if at least 51% of the population identifies itself as protestant, independent, unaffiliated, or Anglican. The segment of the population that identifies itself as Roman Catholic or Orthodox will not be considered Protestant.[2]

FLW (1998) concludes that economic freedom results from increases in economic growth. The authors operationalize prosperity as per capita GDP. Barro (2006) also includes savings rates as another measure of growth. Since individual savings data are unavailable, this study will employ investment as a percentage of GDP as a proxy for individual savings. A combination of the two

authors' work yields the control variables of GDP (gdp) and investment (invest). The source of the data for both GDP and investment are the Penn World Tables 6.2.[3]

The study employs control variables for political freedom from Pickering and Kisangani (2006). The control variables will be the presence of a civil war (civilwar) resulting in over 500 deaths, the degree of democratization (demreg) of other countries in the region, the percentage of a country's population that is Muslim (islam), and whether the country was a British colony (britcol). The civil war variable will be a dummy variable reflecting whether a war occurred during that time period. The source for the data is the UCDP/PRIO Armed Conflict Dataset Codebook Version 4-2008. The former British colony variable will also be a dummy variable reflecting whether the country was ever a British colony or protectorate. The source for this data is the University of London, Institute of Commonwealth Studies, Former British-Administered Territories and Commonwealth Countries list. The Muslim score is a dummy variable that reflects whether a majority of a country's citizens identify themselves as Muslim. The source for this data is the World Christian Encyclopedia (Barret, Kurian, and Johnson, 2001). The score for regional democracy for individual countries is the average Polity IV scale score of all other countries within the region for the given time period. The categories of regions are those from the Correlates of War Database. Modeling the aforementioned variables according to this paper's hypothesis that economic freedom and political freedom develop interdependently yields the following equations:

$$\text{Eq. 1 } e_{ft} = \alpha_0 + \alpha_1 \text{gdp}_t + \alpha_2 \text{prot}_t + \alpha_3 \text{invest}_t + \alpha_4 \text{pft}_t$$

$$\text{Eq. 2 } \text{pft}_t = \beta_0 + \beta_1 \text{britcol}_t + \beta_2 \text{demreg}_t + \beta_3 \text{islam}_t + \beta_4 \text{civilwar}_t + \beta_5 e_{ft}$$

The method for testing the hypothesis will be the Two Stage Least Squares Method.[4]

## Empirical Analysis and Discussion

Table 1 below presents the descriptive statistics of the data supporting the hypothesis. In terms of the number of observations, the limiting factor becomes invest. Nevertheless, this variable has 1015 observations, clearly surpassing the threshold for a "large" sample. Both pf and gdp display a relatively large variance given their range. This large variance may have implications for the appropriateness of the linear nature of equations this study employs, which I discuss later. Finally, the GDP data is skewed towards to low end, as evidenced by the almost order of magnitude difference between the mean and the maximum value. While this skewness likely reflects the actual distribution of economic development throughout the world, it contradicts the assumption of normality in this variable.

**Table 1 Descriptive Statistics**

Variable	Obs	Mean	Std Dev	Min	Max
pf	1360	3.93	6.67	-10	10
ef	1360	6.15	1.11	2.3	8.78
gdp	10199	431.78	8580	484	46959.83
prot	1357	0.101	0.302	0	1
britcol	1360	0.29	0.45	0	1
demreg	1360	3.41	4.7	-7.36	9.06
islam	1360	0.14	0.35	0	1
civilwar	1360	0.12	0.324	0	1
invest	1015	15.9	8.8	1	75

Table 2 displays the empirical findings resulting from testing this study's hypothesis, using the Two-Stage Least Squares method with robust estimators. [5] The findings demonstrate the strong interdependent relationship between economic freedom and political freedom, as evidenced by

the high degree of statistical significance of the two estimators of the respective independent variables. In that sense, the findings support this paper's hypothesis. This outcome supports the statement of Friedman and the work of Dawson (1998) and Vega-Gordilla and Alvarez-Arce (2003) and contradicts that of FLW (1998) and Barro (1996).

**Table 2. Empirical Results [6]**

Variable	ef		pf	
	Coefficient	t value	Coefficient	t value
pf	0.064***	8.95	---	---
ef	---	6.15	1.96***	6.87
gdp	0.0000636***	14.98	---	---
prot	-0.112	-1.38	---	---
invest	0.0038	1.09	---	---
britcol	---	---	1.077***	2.79
demreg	---	---	0.798***	13.55
islam	---	---	-1.41***	-2.38
civilwar	---	---	0.948***	0
R2	0.437		0.525	
Model VIF	1.43		1.81	
Highest VIF	1.23		1.36	
N	1005		1360	

*Note: Two tailed test \* for  $p < 0.10$ , \*\* for  $p < 0.05$ , \*\*\* for  $p < 0.01$*

Despite this strong interrelationship between economic freedom and political freedom, the results show that clearly these are not the only factors at play. With respect to economic freedom, per capita GDP exerts a strong influence. This outcome is in keeping with FLW (1998) suggests that increases in prosperity create conditions for freer markets. Other literature (Barro, 1996) determines that the opposite causal relationship is true; that increases in economic freedom generate increases in prosperity. These two seemingly contradictory outcomes suggest that the two phenomena of economic growth and economic freedom may be interdependent and a one-way causal relationship is too simplistic. Investment and the presence of a protestant majority do not appear to have strong effect on the development of economic freedom. This weak effect may be due in part to the relatively short time period this study employs. Perhaps these variables represent long-term trends that exceed the time horizon of this study. Additionally, the decision to employ a dummy variable for Protestant population may have not allowed enough variation, especially since very few countries since 1970 have a majority Protestant population. As a final thought, investment may not be a good proxy for personal savings. The coding from the Penn World Tables does not differentiate between personal and other forms of investment.

Concerning political freedom, all of the control variables are statistically significant at the 95% interval. The fact that many variables affect democratization is not surprising given the already mentioned complex and numerous explanations for the development of democracy. What does come as somewhat a surprise is the negative effect of majority population of Muslims, as compared to the lack of significance of Protestants on economic freedom. One possible explanation may be the relatively high percentage of Muslims in the countries that scored a "1" on the dummy variable. While the mean scores of Protestants and Muslims were not much different on a global level (0.101 vs. 0.14), those countries coded as "Islamic" had a much higher percentage of Muslims than those countries coded as "protestant" had of Protestants. Additional studies may wish to code religion as something other than a dummy variable to better capture the effect of religion.

Policy makers may wish to bear in mind the strong relationship of a large number of democracies in a region on whether a country becomes a democracy. This outcome would suggest a sort of “domino effect” of democratization, which supports tenets of the U.S. National Security Strategy. Further study should determine whether this domino effect works as well in Islamic countries given the negative effect that Islam appears to have on the prospects for democracy.

The relatively low R<sup>2</sup> values raise some concern about the appropriate fit of the model. This low score is likely due to the use of cross-sectional data. However, the high t values suggest that the model is appropriate in terms of the choice of variables (Gujarati 2008, 243).<sup>[7]</sup> Another possibility is that the model is mis-specified. This study treated the equations for both ef and pf as linear in their variables. This misspecification may account for the relatively large value of the standard deviation in the dependent variables. A more sophisticated study could treat at least some variables as exponential.

## **Conclusion**

This study has determined that there is no simple one-way causal relationship between economic freedom and political freedom. Rather, the two phenomena appear to occur simultaneously and interdependently. Along the way, this study also determined that the one-way causal relationship between economic growth and economic freedom might be too simplistic as well. In light of the conclusions, the U.S. National Security Strategy is incorrect or at least incomplete in asserting that economic freedom leads to political freedom. The opposite can be true, or more likely, they may have to develop together.

The policy implications of these outcomes are important. U.S. foreign aid packages cannot simply prioritize the development of one sector over another. It must be more comprehensive in nature. Moreover, this strong interrelationship suggests that a reversal in the progress of one sector could lead to a reversal in the progress of another. This possibility only reinforces the need for a comprehensive strategy.

In light of the global recession, and in spite of domestic political pressure, this study should cause the democratic leadership to think twice before enacting protectionist trade measures. Leaders need to be aware of the potential for a diminution of political freedoms because of the reductions in free markets that protectionist measures would bring about—particularly in developing export-oriented countries. If the United States truly believes its security and economic interests are served best through a global community of democracies, then the United States should set the example in resisting measures that restrict global market activity, amongst states.

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1. These authors employ religious, historical, economic, and intrastate violence as control variables, drawing upon the work of Reiter (2001).
2. Since there is no data available between 1970 and 1990, this study will carry the 1970 values out to 1990. Similarly, whenever there is a missing value, this study will utilize the previous value.
3. The Penn World Tables data is listed in year 2000 U.S. dollars.
4. This presumes that the equations demonstrate interdependence from the Hausman test. See footnote 5 for test results.
5. The decision to employ the Two-Stage Least Squares method resulted from the outcome of Hausman tests on each equation, which revealed endogeneity between  $ef$  and  $pf$  in both equations.
6. The decision to employ robust estimators resulted from the finding that both equations display heteroskedasticity according the Bruesch-Pagan-Godfrey test at the 95% interval, as well as autocorrelation according to the Geary Test at the 95% interval. According to Kennedy (2009, 345), the use of robust estimators removes the effects of erroneous assumptions regarding the distribution of errors.
7. Scores from Ramsay RESET tests on STATA 10 on both equations determine that the models have no omitted variables.