



Balkan Journal of Social Sciences

BJSS

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Araştırma Makalesi • Research Article

Is Economic Freedom Effective on Poverty Alleviation? *

Ekonomik Özgürlük Yoksullukla Mücadelede Etkili mi?

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MAKALE BİLGİSİ

Makale Geçmişi:

Başvuru tarihi: 21 Şubat 2020

Düzeltilme tarihi: 18 Mart 2020

Kabul tarihi: 28 Mart 2020

Anahtar Kelimeler:

Ekonomik Özgürlük

İş Özgürlüğü

Ticaret Özgürlüğü

Yoksulluk

ARTICLE INFO

Article history:

Received February 21, 2020

Received in revised form March 18, 2020

Accepted March 28, 2020

Keywords:

Economic freedom

Business freedom

Trade freedom

Poverty

ÖZ

Bu çalışmanın amacı 1995-2015 arasındaki dönemde ekonomik özgürlük ve yoksulluk arasındaki ilişkiyi bulmaktır. Bu amaçla sabit etkiler modeli (FEM) ve tesadüfi etkiler modeli (REM) kullanılmaktadır. Modelin spesifikasyonuna karar vermek için Hausman test sonuçları kullanılmıştır. İş ve ticaret özgürlükleri ekonomik özgürlüğe dahil edilmesine rağmen, her üç ölçüt de modellerde ekonomik özgürlüğün ayrı ayrı göstergesi olarak kullanılmaktadır. Analizler, ekonomik özgürlük ile yoksulluk arasında negatif bir ilişki olduğunu ortaya koymuştur. Nüfus artışı yoksulluğu artırır. Bir refah devleti olarak, hükümetin eğitim harcamalarını artırarak müdahil olması yoksulluğu azaltır. GSYH'nın ise yoksulluk üzerinde zayıf bir negatif etkisi vardır.

ABSTRACT

The aim of this study is to find the relationship between economic freedom and poverty for the period between 1995 and 2015. To this end, fixed effect models (FEM) and random effect models (REM) are put into use. Hausman test results are utilized to decide on the specification of the model. Although business and trade freedoms are included in the economic freedom, all three measures are used as the indicators of economic freedom separately in the models. Analyses revealed that there is a negative association between economic freedom and poverty. Population growth raises poverty. As a welfare state, government's involvement by increasing expenditures on education lowers poverty. GDP, on the other hand, has a small negative effect on the poverty.

1. Introduction

In the last few decades, poverty, causes and results of poverty, poverty alleviation, and poverty-related research topics have been getting attention of the social sciences. Although, policies aimed at reducing poverty have become effective considerably, an important part of the world population is still

poor. The population living on less than \$1.90 a day decreased from 36% in 1990 to 10% in 2015. However, 10% corresponds to 736 million people (World Bank, 2019a). Poverty might be a local problem in each country before. But, with globalization, increasing quality of communication and transportation, poverty has become more visible than ever before. While, globalization causes poverty to be visible on

* First version of this study entitled "The Role of Economic Freedom on Poverty" was presented in the XIII. International Balkan and Near Eastern Congress Series on Economics, Business and Management, which was held on 5-6 October 2019 in Tekirdağ/Turkey.

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the one hand, it works as a reducing agent for poverty on the other. Economic agents cannot solve a problem if they are not aware of its existence. So, the visibility element is critical to overcome poverty worldwide. In this respect, freedom overall but especially freedom of trade and business are integral parts of the globalization which as a result makes poverty more visible. So, the effect of economic freedom on poverty constitutes the main topic of this article.

In a significant number of studies, economic growth is used as a synonym of the development which is seen as the key element to reduce poverty. According to Sachs (2005), economic freedom is a stimulant of economic growth and development, but economies such as China, Switzerland and African countries are exceptions. Norton and Gwartney (2008) claim that the relationship between economic freedom and poverty reduction is strongly positive. Economic growth is not the principal factor leading poverty reduction, but the institutional structures and economic freedom-targeted policies are the main sources of economic growth. So, they indirectly provide the decrease in the poverty level. Therefore, if economic growth is not accelerated by the economic freedom, then the poverty level will not decrease as it is in the sub-Saharan Africa. For Norton and Gwartney (2008), first steps toward economic freedom should be eliminating trade barriers and business regulations, improving legal system, and developing interstate highway system. These will provide the key element to reduce poverty, i.e. economic growth in their case. In addition, Easterly (2006) shows that in low and high-income countries, economic growth increases with economic freedom for the period between 1960 and 2002.

Dollar (2004) states that Vietnam's economy gained a high growth rate with the economic reforms in institutions and policies. "...legal reform, regulatory improvements, deepening of the financial system, and regulation that allows efficient infrastructure investment and thus reduces transactions costs" (Dollar, 2004, 48) are the key macroeconomic reforms for a sustained high growth rate. In other words, reforms providing economic freedom guarantee the high growth rate. However, no reform alone is enough to solve the problem. Trade liberalization and economic freedom may be the triggers of the economic growth. But without any advancement in the governance, rule of law and reduction in the corruption, economic improvement may not be possible (Tupy, 2005). For instance, foreign aid does not have any significant impact to reduce poverty in developing countries. In the study examining the impact of foreign aid on economic institutions and poverty rates between 1980 and 2005, Connors (2012) reveal that foreign aid policies have been failed to transform market structure and reduce poverty in developing countries. Even, the foreign aid might cause developing countries to postpone structural reforms that are necessary to strengthen economic freedom. Hence, foreign aid might become the reason of reluctant behavior to call crucial constructive reforms in developing or less developed countries. Connors's (2013) follow-up research on the economic institutions and the global poverty shows that economies that had institutions interiorizing high levels of

economic freedom before the reforms gained more benefits in reducing poverty.

For Hasan et al. (2003), economic freedom is not only important for economic growth, but also it is a significant factor in poverty reduction in developing countries. Especially, openness to trade and small size of the government, civil liberties, such as property rights and rule of law have an effect on poverty reduction. Unlike civil liberties, political liberties have no impact on poverty reduction though.

For capability approach, based on the works of Amartya Sen and Martha Nussbaum, poverty is a limitation of freedom (Nussbaum, 2011; Sen, 1992). Rather than economic or income related measures, freedom here refers to individual capabilities. Thus, lack of public service, health and educational opportunities constitute the unfreedom, i.e. poverty (Graf and Schweiger, 2014). Sen (2006) asserts that lack of capabilities is the definition of poverty. And, income is just one of many determinants of the individuals' capabilities. That is, economic growth may not improve the capabilities of individuals, but the freedom does. Capability is the element that let individuals live the way as they desire. Freedom, in this respect, is the main determinant of the things that individuals are capable of. Moreover, Sen sees "...development in terms of enhancement of human living and the freedom to live the kind of life that we have reason to value..." (Sen, 2006: 35). Hence, freedom is essential for reducing poverty and mitigating its effects and strengthening development.

The relationship between poverty and freedom is too complicated to be limited to a unilateral direction. While freedom or the lack of freedom affects the level of poverty, poverty also has a significant effect on freedom. Freedom of individuals weakens by the absence of the means of subsistence. So, people lose their ability of acting as moral beings (Gewirth, 2007). In contrast, Kaur (2007) claims that economic freedom has no significant effect on economic growth or on poverty. But the research shows that there is a positive effect of government intervention especially on nutrition quality. For Kaur, governments' involvement in poverty reduction policies is necessary, in contrast to the orthodox idea of liberalization after 1980. For the success of this kind of an intervention, the tools of the intervention such as government transfers and subsidies must target enhancing equality, poverty alleviation and decreasing malnutrition. Sen's (2000) view of the importance of social arrangements in the fight against poverty supports the idea of the active role of governments in poverty reduction. Social arrangements in line with individual level freedom boost development. And, there is complementarity between freedom of individuals and the social arrangements which includes involvement of institutions such as "the state, the market, the legal system, political parties, the media, public interest groups, and public discussion forums" (Sen, 2000: xii).

Findings about the relationship between economic freedom and poverty are controversial. But, existence of a negative relationship is searched between economic freedom and

poverty in this paper. The rest of the research is as follows. The second part is a summary of the data and the method. The third part reveals the empirical findings and the fourth part concludes the study.

2. Data and the Methodology

Four measures of poverty are utilized in the analyses. The first measure of poverty is the poverty headcount ratio. It is the percentage of the population living in a house where total consumption is below the poverty line. The second measure of poverty is the poverty gap index. It is defined as the “mean distance below the poverty line as a proportion of the poverty line” (World Bank, 2019b). The third measure of poverty is Watts poverty index. It is the “mean across the population of the proportionate poverty gaps, as measured by the log of the ratio of the poverty line to income” (World Bank, 2019b). Data of these three measures of poverty are from the World Bank PovcalNet database (World Bank, 2019c). Dataset covers the years between 1995 and 2015 for 123 countries.

The fourth measure of poverty is negative of the UNDP’s human development index (UNDP, 2019). HDI shows development level of the economy. But, negative of HDI can be used as an indicator showing the deepness of poverty in an economy. Poverty concept could be divided into four dimensions, such as economic, social, political and legal poverty (Ellis, 1984). Rather than disintegrating the concept, we preferred to use poverty alone. For, different dimensions of it cannot be distinguishable from each other. They are integral parts of a single problem. While solution should include many aspects, they must address all dimensions of poverty. For this aim, HDI data of 162 countries are retrieved from UNDP for the period between 1995 and 2015

In addition to four alternative measures of poverty, there are three variables showing the economic freedom levels. These are overall economic freedom, business freedom, and trade freedom indices. Individual level freedom would be the most relevant measure for the purposes of this research. Yet, it is nearly impossible to obtain an index like that at individual level. So, economic freedom itself and its two components, business and trade are utilized as the freedom indicators.

According to Heritage Foundation (2019) economic freedom is “the fundamental right of every human to control his or her own labor and property”. Its sub-components business freedom and trade freedom show how the regulatory institutions are effective and how the open markets effectively operate.

Three control variables are put into use in the study. Population growth rate is the first. It is expected to raise poverty. The second is GDP per capita. The third is the government expenditure on education as percentage of the GDP. The second and third are expected to decrease poverty. Data for the control variables are retrieved from WDI Databank of the World Bank (2019d).

To conduct empirical analyses, variations of multivariate cross-section FEM and REM are estimated. We use the Hausman test procedure to select between REM and FEM specification.

3. Empirical Findings

To decide on the specification of the models, Hausman test results are used. -HDI, as a dependent variable, changes the test results of the models in Table 1. For the models in which economic freedom is used as the main independent variable, results show that fixed effect model is the proper model specification, if the poverty measures are headcount poverty ratio, poverty gap or Watts poverty index. But, if the -HDI is the poverty measure, model should be random effects model. The situation is the same when business freedom is used as the main independent variable. If the trade freedom is used as the main independent variable, model specifications switch. The regression models in which headcount poverty ratio, poverty gap or Watts poverty index are used as the poverty indicators, random effects is the appropriate choice. On the other hand, -HDI changes the specification to fixed effects model. The number of observations increase if -HDI is used as the dependent variable in the models. Country sample increases from 123 to 162 due to availability of HDI data. So, this may be the reason why specification is different from other cases.

Table 1. Hausman Test for Period Random Effects

Independent Variables	Dependent Variable	Chi-Sq Statistic	(Fixed/Random Effects)	Model
Economic Freedom Population Growth GDP per capita Govt. Exp. on Educ.	Headcount Poverty Ratio	12.0781**	FEM	(1)
	Poverty Gap	11.9558**	FEM	(2)
	Watts Poverty Index	10.7944**	FEM	(3)
	-HDI	5.7293	REM	(4)
Business Freedom Population Growth GDP per capita Govt. Exp. on Educ.	Headcount Poverty Ratio	11.6873**	FEM	(5)
	Poverty Gap	12.0666**	FEM	(6)
	Watts Poverty Index	10.6976**	FEM	(7)

Independent Variables	Dependent Variable	Chi-Sq Statistic	(Fixed/Random Effects)	Model
	-HDI	6.6816	REM	(8)
Trade Freedom	Headcount Poverty Ratio	4.0831	REM	(9)
Population Growth	Poverty Gap	4.1369	REM	(10)
GDP per capita	Watts Poverty Index	4.7726	REM	(11)
Govt. Exp. on Educ.	-HDI	22.0169***	FEM	(12)

*, **, *** indicate significance at 0.01, 0.05, and 0.10 levels respectively.

Table 2 below summarizes the estimation of the relationship between economic freedom and poverty. Most of the coefficients are statistically significant at 1% level of significance. Although the magnitude of the relationship changes, the sign of the relationship is negative in all four models. While the weakest relationship is in model (4) in which -HDI is used as the poverty indicator, the strongest

relationship is in model (3) in which Watts poverty index is utilized. As it is expected population growth is in a significant and positive relationship with the poverty. GDP per capita and government expenditures have negative effects on the poverty. But, the effect of population growth is stronger compared to latter two.

Table 2. Economic Freedom and Poverty

	(1) Headcount Poverty Ratio	(2) Poverty Gap	(3) Watts Poverty Index	(4) -HDI
Economic Freedom	-0.3387***	-0.0976***	-0.1400***	-0.0041***
Population Growth	6.2032***	2.4821***	3.6672***	0.0446***
GDP per Capita	-0.0001***	-0.00003***	-0.00005**	-0.000005***
Gov. Exp. On Educ.	-1.2952***	-0.3894***	-0.4913**	-0.0064***
Constant	31.5999***	9.2815***	12.97278***	-0.4007***

*, **, *** indicate significance at 0.01, 0.05, and 0.10 levels respectively.

Findings about the sign of the relationship do not change if the business freedom is put into use as the freedom indicator. Table 3 summarizes those estimation results. Yet, the magnitude of the relationship between poverty and freedom

shrinks. The negative sign is kept. While, population growth has a positive effect on the poverty, GDP per capita and government expenditure are still in a negative relationship with the poverty.

Table 3. Business Freedom and Poverty

	(5) Headcount Poverty Ratio	(6) Poverty Gap	(7) Watts Poverty Index	(8) -HDI
Business Freedom	-0.1953***	-0.0572***	-0.0855***	-0.0029***
Population Growth	5.8891***	2.3892***	3.5248***	0.0412***
GDP per Capita	-0.00009***	-0.00003***	-0.00005***	-0.000005***
Gov. Exp. On Educ.	-1.0306***	-0.3122**	-0.37694*	-0.0035***
Constant	23.0335***	6.8681***	9.7138***	-0.4644***

*, **, *** indicate significance at 0.01, 0.05, and 0.10 levels respectively.

Table 4 summarizes the estimation results of the models in the third panel of Table 1. Open market operations are considered, and trade freedom is utilized as the economic freedom indicator. The negative sign is preserved. The magnitude of the relationship between freedom and poverty increases

compared to the cases in Table 3. But the magnitude is not as high as the cases of economic freedom in Table 2. Population growth is in a significant and positive relationship with the poverty. But GDP per capita and government expenditures have negative effects on the poverty as it is the case in the previous models.

Table 4. Trade Freedom and Poverty

	(9) Headcount Poverty Ratio	(10) Poverty Gap	(11) Watts Poverty Index	(12) -HDI
Trade Freedom	-0.2556***	-0.0922***	-0.1345***	-0.0028***
Population Growth	5.4858***	2.2205***	3.2734***	0.0421***
GDP per Capita	-0.0001***	-0.00004***	-0.00006***	-0.000005***
Gov. Exp. On Educ.	-1.1461***	-0.3455***	-0.425048**	-0.0036***
Constant	30.0808***	10.267***	14.5422***	-0.4574***

*, **, *** indicate significance at 0.01, 0.05, and 0.10 levels respectively.

4. Conclusion

Fight against poverty has made an important progress in the last four decades. The population living in extreme poverty has shrunk significantly. But, a significant percentage of the world population still lives in poor conditions. Freedom, especially in developing countries is a catalyzer to overcome poverty. Interaction between economic freedom and the institutions, means of production, and resources can help society to prevail in the fight against poverty. However, economic freedom alone might not be enough to solve the problem. Sen's four types of instrumental freedoms; political, economic, and social freedom, security and protection (Moreira, 2003) must work in harmony.

In most of the countries, except authoritarian governments, economic freedom simultaneously develops with other types of freedom. Although, in developing world the case is different, political liberties and economic liberties develop at the same time in the western democracies (Quibria, 2003). So, expecting a negative relationship between economic freedom and poverty is natural. Analyses show that economic freedom has a negative impact on the poverty based on the data between 1995 and 2015. Both business freedom and trade freedom negatively affect poverty level as well. On the other hand, population growth stimulates poverty. GDP has a statistically significant negative effect on the poverty level. But its magnitude is so small to be economically significant. Governments' expenditure on education is effective in the fight against poverty. However, economic freedom may increase schooling so the government expenditures on education as well.

Although a parallel finding is expected, other types of freedom could be used as independent variables for the external validity of the findings. Different country classifications, such as political regime, could be used to form country samples. This is essential to test if democracy has any impact on the effectiveness of the economic freedom in the war against

poverty. Further studies would complete those missing parts of this research.

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