

## **Economic Freedom – The cause of Equality or Inequality?**

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### **Abstract**

Over the past couple of centuries there have been substantive changes in policies and institutions either in favor or against economic freedom. The breaking point was year <1759> when Adam Smith's one of the most influential works was released: "The Theory of Moral Sentiments", where he developed the concept of an "Invisible Hand" for the first time.

From that period, free market economy and globally, economic freedom became major debating topics both for economists and politicians. The questions about economic freedom are often linked with issues like economic development, income inequality, government size, market economy etc.

The aim of our article is to answer the main questions about economic freedom, whether it narrows the gap between "rich and poor" or not, can we discuss economic freedom as the fair economic system, or how is fairness understood between different social classes.

We will use Gini coefficient and the index of economic freedom for calculating relationship between economic freedom and income inequality. Econometric apparatus will give us opportunity to assess whether the link between above mentioned variables is strong or weak. At the end research will lead us to the most hidden parts of free market economy.

**Key Words:** Economic Freedom, Income Inequality, Gini Coefficient, Economic Growth.

**JEL Codes:** C40; D63; D40; E02.

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## 1. Introduction – Understanding Economic Freedom

*Development can be seen ... as a process of expanding the  
real freedoms that people enjoy – Amartya Sen*

*A policy of freedom for the individual is the only truly progressive policy – Friedrich Hayek*

Nowadays, the world holds great awareness of the importance of economic freedom to gain sustainable economic development. In a free society, people are free to choose to go to the college or drop out, work hard or rest more, save for retirement or spend every penny they make. These choices lead people to where they wind up in the income distribution. Free market gives an equal opportunity to everyone to succeed on their own effort.

Capital, labor, entrepreneurial skills and so forth seek the highest returns possible from employment at their highest valued uses only in the framework of a free market.

Liberals mostly argue that the best path to prosperity is the path of freedom, which means letting individuals decide for themselves how best to achieve their goals.

In practice, every country has its own unique way towards development, which includes different cultural, historic or social factors, but there are also some fundamental characteristics which are common to all of them. Take a look on the nations with higher degrees of economic freedom, you will find out that they tend to capitalize more fully on the knowledge and ability of all individuals in society. Economic freedom generates dynamic economic growth and promotes innovation through efficient allocation of resources.

## 2. Body of Paper – The Quality of Modern Equality

*A society that puts equality (in the sense of equality of outcome) ahead of freedom  
will end up with neither equality nor freedom. The use of force to achieve equality  
will destroy freedom, and the force, introduced for good purposes, will end up in the  
hands of people who use it to promote their own interests –*

*Milton Friedman and Rose D. Friedman*

Generally, equality is defined as the state of being equal, especially in status, rights, or opportunities. Every individual should have an equal opportunity to make the most of their talents and no one should have poorer life chances because of where, what or whom they were born, what they believe or whether they have a disability. Though, equality is often misunderstood.

Let us discuss the misunderstanding of the term “equality” on the example of two different economic systems: capitalism and socialism.

The scope of government intervention in the economy is the basic difference between these two models. The capitalist economic model drives innovations and forces the freedom of choice, resulting in either success or failure. On the other hand, socialism advocates that the

means of production, distribution and exchange should be owned or regulated by the community as a whole. The socialist-based economy incorporates elements of centralized economic planning, utilized to ensure conformity and to encourage equality of opportunity and economic outcome.

Firstly, let us discuss how free market works: all the prices for goods and services are determined by demand and supply. There should not be any limits to the amount of freedom granted to each individual with a free market operating, this is usually tempered by stating that absolute freedom of action stops exactly when it would reduce the freedom of others.

Independence and self-respect are invaluable contributors to human dignity and equality.

On the other hand, socialism is based on the public ownership of the means of production. In a socialist system the authority of taking decisions about production and distribution is held by the government. It determines output and pricing levels of all goods and services. Socialists contend that shared ownership of resources and central planning provide a more equal distribution of goods and services what leads to more equitable society.

There are a lot of arguments against or in favor of each economic system's understanding of the term 'equality'. The most important thing about them is to define which one is more fair, because fairness is the thing that really matters.

So, we got equal opportunities versus equal outcomes. Your choice in this case depends on your philosophy or ideology of understanding how this world should run.

### **3. Rethinking the Paradigm**

In this chapter we will rethink the paradigm about inequality in its most economical understanding. As it was mentioned above, socialists argue that socialism leads to outcome equality, while free market advocates say that capitalism strengthens equality of opportunities. In economics, the Gini coefficient (sometimes expressed as a Gini ratio or a normalized Gini index) is a measure of statistical dispersion intended to represent the income or wealth distribution of a nation's residents, and is the most commonly used measure of inequality.

Let's briefly define the Gini coefficient (or Gini index) and then analyze statistical data. The Gini index is a statistical measure of distribution. It is often used as a tool of defining economic inequality and measuring income distribution. The coefficient ranges from 0 to 1, with 0 representing perfect equality and 1 representing perfect inequality (for analytical understanding we will use 100% scale).

It means, that in socialist countries the Gini Coefficient should be close to 0, and much less rather than in free market economies. Our purpose is to show the difference between free market economies and socialistic countries in case of income inequality.

The data about economic freedom was gathered from the official website of the Heritage Foundation and the data about Gini Index was gathered from the World Bank. Unfortunately, there is no comprehensive data about Gini index for all countries (especially socialistic ones). Due to this problem, for our purposes we picked the year 2012, as it is the only year, where the data was given for both variables and every country we picked. As there are not many socialistic countries in a modern world, and the statistical information (about Gini Index) is not provided for some of them, there were left only 6 possible countries for our analysis: Bangladesh, China, India, Portugal, Sri Lanka and Vietnam. There was absolutely no information about Cuba, People's Democratic Republic of Korea, Guyana etc.

On the other hand, we picked 7 freest economies of the world and tried to compare them to above mentioned countries. Unfortunately, the Gini Index data was not fully provided for all of them (e.g. absolutely no information about Hong Kong, Singapore, New Zealand etc.). Due to this problem we picked other 7 countries from two categories (Free and Mostly Free) of heritage foundation economic freedom index: Estonia, Finland, Ireland, Lithuania, Netherlands, Switzerland and Luxembourg.

The data showed that socialist countries' average in Gini income equals 36.73, while economic freedom index averages 55.27 points.

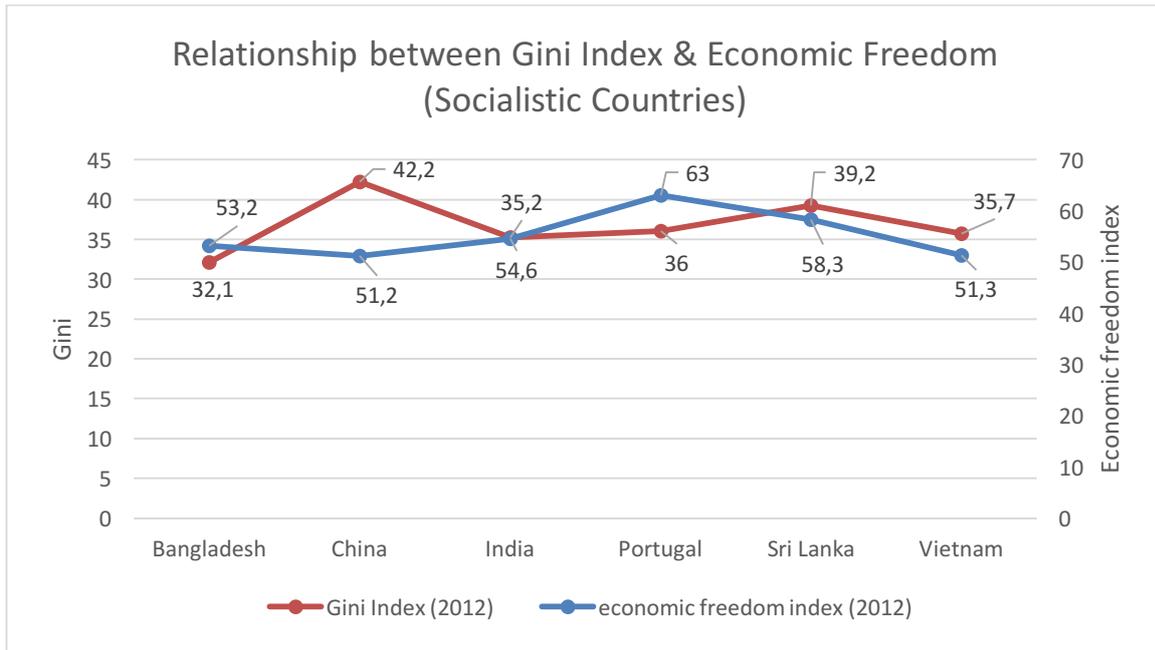
On the other hand, countries from "freest and mostly free" category of the economic freedom index averaged 31.59 points in Gini index and 74.69 points in economic freedom.

Above mentioned numbers prove, that efficiency of income distribution is gained not by centrally planned economic system but giving economic agents equal opportunities to succeed.

**Table 1.**

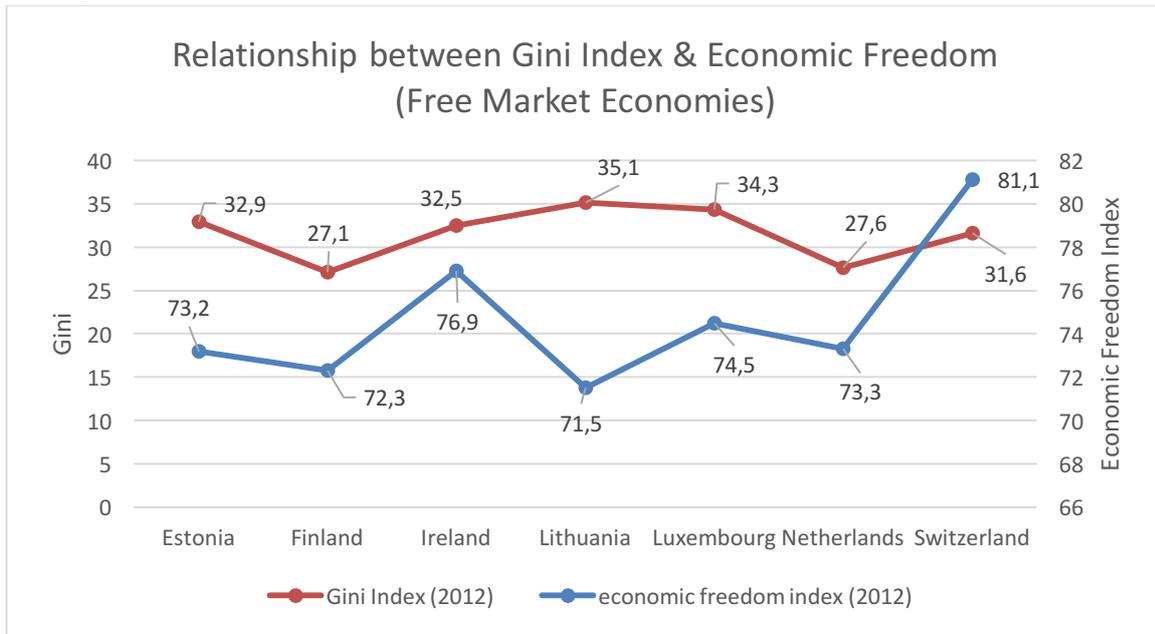
Country	Gini	Economic Freedom
Bangladesh	32.1	53.2
China	42.2	51.2
India	35.2	54.6
Portugal	36.0	63.0
Sri Lanka	39.2	58.3
Vietnam	35.7	51.3
Estonia	32.9	73.2
Finland	27.1	72.3
Ireland	32.5	76.9
Lithuania	35.1	71.5
Luxembourg	34.3	74.5
Netherlands	27.6	73.3
Switzerland	31.6	81.1

**Figure 1: Relationship between Gini Index and Economic Freedom Index on the example of Socialistic countries**



Source: World Bank, Heritage Foundation

**Figure 2: Relationship between Gini Index and Economic Freedom Index on the example of free market economies.**



Source: World Bank, Heritage Foundation

#### 4. Conclusions

From the very basic principles of economics we say that people respond to incentives. Socialist planners do not take in their account so called “incentive problem”, how can you incentivize laborers to accept dangerous or uncomfortable jobs without violating the equality of outcomes? Nobody dreams about becoming for example a sanitation worker, the only thing that makes people to take those jobs are the incentives.

In the 3<sup>rd</sup> paragraph we rethought the paradigm and questioned what is more fair, giving people equal opportunities or equal outcomes? What will lead us to the progress?

Howver the study showed that countries which are regulating equal otcomes get higher inequality rather that those who do not.

Free market drives the most rational incentives to the whole society, it gives a picture of the reality and then you decide where to go or what to do. We should understand, that a worker’s value comes from what he or she produces and is not connected to the amount of time he/she works.

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