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Capitalism and freedom?

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ABSTRACT

This essay tests Milton Friedman's conjecture that capitalism is a necessary condition for political freedom. For the decade around 2000 indices of the degree of capitalism and the degree of political freedom are highly correlated and provide plausibility for Friedman's conjecture. In looking at changes over time in the nineteenth century, however, the analysis refutes Friedman's conjecture. These apparently contradictory results are reconciled by showing that both capitalism and freedom are related to such variables as the educational level of the population so that, although not causally tied, they are correlated in a cross-national comparison.

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1. Introduction

Over the last two centuries, as we all know, capitalism has spread throughout the world and, at the same time, the level of political freedom has risen as well, albeit unsteadily. The relationship between these two trends has been, for the most part, a relatively closed topic for serious analysis¹ since Friedman (1962, pp. 9–10) wrote his oft-cited words when analyzing the “intimate connection between economics and politics” and the fact that “only certain combinations of political and economic arrangements are possible”: “Economic freedom is also an indispensable means toward the achievement of political freedom. . . Historical evidence speaks with a single voice on the relation between political freedom and a free market. I know of no example in time or place of a society that

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¹ A number of analyses have, however, examined the relationship between income and freedom, and their results are relevant to this study since the degree of capitalism and the level of economic development are related.

has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organize the bulk of its economic activities. . . History suggests only that capitalism is a necessary condition for political freedom. Clearly it is not a sufficient condition.”

These ideas, also argued by others (e.g., Hayak, 1944, pp. 69–70), raise a number of theoretical and empirical difficulties.

Certain theoretical problems arise if we consider the possibility of joint causation, a likelihood Friedman (1991) raises in his Smith Center lecture that “while economic freedom facilitates political freedom, political freedom, once-established, has a tendency to destroy economic freedom.”² Moreover, it is unclear about the time-period that must be taken into account to understand these ideas.

Other empirical problems in examining these ideas also arise. Capitalism and freedom are correlated with a number of common variables, so that separating their joint impact is difficult. Country fixed effects also muddy the relationship. Finally, although Friedman speaks of “historical evidence,” he does not actually supply any. Difficulties arise in knowing what he means by a “large measure of political freedom” and quantifying either capitalism (which he equates with economic freedom) or political freedom in a way to allow empirical investigation. Indeed, obtaining the proper data for such an analysis is probably the most important reason why the relationship between capitalism and freedom has been neglected in the literature. Ideally we would like a large panel study of nations reaching back several centuries and offering data for both concepts, but, unfortunately, such an extensive data set does not currently exist.

This essay attempts to pin down the relationship between capitalism and freedom and to extract some stylized facts to serve as a more solid foundation for analyses of the relationships between these two variables, which are so critical for our understanding of how the economic system works. It starts, therefore, with a clarification of capitalism and political freedom and shows how they can be quantified. For a cross-section comparison in recent years, I use a relatively complete measure for both concepts; for the time-series analysis using nineteenth century data, less satisfactory measures must be used for both and are described later in the essay.

For the cross-country comparisons I search for exceptions to Friedman’s conjecture in a straightforward manner and show that capitalism and freedom are positively and significantly related in 2000, with only few notable exceptions. Then I turn to the time-series data for the nineteenth century and find that such a relationship does not occur. This result casts grave doubt on any causal connection between capitalism and freedom and suggests that the cross-section relationship is due to country specific variables (as is the case of the relationship between income and political freedom, as shown by Acemoglu et al., 2008) and to the fact that both capitalism and political freedom are related to per capita GDP, the educational level of the population, and other factors.

2. Conceptual clarifications and quantification

Capitalism has a multitude of definitions, but many are difficult to quantify. Nevertheless, by using a series of indicators, each standardized to have a mean of zero and a standard deviation of one, the available indicators can be easily combined so that for each country we can determine the degree to which it approaches a pure capitalist system. The same approach is also used to determine the degree of political freedom. Thus, both cross-section and time-series comparisons can be made between the two variables for recent years.

Since capitalism is a structure, it is important in calculating the index to avoid selecting elements that reflect, for instance, particular policy instruments or indicators of economic success, such as stable prices and exchange rates, economic efficiency, or equity. This is because many of these policies and results appear in both capitalism and other types of economic systems. In some cases, unfortunately, such as determining the amount or degree of governmental economic intervention in

² This claim, which seems to muddy his earlier argument, was made in the context of his comparison between Hong Kong (which, he claims, had economic, but not political freedom) with India (which, he points out, had political freedom but not economic freedom). The Indian example also contradicts his thesis that economic freedom is indispensable for political freedom.

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