High School Winner Fraser Institute 2009 Essay Contest

Economic Freedom & Poverty

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When William Easterly published his research comparing the impact of foreign aid and increased economic freedom on the long-term economic circumstances of countries, critics condemned his finding that aid mechanisms were largely failures in their present form and derided his call for more market capitalism (Lawson, 2002). Yet, further analysis of the relationship between economic freedom and poverty rates did reveal much empirical evidence indicating that the poorer agents in freer market systems enjoyed substantially higher living conditions than those in centrally planned economies (Gwartney et al., 2008).

Part of the reason, it seems, lies in the increase in the overall welfare of a country's residents due to freedom in the economy. Therefore, reforms that seek to liberalize markets in the less developed countries should lead to a decline in poverty levels. While government intervention may still contribute to poverty reduction through the establishment of basic economic security and a meritocratic environment, the need for a free economy should form the more crucial aim of such stratagem.

The reason for poverty, a term associated with the lowest income bracket and a deficiency of many basic needs (Gwartney et al., 2008), stems from the basic problem of scarcity. Since there are limited factors of production and unlimited wants, the poor are those who get the least of the national output from economic activity. The role of any economic system is to allocate these scarce resources between their alternative uses and to do it well. The free economy, with its markets, uses the price mechanism to do this, emphasizing pursuit of self-interest as the main driving force behind decisions. Economic agents may also own private properties and have freedom of choice as well as enterprise. When working properly, these markets are also characterized by their low barriers to entry due to high competition and the absence of externalities. Here, the effectiveness of market liberalization in easing poverty levels is assessed from a macroeconomic viewpoint, looking mainly at areas of fiscal, monetary, and supply-side policy, albeit with welfare economics when needed.

The most prominent way in which a free market economy may moderate poverty levels is through sustained economic growth throughout a country. Such growth entails an increase in the productive capacity in an economy. A general explanation for observed trends of rapid growth after the opening up of an economy, such as that of Singapore or Hong Kong, is that a free market economy eliminates the costly bureaucracy that is needed to allocate resources otherwise. When the price mechanism is in place, prices reflect the types of goods in demand and amount of resources required for their production. Markets tend to a dynamic equilibrium where quantity demanded is equal to that supplied. Hence, manual methods of addressing resource allocation issues, including price controls and output quotas, and their administrative costs are not necessary in the free economy. Hence, a free market economy leads to less wasteful use of resources which may then be redirected to useful output.

With free trade there is more exchange between buyers and sellers in free economies. They swap products they make for those they have less comparative advantage in, and thus the terms of their trade must be mutually beneficial. In a free market, this stops only when people become worse off when they trade. Thus, the skills of the

poorest segments of society are more transferrable in a free economy, as more people may need their services, and this increases their income levels.

Another reason for economic expansions in free market economies is the resulting growth that is due to the high efficiency of the price mechanism in allocating resources. As there is much competition in the free market, firms have an incentive to lower prices and to maintain their profit-maximizing goals. Because their total costs must be kept low, firms will necessarily lower costs until they are productively efficient. Firms will also lower prices to be competitive until the price for the last unit is equal to the marginal cost of that unit. Thus, firms will reduce their unemployment or underemployment of resources in an economy, because the more efficient the firms are, the more profits they will get. This leads to actual growth in the economy, with aggregate demand rising as more factors of production can be employed. A growing economy will provide for more people and poverty may be alleviated.

Evidence of the positive relationship between economic growth and poverty reduction is abundant. For example, Botswana, with increased government investment, enterprise, and spending, had a reduced GDP growth rate from 2005 to 2008 (Grube, 2008, Oct. 8). Governments, too, have their own objective of maximizing electorate wishes and may be influenced by political lobbies. Likewise, they do not have full information about consumer demand and may have time lags in implementing policies. As such, countries that have done away with excessive government interference, such as Ghana, have reaped the benefits of higher economic growth, and through it, increased standards of living. Mauritius has also had a poverty rate of less than 10% since diversifying and privatizing important industries.

Economic growth tends to decrease destitution among a nation's population by allowing more people access to higher material living standards and qualities of life. The problem of scarcity becomes less acute as, on average, more people can afford essential health care services and education, thus reducing the deficiencies of the poor. A rapidly growing economy can also afford to be more generous to the disadvantaged, as the poor can be made better off without the rich being worse off due to increases in overall income levels. Since 1981, 500 million people have been lifted out of poverty in China due to rapid economic growth (Lardy, 2002). Although this redistribution may require government intervention in the form of a tax structure, the cause of the growth was primarily a free economy, as explained above.

Therefore, reforms may enable governments to decrease the poverty rate. A critical example of why reforms are needed can be seen in Zimbabwe which, among other things, raised its money supply, leading to hyperinflation and an unstable currency. Uncertainty resulted in the withdrawal of foreign direct investment, an economic recession, and eventually widespread famine and disease due to poverty. Since other currencies are being used (a small step to reform), investment may re-enter as the economic climate becomes more stable, although this will be affected heavily by a lack of business confidence in the tattered country.

Zambia's privatization of copper mines (Grube, 2008, Oct. 8) since 2006 has also lead to surges in economic growth patterns as private firms seek to increase their revenue. The

loosening of business regulations has also contributed to the increase in productivity, leading to lower prices for the copper-refining industry there and more output for trade, especially with China. Since there is a wider share of ownership, more people have greater stakes in the economy, and thus there is economic growth and decreased poverty. A new floating exchange rate also allows for the devaluation of Zambia's currency in order to correct the deficit incurred by heavy debt. This allows capital reinvestment to return (Fundanga, 2007).

Detractors might argue that economic growth spurred on by free markets will be unevenly distributed. However, data from Adams (2003) shows that economic growth does not affect inequality much, and that the results of growth are often spread to even the poorest sectors. Yet, larger businesses and unions may gain more at the expense of the others and thus relative poverty may still remain while absolute poverty decreases. Other strategies that are cited often fail to recognize this, calling instead for increased regulation. But the poor have more income in free and rich nations than in unfree ones (Lawson, 2002).

Economic activities should be based primarily on a free market framework

Time lags are also an important concern here. It can take a long time for a nation to realize benefits of growth and lowered poverty. There may be hope in some countries that once economic growth sets in, a high multiplier and accelerator may increase the potential of these economies to offset implementation time costs.

There is also the evident need for intervention where there are monopolies or oligopolies in poverty-stricken countries. Supernormal profits may not be used efficiently for research and development purposes, and it is often the more established firms that tend to increase in size and power, which can lead to increases in inequality after deregulation. Governments need to correct for inefficiencies that limit the extent of macroeconomic growth through lump sum taxes on goods, as well as inefficiencies that are associated with negative externalities, such as pollution, which disproportionately affect the more defenseless poor.

As Easterly (2001) has mentioned, poor nations do grow faster than rich ones once economic freedom has been established. Although there is a need for some form of a mixed economy, depending on the unique circumstances of a nation, economic activities should be based primarily on a free market framework to reap the benefits listed here. Opening up an economy is definitely an effective way to increase living standards and reduce hardship.

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