Economic Freedom, Money and Happiness – Why Deregulation Matters Beyond its Wealth Enhancing Effect

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Why should we care about the relationship of economic freedom and life satisfaction?

For a long time, the main interest of politicians, individuals and economists has been to analyze the determinants of growth and income. Due to the relative scarcity of resources this is quite a natural starting point: what accounts for the difference between high- and low-performing countries? Why did some countries with a rather low capital stock after World War II face high growth rates, while other countries in seemingly better starting conditions fail to expand? The quality of institutions has been found to be one of the most important factors for long-term growth and development. Numerous contributions show that a market-friendly institutional environment has almost certainly a strong and direct positive impact on income levels and on long-term growth through incentives (for example, Knack and Keefer 1995; Hall and Jones 1999; de Haan and Sturm 2000; Olson, Sarna and Swamy 2000; Pitlik 2002; Dawson 2003; Gwartney, Holcombe and Lawson 2006; Justesen 2008; Rode and Coll 2012; see also surveys by Berggren 2003, de Haan, Sturm and Lundberg 2006 and Doucouliagos and Ulubasoglu 2006).

In that respect, economic research has provided overwhelming empirical evidence that economic freedom and deregulation have a positive impact on growth and income. The concept of economic freedom as a whole emphasizes the role of freedom of personal choice, voluntary exchange in markets, freedom of entry and competition, and protection of person and property. A prominent and widely-used indicator of economic freedom has been developed by the Fraser-Institute (Gwartney, Lawson and Hall 2012). The Economic Freedom of the World (EFW) summary index estimates the overall market-friendliness of a bundle of five policy areas on a 0–10 scale, whereby higher values are associated with more economic freedom.

Area 1 relates to the size of government. High government consumption, high transfers and subsidies, high tax rates and the extensive occurrence of state-owned firms impede the economic freedom of individuals. Area 2 measures the quality of the legal system and the protection of property rights. Economic freedom requires secure property rights and the legal enforcement of contracts by impartial courts. Sound money (area 3) is important as modern free market economies are not barter economies. Therefore, both persistently low inflation rates and free access to foreign currencies guarantee low transaction costs and foster trade. Area 4 covers restrictions on international trade, such as tariffs, non-tariff trade barriers, capital controls and regulations of the movement of people. Area 5 captures regulations of credit markets, labor markets and business regulations, which hinder all kinds of economic transactions. The comprehensive index score is simply an equally weighted average of liberalization scores in the five policy areas. Data are derived from various international sources, and in total the summary index comprises 42 distinct variables.

Figure 1 clearly illustrates a positive relationship between economic freedom, as measured by the EFW summary index, and income (PPP converted per capita GDP at 2005 constant prices, in logs), taken from the Penn World Tables. Notwithstanding possible reverse causalities, a higher GDP per capita is associated with greater economic liberties. The EFW summary index as a single explanatory variable explained 45 percent of the variation of GDP per capita in 122 countries in 2010.

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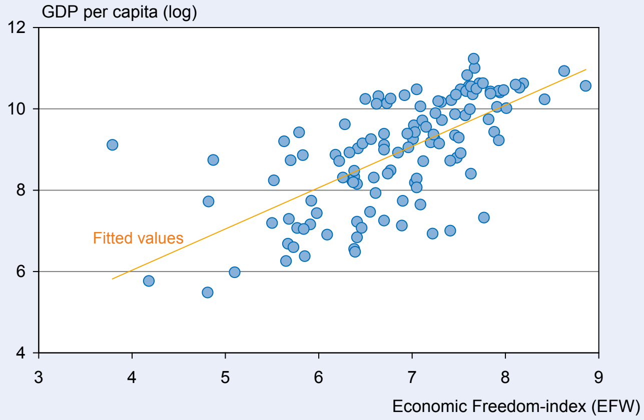
Figure 1

GDP per capita and economic freedom in 2010



Source: Authors' calculations based on Gwartney et al. (2010) and Heston et al. (2012).

Carlsson and Lundström (2002) look at each dimension of the economic freedom index separately. They find a positive correlation between growth and the use of markets, the freedom to use alternative currencies, the security of property rights and the freedom of exchange in capital markets; whereas the size of government and the freedom to international trade are negatively correlated with GDP per capita growth.

GDP, however, is often seen as an imperfect, flawed and even misleading measure of welfare. In addition, improved material well-being in industrialized societies have changed people's attitudes towards income. Post-materialistic societies give more weight to non-pecuniary aspects of the economic order. Together with the recurrent critique of GDP, this value change is partly reflected in attempts to look for alternative indicators measuring quality of life like, for example, the work of the Stiglitz-Sen-Fitoussi Commission (2009). In the same vein, the German Bundestag's "Study Commission on Growth, Well-Being and the Quality of Life" proposes a set of indicators that adds information on the social (employment, education, health and freedom) and ecological status of the society to the usual growth measures (German Bundestag 2010).

Research on life satisfaction likewise employs a broader concept of individual well-being that makes it possible to identify the non-pecuniary effects of economic environments and events on the subjective well-being of individuals. Many social surveys ask respondents about their overall life satisfaction. The World Values Survey, for example, asks the question "All things considered, how satisfied are you with your life as a whole these days?" on a scale from 1 to 10. Other studies (for example, General Social Survey, European Social Survey, German Socio-Economic Panel, British Household Panel Survey) employ similar formulations, in part on a different scale. This measure covers all individual and social determinants of subjective well-being.

Research on life satisfaction identifies a whole array of factors impacting subjective well-being. In that respect, one of the most important determinants is income. On average, richer people report higher degrees of life satisfaction than poorer people. The result, that higher GDP per capita and average life satisfaction levels are correlated positively is replicated in numerous empirical studies (for example, Sacks, Stevenson and Wolfers 2013).[4] Figure 2 displays the strong positive association between per capita income and country averaged life satisfaction, based on data from the most recent World Values Survey/ European Values Study.

In a sample of 91 countries worldwide, GDP per capita accounts for almost 40 percent of the variation in average life satisfaction levels. Provided that people expect to benefit from higher average incomes caused by market-friendly policies, we also expect them to be happier in general with more economic freedom.

Nevertheless, happiness studies frequently feature policy implications recommending more government interventions instead. Unemployment is found to be detrimental to life satisfaction to a far greater degree than merely implied by the loss of income (Frey and Stutzer 2002a, 419–22). Environmental quality contributes considerably to people's life satisfaction, even if they do not report any willingness to pay to avoid damages (for example, Silva, de Keulenaer and Johnstone 2012). As a result, the economics of happiness tends to favor government interventions over market friendly policies for the sake of raising citizens' subjective well-being. The positive effects of economic freedom appear to be limited to

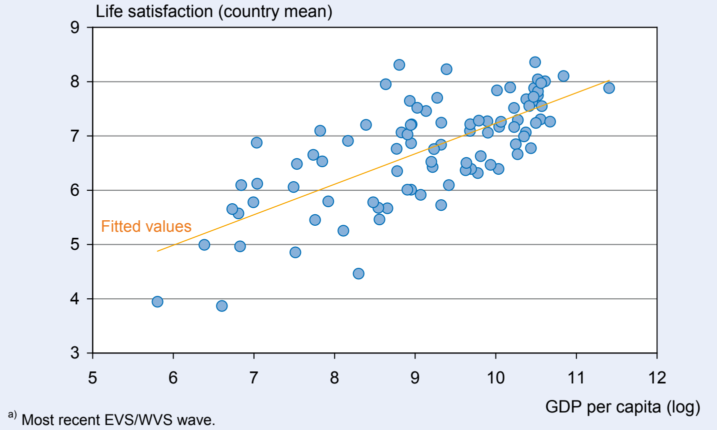
[4] Estimations using cross-sectional micro data also confirm a positive correlation between income and life satisfaction. However, simple OLS-estimations suggest a rather weak relationship (Frey and Stutzer 2002a, 408–418). A few studies address the potential endogeneity by using natural experiments (Frijters, Haisken-DeNew and Shields 2004; Gardner and Oswald 2007) or an instrumental variable approach (for example Luttmer 2005; Powdthavee 2010).

the benefits that are incorporated in the price system and enhance people's income. Regulations and restrictions of economic freedom may reduce available resources and disposable income; yet, in addition to the potential correction of market failures, regulatory activities still seem to provide additional non-pecuniary benefits.

This kind of reasoning systematically overestimates the welfare effects of government interventions and underestimates the real advantages of economic freedom and deregulation for individual well-being. A more balanced consideration of economic freedom, therefore, should examine both the pecuniary and the non-pecuniary effects of such government intervention on life satisfaction.

Figure 2

GDP per capita and life satisfaction[a)]



[a)] Most recent EVS/WVS wave.

Source: Authors' calculations based on Gwartney et al. (2010) and Heston et al. (2012).

Pecuniary and non-pecuniary effects of (de-) regulation and economic freedom on life satisfaction

Economic freedom can have both positive and negative effects on individual life satisfaction. Some of these effects are related to individual income: On the one hand, economic freedom is conducive to prosperity in general. Individuals can, on average, expect to benefit from productivity gains and to earn more money on average in freer markets. On the other hand, risk aversion may put an individual's subjective perception of economic freedom into perspective. One might associate economic freedom with higher volatility of income streams and business cycles. Free markets could amplify economic instability as it promotes innovative activity and creative destruction.[5] Given such a relationship between income volatility and economic freedom, risk lovers would face extra gains from freer markets because economic freedom creates extra opportunities for gambling. On the contrary, risk-averse individuals prefer constant and secure income streams, even at the cost of a lower expected lifetime income.

Other explanations for non-pecuniary effects relate to ideological beliefs and the procedural utility of institutions. Economic freedom contributes to freedom of choice, and people may feel happier if they have more control over their own business. Many people, however, also favor governmentally imposed restrictions of choice, in cases where they believe that this promotes a social goal such as the diminution of inequality or an improvement in the environment. Voters sometimes dislike competition and free markets, as they directly benefit from regulations that generate and protect rents. Such self-interest cannot always be separated from ideology, as ideological convictions often shape perceived subjective self-interest and attitudes towards economic policy issues (Pitlik et al. 2011). On a different level, not all individuals believe that they stand to benefit from economic freedom, even if they do so from an 'objective point of view'. A priori, it is therefore unclear whether more economic freedom has a positive effect on the subjective well-being of people who have a different model of the world in mind.

Increasing freedom of choice may also have both positive and negative effects on subjective life satisfaction. It promotes subjective well-being as it makes it possible to link economic success with personal endeavor. Having more alternatives to choose from may also be of value in itself. Instead of merely looking at the outcome of an economic activity, people are likely to derive some procedural utility from fair institutions and procedures (Frey and Stutzer 2002b). Again, this very much depends on personal normative beliefs and on what kind of economic order is seen as "fair". People who live in a society with fair procedures (according to their own moral framework) can be expected to be more satisfied with their personal outcomes in terms of income and social status.

[5] From a theoretical perspective, however, the relationship is not clear. Weak institutions and a lack of economic freedom make contractual arrangements insecure. As a result, the cooperation of market participants may be more susceptible to exogenous shocks and therefore macroeconomic instability could rise (Dawson 2010, 189).

Choosing freely among a great number of alternatives, however, can also be costly und thus unattractive in itself (Veenhoven 2000; Schwartz 2000). Some people feel unable to cope with the complexity of decision making, especially if decisions have far-reaching consequences for their own life. If individual decision-making involves high psychological costs stemming from market-driven uncertainty, more detailed regulations and stronger restrictions of individual freedom appear as a 'happiness enhancing policy' option, provided that interventions reduce the choice set, give orientation and simplify decision-making. Individuals have very different perceptions of how much control they have over the outcome of economic decisions. Correspondingly, they value freedom of choice differently. Those who believe that outcomes are driven primarily by external factors that are beyond their control have a lower interest in large choice sets compared with those who think that their own choices and actions determine outcomes. Non-pecuniary effects may arise if people's ideological positions are taken into account. Depending on an individual's ideological position, s/he subjectively appreciates freedom regardless of being in a better economic position or not.

Studies on the country level

Several empirical studies address the question of how economic freedom affects life satisfaction using cross-country data at an aggregate level. Veenhoven (2000), for example, reports that economic freedom is positively correlated with happiness and life satisfaction, whereas the relationship between subjective well-being and political freedom is less clear. Moreover, he finds that economic freedom has a relatively large effect in poor countries, whereas political freedom tends to dominate in rich countries. Later studies confirm these results.

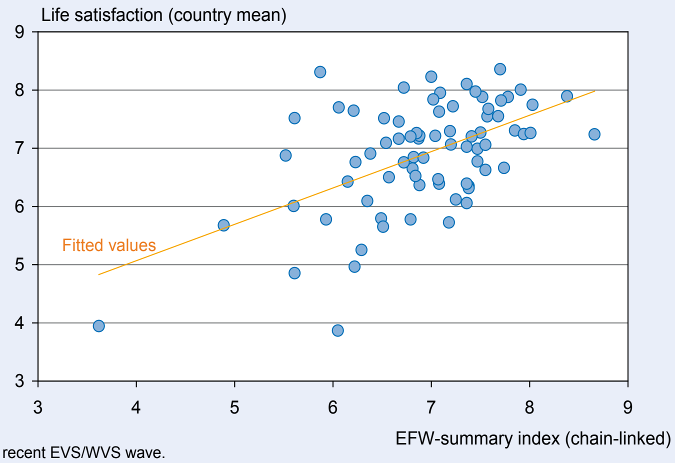
Figure 3 shows the positive relationship between economic freedom and life satisfaction using data from the fifth wave of the World Values Survey and the Economic Freedom of the World-index from the corresponding years. If one controls for GDP or growth, the positive effect of economic freedom on well-being is considerably smaller, indicating that the positive relationship of economic freedom to life satisfaction can partly be explained by the growth-enhancing channel. Nevertheless, a significant and positive impact remains (for example, Ovaska and Takashima 2006). This result is in line with the idea that economic freedom contributes to life satisfaction beyond the narrowly defined pecuniary effect.

One might be concerned that these results suffer from reverse causality and cannot be interpreted as causal for this reason. Rode (2012) asks if economic freedom contributes to higher life satisfaction, or if societies with happier citizens vote for a more economically free market-order. He uses average national consumption of cigarettes per capita and average national alcohol-use disorders rates as an instrumental variable for life satisfaction, as this index explains life satisfaction levels, but should be independent from a country's institutions. Economic freedom is instrumented by dummy variables for a country's legal origin, which should have no direct impact on life satisfaction. He finds that economic freedom can be confirmed as having a positive effect on life satisfaction, but not the other way around.

Some papers document research into singular components of economic freedom. No clear consensus has been reached yet in this field. While Veenhoven (2000) finds no evidence for the hypothesis that the size of the welfare state is related to a country's average life satisfaction level, Bjørnskov, Dreher and Fischer (2007) show a decreasing effect of government consumption on life satisfaction. Studies that focus on single instruments of the welfare state (like unemployment insurance, for

Figure 3

Life satisfaction and economic freedom[a)]



[a)] Most recent EVS/WVS wave.

Source: Authors' calculations based on Gwartney et al. (2010) and World Values Survey/European Values Study.

example) find that these instruments have a positive effect (beyond the pure income effect for the addressees of these measures). Rode (2012) and Gehring (2012) use Economic Freedom of the World-data to disentangle the effects of each dimension of economic freedom separately. Both papers confirm a positive relationship between life satisfaction and areas 2–5; no effect is found for government size.

Gropper, Lawson and Thorne (2011) include an interaction term between GDP per capita and economic freedom because they argue that the impact of economic freedom on happiness may be contingent to the level of development and vice versa. In a very parsimonious estimation model, they find a positive relationship between country happiness level and economic freedom, as measured by the EFW summary index. GDP per capita also has a strong positive impact. Moreover, the well-being effect of both economic freedom and GDP per capita diminishes as the other increases, but the combined effect of simultaneously higher economic freedom and GDP per capita is positive, particularly for poorer and economically less free nations. This is also an indication that there is more to the well-being effects of economic freedom than its pure income effects.

Who benefits (most) from economic freedom?

Cross-country studies using country averages cannot capture asymmetric effects across individuals. As argued above, there are some theoretical reasons why economic freedom has different effects on different groups in society. This holds true both for income and the subjective well-being of individuals. Verme (2009) provides empirical evidence for the hypothesis that there is an intrinsic value of economic freedom for people. He shows that an individual's perceived degree of control over his/her own life course determines how individuals value freedom of choice. Moreover, perceived freedom of individual choice is a robust and strong predictor for reported life satisfaction levels.

Bavetta and Navarra (2011) combine available information on perceived personal decision-making autonomy from the World Values Survey with economic freedom data from the Heritage Foundation's Index of Economic Freedom for a worldwide sample of about 60 countries. Subjective well-being is measured by the WVS data on happiness and on life satisfaction. Bavetta and Navarra distinguish between opportunity to choose, which is reflected by the Heritage/Wall Street-index of economic freedom, and autonomy to choose. The latter reflects the survey respondents' view of the extent to which they have control over their own life. Employing a multi-level logit model for estimation, the authors find that both perceived autonomy (individual-level variable) and economic freedom (country-level variable) have a positive impact on the probability of experiencing more happiness and higher life satisfaction. Moreover, a higher degree of economic freedom not only increases the probability of happiness. An increase in perceived life autonomy also makes a greater contribution to life satisfaction and happiness, the higher the level of economic freedom in a country is. Bavetta and Navarra, however, do not control for GDP per capita and individual income positions. Thus, it is impossible to conclude directly from their analysis that economic freedom has a positive impact beyond material well-being effects.

From a theoretical perspective it is not clear, however, who benefits most from economic freedom. Redistribution obviously has asymmetric effects on donors and receivers of state transfers. Simple median voter theories predict that government size tends to be inefficiently large as the median voter's income level is below the mean income and the median voter therefore prefers to raise high income taxes and redistribute income to medium and low-income earners (Meltzer and Richard 1981). These models would be in line with the observation of large income losses and the low life satisfaction of the rich and corresponding gains in income and happiness of the poor. If one accounts for altruism of the rich, a redistribution of income does not necessarily lead to losses in terms of their life satisfaction.

Regulations and the provision of public goods may also have different income and life satisfaction effects across the population. Here, it seems less clear whether the poor or the rich benefit more from government activities. According to the standard interest group theory of Olson (1965) workers and consumers may not be in the best position to enforce their interests in the political process. Small and well organized special interest groups (for example, small industry lobby groups) with large resources are likely to be more effective rent-seekers and to be more successful in requesting regulations that are beneficial to their members. If special interest groups' regulations and government activities dominate over the social-policy oriented measures of the welfare state, large governments and highly regulated markets are compatible with high-income earners benefitting more from lower economic freedom compared to low-income individuals.

As life satisfaction may depend on individuals' attitudes towards markets, some papers explicitly account for the ideological convictions of respondents. Dreher and Öhler (2011), for example, analyse whether the self-reported political left-right-orientation has an impact on life satisfaction. They find that the individuals who describe themselves as left-wingers report lower levels of happiness than right-wingers.

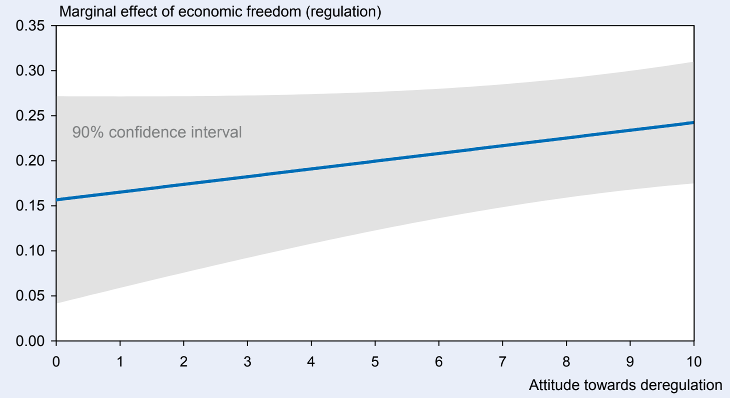
Similarly, Knoll, Pitlik and Rode (2013) account for freedom-related value statements. Some specifications show unexpected results: those who dislike economic freedom benefit most if they live actually in an economically free market order compared to self-reported proponents of economic freedom.

The study uses data from the combined dataset of the World Values Survey and the European Values Study from 1981–2008 for information on subjective well-being, individual characteristics and preferences over (de-)regulation. Individual attitudes towards economic deregulation are measured by various questions. Respondents answering that "Competition is good. It stimulates people to work hard and develop new ideas" instead of "Competition is bad. It brings out the worst in people" on a 10-point-scale are considered to have pro-market views. "Private ownership of business and industry should be increased" is also considered as a proxy for a pro-market view, whereas "Government ownership of business and industry should be increased" indicates disapproval of deregulation. Alternative proxies use information on attitudes towards income inequality and respondents' self-assessment on a political left-right-scale. Actual regulation levels are measured by the EFW-sub-index on regulation.

Controlling for a standard set of individual characteristics, GDP per capita, government size and political freedom and deregulation reveals that these country characteristics have a strong and significant impact on life satisfaction." This effect remains after inclusion of the policy preferences. Specifications with interactions of the deregulation index and attitudes towards market-friendly policies suggest that individual approval or disapproval for free markets matters. One may expect the proponents of deregulation to benefit more from actual deregulation policies. However, this relationship is confirmed only if policy attitudes are measured by opinions on private ownership (see Figure 4). Somewhat paradoxically, using left-right ideology or inequality preferences as proxies for policy attitudes, the sign of the interaction term turns negative (Figure 5).

Figure 4

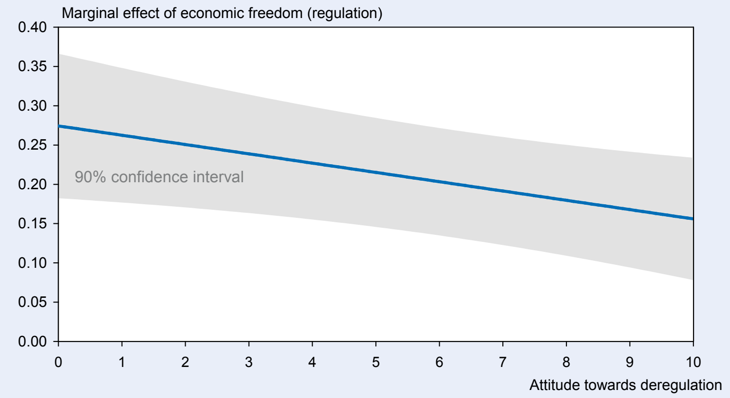
Marginal effects of deregulation of credit, business and labor markets on life satisfaction at various policy attitude levels towards privat ownership of business and industry



Source: Authors' calculations based on Knoll, Pitlik and Rode (2013), p. 918.

Figure 5

Marginal effects of deregulation of credit, business and labor markets on life satisfaction at various levels of left-right-ideology



Source: Authors' calculations based on Knoll, Pitlik and Rode (2013), p. 918.

Conclusion

For a long time economic happiness research has focused on the question: "Does money make people happy?" In recent years, some researchers have broadened the scope of this question by asking if (economic) events and situations can have effects that go beyond pure pecuniary effects. Periods of unemployment are detrimental for subjective well-being to a far greater extent than the loss of labor income and the reduced consumption levels of the unemployed. Institutions matter for two reasons: (1) Free markets are an important determinant of growth, thereby contributing to life satisfaction via higher income levels. (2) In addition, ideology, risk aversion and freedom of choice as a value in itself may explain why positive or negative effects on life satisfaction remain even after controlling for the individual income position. These non-pecuniary effects seem to be unequally distributed within societies. Further research is needed to address endogeneity issues and to fully understand some of the paradoxical results that have emerged from previous empirical studies.

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