



# Economic Freedom: Indonesia Underperforms

**P**OVERTY IS A SCOURGE WHICH LEAVES THOSE IN ITS grip to lead lives that are brutish, dangerous, and short. Economic growth is a poverty elixir. From the works of the earliest economists — Richard Cantillon (1680–1734), Adam Smith (1723–1790) and Jacques Turgot (1727–1791) — we have learned that economic liberty is a crucial precondition for sustained economic growth.

Metrics which serve as proxies for economic freedom have been developed and are widely used. For example, The Heritage Foundation and The Wall Street Journal jointly publish an annual volume, *The Index of Economic Freedom*, which now incorporates 157 countries. The *Economic Freedom of the World*, which includes 130 countries, is published by Canada's Fraser Institute. And the World Bank issues an annual, *Doing Business*, which reports on the ease of doing business in 175 countries. Data from these annuals on economic freedom show that there is a strong positive linkage between measures of economic freedom and economic growth.

To improve a country's economic freedom score, and in consequence ratchet up its economic growth rate, governments must make credible commitments to implement liberal economic reform programs. A commitment is made more credible the more one binds oneself to the achievement of an objective. At the extreme, on a battlefield when a commander orders his troops to burn all bridges behind them to cut off avenues for their retreat, his enemies will be confident that his intentions are to fight to the last man.

A credible commitment is something that many politicians are reluctant to entertain. That said, there have been numerous

cases in which politicians have made credible commitments to adopt liberal economic policies. These have resulted in dramatic increases in economic freedom and prosperity regardless of the type of political regime or stripe of the political party that embraced reforms.

Several examples support this conclusion. In 1965, Singapore gained its independence when it was expelled from a two-year federation with Malaysia.

At that time, Singapore was backward and poor — a barren speck on the map in a dangerous part of the world. Its population was made up of a diverse group of immigrants with a history of communal tensions. However, Singapore had a leader with clear ideas on how to modernize the country.

Lee Kuan Yew ruled out passing the begging bowl and accepting foreign assistance of any kind. Instead, he embraced stable money and first-world competition. Stable money was initially achieved with a currency board. Competition was attained by light taxation, minimal regulation of business

and free trade. In addition, Lee Kuan Yew insisted on personal security, public order and the protection of private property. To accomplish his objectives, his central principle for organizing a "small" government was to run a tight ship with no waste or corruption. To implement that principle, Lee Kuan Yew appointed only first-class civil servants and paid them first-class wages.

Today, Singapore is one of the freest, most flexible and prosperous economies in the world. Indeed, both the *Index of Economic Freedom* and the *Economic Freedom of the World* rank Singapore as the second freest economy, and in terms of the ease of doing business, Singapore is ranked first.



Hong Kong, along with Singapore, ranks as one of the world's freest economies. Indeed, it ranks first on the two most widely used economic freedom metrics and fifth in terms of the ease of doing business. Established as an entrepôt free port, Hong Kong has achieved its status as one of the freest economies in the world by making a credible commitment to stable money (via a currency board), free trade, free markets, low taxes, non-intervention and personal liberty (via the application of the rule of law).

What makes Hong Kong so interesting is that it attained its economic freedom and prosperity in an absence of democracy. Ceded by China to the British Crown in 1841, Hong Kong became a British Crown Colony — not a representative democracy. It remained a colony until July 1, 1997, when it became a Special Administrative Region of the People's Republic of China. Hong Kong illustrates that a representative democracy — while perhaps desirable — is not a precondition for the application of the rule of law and attainment of freedom in the economic sphere. On this important point, I agree with Nobel laureate Friedrich von Hayek who wrote: "Although there is good reason for preferring limited democratic government to a non-democratic one, I must confess to preferring non-democratic government under the law to unlimited (and therefore essentially lawless) democratic government."

Estonia is another country that has made a credible commitment to liberal economic reforms. Estonia — where I witnessed the birth of such a preeminent commitment — merits attention because it has the highest economic freedom ranking of any former communist country. It ranks twelfth on both of the standard measures for economic freedom.

**IT IS WORTH STRESSING THAT THERE IS OFTEN A WIDE GAP BETWEEN A GOVERNMENT'S RHETORIC AND THE REALITY OF ITS REFORMS.**

The USSR State Council conceded Estonia's fully independent status on September 6, 1991. The economy was in shambles and the Estonians were left to use the hyperinflating Russian ruble. At the invitation of the Estonian parliament, in a presentation on May 5, 1992, I laid out a blueprint to replace the Russian ruble with a freely convertible Estonian kroon, linked to the German mark at a fixed rate and fully backed by mark (and gold) reserves. The parliamentarians wasted little time in committing to the proposed currency board blueprint. On June 24, 1992, the ruble was out and a currency board-issued kroon was in. Building on this initial success, Estonia has steadfastly continued to embrace a liberal reform agenda.

When we move down — way down — on the economic freedom ranking lists, we find Indonesia. In The Index of Economic Freedom, it ranks 110th out of 157 countries. Indonesia is tied for 83rd (along with Albania, Sri Lanka, Turkey and Azerbaijan) out

## Economic Freedom Rankings

	WALL STREET JOURNAL/ HERITAGE FOUNDATION	FRASER INSTITUTE	WORLD BANK
Indonesia	110	83	135
Hong Kong	1	1	5
Singapore	2	2	1
Estonia	12	12	17

Sources: *The Wall Street Journal/The Heritage Foundation, Fraser Institute, and The World Bank*

## Comparative Growth Rates 1996-2006

	REAL GDP GROWTH	CPI INFLATION GROWTH
Indonesia	28.4%	271.1%
Hong Kong	49.7%	-4.1%
Singapore	65.4%	7.5%
Estonia	113.7%	60.7%

Sources: *IMF and author's calculations.*

of the 130 countries in *The Economic Freedom of the World*. And out of the 175 countries studied by the World Bank, Indonesia ranks a dismal 135th in terms of the ease of doing business. A review of Table 1 shows just how poorly Indonesia stacks up against three countries that have made credible commitments to liberal economic reforms. And Table 2 proves the old adage that the proof of the pudding is in the eating. Indonesia's poor scores on economic freedom translate, as expected, into a relatively poor economic growth (and inflation) performance.

In closing, it is worth stressing that there is often a wide gap between a government's rhetoric and the reality of its reforms. For example, many governments in the former Soviet Union, Eastern Europe, Latin America and elsewhere have come to power on liberal reform platforms, only to be swept aside in the next election. Why? The common thread running through all these cases is that reform reality has not matched reform rhetoric. Indeed, commitments to reform have not been credible, reforms have been narrow and superficial, economic freedom has not been significantly enhanced, state-imposed burdens on doing business have remained onerous, and most importantly, the scope and scale of government activity has not been dramatically reduced. In consequence, corruption has gone unchecked and remains a systemic problem. All this amounts to a recipe for superficial reformers to discredit themselves, their political parties and the ideas they have masqueraded behind.

(For a full treatment of this topic, see: S. H. Hanke and S. J. K. Walters, "Economic Freedom, Prosperity, and Equality: A Survey," *The Cato Journal*, Vol. 17, No. 2, Fall 1997; [www.cato.org](http://www.cato.org).) GA

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