

Index of Economic Freedom: Latin America Leadership and Regulatory Inefficiencies

After the crisis of 2009, Chile managed to recover and consolidate itself as the best in Latin America in the Index of Economic Freedom 2014, with the seventh place of the ranking. This figure reflects last years' progress and gives us a vision of how we are and should grow in the future, as long as new reforms do not alter the road that has been built.

The 20th version of the Index of Economic Freedom was published last week; this Index is produced by the Heritage Foundation, The Wall Street Journal and sponsored by *Libertad y Desarrollo*. This figure means a systematic effort to identify the countries where every person's fundamental rights concerning his work and property are most respected. Thus, a society that enjoys economic freedom is precisely that in which individuals are free to work, produce, consume and invest as he wishes, under a government allowing free mobility of work, goods and capital. Therefore, the survey assesses 10

indicators, equally relevant, both quantitative and qualitative, which in turn can be grouped into four basic pillars: Rule of Law, Limited Government, Regulatory Efficiency and Open Markets.

2014 Results

The last report indicates that the global progress towards economic freedom has regained strength after the 2009 crisis, when it entered a cooling period –and even lost ground- since the previous maximum score was in 2008. In general terms, all regions made progress compared with 2013, except the Middle East and North Africa, which showed significant setbacks. As for North America, although we do not appreciate a progress, it continues to be the region with most economic freedom in the world, despite the fact that the United States, once one of the best qualified countries, has lost ground in the ranking while holding the 12th position. It is especially concerning that the three countries with lowest scores – Ecuador, Argentina and Venezuela- are located precisely in Latin America, and are currently considered “repressed” economies according to the Index, with the disastrous economic and social results that countries in

those categories usually present. Moreover, no other country has presented such a sustained and pronounced fall as Argentina in the 20 years of existence of the Index.

Table 1
RANKING OF THE INDEX OF ECONOMIC FREEDOM

Place	2012	2013	2014
1	Hong Kong	Hong Kong	Hong Kong
2	Singapore	Singapore	Singapore
3	Australia	Australia	Australia
4	New Zealand	New Zealand	Switzerland
5	Switzerland	Switzerland	New Zealand
6	Canada	Canada	Canada
7	Chile	Chile	Chile
8	Mauritius	Mauritius	Mauritius
9	Denmark	Ireland	Ireland
10	United States	United States	Denmark

Source: Index of Economic Freedom 2012, 2013 and 2014, Heritage Foundation.

As for Chile, it holds the seventh position in the ranking of the Index of Economic Freedom, maintaining its leadership in the region. However, in spite of keeping its place in relation to 2012 and 2013, Chile gets a slightly lower score, as a consequence of reforms that have increased the size of the State and the tax burden, as well as the minimum wage increase which exceeds our country's productivity earnings, among other insufficient regulatory headways. Thus, the score obtained in the last ranking, 78.7, is lower than the 79.0 reached in 2013. The following table summarizes the changes in the 10 components of the Index, whose scores are graded on a scale from 0 to 100, and the aggregate index is formed by evenly weighting these components.

Table 2
VARIATIONS IN THE INDICATORS' SCORES

Rule of Law		Limited Government	
Protection of Property Rights	0.0	Fiscal Freedom	-1.1
Freedom from Corruption	0.3	Government Spending	0.1
Regulatory Efficiency		Open Markets	
Business Freedom	-1.2	Trade Freedom	0.0
Labor Freedom	-4.9	Investment Freedom	5.0
Monetary Freedom	-0.5	Financial Freedom	0.0

Source: Index of Economic Freedom 2014, Heritage Foundation.

Specifically, the setback is due to deterioration in two of the four pillars of the Index, Fiscal Freedom and Regulatory Efficiency, which is only partially counterweighted by a relevant increase in Open Trade, all of which are analyzed with greater detail in the following lines.

- Limited Government

It comprises the item Fiscal Freedom (ranking 113), which refers to the tax burden and it proportionally includes the maximum marginal rate for individuals, businesses and the total burden measured as percentage of the GDP; additionally, the item Government Spending (ranking 37) punishes high levels of public spending, in a non-linear way, in such a manner that a spending increase is reflected by a more than proportional score drop.

It is precisely in the item of Fiscal Freedom that Chile shows a setback, as a result of the permanent increase approved in September 2012 of the first category tax and the greater –and increasing- share of taxes as a percentage of the product. It should be noted here that this is in no way compensated in the Index by the rebate of inframarginal rates for individuals, since the ranking only considers changes in the maximum marginal rate for individuals, which, as we know, was not rebated in 2013, as was proposed in the original bill introduced by the Executive.

- Regulatory Efficiency

It is made up of three items: Business Freedom (81), Labor Freedom (67) and Monetary Freedom (7). The first is a quantitative measurement of the difficulties, both in time and money, to start, operate and terminate a business based on the World Bank's study Doing Business. Therefore, 10 factors are evaluated, always in relation to the global average; thus, the improvement in the rest of the countries does not only entail a worst ranking, but also, unlike other indicators of the Index of Economic Freedom, results in a lower absolute score than the previous year. In a similar way, the item of Labor Freedom is built based on six factors taken from the study Doing Business and their deviation from the global average. Among these factors, we find the minimum wage level in relation to the aggregate value for each worker, schedule rigidities, and mandatory compensations for dismissals (different from insurances). Finally, Monetary Freedom refers to the price stability in the absence of micro-controls (as price controls usually are). Thus, for this indicator, a country with low inflation –incorporated as the root of the last three years' average to increase the ranking in low inflation levels- and absence of price controls obtains a high index.

The first two components, Business Freedom and Labor Freedom, show relevant setbacks in relation to the global mean; we have not been able to

be at the forefront in labor flexibility, labor productivity increases and costs of making businesses. However, it is important to highlight that many of the Government's efforts are still not reflected on this Index, because collected data have generally a time-lag of at least six months (or more when based on Doing Business); therefore, we will probably see future improvements in the next measurements, as a result of the relevant reforms enabling to create partnerships in a more expeditious and economical way, even online, and the recently approved law of reorganization and liquidation, which allows dealing better with insolvency. As for inflation, although we observe a slight drop, it does not seem relevant but rather cyclical, and thus Chile is still in the seventh place for this indicator.

- Open Markets

This indicator includes Trade Freedom (tariff and non-tariff barriers), Investment Freedom (investment flow restrictions in some or all sectors) and Financial Freedom (bank efficiency and independence). The item of Investment Freedom shows a significant improvement and Chile consolidates once again as an economy that is opened to foreign investment, treating foreign investors with justice and no discrimination. In this context, the elimination of the decree law DL600, a proposal of the elected president's program, seems a contradiction, because this instrument has allowed giving security to foreign investors and its elimination, in a possible tax reform scenario, seems very unfortunate.

Progress of Freedom in the Last Governments

When making a follow-up of the progress of economic freedom in the last administrations, as we can observe in Chart 1, in the beginning of Frei's administration, Chile had a score of 71.2 and at the end of his government it had increased to 74.1, due to significant increases in the open trade area thanks to FTAs, the lower inflation pressure, and the opening of private investment on public utility services.

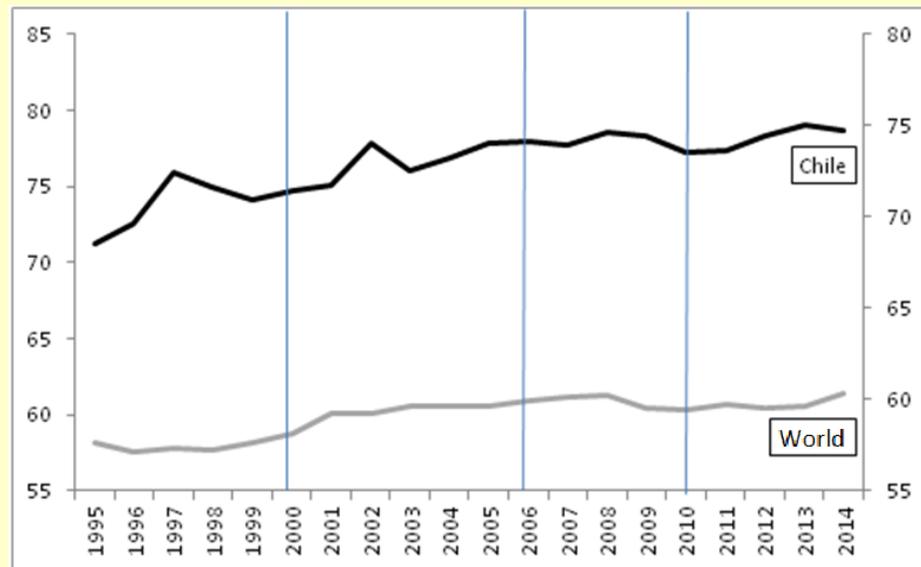
At the end of Lagos' government period, the indicator had reached 77.8 thanks to new Free Trade Agreements, reforms to the capital Market and improvement of opportunities for the private sector due to increased concessions.

However, this ascending curve ceases to rise –and even starts to descend– with the last government of the *Concertación*. Thus, in 2009, under the administration of Michelle Bachelet, the Index reached a score of 77.2, due to increased red tape, explosive increase of public spending and fragility of property rights, which counterweighted the foreign trade improvements.

After the 2009 crisis, during Piñera's administration, Chile resumed the improvements in the ranking, obtaining the highest score ever, with 79.0 points in 2013 and 78.7 in 2014. The government took the right road, but this achievement will be obstructed if the future Congress does not allow the bills to progress and if this administration's weak points –such as labor rigidity, high tax burden on individuals and corporate tax increase, minimum wage increase above productivity, and greater interference of groups who stop projects already approved by the respective regulatory organism- are not reverted as soon as possible. In fact, when comparing with 1995, we have improved in five of the 10 evaluated items, keeping the score in property rights (second place at global level), but falling on four items, especially regarding labor regulation, easiness to start businesses, government spending and tax burden. This situation is pretty much expectable, since the improvement in business matters has not been sufficiently fast compared to the world progress and due to successive corporate burden increases since the 90's.

Chart 1

EVOLUTION OF THE INDEX OF ECONOMIC FREEDOM



Source: L&D based on the Index of Economic Freedom 1995-2014, Heritage Foundation.

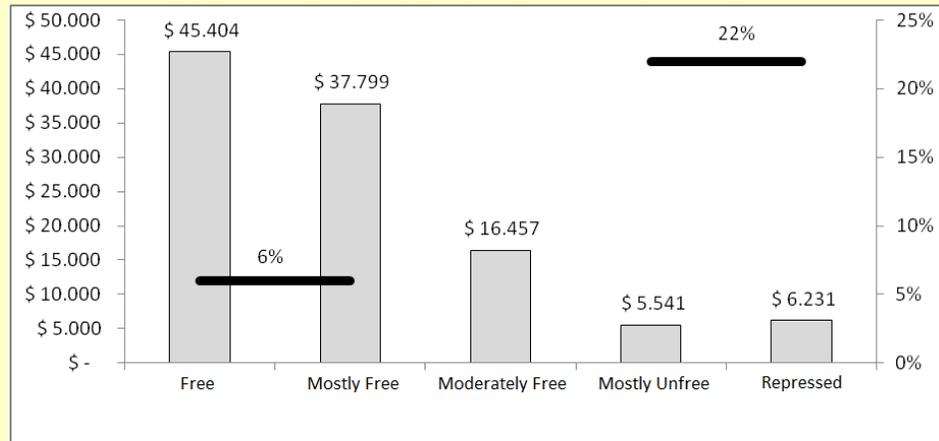
The Importance of the Index

A free economy, which is a necessary condition for a free society, is the fundamental pillar that has allowed reaching levels of development and poverty uprooting without precedent in the human history. In the words of 1979 Economy Nobel Prize Milton Friedman, "no economic system in

history has been as successful at lifting people out of poverty as that of capitalism and free trade, based on the principles of economic freedom”. This is how we should interpret, with these words in mind, the performance in the Index of Economic Freedom, a proxy –imperfect as all measurements- of the true and most extensive economic freedom, which in the end entails greater well-being for all inhabitants of a nation. When we observe the most basic well-being measurement, GDP per capita, we can clearly appreciate that precisely those States with better rankings in the Index are those with greater wealth and, still more, they also show a smaller proportion of people in poverty conditions.

Chart 2

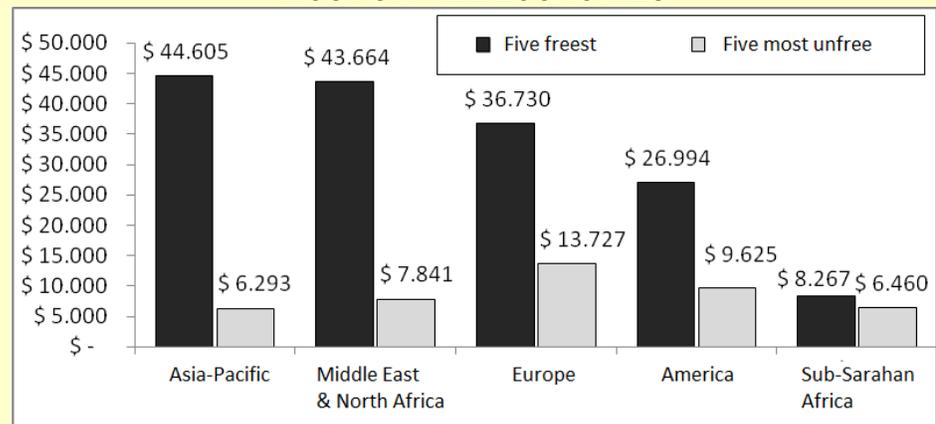
GDP PER CAPITA (US\$ PPP) AND POVERTY PROPORTION (%) ACCORDING TO ECONOMIC FREEDOM DEGREE



Source: Index of Economic Freedom 2014, Heritage Foundation.

Chart 3

GDP PER CAPITA (US\$ PPP) BY REGION FOR THE FIVE FREEST AND MOST UNFREE ECONOMIES



Source: Index of Economic Freedom 2014, Heritage Foundation.

Still more evident, the countries that have improved in economic freedom are those which on average have grown the most in target periods of five, 10 and 20 years.

Chart 4

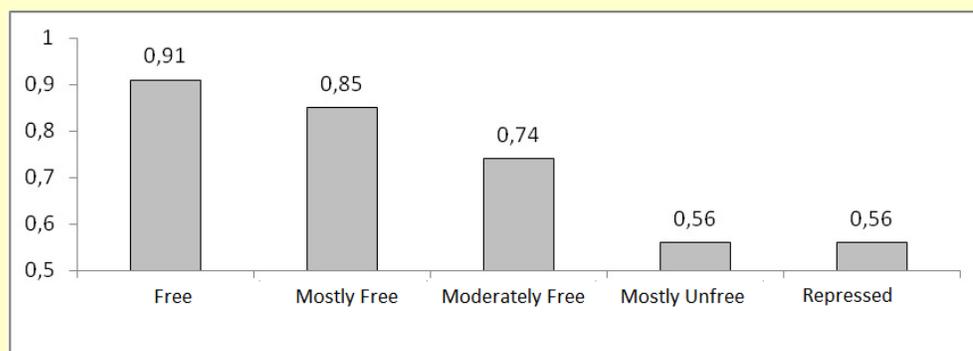
REAL GROWTH OF THE GDP PER CAPITA (US\$ PPP) PER IMPROVEMENT QUARTILE IN THE INDEX OF ECONOMIC FREEDOM



Source: Index of Economic Freedom 2014, Heritage Foundation.

Chart 5

HUMAN DEVELOPMENT INDEX BY ECONOMIC FREEDOM DEGREE



Source: Index of Economic Freedom 2014, Heritage Foundation

But this greater well-being does not limit itself to the GDP per capita; other measurements such as the United Nations Human Development Index or the Global Innovation Index reaffirm this pattern: greater economic freedom goes along with greater well-being, prosperity and development.

In brief...

- The Index of Economic Freedom places Chile in the seventh place, consolidating it as the best country in Latin America and doing even better than the United States which dropped in the ranking.
- This figure partly reflects the society in which Chileans develop, and allows establishing a horizon in the road that the country shall follow in the future. The countries which advance the most in economic freedom increase their growth in target periods of five, 10 and 20 years.
- There are items in which Chile obtains a relevant improvement, such as Investment Freedom; however, the next government intends to take some measures that could result in going back over the traveled road.