

ECONOMIC FREEDOM OF THE WORLD INDEX: TAKING CARE OF IMPROVEMENTS

- Chile was ranked in the 10th position, among 157 countries, in the 2015 version of the Index of Economic Freedom of the Fraser Institute. This score represents an improvement of 1 position compared with the previous report, but a drop of 3 positions since Chile got its best mark in 2011.
- Chile consolidates as the best Latin American country in the ranking and it is included again in the world's "top ten"; however, the setback from the top levels is a call to keep progressing towards higher economic freedom and not to reverse everything that has been achieved in the past 30 years.
- The most economically free countries have been more successful in uprooting poverty: the poorest 10% of the freest nations are more than twice as prosperous as an average person of the countries with least economic freedom.

Almost 30 years have passed since the Fraser Institute of Canada, together with Milton and Rose Friedman, started the Economic Freedom of the World project (EFW), whose sole objective was to define, measure and quantify institutions and policies that were consistent with economic freedom in a large group of countries and territories around the world.

Today, the EFW Index incorporates 157 countries (and territories), and for at least 100 of them - including our country- there are consistent and comparable data available since 1980. Thus, it has become a highly valuable and recurrent input for the increasing amount of research, which empirically analyzes the impact of economic, social and political institutions on the countries' path to development, by understanding this in a much more comprehensive way than the GDP per capita.

Among this scholarly literature, where renowned economists Daron Acemoglu from the MIT and James Robinson from Harvard are the most visible faces today, the studies that incorporate the EFW Index clearly suggest that higher levels of economic freedom are associated with better results in relation to economic growth, improvement in the standard of living, health indicators, and even more happiness and personal life satisfaction.^{i,ii}

Since its first version in 1996, EFW data have been used in more than 500 papers with the purpose of studying a wide variety of subjects. North American professors Hall and Lawsonⁱⁱⁱ present a review of 402 articles quoting the EFW. Among these articles, 198 use the Index data as explanatory variable in an empirical study. The authors have found that more than two thirds of the papers relate higher economic freedom to “positive” results like greater economic growth, more happiness, better standard of life, etc. While less than 4% of the analyzed works found that economic freedom is associated to “negative” results, such as higher levels of income dispersion. This fact allows concluding that there is overwhelming evidence that more economic freedom, quantified through the EFW Index, is associated to a wide range of positive results without practically no “secondary effect”.

Therefore, this Index, and the advances or setbacks in our country, are clearly relevant and constitute an opportunity to reflect about the direction to where these newly adopted public policies are taking us. In fact, a study of professors Gwartney, Holcombe and Lawson^{iv}, included in the review mentioned earlier, quantifies the magnitude of the Index influence on the product growth, showing a stunning result. A 1-point drop in the Index (in a scale from 0 to 10) is associated to a long-term growth rate decline between 1 and 1.5 annual percentage points.

THE INDEX

The Index is periodically elaborated by the Fraser Institute, a Canadian think-tank, in cooperation with the Economic Freedom Network, a group of autonomous research and education institutes – Libertad & Desarrollo among them – located in 90 countries around the world. It is considered one of the most prestigious measures of economic freedom, which currently uses 42 different variables to create an index based on policies and institutions that support economic freedom.

In this way, economic freedom is measured in five different areas that group these 42 variables^v, whose cornerstones are personal choice, voluntary exchange, freedom to enter markets and compete, and security of the person and privately owned property. These areas are built on three methodological principles. First, when possible, using objective variables rather than surveys and opinions; data from external sources such as the IMF, the World Bank and the World Economic Forum, instead of local sources; and transparency regarding data sources, methodologies and weighting of each variable.



ECONOMIC FREEDOM IS MEASURED IN 5 DIFFERENT AREAS

Table 1. The EFW Index is made of 42 variables

I. Size of Government	<ul style="list-style-type: none"> • Government consumption (% GDP) • Transfers and subsidies (% GDP) • Government enterprises and investment (% public investment on the total) • Top marginal tax rate and income tax threshold
II. Legal System and Property Rights	<ul style="list-style-type: none"> • Judicial independence (GCR Expert Survey^{vi}) • Impartial courts (GCR Expert Survey) • Protection of property rights (GCR Expert Survey) • Military interference in rule of law and politics (ICRG^{vii}) • Integrity of the legal system (ICRG) • Legal enforcement of contracts (Based on Doing Business) • Regulatory costs of the sale of real estate (idem) • Reliability of police (GCR Expert Survey) • Business costs of crime (GCR Expert Survey)
III. Sound Money	<ul style="list-style-type: none"> • Money growth (M1 money supply) • Standard deviation of inflation (Deviation of the GDP Deflector of the last 5 years) • Inflation: most recent year (Consumer Price Index, CPI) • Freedom to own foreign currency bank accounts (IMF^{viii})
IV. Freedom to Trade Internationally	<ul style="list-style-type: none"> • Tariffs (Collection as % of the tradeable sector; deviation and average of tariff rates) • Regulatory trade barriers (GCR Expert Survey for non-tariff barriers; cost of importing and exporting based on Doing Business) • Black-market exchange rates (Difference between official and parallel (black) market according to the MRI^{ix}) • Controls of the movement of capital and people (GCR Expert Survey for foreign investment restrictions; FMI capital controls; and Lawson and Lenke^x for visa requirements)
V. Regulation	<ul style="list-style-type: none"> • Credit market regulations (% of deposits in privately-owned banks; fiscal deficit as % of gross saving; and moderate spreads and real interest rates above 0) • Labor market regulations (based on Doing Business for hiring regulations and firing costs; GCR for hiring and firing regulations, and centralized collective bargaining; International Institute for Strategic Studies and War Resisters International^{xi} for military service) • Business regulations (GCR for administrative requirements, bureaucracy costs, bribes and favoritism; and based on Doing Business for difficulty to start a business, building licenses and costs of tax compliance)

Source:

2015 EFW Report.

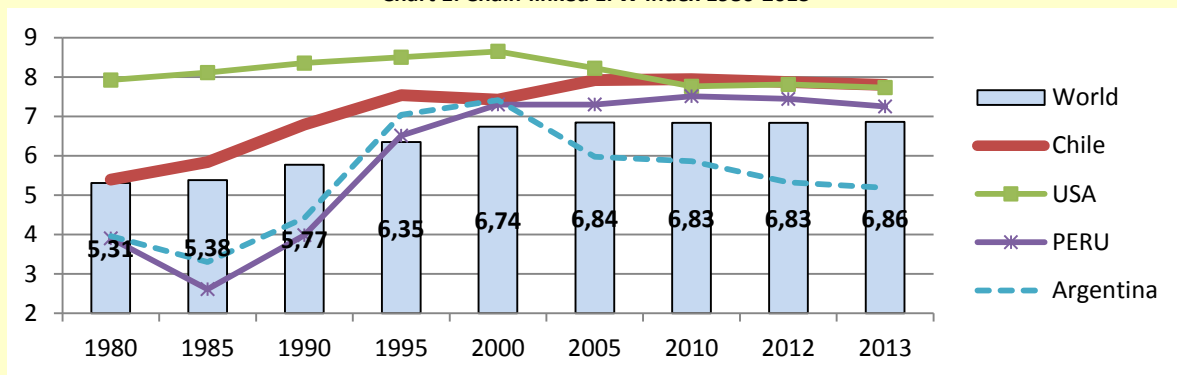
RESULTS OF THE 2015 REPORT (BASED ON DATA FROM 2013)

Chile was ranked in the 10th position, among 157 countries, in the Index of Economic Freedom of the World: 2015 Annual Report, which was published last September 14th by the Fraser Institute in association with Libertad & Desarrollo for Chile. This score represents a 1-point improvement compared to the previous report, which is in line with the good results that the country has been able to maintain and that consolidates the country as unquestionable leader of the region.

Once again, Hong Kong occupies the top position of the ranking among 157 countries and territories, followed by Singapore, New Zealand and Switzerland. At global level, the average score increased slightly from 6.83 last year to 6.86, in a scale from 1 to 10, getting close to the maximum levels reached before the crisis of 2008-2009. In terms of economic freedom, the progress at global level has been remarkable since the early eighties, but it should be highlighted that most of the change occurred before the year 2000 and from then on the improvements have been rather marginal. There is no doubt that, currently, the world is a place with more economic freedom than 3 decades ago, and most of the change is due to significant reductions in top marginal tax rates, stabilization of the inflation and liberalization of international trade.

THE ECONOMIC FREEDOM IN THE WORLD IS DEFINETELY HIGHER THAN IN 1980

Chart 1. Chain-linked EFW Index 1980-2013



Source: 2015 EFW Report.

The United States, formerly considered the bastion of economic freedom, is now barely in the 16th position, leaving behind the third position that they used to occupy after Hong Kong and Singapore, which is especially concerning, considering that even in year 2000 they were ranked in the second place. This is due to excessive government spending, weakening of the rule of law and increasing regulations from the federal government.

Once again, Venezuela shows the lowest level of economic freedom at global level, together with the Republic of Congo, Libya, Chad and Syria, who follow respectively in the worst positions. Some countries, where the lack of economic freedom is evident, such as North Korea and Cuba, could simply not be evaluated due to the lack of reliable data.

As for Chile, the scores obtained in the five categories^{xii} are (between 1-10 where a higher value indicates a higher level of economic freedom):

- **Size of Government:** 8.0 points (15); here, Chile keeps the score of previous years and the improvement in the ranking (from position 18) is due to a decline of other countries. A fiscal rule that has allowed to constrain the size of the State has been, until now, one of the nation's strength on this matter. In particular, the fact of being able to recover the balance, in matters regarding the cyclically adjusted deficit after the crisis of 2008-2009, is what allowed Chile to maintain its position.
- **Legal System and Property Rights:** 7.01 points (27); very similar to previous reports, with score reductions as a consequence of a worst perception from the experts consulted in the Global Competitiveness Report of the World Economic Forum. This reveals a deterioration in the margin of the existing perception regarding the impartiality of our courts and the protection of property rights in the country. This category includes the largest number of "soft" indicators, therefore, it is more sensitive to perceptions than other categories.
- **Sound Money:** 9.02 points (57); in this case, the decline of inflation, which was becoming dangerous before the Subprime Crisis, and a smaller growth of the money supply (in relation to the product) allowed this indicator to improve, but it is still below the levels of the mid 2000.
- **Freedom to Trade Internationally:** 8.11 points, above the 8.03 points obtained a year ago, thereby ranking the country in the 12th position at global level. If the total elimination of tariffs were approved, which was included in the original version of the tax reform of the government of Sebastián Piñera, Chile would have improved up to 0.1 points in the aggregate indicator and would have been included in the "top ten" in trade liberalization, together with countries like Holland, New Zealand and Singapore. The indicator of foreign investments restrictions, also based on the Global Competitiveness Report of the World Economic Forum, is practically the only deteriorating variable in this category, which illustrates once again the importance of the existing perception towards the country.
- **Credit Market, Labor Market and Business Regulations:** 7.18 points (71); as usual, this is one of the weak points in our country and, therefore, there is more space for improvements here, especially in matters concerning the regulation of the labor market, where the country occupies the position 117, close to nations like Ghana, Mozambique, Pakistan and El Salvador. The high costs of dismissals, the existence of the mandatory

military service, (although in practice, volunteers exceed the quota), and the hiring and firing regulations explain this low position. As for business regulations, the bureaucracy costs, measured through perceptions by the Global Competitiveness Report, have strongly deteriorated since the beginning of the 2000 decade, despite the fact that the variable “Starting a Business”, measured through the exercise of a standard company based on the Doing Business report of the World Bank, which reflects the cost of time, red tape and money for starting a business, have strongly improved from 5.65 to 9.82 (in the scale of 10). Finally, it is also concerning that the variable “Extra payments/bribes/favoritism”, measured through the experts’ perceptions in the Global Competitiveness Report, has also deteriorated in the last 20 years.

This version includes comparable data until 2013, so considering the last events in the country it is hard to believe that we will show improvements in the following years. The public spending increase (both in consumption and transfers), the actual higher fiscal deficits and, in general, “soft” or business climate variables, which are more difficult to evaluate than corruption, rule of law, legal system or bureaucracy, and therefore, they imply to resort to the opinion of an expert panel of the World Economic Forum, are starting to show a decline, which will probably reveal itself.

Looking forward, and considering the reforms currently being discussed, the future beyond the present year is still less promising. And although the reduction in the top marginal income tax rate will reflect as an improvement in the index, since it does not directly consider other elements of the tax system, the labor reform, the end of the special foreign investment regulation (DL 600), the persistence of higher inflation, and the significant effective fiscal deficits will prevail in the indicator’s decline.

Chile still occupies the best position in the ranking among Latin American countries, and the fact of returning to the “top ten” after being excluded, invites us to go on making improvements towards greater economic freedom and, most of all, and not reversing everything that has been achieved in the last 30 years, when in the beginning Chile barely exceeded the 50th position (among only 100 countries being evaluated).

ECONOMIC FREEDOM, GROWTH AND DEVELOPMENT

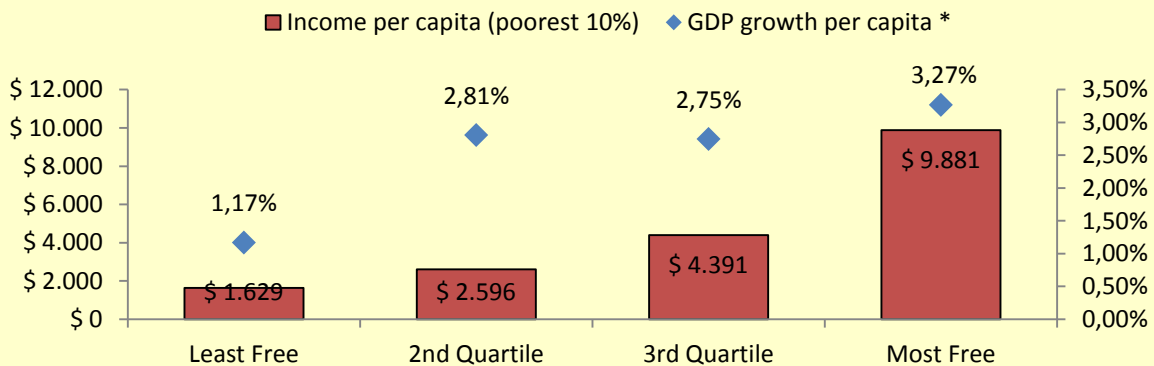
As we already mentioned, a large amount of scholarly research shows that individuals living in countries with high levels of economic freedom enjoy more prosperity, greater political rights and civil liberties, and even longer life expectancy. The following charts contained in the last EFW report are a good first approach to the type of relations reviewed by more sophisticated studies,

like those of Hall and Lawson (2014), which do nothing less than stress the importance of policies aimed at promoting freedom.

Thus, they highlight that in 25% of the best ranked countries, the average income of the poorest 10% was US\$9,881 in 2013, compared to only US\$1,629 for those living in the least free economies. On average, the poorest 10% of the freest nations is twice as prosperous as an average person of the countries with least economic freedom. Furthermore, and again classifying by quartiles according to the level of economic freedom, we observe an enormous positive correlation with greater Political Rights and Civil Liberties, based on the Study of the Freedom House, Freedom in the World. The same is observed for something as basic as life expectancy.

ECONOMIC FREEDOM IS RELATED TO GREATER PROSPERITY AND GROWTH

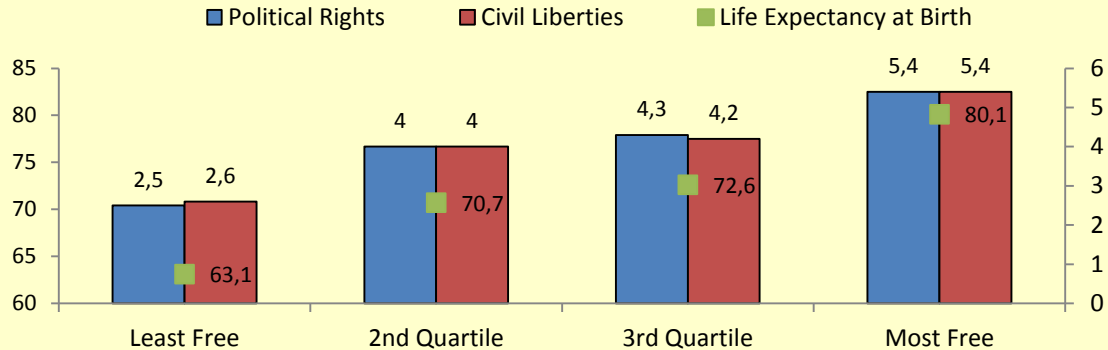
Chart 2. Economic Freedom Quartiles, GDP growth per capita between 1970 and 2013 (controlled by initial income level) and GDP per capita of the poorest 10% (PPP)



Source: 2015 EFW Report based on data of the World Bank.

ECONOMIC FREEDOM IMPLIES MUCH MORE THAN ECONOMIC GROWTH

Chart 3. Economic Freedom Quartiles, (controlled by initial income level), and GDP per capita of the poorest 10% (PPP)



Source: 2015 EFW Report based on data of the World Bank and Freedom House

The EFW Index is useful, not only because the quantification of economic freedom over time and among countries is an objective per se, but also because it creates an important tool that allows making research regarding the effects of economic freedom on the life and wellbeing of those who experience it – or suffer the lack of it.

ⁱ Martin Rode, Bodo Knoll, and Hans Pitlik (2013). Economic Freedom, Democracy, and Life Satisfaction.

ⁱⁱ Hans Pitlik, Dulce M. Rediñ, and Martin Rode (2015). Economic Freedom, Individual Perceptions of Life Control and Life Satisfaction.

ⁱⁱⁱ Joshua C. Hall and Robert A. Lawson (2014). Economic Freedom of the World: An Accounting of the Literature.

^{iv} James D. Gwartney, Randall G. Holcombe, and Robert A. Lawson (2006). Institutions and the Impact of Investment on Growth.

^v The complete report can be downloaded in www.freetheworld.com.

^{vi} Global Competitiveness Report of the World Economic Forum.

^{vii} International Country Risk Guide of the PRS Group.

^{viii} Annual Report on Exchange Arrangements and Exchange Restrictions.

^{ix} Banker's Guide to Foreign Currency of the Monetary Research Institute.

^x Robert Lawson and Jayme Lemke (2012). Travel Visas.

^{xi} International Institute for Strategic Studies, The Military Balance; War Resisters International, World Survey of Conscription and Conscientious Objection to Military Service.

^{xii} The ranking is used without correcting by chain-linked data.