Chapter 5: Explaining the Factors of the Index of Economic Freedom

Extracted from 2003 Index of Economic Freedom
William W. Beach and Gerald P. O'Driscoll, Jr.

Since 1995, the Index of Economic Freedom has offered the international community an annual in-depth examination of the factors that contribute most directly to economic freedom and prosperity. As the first comprehensive study of economic freedom ever published, the 1995 Index defined the method by which economic freedom can be measured in such vastly different places as Hong Kong and North Korea. Since then, other studies have joined the effort, analyzing such issues as trade, corruption, or government intervention in the economy.¹

There is overlapping coverage among these indices, but the Index of Economic Freedom includes the broadest array of institutional factors determining economic freedom:

- Corruption in the judiciary, customs service, and government bureaucracy;
- Non-tariff barriers to trade, such as import bans and quotas as well as strict labeling and licensing requirements;
- The fiscal burden of government, which encompasses income tax rates, corporate tax rates, and government expenditures as a percent of output;
- The rule of law, reliability, impartiality, and efficiency of the judiciary, and the ability to enforce contracts;
- Regulatory burdens on business, including health, safety, and environmental regulation;
- Restrictions on banks regarding financial services, such as selling securities and insurance;
- Labor market regulations, such as established work weeks and mandatory separation pay; and
- Black market activities, including smuggling, piracy of intellectual property rights, and the underground provision of labor and other services.

Analyzing economic freedom on an annual basis permits the authors of the Index to include the most recent data on these variables as they become available on a country-by-country basis. Not surprisingly, changes in government policy are occurring at a rapid rate in many less-developed countries. The Index of Economic Freedom, because it is published each year, enables readers around the world to see how recent changes in government policy affect economic freedom in any one of 161 specific countries. (This year, numerical grading was suspended for five countries Angola, Burundi, Democratic Republic of Congo, Iraq, and Sudan that are currently in a state of civil unrest or anarchy or for which data necessary to grade the country are unavailable. Information is provided, however, even for these countries.)

MEASURING ECONOMIC FREEDOM

Economic freedom is defined as the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself. All government action involves coercion. Some minimal coercion is necessary in order for the citizens of a community or nation to defend themselves, promote the evolution of civil society, and enjoy the fruits of their labor. This Lockean idea was embodied in the U.S. Constitution. For example, citizens are taxed to provide revenue for the protection of person and property as well as for a common defense. Most political theorists also accept that there are certain goods that economists call "public goods" that often can be supplied most conveniently by government.

When government employs coercion beyond that minimalist standard, however, it risks trampling on freedom. When it interferes in the market to effect ends other than the protection of person and property, it undermines economic freedom. Exactly where that line is crossed is open to reasoned debate. Only a standard achievable by imperfect human beings neither anarchy nor utopia is envisioned in the scoring of economic freedom.

Throughout history, governments have exercised their power to place a wide array of constraints on economic activity. Many such constraints can be measured by assessing their impact on economic choices. Constraining economic choice interferes with the production, distribution, or consumption of goods and services (including, of course, labor services).²

One overriding reality characterizes the world: To varying degrees, governments realign through coercion the choices that ordinary people make with respect to their persons and property. Economic freedom is diminished when governments do this. Additionally, economic growth suffers to the extent that governments practice coercion in the marketplace.
To measure economic freedom and rate each country, the authors of the Index study 50 independent economic variables. These variables fall into 10 broad categories, or factors, of economic freedom:

- Trade policy,
- Fiscal burden of government,
- Government intervention in the economy,
- Monetary policy,
- Capital flows and foreign investment,
- Banking and finance,
- Wages and prices,
- Property rights,
- Regulation, and
- Black market activity.

A detailed discussion of each of these factors and their variables follows this overview.

**Weighting**

The Index of Economic Freedom treats the 10 factors as equally important in evaluating the level of economic freedom in any country. Thus, to determine a country's overall score, the factors are weighted equally.

This approach is the fairest and most consistent with the purpose of the Index: to produce a score that reflects the institutional environment for economic activity in every country. The Index is not designed to measure the proportionate contribution made by a set of statistically independent variables to economic growth. That is ably done in the many empirical studies of economic growth. Rather, the authors of the Index identify a set of institutional factors that, taken together, determine the degree of economic freedom in a society. It is this institutional environment that is viewed as necessary for economic growth in the first place. Although it is not possible at this stage of academic research to know with a high degree of certainty which factors are more important than others for economic freedom, it is clear that, for a country to achieve long-term growth and economic well-being, it must perform well in all 10 factors. When a sufficient history has been developed, Heritage analysts intend to re-examine the issue of differential weighting of factors. The authors welcome the opportunity to work with outside scholars and researchers to enhance the Index in any and all ways.

**The Grading Scale**

Each country receives its overall economic freedom score based on the average of the 10 individual factor scores. Each factor is scored according to a grading scale that is unique for that factor. The scales run from 1 to 5: A score of 1 signifies an institutional or consistent set of policies that are most conducive to economic freedom, while a score of 5 signifies a set of policies that are least conducive.

In addition, each factor score is followed by a description "better," "worse," or "stable" to indicate, respectively, whether that factor of economic freedom is improving, is getting worse, or has stayed the same compared with the country's score last year.

Finally, the factors are added and averaged, and an overall score is assigned to the country.

The four broad categories of economic freedom in the Index are:

- Free—countries with an average overall score of 1.95 or less;
- Mostly Free—countries with an average overall score of 2.00 to 2.95;
- Mostly Unfree—countries with an average overall score of 3.00 to 3.95; and
- Repressed—countries with an average overall score of 4.00 or higher.

**Previous Scores**

The Index of Economic Freedom includes a comprehensive listing of 161 countries with their scores for each of the 10 factors. This year, each country's listing includes its overall score for each of the years the country was graded between 1995 and 2002. With this history, readers can easily discern whether a country is improving or restricting economic freedom over time, or whether its level of economic freedom has not changed.

**Transparency**

The discussions that follow in this chapter explain why each factor is an important element of economic freedom, how the levels of economic freedom are broken down and scored for that factor, and what sources of data and information were used for this analysis. The authors endeavor to make their scoring as transparent as possible to the reader.
Thus, factor scoring is straightforward. If a country's banking system received a score of 3, for example, this means that its banking and financial system displays most of the characteristics for level 3, which are spelled out on page 60: The government exercises substantial influence on banks; the government owns or operates some banks; the government significantly influences credit allocation; and there are significant barriers to the formation of domestic banks. Similarly, a country receiving a score of 5 in trade policy has the characteristics explained on page 52: an average tariff rate of at least 19 percent or a lower tariff but very high non-tariff barriers that, for all practical purposes, close its markets to imports.

A country must meet most, but not necessarily all, of the conditions specified for each grade level of a factor. In the banking and finance factor, a country would rate a grade of 2 (which is better than a grade of 3) if its banking system has only some government limits on financial services and minor barriers to new bank formation. It would receive a 4 (which is worse than a 3) if its banking system is in transition from a state-dominated, primitive, or crisis-ridden state; the government keeps its banks under tight control; some corruption is present; or domestic bank formation is virtually nonexistent.

Period of Study
For the 2003 Index of Economic Freedom, the authors generally examined data for the period covering the second half of 2001 through the first half of 2002. To the extent possible, the information considered for each factor was current as of June 30, 2002. It is important to understand, however, that certain factors are based on historical information. For example, the monetary policy factor considers a 10-year weighted average inflation rate, from January 1, 1992, to December 31, 2001. Other factors are current for the year in which the Index is published. For example, the taxation variable for this Index considers tax rates that apply to the taxable year 2002 (the year in which the 2003 Index is published).

Sometimes, because the Index is published several months after the cutoff date for evaluation, major economic events occur after that date that cannot be factored into the scores. In the past, such occurrences have been uncommon and isolated to one region of the world. The Asian financial crisis, for example, erupted as the 1998 Index of Economic Freedom was ready to go to print. As a result, the effects of policy changes in response to that crisis were not considered in that year's scoring; instead, they have been considered in later editions. The authors and editors also note in the country write-ups any major event that might have a substantial impact on a country's score in the future.

Sources
In determining how a country meets the criteria for each factor, the authors have used a range of authoritative sources. For example, a statement about the level of corruption in a country's customs service may be followed by a supporting quote from a source of demonstrated reliability. There also are innumerable lesser sources of information, including conversations with government officials and visits to Internet sites. These sources are indicated in the narrative where appropriate. It would be unnecessarily cumbersome to cite all the sources used in scoring every single variable of each factor; therefore, unless otherwise noted, the major sources used in preparing the country summaries may be found below, in the introduction to Chapter 6, and in the list of Major Works Cited on pages 437 and 438.

A SUMMARY OF FACTOR VARIABLES
To grade each country for the Index, the authors examined some 50 independent variables to determine an overall level of economic freedom. They collected information pertaining to all 50 independent variables and analyzed it to determine which of the five grade levels established for each factor most closely applies to a country. Even though all of the variables were studied, however, not all are given an individual score or specific mention in the text. For example, it is not necessary to mention cases in which corruption in the judiciary is virtually nonexistent; in general, this variable is discussed only when corruption in the judiciary is a documented problem.

Thus, instead of grading each of the 50 variables individually for each of the 156 countries that are scored in this year's edition, the variables are divided into the 10 broad factors of economic freedom, which are then graded. Such a system keeps the Index to a manageable length. The independent variables for each factor are summarized in the callout box within the factor's description.

FACTORS OF ECONOMIC FREEDOM

Factor #1: Trade Policy
Trade policy is a key factor in measuring economic freedom. The degree to which government hinders the
The free flow of foreign commerce can have a direct bearing on an individual's ability to pursue his economic goals. For example, when a government taxes directly through tariffs, or impedes through non-tariff barriers, the importation of a certain product, some group of people in that country will produce that product instead of another product they may be better suited to producing. The import limitation reduces economic freedom by discouraging individuals from applying their talents and skills in a manner that they know or believe will be better for them. In addition, it limits consumers' choices, thereby limiting their well-being.

### Trade Policy Grading Scale

<table>
<thead>
<tr>
<th>Score Levels of Protectionism Criteria</th>
<th>Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Very low</td>
<td>Weighted average tariff rate less than or equal to 4 percent.</td>
</tr>
<tr>
<td>2) Low</td>
<td>Average tariff rate greater than 4 percent but less than or equal to 9 percent.</td>
</tr>
<tr>
<td>3) Moderate</td>
<td>Average tariff rate greater than 9 percent but less than or equal to 14 percent.</td>
</tr>
<tr>
<td>4) High</td>
<td>Average tariff rate greater than 14 percent but less than or equal to 19 percent.</td>
</tr>
<tr>
<td>5) Very high</td>
<td>Average tariff rate greater than 19 percent.</td>
</tr>
</tbody>
</table>

### Methodology

The trade policy score is given based on a country's weighted average tariff rate weighted by imports from the country's trading partners. The higher the rate, the worse (or higher) the score.

Gathering these trade data to make a consistent cross-country comparison can be a challenging task. Unlike inflation data, for instance, countries do not report their weighted average tariff rate or simple average tariff rate every year; in some cases, the last time a country reported its tariff data could have been as far back as 1993. To preserve a consistent way of grading the trade factor, the authors have decided to use the most recent weighted average tariff rate reported for a country as our primary source. If a reliable source reports more updated information on the country's tariff rate, the authors note this fact and may review the grading of this factor if there is strong evidence that the last reported weighted average tariff rate is outdated.

The World Bank produces the world's most comprehensive and consistent information on weighted average tariffs rates. When the weighted average tariff rate is not available, the authors utilize the country's average tariff rate; and when the country's average tariff rate is not available, the authors base their grading on the revenue raised from tariffs and duties as a percentage of total imports of goods. The data for customs revenues and total imports may be found in different sources and not consolidated in just one source. In addition, in the very few cases in which data on duties and customs revenues are not available, the authors use data on international trade taxes instead. In any instance, the authors clarify the type of data used and the different sources for those data in the corresponding write-up for the trade policy factor. Sometimes, none of this information is available. In such cases, the authors analyze information on the overall tariff structure and estimate an average tariff rate. Tariffs, however, are not the only barriers to trade. Many countries impose import quotas, licensing requirements, and other mandates or non-tariff barriers (NTBs) to restrict imports. The trade analysis also considers corruption within the customs service. This is an important consideration because, even though countries may have lower published tariff rates and no official NTBs, their customs officials may be corrupt and may require bribes to allow products to enter their ports. Or customs officials may steal goods for themselves, which also constitutes a barrier to trade.

These circumstances are analyzed and documented whenever possible. If NTBs exist in sufficient quantity, or if there is ample evidence of corruption, a country's score based solely on tariff rates receives an additional point on the scale (representing decreased economic freedom).

### Sources

Unless otherwise noted, the authors used the following sources to determine scores for trade policy:
Factor #2: Fiscal Burden of Government

To measure the fiscal burden a government imposes on its citizens, the authors examined both tax rates and the level of government expenditures. The tax rate confronting an individual is effectively a "price" paid for supplying economic effort or engaging in an entrepreneurial venture. The higher the price of effort or entrepreneurship, the less of it will be undertaken. Higher tax rates discourage individuals from pursuing their goals in the marketplace.

Government expenditures, measured as a percent of GDP, capture the true cost of government in a society. When a government expends money, it acquires resources, diverting them away from private choices and private goals. This is true whether the expenditure is to acquire resources for its own purposes (government consumption) or for transfer payments among citizens.

<table>
<thead>
<tr>
<th>Individual Income Tax Grading Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Score Tax Rates Criteria</strong></td>
</tr>
<tr>
<td>1) <strong>Very low</strong> - Top income tax rate 0 percent. Marginal rate for the average taxpayer 0 percent.</td>
</tr>
<tr>
<td>2) <strong>Low</strong> - Top income tax rate greater than 0 percent and less than or equal to 25 percent. Marginal rate for the average taxpayer greater than 0 percent and less than or equal to 10 percent.</td>
</tr>
<tr>
<td>3) <strong>Moderate</strong> - Top income tax rate greater than 25 percent and less than or equal to 35 percent. Marginal rate for the average taxpayer greater than 10 percent and less than or equal to 15 percent.</td>
</tr>
<tr>
<td>4) <strong>High</strong> - Top income tax rate greater than 35 percent and less than or equal to 50 percent. Marginal rate for the average taxpayer greater than 15 percent and less than or equal to 20 percent.</td>
</tr>
<tr>
<td>5) <strong>Very high</strong> - Top income tax rate greater than 50 percent. Marginal rate for the average taxpayer greater than 20 percent.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Corporate Tax Grading Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Score Tax Rates Criteria</strong></td>
</tr>
<tr>
<td>1) <strong>Very low</strong> - Corporate tax rate less than or equal to 20 percent.</td>
</tr>
<tr>
<td>2) <strong>Low</strong> - Corporate tax rate greater than 20 percent and less than or equal to 25 percent.</td>
</tr>
<tr>
<td>3) <strong>Moderate</strong> - Corporate tax rate greater than 25 percent and less than or equal to 35 percent.</td>
</tr>
<tr>
<td>4) <strong>High</strong> - Corporate tax rate greater than 35 percent and less than or equal to 45 percent.</td>
</tr>
<tr>
<td>5) <strong>Very high</strong> - Corporate tax rate greater than 45 percent.</td>
</tr>
</tbody>
</table>

The government's method of financing its expenditures, in addition to their absolute amount, has an impact. Whether a given level of government expenditure is financed by taxation, debt issuance, or money creation (or varying amounts of each) has its own impact on the economy and society. The financing method imposes its own burden, but the expenditures are a fiscal burden unto themselves.

Milton Friedman believes that government expenditures are the most complete measure of a state's burden on the economy. Government expenditures capture the possibility of spending in excess of tax revenues, financed either by increased borrowing or by the printing of money, which imposes further costs on an economy. The size of a government's appetite for private resources affects both economic freedom and economic growth. For example, if the government of an economically small and emerging country appropriates one-third of the nation's total output through expenditures, it drains away resources that could have been used for private investment projects and consumption. The same appetite by the government of a large advanced economy may do comparatively less to affect the growth rate, since advanced societies typically enjoy substantial savings and a large base of productive capital, but high levels of government expenditures in developed countries can still significantly hamper their economic growth.
Methodology
The score for the fiscal burden of government has two components: tax rates and government expenditures as a percentage of GDP. The tax component reflects the country’s income and corporate tax rates. The authors followed several steps in scoring the tax portion for this factor. First, a country’s individual income tax score was determined by averaging the score for the top income tax rate and the score for the marginal rate for the average taxpayer. For instance, Chile has a top income tax rate of 43 percent, and the marginal rate for the average taxpayer is 0 percent. Chile would receive a 4 for the top income tax of 43 percent and a 1 for the 0 percent marginal rate for the average taxpayer. The individual income tax score would be 2.5. Some countries had 1 point subtracted from their individual income tax score because they had a flat tax. While the level of taxation is the most important issue, a flat tax conveys benefits that a traditional progressive tax bracket system does not. For instance, a simple flat tax reduces the hours invested in calculating tax payments, increases the accuracy of returns, and reduces expenditures on tax preparation by experts; it does not discourage increased income because more income is retained as it increases, as opposed to traditional progressive tax systems; it is fairer because all people are treated equally for tax purposes; it eliminates opportunities for political influence over the tax system because deductions, preferences, exclusions, loopholes, credits, and exemptions are eliminated; and it helps avoid corruption and tax collection as avenues for tax avoidance and evasion are eliminated. In sum, the ease of administration and compliance avoids the distortions caused by progressivity, and thereby merits special notice in scoring.

The individual income tax score is averaged with the corporate tax score to calculate the overall income and corporate taxation score. For instance, Chile’s corporate tax of 16 percent earns it a “very low” score of 1. To calculate the income and corporate taxation score, Chile’s individual income tax score of 2.5 would be added to its corporate tax score of 1 and divided in half to yield an overall score of 1.75. This would be rounded up to a 2, giving Chile an overall income tax rating of "low."

The second half of the fiscal burden of government score is government expenditures as a percent of gross domestic product (GDP). Government expenditure as a percent of GDP was assigned a score from 1 to 5.8. As a developing country, Chile’s government expenditure of 24.6 percent of GDP earns Chile a “moderate” government expenditure score of 3. The authors then averaged the scores for income and corporate taxation and for government expenditures to arrive at a final score for the fiscal burden that the government imposes on a country. For Chile, this process resulted in a “moderate” overall fiscal burden of government score of 2.5.

To keep the fiscal burden of government score consistent with the other nine factorss, each score ends in either 0.00 or 0.50; all numbers that end with a 0.25 were rounded up to 0.50, while numbers that end with a 0.75 were rounded up to the nearest whole number.

Sources
Unless otherwise noted, the authors used the following sources for information on taxation, in order of priority: Ernst & Young, 2002 The Global Executive and 2002 Worldwide Corporate Tax Guide; International Monetary Fund Staff Country Report, Selected Issues and Statistical Appendix, 2000 to 2002; Economist Intelligence Unit, Country Commerce, Country Profile, and Country Report for 2001 and 2002; U.S. Department of State, Country Commercial Guide9; and official government publications of each country. Sources other than Ernst & Young are noted in the text.

Factors used in government expenditures, the authors’ primary sources were Organisation for Economic Co-operation and Development data (for member countries); International Monetary Fund, Government Finance Statistics Yearbook for 2001, and International Monetary Fund Staff Country Report, Selected Issues and Statistical Appendix, 2000 to 2002; Standard & Poor’s, Sovereigns Ratings Analysis; Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries 2001; African Development Bank, ADB Statistics Pocketbook 2002; European Bank for Reconstruction and Development, Country Strategies; Inter-American Development Bank; U.S. Department of State, Country Commercial Guide10; and official government publications of each country. Sources other than the OECD and the IMF are noted in the text.

Factor #3: Government Intervention in the Economy
This factor measures government’s direct use of scarce resources for its own purposes and government’s control over resources through ownership. The measure comprises both government consumption and
government production. Transfer payments, which consist of compulsory exchange of titles over resources among individuals, are excluded from this measure.

Government consumption consists of net purchases of goods, services, and structures (for example, bridges and buildings); wages paid to government employees; net purchases of fixed assets; and inventory changes in government enterprises.11 Government production is measured as described below. The measure of government intervention is distinct from government's regulatory role and complements the measure of fiscal burden.12

<table>
<thead>
<tr>
<th>Government Expenditures Scale for Developed Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score Government Expenditures Criteria as Percent of GDP</td>
</tr>
<tr>
<td>1) Very low - Less than or equal to 15 percent.</td>
</tr>
<tr>
<td>2) Low - Greater than 15 percent but less than or equal to 25 percent.</td>
</tr>
<tr>
<td>3) Moderate - Greater than 25 percent but less than or equal to 35 percent.</td>
</tr>
<tr>
<td>4) High - Greater than 35 percent but less than or equal to 45 percent.</td>
</tr>
<tr>
<td>5) Very high - Greater than 45 percent.</td>
</tr>
</tbody>
</table>

**Methodology**

By taking government consumption as a percentage of GDP, one can begin to determine the level of government intervention in the economy. The higher the rate of government consumption as a percentage of GDP, the higher the Index score and, hence, the lower the level of economic freedom.

Governments intervene in the economy not only by consuming scarce resources, but also by engaging in business activities that generally could be carried out in the private sector. Governments that operate state-owned enterprises crowd out private initiative and investment. In addition, state-run enterprises are generally inefficient and deter economic growth. The authors measure the size of the state-owned sector by using the share of revenues a country receives from state-owned enterprises and government ownership of property. To scale this statistic, the authors computed the standard deviation around the median value and then added and subtracted one standard deviation to the median using the data from the International Monetary Fund's 2001 Government Finance Statistics Yearbook. To ensure that changes in scores reflect only changes in the statistic and not a change in the scale, the authors do not rescale this statistic each year. The median value is 6.12 percent, and the standard deviation is 1.7; thus, the demarcations in the scale are 4.4 percent and 7.8 percent. The authors then added 0 points to the government consumption score if its share of the revenue for state-owned enterprises and government-owned property was less than 4.4 percent, 0.5 point if its share was greater than or equal to 4.4 percent but less than 7.8 percent, and 1 point if the statistic was greater than or equal to 7.8 percent.

The main source used for revenues from state-owned enterprises is the International Monetary Fund's Government Finance Statistics Yearbook. When these data are not available in this source, the authors look for them in the country's Ministry of Economy or Finance's Web site or through the country's embassy in the United States. When the authors obtain the data on revenues from state-owned enterprises from more than one place, they note this fact in the country's write-up.

<table>
<thead>
<tr>
<th>Variables of Factor #3: Government Intervention in the Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Government consumption as a percentage of the economy</td>
</tr>
<tr>
<td>• Government ownership of businesses and industries</td>
</tr>
<tr>
<td>• Share of government revenues from state-owned enterprises and government ownership of property</td>
</tr>
<tr>
<td>• Economic output produced by the government</td>
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</tbody>
</table>

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</tr>
<tr>
<td>3) Moderate - Greater than 20 percent but less than or equal to 25 percent.</td>
</tr>
<tr>
<td>4) High - Greater than 25 percent but less than or equal to 30 percent.</td>
</tr>
<tr>
<td>5) Very high - Greater than 30 percent.</td>
</tr>
</tbody>
</table>

For countries in which the share of total revenues from state-owned enterprises and government ownership of property was not available, the following methodology was employed: For countries with evidence of many
state-owned enterprises, 1 point was added to the government intervention score (with a variety of sources used in making this judgment).

This factor also examines the state of privatization programs. If a country has a state-owned sector that is being aggressively privatized, the authors note this fact; it puts into context any statements about the size of the state-owned sector. If the privatization program has stalled or if one is not in place, however, the authors note that as well.

**Government Intervention Grading Scale**

<table>
<thead>
<tr>
<th>Score Level of Government Intervention</th>
<th>Criteria in the Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Very low</td>
<td>Less than or equal to 10 percent of GDP.</td>
</tr>
<tr>
<td>2) Low</td>
<td>Greater than 10 percent but less than or equal to 25 percent of GDP.</td>
</tr>
<tr>
<td>3) Moderate</td>
<td>Greater than 25 percent but less than or equal to 35 percent of GDP.</td>
</tr>
<tr>
<td>4) High</td>
<td>Greater than 35 percent but less than or equal to 45 percent of GDP.</td>
</tr>
<tr>
<td>5) Very high</td>
<td>45 percent or more of GDP.</td>
</tr>
</tbody>
</table>

Additionally, in a few cases, there is strong reason to doubt either the measure of government consumption or the share of enterprise income. In these cases, where there is compelling evidence of heavy government involvement in the economy, the authors added 1 or more points to the score (making it worse).13

The final variable is whether or not the government intervenes in the stock market. When a government intervenes in the stock market, it contravenes the choices of millions of individuals. It does so by interfering with the pricing of capital, the most critical function of a market economy. Equity markets measure, on a continual basis, the expected profits and losses in publicly held companies. This measurement is essential in allocating capital resources to their highest valued uses and thereby satisfying consumers' most urgent wants. When the authors find evidence of government intervention in the stock market, they add 1 point more to the score.

**Sources**

Unless otherwise noted, the authors used the following sources for information on government intervention in the economy: International Monetary Fund, Government Finance Statistics Yearbook 2001; U.S. Department of State, Country Commercial Guide14 and Country Reports on Economic Policy and Trade Practices for 2001 and 2002; Economist Intelligence Unit, Country Report, 2002; World Bank, World Development Indicators 2002; and official government publications of each country.

Sometimes, the data for the share of total revenues from state-owned enterprises and government ownership of property are not readily reported. In these cases, the authors look both for the data on total revenues from state-owned enterprises and government ownership of property and for the data on total government revenues and then calculate the percentage of total revenues represented by revenues from state-owned enterprises and government ownership of property.

**Factor #4: Monetary Policy**

The value of a country's currency is shaped largely by its monetary policy. When a government's monetary policy facilitates market pricing, individuals enjoy greater economic freedom. John Maynard Keynes observed that "by a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens."15

Inflation not only confiscates wealth, but also distorts pricing, misallocates resources, and undermines a free society.

**Monetary Policy Grading Scale**

<table>
<thead>
<tr>
<th>Score Weighted Average Criteria</th>
<th>Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Very low</td>
<td>Weighted average inflation less than or equal to 3 percent.</td>
</tr>
<tr>
<td>2) Low</td>
<td>Weighted average inflation greater than 3 percent but less than or equal to 6 percent.</td>
</tr>
<tr>
<td>3) Moderate</td>
<td>Weighted average inflation greater than 6 percent but less than or equal to 12 percent.</td>
</tr>
<tr>
<td>4) High</td>
<td>Weighted average inflation greater than 12 percent but less than or equal to 20 percent.</td>
</tr>
<tr>
<td>5) Very high</td>
<td>Weighted average inflation greater than 20 percent.</td>
</tr>
</tbody>
</table>
There is no singularly accepted theory of the right monetary institutions for a free society. At one time, the gold standard enjoyed widespread support, but this is no longer the case (though some continue to support that system). What characterizes almost all monetary theorists today, however, is support for low or zero inflation. A good way to gauge the influence of monetary policy on economic freedom is to analyze the inflation rate over a period of time.

**Variables of Factor #4: Monetary Policy**
- Weighted average inflation rate from 1992 to 2001

**Methodology**
The main criterion for this factor is a country's weighted average annual rate of inflation from 1992 to 2001. The authors created the monetary policy score by first weighting inflation rates for each of the past 10 years so that the year farthest from the present has the least weight and the current year has the greatest weight. Then the authors calculated an average of these weighted rates. In some cases, data were not available for all 10 years; for these countries, the authors used as many years as the availability of data would allow. The reader should be aware that when governments have comprehensive price and wage controls, measured inflation may be distorted.

**Sources**

**Factor #5: Capital Flows and Foreign Investment**
Restrictions on foreign investment limit the inflow of capital and thus hamper economic freedom. By contrast, little or no restriction of foreign investment enhances economic freedom; foreign investment provides funds for economic expansion. For this category, the more restrictions a country imposes on foreign investment, the lower the level of economic freedom and the higher the score.

**Capital Flows and Foreign Investment Grading Scale**

<table>
<thead>
<tr>
<th>Score Barriers to Foreign Investment Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Very low - Open and impartial treatment of foreign investment; accessible foreign investment code; almost no restrictions on foreign investments except for fields related to national security.</td>
</tr>
<tr>
<td>2 Low - Restrictions on investments in few sectors, such as utilities, companies vital to national security, and natural resources; limited, efficient approval process.</td>
</tr>
<tr>
<td>3 Moderate - Restrictions on many investments, but official policy conforms to established foreign investment code; bureaucratic approval process.</td>
</tr>
<tr>
<td>4 High - Investment permitted on a case-by-case basis; possible presence of bureaucratic approval process and corruption.</td>
</tr>
<tr>
<td>5 Very high - Government seeks actively to prevent foreign investment; rampant corruption.</td>
</tr>
</tbody>
</table>

**Methodology**
This factor scrutinizes each country's policies toward foreign investment in order to determine its overall investment climate. It examines such variables as the presence of a foreign investment code that defines the country's investment laws and procedures; whether the government encourages foreign investment through fair and equitable treatment of investors; whether there are restrictions on access to foreign exchange; whether foreign firms are treated the same as domestic firms under the law; the presence of restrictions on payments, transfers, and capital transactions; and whether specific industries are closed to foreign investment. This analysis helps to develop an overall description of the country's investment climate. The authors then grade each country based on those variables.
Variables of Factor #5: Capital Flows and Foreign Investment

- Foreign investment code
- Restrictions on foreign ownership of business
- Restrictions on the industries and companies open to foreign investors
- Restrictions and performance requirements on foreign companies
- Foreign ownership of land
- Equal treatment under the law for both foreign and domestic companies
- Restrictions on repatriation of earnings
- Availability of local financing for foreign companies

Sources


Factor #6: Banking and Finance

In most countries, banks provide the essential financial services that facilitate economic growth; they lend money to start businesses, purchase homes, and secure credit to purchase consumer durable goods, in addition to furnishing a safe place in which individuals can store their earnings. The more banks are controlled by the government, the less free they are to engage in these activities. One consequence of heavy bank regulation is restricted economic freedom; therefore, the more a government restricts its banking sector, the higher its score and the lower its level of economic freedom.

In developed economies, commercial banks are relatively less important; a higher proportion of credit is supplied in organized securities markets. Over the years, the authors have devoted more attention to the non-banking part of the financial services industry (insurance and securities).

Banking and Finance Grading Scale

Score Restrictions on Banks Criteria

1 Very low - Government involvement in the financial sector negligible; very few restrictions on foreign financial institutions; banks may engage in all types of financial services.
2 Low - Government involvement in the financial sector minimal; few limits on foreign banks; country may maintain some limits on financial services; domestic bank formation may face some barriers.
3 Moderate - Substantial government influence on banks; government owns or controls some banks; government controls credit; domestic bank formation may face significant barriers.
4 High - Heavy government involvement in the financial sector; banking system in transition; banks tightly controlled by government; possible corruption; domestic bank formation virtually nonexistent.
5 Very high - Financial institutions in chaos; banks operate on primitive basis; most credit controlled by government and goes only to state-owned enterprises; corruption rampant.

It should be noted that virtually all countries provide some type of prudential supervision of banks and other financial services. This supervision serves two major purposes: ensuring the safety and soundness of the financial system and ensuring that financial services firms meet basic fiduciary responsibilities.
Ultimately, this task falls under a government's duty to enforce contracts and protect its citizens against fraud. Some protection of this sort is provided in the marketplace by such institutions as independent auditors and firms providing information services, and the market arguably could take over even more of this oversight responsibility. The key point, however, is that markets demand independent oversight of financial services firms because of the high standards of fiduciary duty required in that industry. Such oversight is distinguished from burdensome government regulation, which interferes with market provision of financial services to consumers. It is the latter, not the former, that interferes with economic freedom and causes the grade on this factor to be better or worse.

Methodology
The banking and finance factor measures the relative openness of a country's banking and financial system, and the authors score this factor by determining the openness of a country's banking and financial system: specifically, whether foreign banks and financial services firms are able to operate freely, how difficult it is to open domestic banks and other financial services firms, how heavily regulated the financial system is, the presence of state-owned banks, whether the government influences allocation of credit, and whether banks are free to provide customers with insurance and invest in securities (and vice-versa). The authors use this analysis to develop a description of the country's financial climate.

Sources

Factor #7: Wages and Prices
In a market economy, prices allocate resources to their highest use. A firm that needs more employees may signal this need to the market by offering a higher wage; an individual who greatly values a home on the market offers a higher price to purchase it. Prices also act as signals to producers and consumers by conveying information that otherwise would be prohibitively costly to obtain. For example, if the demand for a good increases, this will be reflected in the price of the product and will be a signal to producers to increase production.

Wages and Prices Grading Scale
Score Wage and Price Controls Criteria
1) Very low - The market sets prices of goods and services, and the country either does not have a minimum wage or the evidence indicates that the minimum wage applies to a small portion of the work force and is therefore not relevant in wage setting. The government may participate in collective bargaining as long as it does not impose those wage agreements on other sectors or on workers that are not immediately parties to the agreement.
2) Low - The government controls prices on some goods and services, but controls do not apply to a significant portion of national output. The government either has a minimum wage that applies to a significant portion of the work force or extends collective bargaining agreements across industries or sectors and on workers that are not immediately party to the agreement.
3) Moderate - The government controls prices of goods and services that constitute a significant portion of national output, government-set wages apply to a large portion of the work force, or both.
4) High - The government determines most prices of goods and services and most wages.
5) Very high - Wages and prices of goods and services are almost completely controlled by the government.
When prices are determined freely, resources go to their most productive use for satisfying consumers. As Nobel Laureate Friedrich A. Hayek put it, "We must look at the price system as...a mechanism for communicating information if we want to understand its real function a function which, of course, it fulfills less perfectly as prices grow more rigid."²⁰

Some governments mandate wage and price controls. By so doing, they restrict economic activity and curtail economic freedom. Government control its score and the lower its level of economic freedom.

**Methodology.** The authors score this factor by the extent to which a government allows the market to set wages and prices. Specifically, this factor looks at which products have prices set by the government and whether the government has a minimum wage policy or otherwise influences wages. The factor's scale measures the relative degree of government control over wages and prices. A "very low" score of 1 represents wages and prices that are set almost completely by the market, whereas a "very high" score of 5 means that wages and prices are set almost completely by the government.

**Sources**

**Factor #8: Property Rights**
The ability to accumulate private property is the main motivating force in a market economy, and the rule of law is vital to a fully functioning free-market economy. Secure property rights give citizens the confidence to undertake commercial activities, save their income, and make long-term plans because they know that their income is safe from expropriation. This factor examines the extent to which the government protects private property by enforcing the laws and how safe private property is from expropriation. The less protection private property receives, the lower the level of economic freedom and the higher the score.

**Property Rights Grading Scale**

<table>
<thead>
<tr>
<th>Score Protection of Private Property Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) <strong>Very high</strong> - Private property guaranteed by the government; court system efficiently enforces contracts; justice system punishes those who unlawfully confiscate private property; corruption nearly nonexistent and expropriation unlikely.</td>
</tr>
<tr>
<td>2) <strong>High</strong> - Private property guaranteed by the government; court system suffers delays and is not always strict in enforcing contracts; corruption possible but rare; expropriation unlikely.</td>
</tr>
<tr>
<td>3) <strong>Moderate</strong> - Court system inefficient and subject to delays; corruption may be present; judiciary may be influenced by other branches of government; expropriation possible but rare.</td>
</tr>
<tr>
<td>4) <strong>Low</strong> - Property ownership weakly protected; court system inefficient; corruption present; judiciary influenced by other branches of government; expropriation possible.</td>
</tr>
<tr>
<td>5) <strong>Very low</strong> - Private property outlawed or not protected; almost all property belongs to the state; country in such chaos (for example, because of ongoing war) that property protection is nonexistent; judiciary so corrupt that property is not effectively protected; expropriation frequent.</td>
</tr>
</tbody>
</table>

**Methodology**
This factor scores the degree to which private property rights are protected and the degree to which the government enforces laws that protect private property. It also accounts for the possibility that private property will be expropriated. In addition, it analyzes the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts. The less the
legal protection of property, the higher the score; similarly, the greater the chances of government expropriation of property, the higher the score.

<table>
<thead>
<tr>
<th>Variables of Factor #8: Property Rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Freedom from government influence over the judicial system</td>
</tr>
<tr>
<td>• Commercial code defining contracts</td>
</tr>
<tr>
<td>• Sanctioning of foreign arbitration of contract disputes</td>
</tr>
<tr>
<td>• Government expropriation of property</td>
</tr>
<tr>
<td>• Corruption within the judiciary</td>
</tr>
<tr>
<td>• Delays in receiving judicial decisions</td>
</tr>
<tr>
<td>• Legally granted and protected private property</td>
</tr>
</tbody>
</table>

**Sources**


**Factor #9: Regulation**

Regulations and restrictions make it difficult for entrepreneurs to create new businesses. In some countries, government officials frown on any private-sector initiatives; in a few, they even make them illegal. Although many regulations hinder business, the most important are associated with licensing new companies and businesses. In some countries, as well as many states in the United States, the procedure for obtaining a business license can be as simple as mailing in a registration form with a minimal fee. In Hong Kong, for example, obtaining a business license requires filling out a single form, which can be completed in a few hours.23 In other countries, such as India and in parts of South America, obtaining a business license requires endless trips to government offices, and the process can take a year or more.

**Regulation Grading Scale**

<table>
<thead>
<tr>
<th>Score Levels of Regulation Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) <strong>Very low</strong> Existing regulations straightforward and applied uniformly to all businesses; regulations not much of a burden for business; corruption nearly nonexistent.</td>
</tr>
<tr>
<td>2) <strong>Low Simple</strong> Licensing procedures; existing regulations relatively straightforward and applied uniformly most of the time, but burdensome in some instances; corruption possible but rare.</td>
</tr>
<tr>
<td>3) <strong>Moderate</strong> Complicated licensing procedure; regulations impose substantial burden on business; existing regulations may be applied haphazardly and in some instances are not even published by the government; corruption may be present and poses minor burden on businesses.</td>
</tr>
<tr>
<td>4) <strong>High</strong> Government-set production quotas and some state planning; major barriers to opening a business; complicated licensing process; very high fees; bribes sometimes necessary; corruption present and burdensome; regulations impose a great burden on business.</td>
</tr>
<tr>
<td>5) <strong>Very high</strong> Government impedes the creation of new businesses; corruption rampant; regulations applied randomly.</td>
</tr>
</tbody>
</table>

Once a business is open, government regulation does not always subside; in some cases, it increases. In some cases, two countries with the same set of regulations can impose different regulatory burdens. If one of them, for example, applies its regulations evenly and transparently, it lowers the regulatory burden since businesses can make long-term plans. On the other hand, if a country applies regulations inconsistently, it raises the regulatory burden on businesses by creating an unpredictable business environment. For example, in some countries, an environmental regulation may be used to shut down one business but not another. Business owners are uncertain about which regulations they must obey. In addition, the existence of excessive regulation can support corruption as confused and harassed business owners attempt to navigate the red tape.
Methodology
This factor measures how easy or difficult it is to open and operate a business. The more regulations imposed on business, the harder it is to establish one. The factor also examines the degree of corruption in government and whether regulations are applied uniformly to all businesses. Another consideration is whether the country has state planning agencies that set production limits and quotas. The scale establishes a set of conditions for each of the five possible grades. These conditions also include such items as the extent of government corruption, how uniformly regulations are applied, and the extent to which regulations impose a burden on business. A "very low" score of 1 indicates that corruption is virtually nonexistent and regulations are minimal and applied uniformly; a "very high" score of 5 indicates that corruption is rampant, regulations are applied randomly, and the general level of regulation is very high. A country need only meet a majority of the conditions for a particular score to receive that score.

Variables of Factor #9: Regulation
- Licensing requirements to operate a business
- Ease of obtaining a business license
- Corruption within the bureaucracy
- Labor regulations, such as established work weeks, paid vacations, and parental leave, as well as selected labor regulations
- Environmental, consumer safety, and worker health regulations
- Regulations that impose a burden on business

Sources

Factor #10: Black Market
In some cases, the existence of a black market may appear positive; at least there is some ability to engage in entrepreneurship or to obtain scarce goods and services. Harvard economist Robert Barro notes, "In some circumstances, corruption may be preferable to honest enforcement of bad rules. For example, outcomes may be worse if a regulation that prohibits some useful economic activity is thoroughly enforced rather than circumvented through bribes." Alejandro Chafuen and Eugenio Guzmán, however, point out that "corruption is the cost of obtaining privileges that only the State can `legally' grant, such as favouritism in taxation, tariffs, subsidies, loans, government contracting, and regulation."

Black Market Grading Scale
Score Black Market Activity Criteria
1) Very low Very low level of black market activity; economies are free markets with black markets in such things as drugs and weapons.
2) Low Low level of black market activity; economies may have some black market involvement in labor or pirating of intellectual property.
3) Moderate Moderate level of black market activity; countries may have some black market activities in labor, agriculture, and transportation, and moderate levels of intellectual property piracy.
4) High High level of black market activity; countries may have substantial levels of black market activity in such areas as labor, pirated intellectual property, and smuggled consumer goods, and in such services as transportation, electricity, and telecommunications.
5) Very high Very high level of black market activity; countries have black markets that are larger than their formal economies.

Black markets are the direct result of some kind of government intervention in the marketplace. A black market activity is one that the government has taxed heavily, regulated in a burdensome manner, or simply
outlawed in the past. This factor captures the effects of government interventions not always fully measured elsewhere.

Although many societies outlaw such activities as trafficking in illicit drugs, others frequently limit individual liberty by outlawing such activities as private transportation and construction services. A government regulation or restriction in one area may create a black market in another. For example, a country with high barriers to trade may have laws that protect its domestic market and prevent the import of foreign goods, but these barriers create incentives for smuggling and a black market for the barred products. In addition, governments that do not have strong property rights protection for items like intellectual property, or that do not enforce existing laws, encourage piracy and theft of these products.

For the purposes of this Index, the larger the black market in a particular country, the lower the level of economic freedom; and the more prevalent black market activities are, the worse the score. Conversely, the smaller the black market, the higher the level of economic freedom; and the less prevalent these activities are, the better the score.

**Methodology**

This factor relies on Transparency International's Corruption Perceptions Index (CPI), which measures the level of corruption in 91 countries, to determine the black market score.\(^{27}\) As the level of corruption increases, the level of black market activity rises as well. Citizens often engage in corrupt activity, such as bribing an official, so that they can enter the black market.

Because the CPI is based on a 10-point scale in which 10 equals very little corruption and 1 equals a very corrupt government, it was necessary to transform the CPI to a five-point scale consistent with the other nine factors graded in the Index. To do this, the authors regressed the CPI on the black market Index of Economic Freedom score. After estimating the relationship between the two variables, the authors substituted the CPI into the equation to arrive at a number between 1 and 5. The authors then rounded the numbers to the nearest half point (0.5 point).\(^{28}\) If 2001 Transparency International data were not available and 2000 TI data were available, the authors used the 2000 TI data.

For countries that are not covered in the CPI, the black market score is determined by using the same procedure as in previous years. (See text box.) This factor considers the extent to which black market activities occur. Although information on the size of black markets in less-developed countries is difficult to obtain, information on the extent of smuggling, piracy of intellectual property, and black market labor can be found. When such information is available, the authors use it to determine the extent of black market activities. The higher the level of black market activity, the higher the score and the lower the level of economic freedom. As newer data become available, it may become possible to document the percentage of black market activity in a country's overall economy.

Although this factor measures black market activity in the production, distribution, or consumption of goods and services, it does not measure such things as black market exchange rates or illegal provision of "vices," such as gambling, narcotics, prostitution, and related activities. Such activities are very difficult to quantify with objectivity.

**Sources**


**Notes:**


2) "The property which every man has in his own labour, as it is the original foundation of all other property, so it is the most sacred and inviolable." Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (New York: The Modern Library, 1937), pp. 121122; first published in 1776.

3) The Country Commercial Guides are published by the U.S. Commercial Service but are based on data from U.S. embassies, the U.S. Department of State, and the U.S. Department of Commerce. Quotes from this publication are cited as originating with the U.S. Department of State in the country write-ups.


5) A Note on Income Taxes:
The marginal income tax rate for the average taxpayer is calculated by establishing the per capita GDP for the nation and determining what income tax rate would be assessed on that level of income. Per capita GDP is from the World Development Indicators 2002 on CDROM, and the tax rates are from the sources noted for tax information. If data are not available for both the top individual income tax rate and the marginal rate for the average taxpayer, the data that are available will be used to determine the individual income tax score.

6) These countries are Bolivia, Estonia, Hong Kong, Iceland, Latvia, Lithuania, and Russia.


8) A Note on Government Expenditures:
The authors divided the countries into two groups: countries recognized as economically developed and countries that are emerging or developing. This division reflects the differing effects of government expenditures in countries of significantly different sizes. "Developed countries" enjoy this designation in part because they have accumulated substantial capital structures and high levels of productivity per capita. Substantial savings in developed countries permit resource owners and entrepreneurs to prosper even when government absorbs a significant portion of the economy's annual output, say, 25 percent. This ability to weather government's presence in the economy, however, is not found as readily in an emerging economy. The government of an emerging country that spends 25 percent of annual economic output will have a much greater influence on entrepreneurship than the government of its developed counterpart will have. Thus, the authors used two scales in calculating the government expenditures component of the fiscal burden score: the first for government expenditures (federal, state, and local levels) as a percentage of a developed country's GDP and the second for the same statistic in developing and emerging countries. The authors ranked the countries using per capita GNP and designated the top 40 countries as developed countries. This list will be revised in the tenth edition

9) See note 3.

10) See note 3.


12) In a few cases, data on government consumption were not available for a country, but data on government expenditures were available, or vice versa. When information on government consumption was not available for the government intervention factor and government expenditure data were available, the authors used government expenditures as a proxy for government consumption. Similarly, when government expenditure data were not available for the fiscal burden of government factor and government consumption data were available, the authors used government consumption as a proxy for government expenditures.

13) The countries for which a point was added include Bangladesh, Burma, Belarus, Cuba, Chad, China, Egypt, Haiti, Indonesia, Iran, Libya, Macedonia, Syria, Tajikistan, Venezuela, and Vietnam.

14) See note 3.


16) The weights were generated using an exponential weighting procedure. The weights are as follows: The most recent year received a weight of 1.0, followed by 0.36788, 0.13534, 0.04979, 0.01832, 0.00674, 0.00248, 0.00091, 0.00034, and 0.00012.

17) In his cross-country study on growth, Robert J. Barro found that relatively recent inflation had the main explanatory power for growth. Robert J. Barro, Determinants of Economic Growth: A Cross-Country Empirical Study (Cambridge, Mass.: MIT Press, 1997).

18) See note 3.

19) See note 3.


21) See note 3.

22) See note 3.
24) See note 3.
27) Last year, the authors graded the black market factor using Transparency International’s 2000 and 2001 Corruption Perceptions Index (CPI) reports. At the time of writing the 2003 Index of Economic Freedom, the 2002 CPI report had not been published. Therefore, the black market factor could be updated this year only for those countries that were not covered in the 2000 and 2001 CPI reports and for which additional information was available.
28) The equation the authors estimated is as follows: black market = 5.227 -.4771*CPI. The authors then substituted the CPI score back into the equation to arrive at a number between 1 and 5. For example, substituting Denmark's CPI score of 9.5 back into the equation yields a black market score of 0.695 (which rounds up to a score of 1).
29) See note 3.