Economic Growth, Foreign Investments and Economic Freedom: A Case of Transition Economy

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- The main objective of the current paper is to test hypothesis about impact of economic freedom as one of the main factor of economic growth paying special attention to CEE transition countries. I have combined it with looking at the impact of FDI.

- The theme of economic growth is perhaps the most researched theme in economic literature. There are numerous textbooks and researches on that, but until now no proven correlation between the theory and empirical data for different economic situations can be found.

- The connection between economic freedom and economic growth is relatively controversial. Even if the economic growth can be managed in stable economies, nobody has universal receipt for transition economies.

Economic freedom – where is the problem?

- There are three respected major surveys that measure economic liberty on a systematic basis: the Fraser Institute's economic freedom index, Freedom House's economic freedom indicators, and the Heritage Foundation's indices of economic freedom.

Fraser Institute's economic freedom index

- The EFN (derived by the Fraser Institute) index measures the degree to which the policies and institutions of countries are supportive of economic freedom.
- According to the authors of EFN index the cornerstones of economic freedom are: personal choice, voluntary exchange, freedom to compete, and security of privately owned property.
- Thirty-eight components and sub-components are used to construct a summary index and to measure the degree of economic freedom in five areas: (1) size of government; (2) legal structure and protection of property rights; (3) access to sound money; (4) international exchange; and (5) regulation.
- The composition of the index has had some small changes compared to the first time it has been published.

Heritage Index (Index of Economic Freedom)

- To measure economic freedom and rate each country, the authors of the Heritage Index (Index of Economic Freedom) study 50 independent economic variables. They include:
- **Business freedom** is the ability to create, operate, and close an enterprise quickly and easily. Burdensome, redundant regulatory rules are the most harmful barriers to business freedom.
- **Trade freedom** is a composite measure of the absence of tariff and non-tariff barriers that affect imports and exports of goods and services.
- **Monetary freedom** combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market.
- **Freedom from government** is defined to include all government expenditures—including consumption and transfers—and state-owned enterprises. Ideally, the state will provide only true public goods, with an absolute minimum of expenditure.

- **Fiscal freedom** is a measure of the burden of government from the revenue side. It includes both the tax burden in terms of the top tax rate on income (individual and corporate separately) and the overall amount of tax revenue as portion of GDP.
- **Property rights** is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state.
- **Investment freedom** is an assessment of the free flow of capital, especially foreign capital.
- **Financial freedom** is a measure of banking security as well as independence from government control. State ownership of banks and other financial institutions such as insurer and capital markets is an inefficient burden, and political favoritism has no place in a free capital market.
- **Freedom from corruption** is based on quantitative data that assess the perception of corruption in the business environment, including levels of governmental legal, judicial, and administrative corruption.
- **Labor freedom** is a composite measure of the ability of workers and businesses to interact without restriction by the state.

- In the Index of Economic Freedom, all 10 factors are equally important to the level of economic freedom in any country. Thus, to determine a country's overall score, the factors are weighted equally.

- Based on the old methodology, the higher a country's score on a factor the less economic freedom there is. The 10 factors are given equal weight in determining the final score. Depending on their score, countries are then separated into four categories: Free, Mostly Free, Mostly Unfree, and Repressed.

- In the last publications the methodology is changed and the higher the score is the more economic freedom the country has.

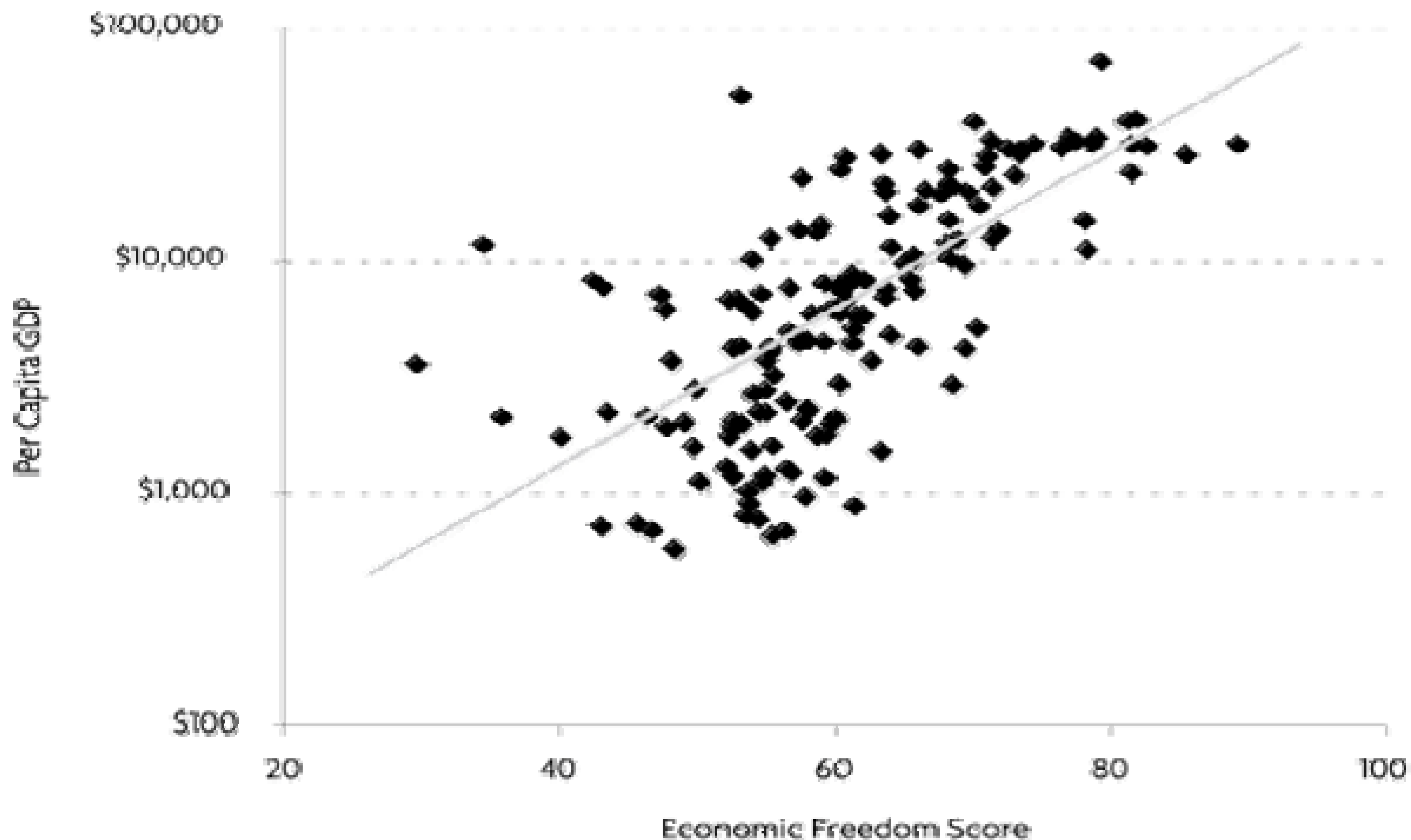
- Most of researches on the area of relationship between economic freedom and economic growth use EFN index, which is derived by the Fraser Institute.
- For transition countries this index is calculated since 1995. Because the index has been provided only in five years cycle before 2000, there is index value for CEE countries in 1995, in 2000 and then annually for 2001, 2002 and so on.
- Therefore only few values of the index are available for most CEE transition countries – Estonia, Latvia, Lithuania, Ukraine, Slovenia, Slovakia, Czech Republic, Croatia - all those have only short series.

- Comparison of rankings of individual countries in EFN and HF indexes does confirm that different methods create different absolute rankings.
- Whereas most of the countries with top ranking are same (19 out of top 23 are overlapping), some differences remain.
- EFN index ranks United Arab Emirates on 12th position, when HF places it only as 65th. Similar situation is with Oman – EFN 18th, HF 74th. Smaller differences are with Czech Republic – HF 26th, EFN 44th or with Cyprus – HF 16th, EFN 38th.

Index of Economic Freedom – some conclusions

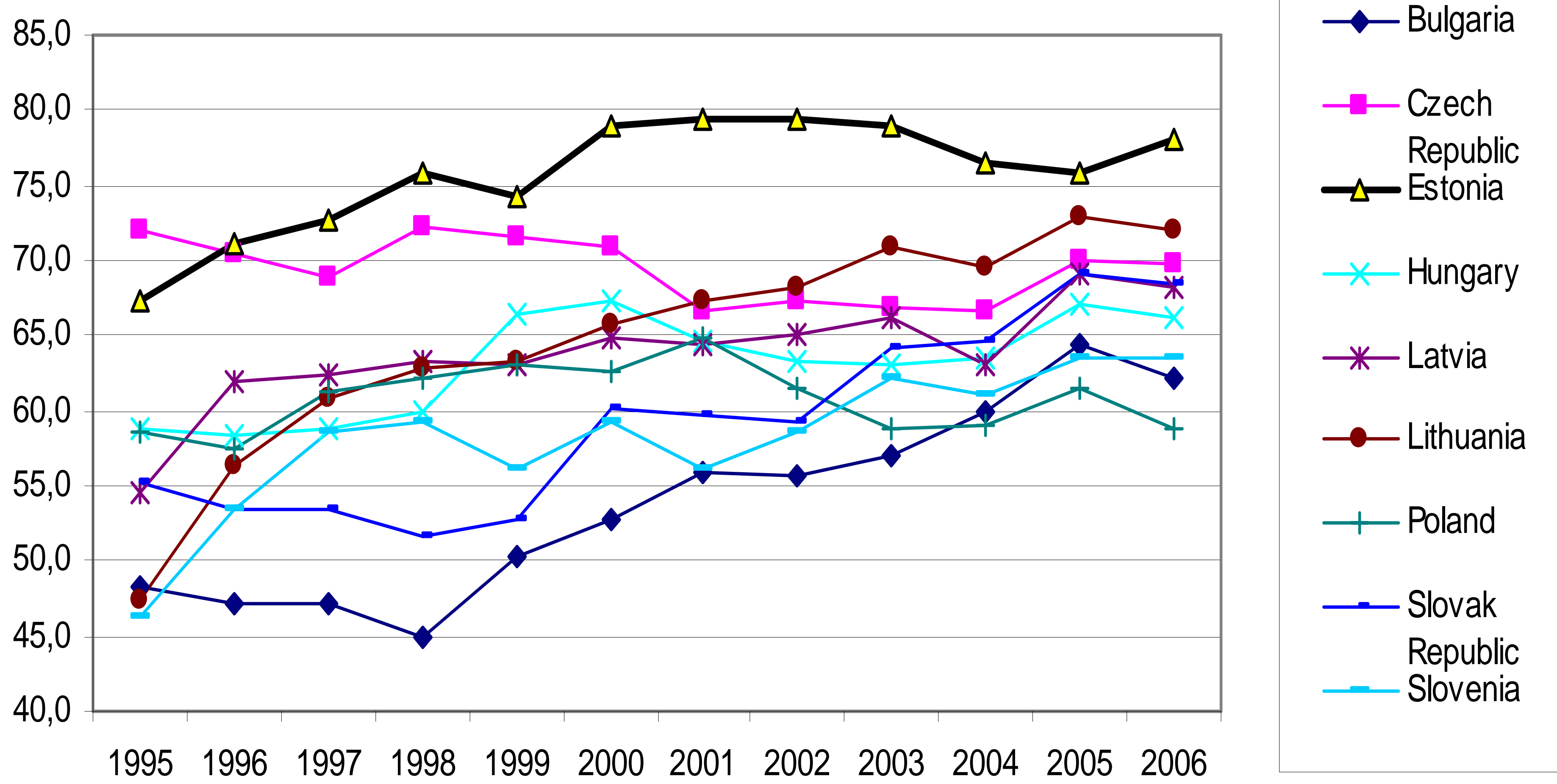
- **Twelve of the top 20 freest economies are European.** A majority of the freest economies are in Europe, led by the United Kingdom, Ireland, Luxembourg, and Switzerland. Only five are in the Asia–Pacific region. The remaining three are from the Americas: the United States, Canada, and Chile.
- **Economic freedom is strongly related to good economic performance.** The world's freest countries have twice the average per capita income of the second quintile of countries and over five times the average income of the fifth quintile of countries. The freest economies also have lower rates of unemployment and lower inflation. These relationships hold across each quintile, meaning that every quintile of less free economies has worse average rates of inflation and unemployment than the preceding quintile has.
- **The top 20 countries have held relatively steady.** Even though the methodology used for rating economic freedom has been revised with this edition of the *Index*, the composition and order of the top 20 economies have hardly changed at all. Japan and Belgium moved into the top group, whereas Austria and Sweden fell to lower positions.

Chart 4: Economic Freedom vs. Per Capita GDP

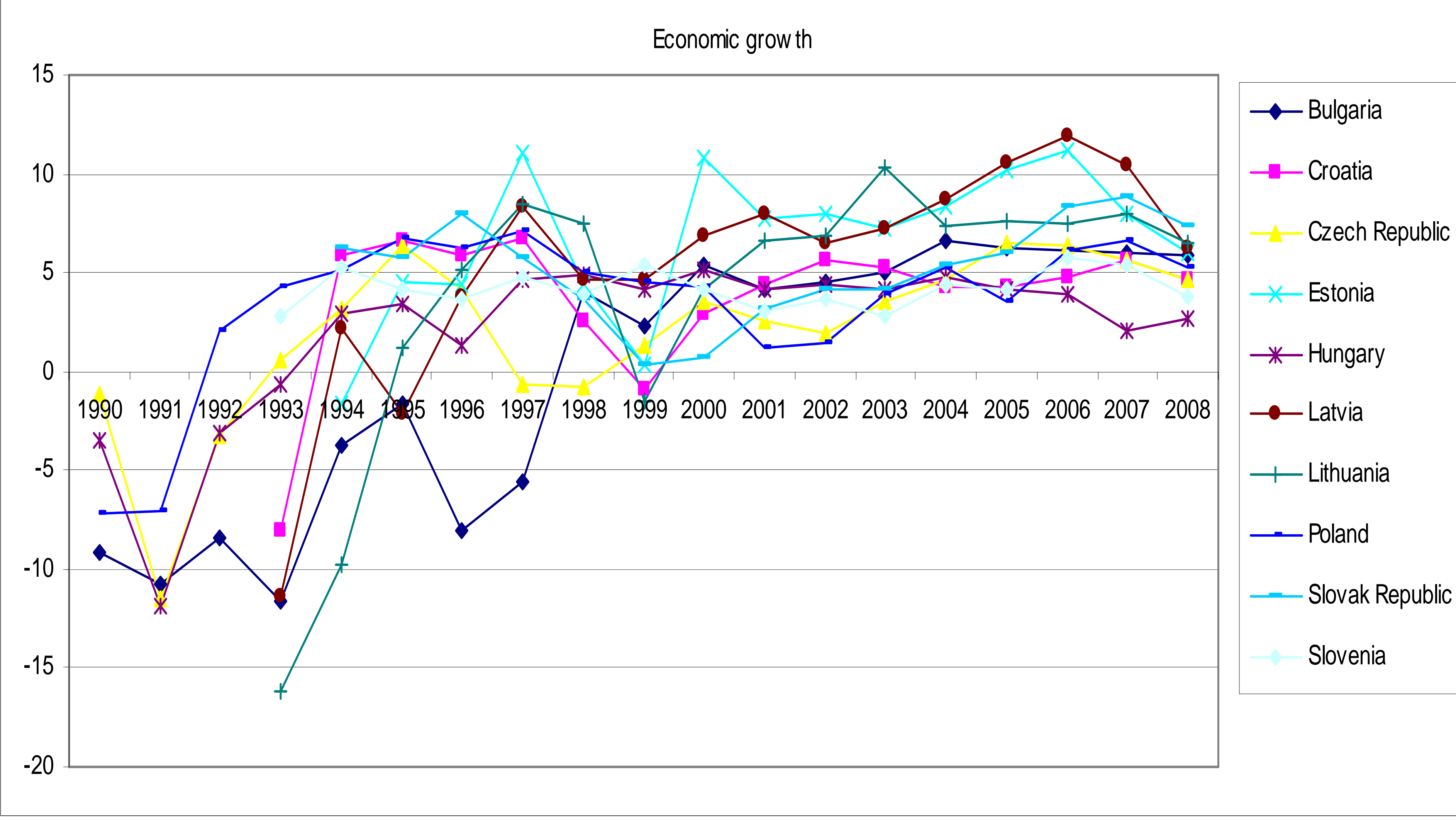


Sources: World Bank, *World Development Indicators Online*, at *publications.worldbank.org/subscriptions/WDI* (October 19, 2006; subscription required); Central Intelligence Agency, *The World Factbook 2005*, at *www.cia.gov/cia/publications/factbook/index.html* (October 19, 2006); International Monetary Fund, World Economic Outlook database, April 2006, at *www.imf.org/external/pubs/ft/weo/2006/01/data/* 24 *index.htm* (October 19, 2006); and Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index*.

Index of Economic Freedom 1995 – 2006 recalculated based on 2006 methodology



Economic growth of 10 accession countries from 1990 to 2008 (official prognosis of growth used for 2008)



Relationship between Economic freedom and growth

- When we compare annual level of the index for all countries represented in the Heritage Foundation’s calculations and estimate the influence of economic freedom to the GDP growth rate, the result is approximately zero relation between the levels and GDP growth during 1995 – 2005. That has been predicted already by other authors.
- When we change the approach and compare the change in index with the GDP growth per capita, then we can see that there exists statistically significant correlation for single countries.
- For example the correlation between GDP growth rate and change in index number was statistically significant in Slovenia (0,787) and Hungary (0,558). Medium correlation was in data of Czech Republic (0,349) and Slovakia (0,36).
- There was practically no correlation between the change in index and growth in GDP for Croatia, Bulgaria, Estonia, Latvia, Lithuania, Poland and Romania (all had correlation rounded to 0,08).
- From this part I can draw a conclusion that it is not justified to formulate the deduction about the effect of economic freedom in transition economy.

- Regression analysis demonstrates however, that the variability of factors has no statistically significant influence on the growth in GDP.

- For the regression model the significance F=0.0807; RSQUARE = 0.798, but the adjusted R2 is -0.816. I can conclude that there is no factor having statistical reliability.

- For testing hypothesis about relationship between economic freedom and economic growth we need factors with larger variability for measuring the economic freedom. Different index numbers could be efficient in case of longer time series but unfortunately time series for transition countries are insufficient.

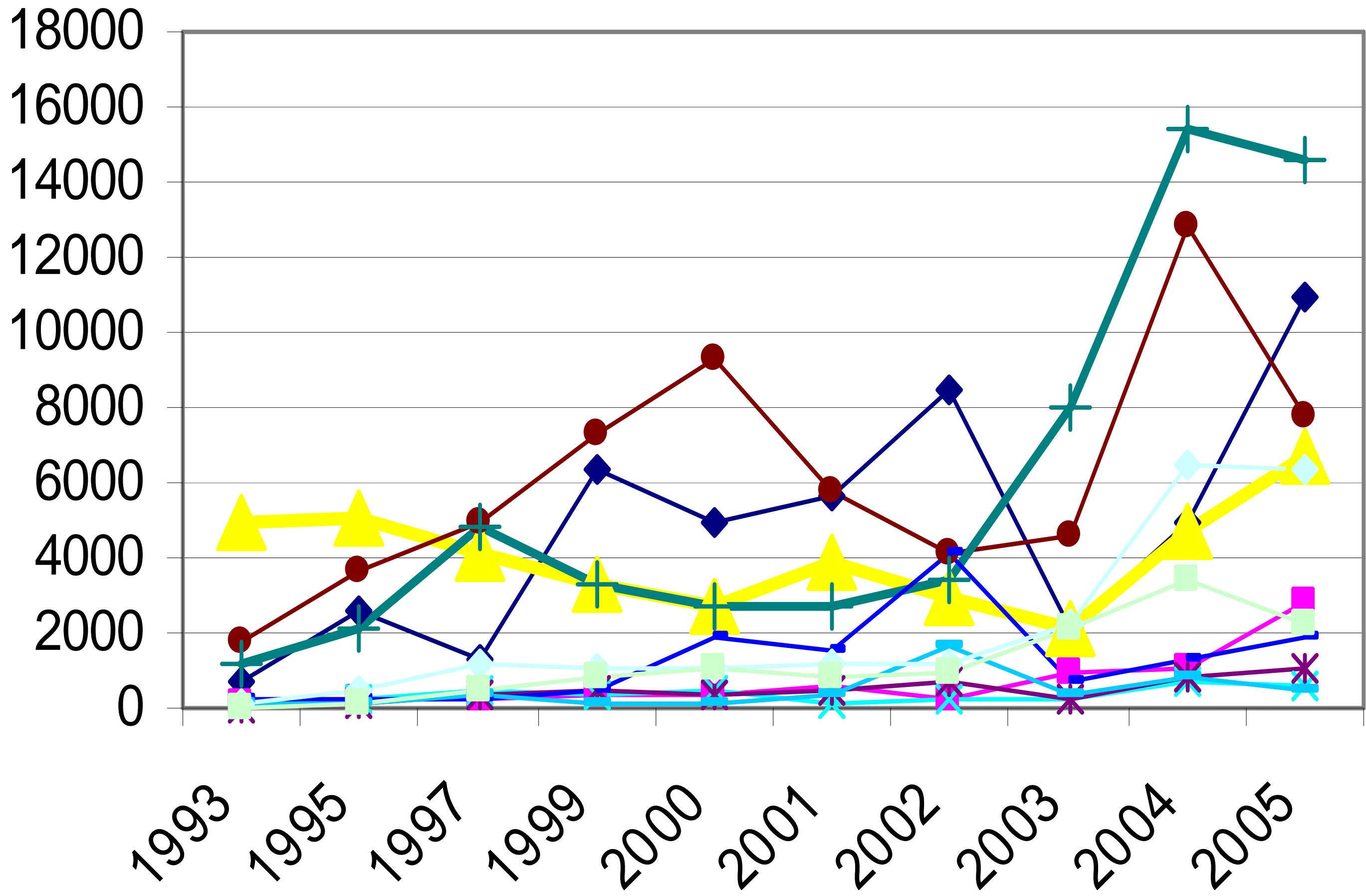
Investments

- Investments between different countries have two basic forms: foreign direct investment (FDI) and international portfolio investment (IPI). FDI can be generally understood as investment by a company domiciled in one country in an asset located in another country with the intent to control the asset and manage it. IPI on the other hand is generally understood as international investment in stocks and shares, bonds or other parts of the financial markets that does not result in a 'controlling stake'. In other words, FDI is by nature active whereas IPI is passive.

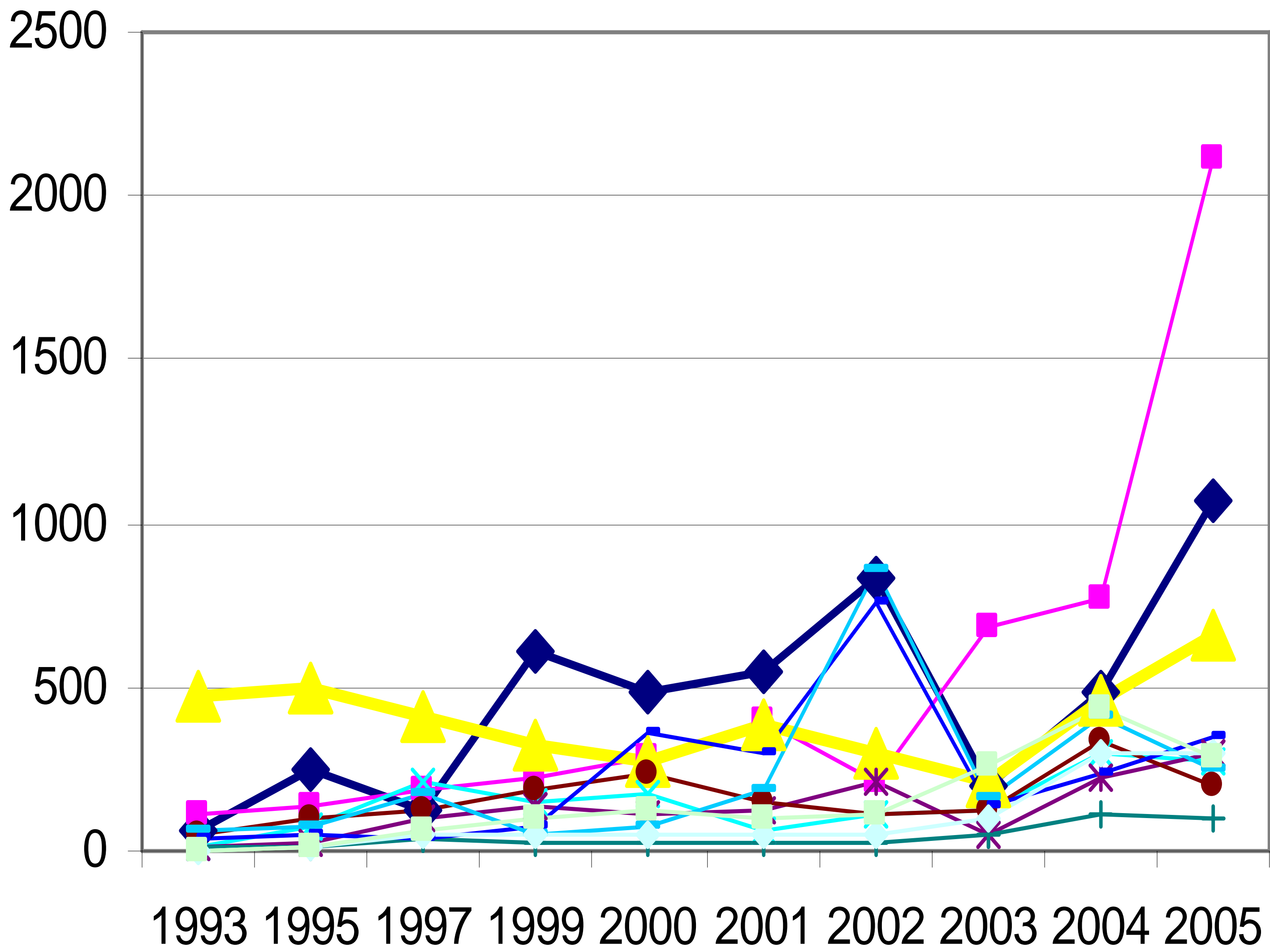
- FDI does more likely benefit a developing country than IPI, but it is by no means beneficial in every situation and every time. Governments therefore have every right to decide on circumstances and guide the flows of foreign investment either by means of regulation or by direct intervention.

- Most analyses of the determinants of FDI inflows have included the size of the host market measured by GDP.
- The market size has been widely found to be an important, if not the most important, incentive for FDI.
- A larger market allows a more efficient utilization of resources and the exploitation of economies of scale, and therefore a higher return of investment

Foreign direct investments (millions of US$)



FDI per capita USD



Czech Republic
Estonia
Hungary
Latvia
Lithuania
Poland
Russia
Slovakia
Slovenia
Romania
Bulgaria

Influence of Regulations

- Historically there have been large differences in the economic freedom between Estonia, Latvia, Lithuania and other transition countries. The Heritage Foundation's index of economic freedom in the group of transition countries has been with quite similar tendency.
- We need to emphasise that statistical methods do not give any hint on the reasons of such result. We can only guess those reasons:
- The first and most probable reason is that Estonia, Latvia and Lithuania are considered to be one region and the foreign investors are treating them as similar. Similarity is not actually true – differences in culture are notable, starting from the fact that Lithuania is Catholic, Latvia and Estonia Lutheran countries and ending with three different languages from two different language group.
- The second reason is microscopic size of each country in world terms, whereas adding three countries together creates a small market with 8 million people. Large international corporations may have tendency for such adding together.

- It is impossible to find regularities in the comparison of the economical data and FDI, because each single larger-than-average FDI has a nature of random shock. To find regularities small countries need to be aggregated, but that eliminates also effects of regulations.

- Comparison of three Baltic countries gives a strong suggestion that similar countries in terms of the size of economy in similar geopolitical location are treated similarly by the foreign investors despite differences in the economic freedom.

- However, the market size might be less influential, or even insignificant, if foreign companies are using the host country only as a production base, taking advantage of the low costs of the host economy in order to export their production more competitively to a third or home markets.

- Consequently, there are likely to be other factors than the economic freedom or FDI may play more significant role in actual GDP growth.

Conclusions

- When we compare annual level of the index for all countries represented in the Heritage Foundation's calculations and estimate the influence of economic freedom to the GDP growth rate, the result is approximately zero relation between the levels and GDP growth during 1995 – 2005.
- When we change the approach and compare the change in index with the GDP growth per capita, then we can see that there exists statistically significant correlation for single countries.
- It is not justified to formulate the deduction about the effect of economic freedom in transition economy. Regression analysis demonstrates however, that the variability of factors has no statistically significant influence on the growth in GDP.
- For testing hypothesis about relationship between economic freedom and economic growth we need factors with larger variability for measuring the economic freedom.

Conclusions

- FDI does not depend only on government action and regulations but also on development of economy. Too fast development of economy and increase of cost of labour can stop investment.
- FDI may have positive impact on the domestic companies, but due to the short time series of statistical data in transition countries the analysis can not demonstrate statistically significant relationship.
- To demonstrate statistically significant relationship we need to build up lag models, whereas the determination of the lag is complicated due to the relatively different base development.
- Transition countries in Europe can not influence FDI by changing their economic environment. FDI is mostly determined by the change in Asian countries. More than ½ of total available FDI is received by Latin America and Asia. European countries have had weak increase trend only.

Thank you for your attention!