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The importance of The Economic Freedom Index and how Iceland can change course.

Gisli Hauksson, Economist
CEO of GAMMA

Why is the Economic Freedom of the World Index important?

- *"Góð frétt: Frjálshyggju-vísitalan lækkar" (eng. "Good news: The Libertarian Index decreases")*

  -Professor Stefan Olafsson (University of Iceland, Faculty of Social Sciences, September16th 2012).
- Comments like these are typical after the financial crisis; central planning and Keynesian economics seems to have had a comeback.
- The index measures the degree to which the policies and institutions of countries are supportive of economic freedom.
- The cornerstone of economic freedom are personal choice, voluntary exchange, freedom to compete and security of privately owned property.
- The construction of the index is based on three methodological principles (objective components, external sources for data and transparency throughout)
- 42 variables are used to construct the index, with five broad areas
  - Size of government
  - Legal System and Property Rights
  - Sound Money
  - Freedom to trade Internationally
  - Regulation

The impact of economic freedom

- Milton Freedman believed that if economic freedom could be measured with greater accuracy, it would be possible to isolate its impact on the performance of economies.
- Numerous studies been done to examine impact of economic freedom on:
  - Investment
  - Economic growth
  - Income levels
  - Poverty rates
- These studies find that countries with institutions and policies more consistent with economic freedom have
  - Higher investment rates
  - More rapid economic growth
  - Higher income levels
  - More rapid reductions in poverty rates

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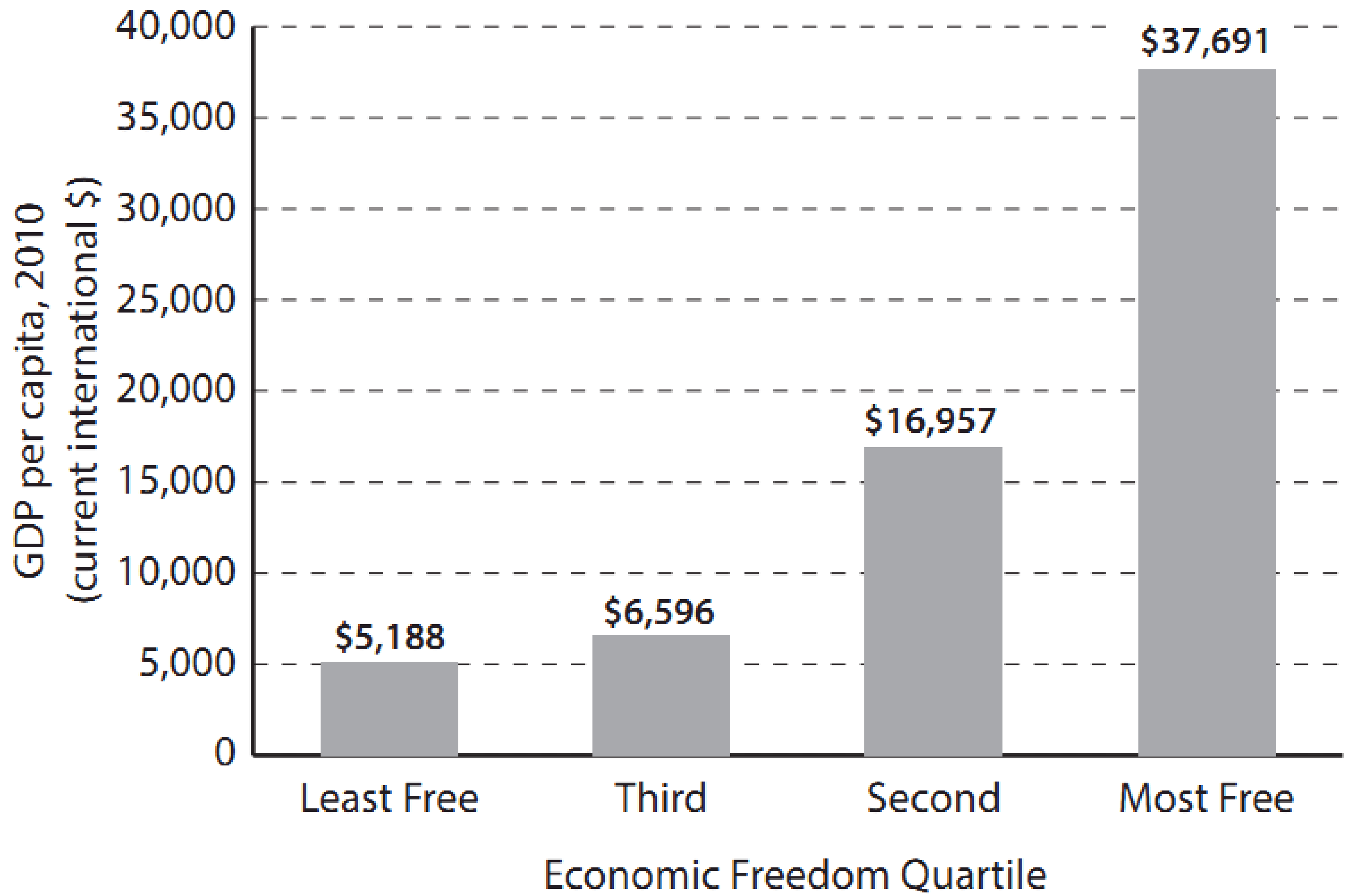
The contrast between market oriented and government planning economies

Exhibit 1.7: Economic Freedom and Income per Capita, 2010

Countries with more economic freedom have substantially higher per-capita incomes.

Sources: Fraser Institute, *Economic Freedom of the World: 2012 Annual Report*; World Bank, *World Development Indicators 2011*.



The contrast between market oriented and government planning economies

Exhibit 1.8: Economic Freedom and Economic Growth, 1990–2010

Countries with more economic freedom tend to grow more rapidly.

Sources: Fraser Institute, *Economic Freedom of the World: 2012 Annual Report*; World Bank, *World Development Indicators 2011*.

Note: The growth data were adjusted to control for the initial level of income.

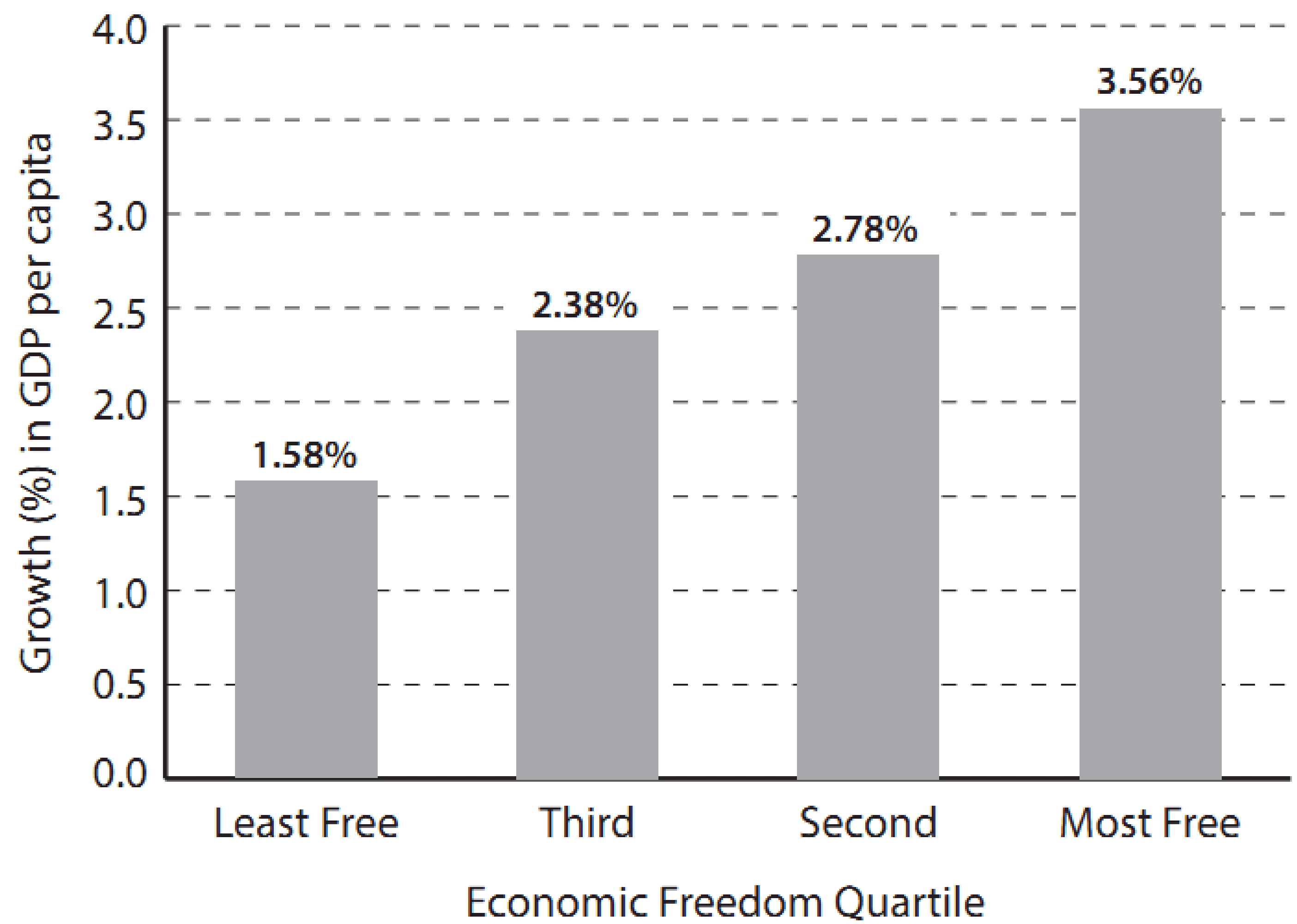


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Exhibit 1.9: Economic Freedom and the Income Share of the Poorest 10%, 2000–2010

The share of income earned by the poorest 10% of the population is unrelated to economic freedom.

Sources: Fraser Institute, *Economic Freedom of the World: 2012 Annual Report*; World Bank, *World Development Indicators 2011*.

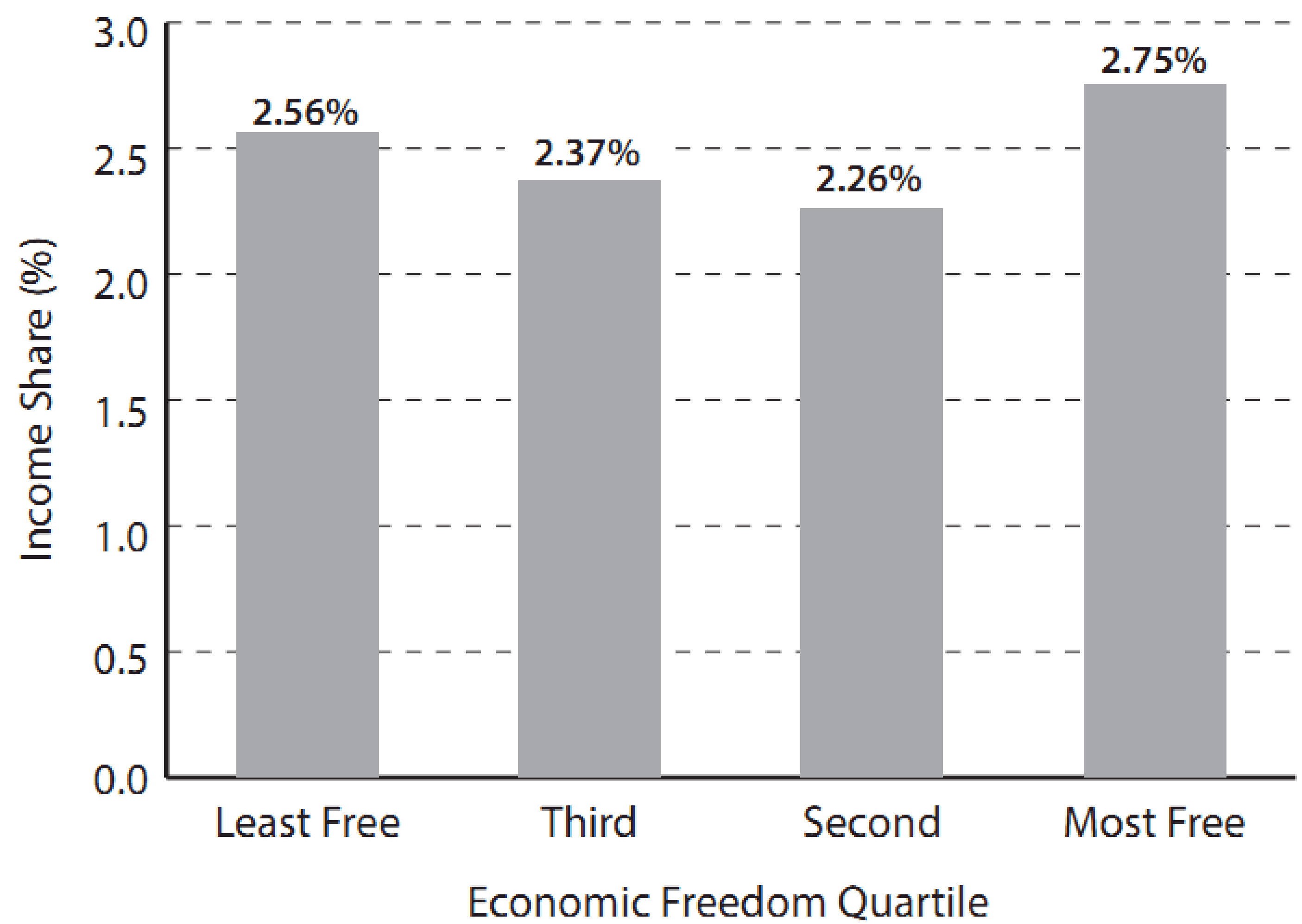

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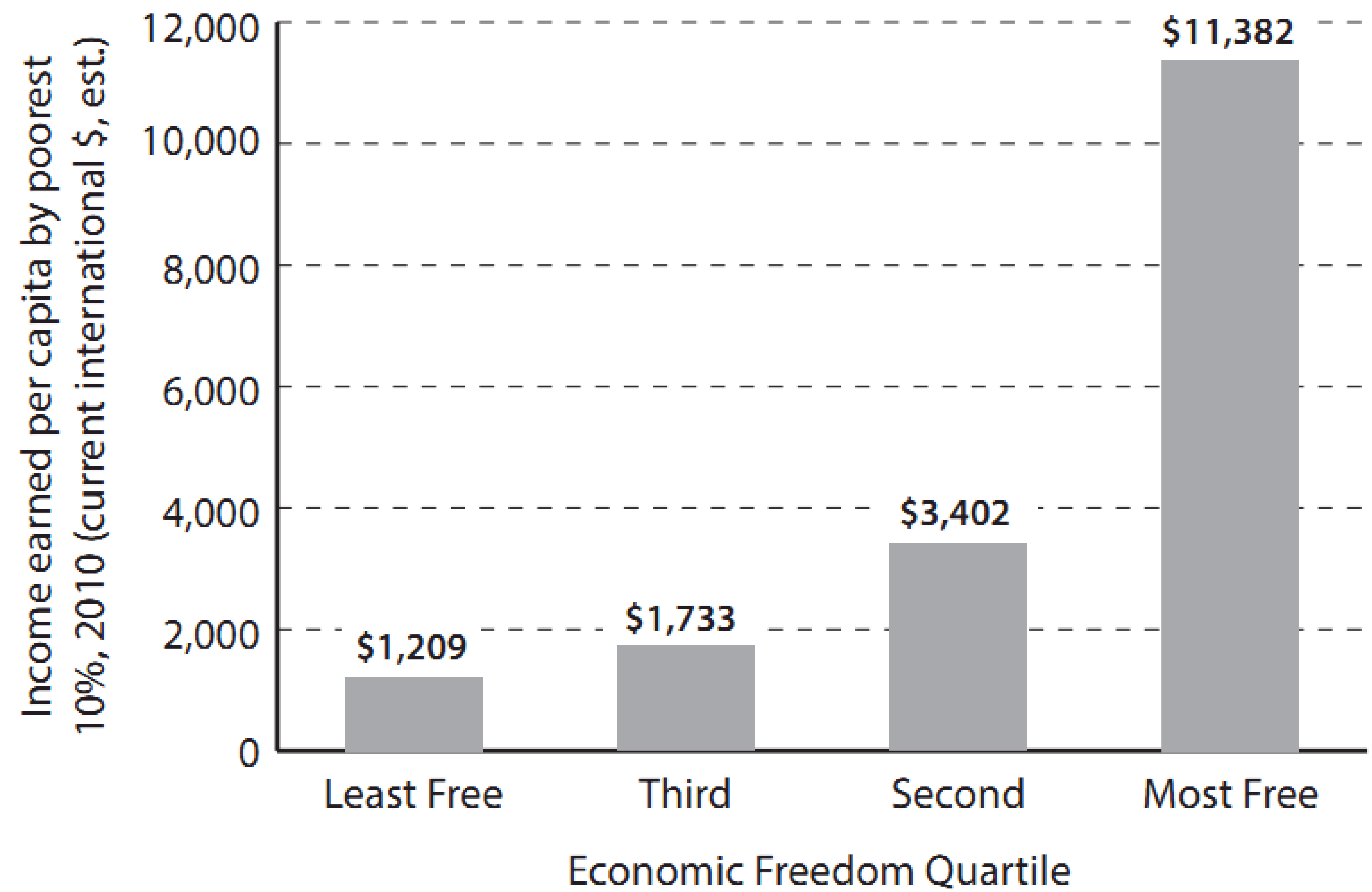
Exhibit 1.10: Economic Freedom and the Income Level of the Poorest 10%, 2010

The amount of income, as opposed to the share, earned by the poorest 10% of the population is much higher in countries with higher economic freedom.

Sources: Fraser Institute, *Economic Freedom of the World: 2012 Annual Report*; World Bank, *World Development Indicators 2011*.

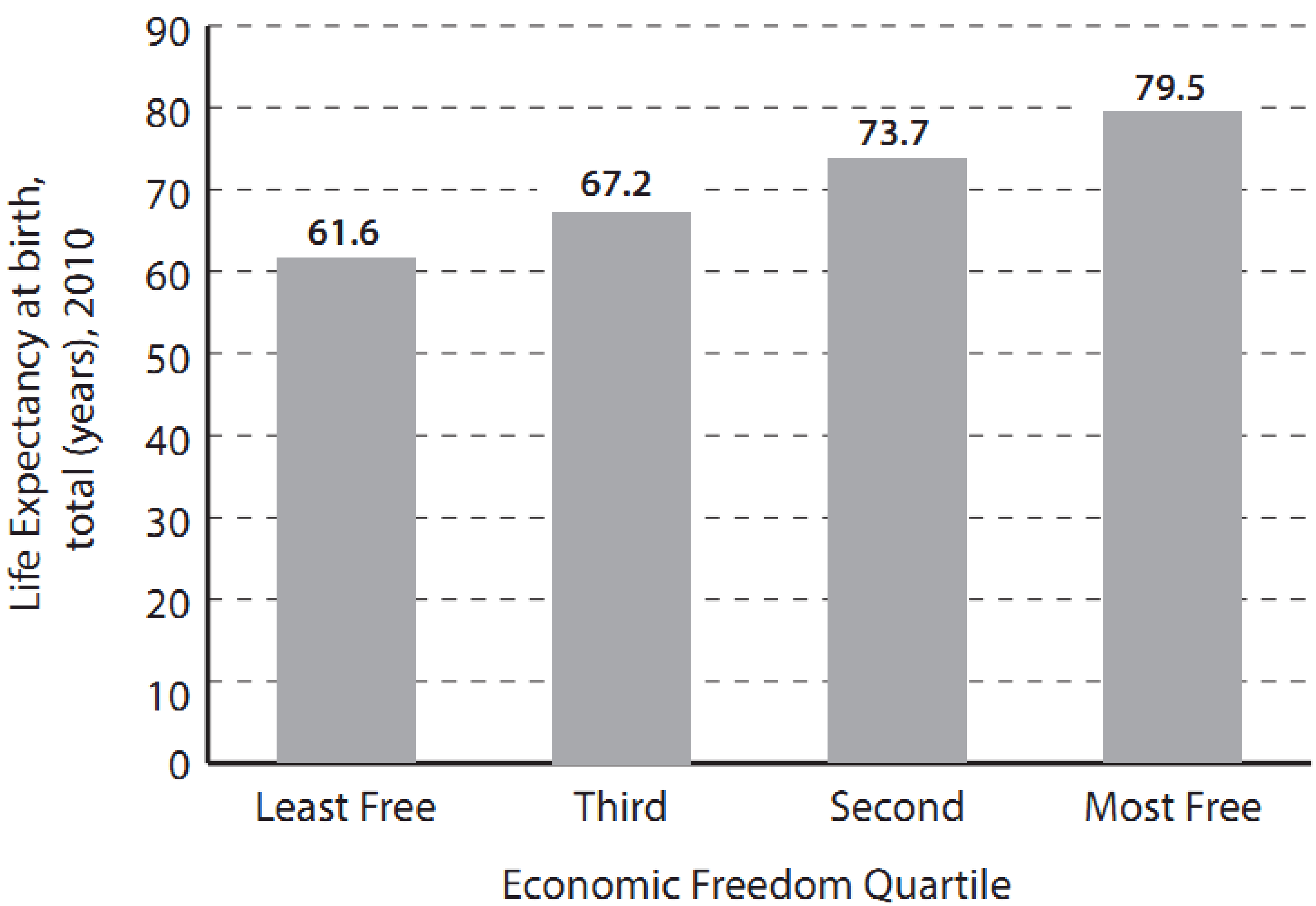


The contrast between market oriented and government planning economies

Exhibit 1.11: Economic Freedom and Life Expectancy, 2010

Life expectancy is about 18 years longer in countries with the most economic freedom than in countries with the least.

Sources: Fraser Institute, *Economic Freedom of the World: 2012 Annual Report*; World Bank, *World Development Indicators 2011*.



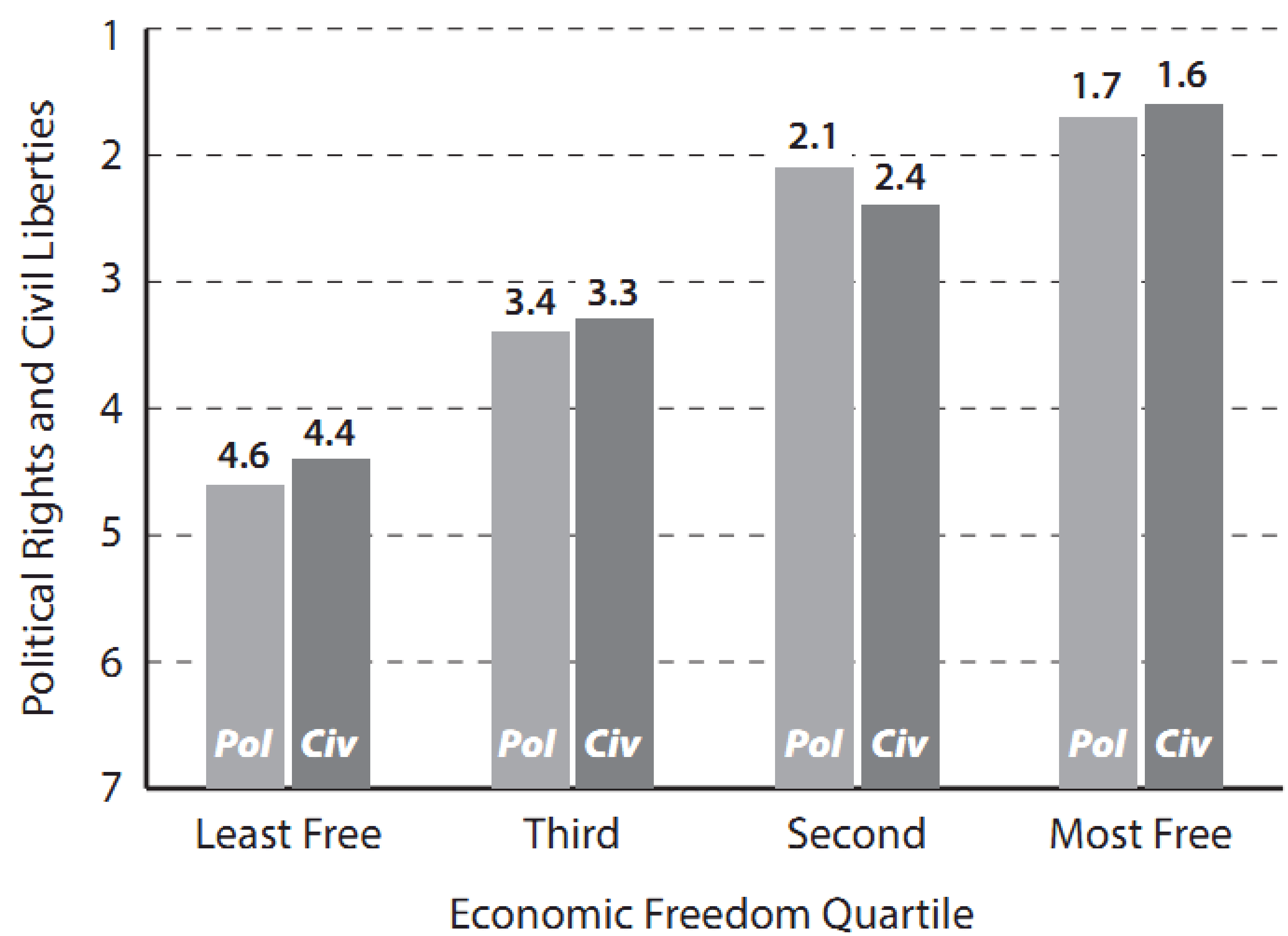
The contrast between market oriented and government planning economies

Exhibit 1.12: Economic Freedom and Political Rights and Civil Liberties

Greater economic freedom is associated with more political rights and civil liberties.

Sources: Fraser Institute, *Economic Freedom of the World: 2012 Annual Report*; Freedom House, *Freedom in the World 2011*.

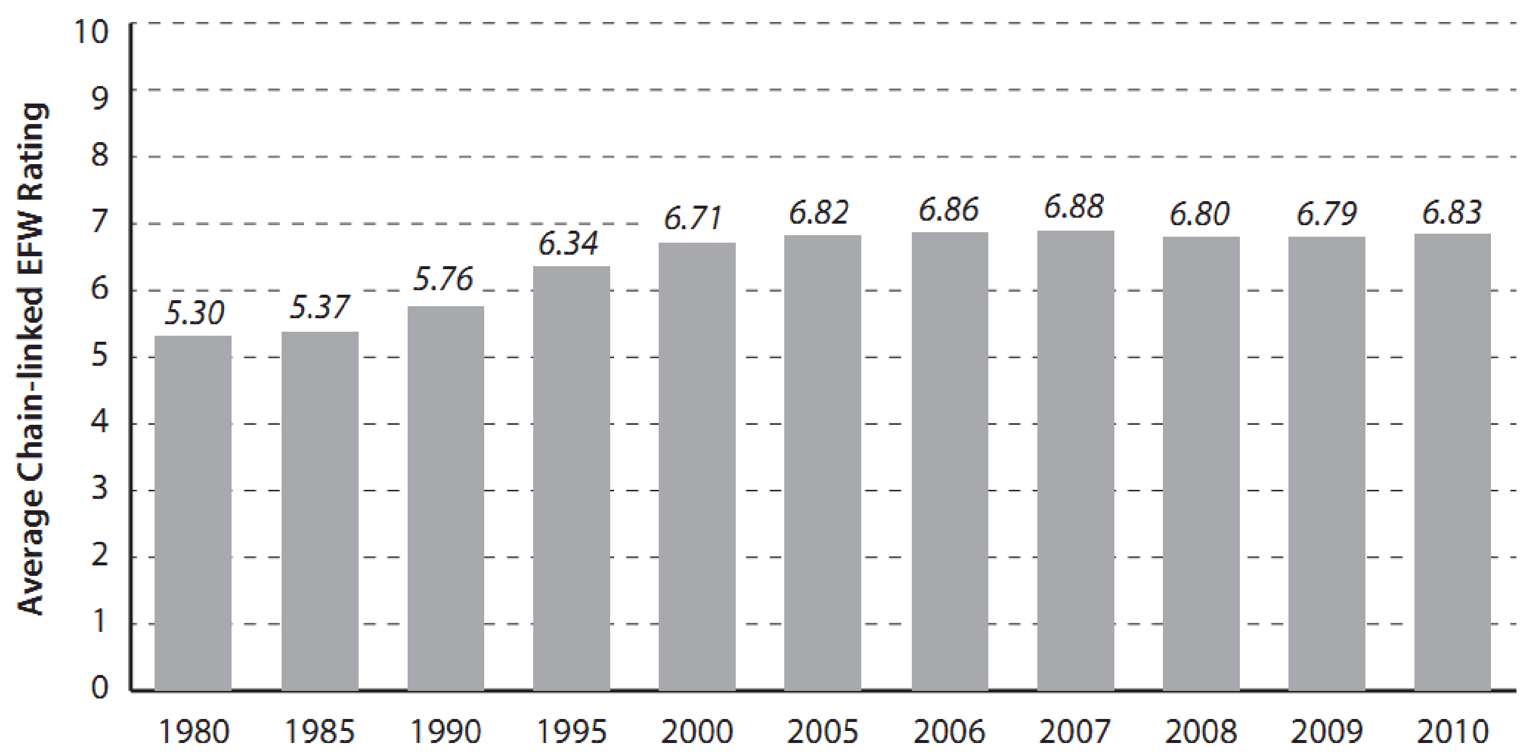
Note: Political rights and civil liberties are measured on a scale from 1 to 7: 1 = the highest degree of political rights and civil liberties; 7 = the lowest.



Economic Freedom from around the world

- Average level of economic freedom has increased since 1980
- After a drop in 2007-2008 the index has started rising again.
- The reason for the increase since 1980 mainly:
  -reduction in marginal income tax rates
  -improvements in monetary policy
  -elimination of military conscription
  -global trade liberalization

Exhibit 1.4: Average Chain-linked EFW Rating for the 102 countries with ratings since 1980



Big movers

In the last 10 years, both African and formerly Communist nations—such as Rwanda, Malawi, and Ghana, and Romania, Bulgaria, and Albania—show the largest increases in economic freedom. Countries showing the biggest declines since 2000 include Venezuela, Argentina, Iceland, and the United States.

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The lowest score for Iceland in 20 years

Iceland

	1980	1985	1990	1995	2000	2005	2009	2010
Chain-Linked	Rating (Rank)	Rating (Rank)	Rating (Rank)	Rating (Rank)	Rating (Rank)	Rating (Rank)	Rating (Rank)	Rating (Rank)
Summary Rating (Rank) ➤	**5.25** (54)	**5.53** (47)	**6.95** (24)	**7.69** (13)	**8.04** (11)	**8.09** (10)	**7.02** (59)	**7.02** (59)
Area 1. Size of Government	5.02 (52)	5.24 (48)	5.91 (47)	5.60 (78)	6.07 (69)	6.90 (52)	5.01 (100)	4.83 (107)
Area 2. Legal System and Property Rights	6.83 (21)	7.88 (12)	8.35 (13)	8.30 (18)	9.03 (12)	9.27 (4)	8.65 (15)	8.53 (15)
Area 3. Sound Money	2.62 (101)	2.84 (104)	7.08 (40)	9.45 (25)	9.18 (34)	8.75 (53)	7.80 (78)	8.42 (66)
Area 4. Freedom to Trade Internationally	5.65 (39)	5.49 (43)	6.72 (37)	8.00 (30)	8.24 (36)	7.00 (67)	6.43 (85)	6.19 (95)
Area 5. Regulation	6.34 (27)	6.35 (33)	6.72 (26)	7.16 (17)	7.69 (10)	8.54 (4)	7.21 (34)	7.16 (41)
Unadjusted								
Summary Rating (Rank) ➤	**5.15** (57)	**5.42** (52)	**6.92** (25)	**7.73** (13)	**8.04** (11)	**8.13** (9)	**7.06** (62)	**7.06** (65)

- Iceland ranks number 65 in the index with a score of 7,06
- The only top 20 area is Legal system and property rights (nr4 in 2005)
- Now under attack: a) Proposed naturalization of fishing quotas and natural resources in general, b) Significant changes to the constitution
- Countries in places 60-70 are not the usual comparison for Iceland →
- Comparison countries much higher on the list e.g.
  - Finland nr. 9
  - Denmark nr. 16
  - Norway nr. 25
  - Sweden nr. 30

Portugal	60
Latvia	61
Philippines	61
Dominican Republic	63
Hungary	64
Iceland	65
Saudi Arabia	65
Botswana	67
Papua New Guinea	67
Mongolia	69
Kazakhstan	70
Ghana	71
Malaysia	71

Why have we moved back 20 years?

- We are back to “square one”
- Multitude of reasons, most resulting from the last 4 years but the index started to head south before the financial crash
- Some major reasons are e.g.
  - Constant expansion of government over the last decade
  - Major increase in government borrowing since 2008
  - Capital controls since 2008
  - Government ownership of banks and financial institutions
  - Multitude of changes to the tax system (tax increases, marginal tax rate changes etc)
  - Increased transfers and subsidies

Why have we moved back 20 years?

- Acccording to the index the lowest scores for Iceland are as follows (42 scores in total, max score 10)
  - Capital controls (0,77)
  - Standard deviation of tariff rates (0,91)
  - Government consumption (1,88)
  - Top marginal income and payroll tax rate (3,00)
  - Foreign ownership/investment restrictions (3,47)
  - Controls of the movement of capital and people (3,61)
  - Overall size of government (4,83)
  - Business regulations/administrative requirements (5,24)
  - Centralized collective bargaining (5,51)
  - Money growth (5,78)
  - Freedom to trade internationally (6,31)

How can we move up the list again?

- A few changes would send Iceland on a fast track up the list
- Abolishment of capital controls
  - According to HSBC Iceland has the most extreme capital controls in OECD
- Simplified and more efficient tax and tariff system
  - Over 100 changes made to the tax code in the last 3,5 years
- Privitization of financial institutions
  - Over 60% of all equity in Icelandic financial institution owned by the government
- Decrease in government guarentees
  - Government guarentees amount to 80% of GDP

How can we move up the list again?

- Fiscal prudence
  - Average annual fiscal deficit since 2008 of 7% of GDP
- Allow foreign investments in fishing and energy industry
  - According to statistics from OECD Iceland is number 6 of the countries with the most restrictions on FDI (behind Indonesia, Japan, China, Russia and India)
- A more efficient monetary policy
  - Inflation target of 2,5% but average inflation over the last 10 years is 6,1%
  - Money supply increased fourfold since 2003
- More caution and responsibility in wage negotiation
  - In 2011 higher pay rises in Iceland than in Germany from 2000-2011

Final remarks

- Decreased economic freedom leads to lower GDP growth
  - The one point decline in the score of the index in the US from 2000-2010 results in a reduction in the long term growth of GDP of between 1,0-1,5% annually (historical average 3,0%) (Gwartney, Holcombe and Lawson, 2006)
- If same is true for Iceland (reduction of 0,98 point of the score from 2000-2010)
  - Future GDP annual growth in Iceland will be 0,98-1,47% less than historical average of 3,1% or a reduction of potential annual growth of 33-50%.
- We need to take the results and the low rank of Iceland seriously, our future depends on it.