

University of Economics, Prague

**Faculty of Economics**



Index of Economic Freedom, case of  
Czech Republic  
*Bachelor Thesis*

Author: Filip Shrbený

Thesis supervisor: Ing. Mgr. Dominik Stroukal

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I hereby declare on my honors that I wrote this bachelor's thesis independently, and I used no other sources and aids than those indicated.

Filip Shrbený

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# **Abstract**

We have identified number of possible advices for the Czech Republic to improve its rating for both Heritage Foundation and Fraser Institute Economic Freedom Index, which often leads to top 10 countries in the world. These advices range from cuts in government spending, betterment in judicial system, to the establishing healthier environment for startups and advices to combat corruption. We further noticed some divergence between above mentioned indexes and managed to evaluate those indexes, which showed the simplicity yet usefulness of Heritage EFI and flexibility and sensitivity of the Fraser EFI. Weak sides of the research were noted and ideas for further research were given.

## **Keywords**

EFI, advices, improvement, evaluation

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# 1. Introduction

The goal of this paper is to provide advices and possible ways of improving the standing of the Czech Republic in the Economic Freedom Index produced by the Fraser Institute and by the Heritage Foundation. It has found a several advices which are available for the country. This includes cuts in the spending of the state, tax reforms, reworking the process of starting up a business, or the ease at which are the new companies started, and improvement of the judicial system with the inspiration in Iceland's standards of the judicial system and combating the corruption, which this paper found critical for the future development in the country.

This is possibly the first and so far the only paper which tries to assess the standing of the Czech Republic with respect to both Fraser Institute and Heritage Foundation Economic Freedom Index, providing basic insight to the differences in the grading and lays the ground floor for further research while providing possible ways of improving the standing of the country in the above mentioned indexes.

The Economic Freedom Index (EFI) is becoming more and more cited source of information throughout many papers and researches. It helps to improve our knowledge of the important effect of economic freedom on economic prosperity and stability. The first such an index, in fact the original EFI, was The Economic Freedom Index reported by *Economic Freedom of The World*, (Gwartney and Lawson 2002). Data is published since the year of 1996 and it contains information even back to the year of 1970. This is considered to be the most cited Index for economic freedom, (Berggren 2003), however this paper works also with different source and with different index as well as with the original EFI.

As a more and more important indicator of economic standing of the country, EFI of not only the Fraser Institute but others creators, such as The Heritage Foundation, deserve more attention and further study. We will take into our consideration the Fraser Institute and its index published in *Economic Freedom of The World* ([www.fraserinstitute.org](http://www.fraserinstitute.org), 2016) and the *Index of Economic Freedom* ([www.heritage.org](http://www.heritage.org), 2016) published and constructed by The Heritage Foundation. And though there is only one original EFI, we will, for the sake of decent navigation, refer to each of these indexes as to EFI. We will use data from the year of 2012. By the time this paper is created (2016), these data are the newest ones we can get our hands on from both The Heritage Foundation and the Fraser institute.

Our task is to decompose both indexes into their original parts. For the Fraser Institute EFI it is the size of the government, legal system and property rights, sound money, freedom to trade internationally and regulation, (Gwartney, Lawson and Hall 2014). For The Heritage Foundation it is: rule of law, government size, regulatory efficiency and market openness (Miller, Kim, Holmes, Roberts, Riley, Olson 2014).

We will take a look at these almost identical components of each EFI and apply them to the case of Czech Republic. Czech Republic is ranked differently by both index creators. To be exact, The Heritage Foundation ranks it as 26<sup>th</sup> in the world (Miller, Kim, Holmes, Roberts, Riley, Olson 2014), and the Fraser Institute as 45<sup>st</sup> in the world (Gwartney, Lawson and Hall 2014). We will find why this is the case by taking a closer look at the individual components and the weight they are assigned by each index creator. By doing so, we can make a suggestion as to which EFI could potentially be used as an indicator of which state quality, making the process of using those EFIs more comprehensible and easy. We will then proceed to create an “advice” in the form of reforms/changes which Czech Republic could adopt in order to get to the Top 10 countries for both EFIs. As I am not an expert on the topics at hand, multiple authors and experts who worked with similar problems (reforms and changes) will be quoted while we tackle the advices for reforms and changes. OECD material related to individual topics will be used for evaluation of chosen reforms. This should make us more informed about the potential options, which not only Czech Republic has.

## 2. Background

As this topic falls mainly into the domain of institutional economy, main source of information will be, besides Heritage Foundation and Fraser Institute, work done by authors concerned with the topic of institutions. In the past few years, more and more importance was given to the research from this branch of economy and this paper is only one of many that proves this trend.

*“Economic freedom may constitute an explanatory factor for growth and the distribution of income.” (Berggren 2003)*

Berggren’s work also shows the growing importance of Economic Freedom and its effect on variety of economic indicators in the country. Miller, Kim, Holmes, Roberts, Riley, Olson (2014) say:

*“...studies have found that countries with institutions and policies more consistent with economic freedom have higher investment rates, more rapid economic growth, higher income levels, and a more rapid reduction in poverty rates.”*

Showing how important ranking like Economic Freedom Index has become. And indeed Lawson, Gwartney (2004) show that more free economies outperforms the less free ones in multiple ways.

Although this paper compares two indexes, decomposes them and tries to come up with possible solutions for improvements of these components, we should not forget that the main driving force behind this paper is ever growing importance of economic freedom and growth.

## 3. Methodology

Quantification of the advices and approaches from selected sources through the ranking of the Heritage Foundation and Fraser Institute Economic Freedom index.

## 4. Practical Part

### 4.1. Heritage Foundation Index

The first of our 2 indexes will be the one produced by the Heritage Foundation. The Foundation itself was created in the year of 1973.

*“ The Heritage Foundation is a research and educational institution—a think tank—whose mission is to formulate and promote conservative public policies based on the principles of free enterprise, limited government, individual freedom, traditional American values, and a strong national defense.” (www.heritage.org, 2016)*

The index itself is over 20 years old. It focuses on four broad categories which are further divided into 10 quantitative and qualitative factors, these are: rule of law (property rights, freedom from corruption), limited government (fiscal freedom, government spending), regulatory efficiency (business freedom, labor freedom, monetary freedom) and open markets (trade freedom, investment freedom and financial freedom).

#### 4.1.1. The Rule of law

*“The rule of law is an ambiguous term that can mean different things in different contexts. In one context the term means rule according to law. No individual can be ordered by the government to pay civil damages or suffer criminal punishment except in strict accordance with well established and clearly defined laws and procedures. In a second context the term means rule under law. No branch of government is above the law, and no public official may act arbitrarily or unilaterally outside the law. In a third context the term means rule according to a higher law. No written law may be enforced by the government unless it conforms with certain unwritten, universal principles of fairness, morality, and justice that transcend human legal systems.” (legal-dictionary.thefreedictionary.com, 2016)*

#### 4.1.1.1 Property Rights

Again, using [www.heritage.org](http://www.heritage.org) (2016) as a source of information for clarification of the first component of “The Rule of Law” section, property rights according to Heritage Foundation means an ability of the individual to collect (accumulate) private property, which is protected by property rights and the enforcement of these rights by the government. It also assesses the likelihood of the expropriation of private property and analyzes the judicial system. The grading for each country with regards to the property rights is shown in the *Table 1*. Table was created according to [www.heritage.org/index/property-rights](http://www.heritage.org/index/property-rights) (2016).

The Czech Republic is standing pretty solidly in the light of these criteria.

It is graded as 70.0 in the Table 1. The Heritage comments the fact in following manner:

*“...The judiciary’s independence is largely respected, though its complexity and multilayered composition lead to the slow delivery of judgments. Property rights are relatively well protected, and contracts are generally secure.”* (Miller, Kim, Holmes, Roberts, Riley, Olson 2014)

The same source also suggest that further strengthening of judiciary is and will be vital in further advancement of the Czech Republic up the ladder of Economic Freedom. Although score of 70.0 ranks the Czech Republic as 27<sup>th</sup>, there is still room for improvement. The trend, however is upwards going, so we can expect, if it maintains its current course, the Czech Republic to rise higher in the ranging.

According to United Nations Office on Drugs and Crime (2011) there is a number of steps a country could take in order to increase its judicial integrity and capacity. Throughout all their recommendations, transparency is the word we can read the most, as we can see in the part bellow.

Table 1

Grade	Criteria
100	Private property guaranteed by government, court system enforces contracts efficiently and quickly, the justice system punishes those who unlawfully confiscate private property, there is no corruption or expropriation.
90	Private property is guaranteed by the government, the court system enforces contracts efficiently, justice system punishes those who unlawfully confiscate private property, corruption is nearly nonexistent, and expropriation is highly unlikely.
80	Private property is guaranteed by the government, the court system enforces contracts efficiently but with some delays, corruption is minimal, and expropriation is highly unlikely.
70	Private property is guaranteed by the government, the court system is subject to delays and is lax in enforcing contracts, corruption is possible but rare, and expropriation is unlikely.
60	Enforcement of property rights is lax and subject to delays, corruption is possible but rare, and the judiciary may be influenced by other branches of government, expropriation is unlikely.
50	The court system is inefficient and subject to delays, corruption may be present, and the judiciary may be influenced by other branches of government, expropriation is possible but rare.
40	The court system is highly inefficient, and delays are so long that they deter the use of the court system, corruption is present, and the judiciary is influenced by other branches of government, expropriation is possible.
30	Property ownership is weakly protected, the court system is highly inefficient, corruption is extensive, and the judiciary is strongly influenced by other branches of government, expropriation is possible.
20	Private property is weakly protected. The court system is so inefficient and corrupt that outside settlement and arbitration is the norm. Property rights are difficult to enforce. Judicial corruption is extensive. Expropriation is common.
10	Private property is rarely protected, and almost all property belongs to the state. The country is in such chaos (for example, because of ongoing war) that protection of property is almost impossible to enforce. The judiciary is so corrupt that property is not protected effectively. Expropriation is common.
0	<i>Private property is outlawed, and all property belongs to the state. People do not have the right to sue others and do not have access to the courts. Corruption is endemic.</i>

Source: [www.heritage.org/index/property-rights](http://www.heritage.org/index/property-rights) (2016)

*“When recruitment takes place by means of written exams, the exams should be organized by the state in order to establish common standards and transparent procedures...”*

*“...Candidates should participate anonymously in the exams.”*

*“...The number of successful appeals against the decisions/judgments of a single judge should not be the criteria for the assessment of the quality of his work.*

*“...the procedure through which the nominations and appointments are decided should be fully transparent...”*

*“In case that the judges are elected, the election should be prepared by collecting enough information on all candidates concerning their professional behavior...” etc.*

(United Nations Office on Drugs and Crime 2011)

The question now is, where to get the financial means in order to even make these suggestions possible. In 2016, the Czech Republic started following the registered sales law, that is expected to bring additional 10 billion ([www.financisprava.cz](http://www.financisprava.cz), 2016) into the state treasury, although is as admittedly expected to bring even more than that. So the extra financial means are potentially available. We can argue that quickly solved dispute over property rights, which is led through the judges, is very important element, which classifies state as effective,

*“Effective states in the current context are those that support institutions that allow households and firms to enjoy secure property rights.”* (Bresley, Ghatak 2009)

And marks it as a good investment place for foreign investors. And as Acemoglu, Johnson and Robinson (2005) say:

*“Economic institutions encouraging economic growth emerge when political institutions allocate power to groups with interests in broad-based property rights enforcement...”*

Improving the state of the judicial system in the Czech Republic would greatly improve its standing not only among the indexes, but also among the foreign investors, which are attracted by strong and sound property rights. Should the Czech Republic adopt these suggestions and successfully integrate them into its system in 2012, it would jump 10 points up in the property rights grading and by 2016 would be in the top 10 ranked countries, above Canada (5<sup>th</sup> place). We can see here that the juridical integrity, transparency and efficiency, or in other words rule of law, is a very important factor in Heritage EFI.

#### **4.1.1.2 Corruption**

The Second part of “The Rule of Law” section, corruption

*“...is the abuse of entrusted power for private gain. It can be classified as grand, petty and political, depending on the amounts of money lost and the sector where it occurs.”* (www.transparency.org, 2016)

The Heritage approach to measuring corruption is basically taken from the Transparency International, which is frequently mentioned source of information about corruption. Transparency International uses Corruption Perception Index (CPI) to measure level of corruption in 183 countries.

*“The CPI is based on a 10-point scale in which a score of 10 indicates very little corruption and a score of 0 indicates a very corrupt government. In scoring freedom from corruption, the Index converts the raw CPI data to a scale of 0 to 100 by multiplying the CPI score by 10. For example, if a country’s raw CPI data score is 5.5, its overall freedom from corruption score is 55...”* (www.heritage.org, 2016)

It has to be said, that the CPI in 2016 is measured already in the same manner as the freedom from corruption on the scale 0-100. Heritage Foundation graded Czech Republic with the 45.3 points (CPI of 4.5) which placed it on 55<sup>th</sup> place in 2012. According to Miller, Kim, Holmes, Roberts, Riley, Olson (2014):

*“In 2012, several scandals involving senior government officials highlighted ongoing corruption and lack of transparency and caused the European Commission to cut around \$650 million of EU aid to the Czech Republic.”*

So it is safe to tell that corruption is pretty big issue in the eyes of the outside world. Looking at the data from www.transparency.com (2016), we are able to see that the standing

of the Czech Republic has slightly improved. By the year of 2015, it has risen from CPI 4.5 (45) to the score of 56 (5.6). We can also see what the costs of the corruption are, again according to [www.transparency.com](http://www.transparency.com) (2016).

*“On the political front, corruption is a major obstacle to democracy and the rule of law...”*

*Economically, corruption depletes national wealth. Corrupt politicians invest scarce public resources in projects that will line their pockets rather than benefit communities and prioritize high-profile projects such as dams, power plants, pipelines and refineries over less spectacular but more urgent infrastructure projects such as schools, hospitals and roads.”*

As we can see, combating corruption can actually save financial resources of the country, freeing more of those resources to be used in various, more helpful ways. The same source also states that newly emerging democracies suffer the most from the effects of corruption as it is very hard to create sound government in corrupt environment. Whether or not can the Czech Republic be called a new democracy is a different topic.

Sticking with the Transparency International as with the world-wide leader on fight with corruption, we can dive a little deeper into the topic and see, what instruments do they offer to help fight the unwanted element which the corruption is. For private sector, so called “*Business Principles for Countering Bribery*” was created. Most firms have some anti-bribery rules and this program helps them to improve upon those rules and enforce them more efficiently. For public sector, there is “*Integrity Pacts*”, it is basically

*“...an agreement between government agency offering contracts and the companies bidding for it that they will abstain from bribery, collusion and other corrupt practices for the extent of the contract.”*

The source also mentions that in certain countries (it specifically mentions Mexico), and independent monitors have been implemented in contracts above certain threshold. Till this point, we have been talking about advices and frameworks for implementation of rules, but the independent monitoring is a step into the field of actual and practical solution. Czech Republic does not have such a tool of outside monitoring, it relies on its administration to do all the necessary work. We may argue that addition supervision is costly and would make

projects impose that much higher burden on the treasury of the country, but the other side of the problem is financial resources saved in form of bribes and corrupt practices prevented.

Though looking at the above mentioned Mexico, which rating according to [www.transparency.com](http://www.transparency.com) (2016) was by 2002 (the year in which Transparency International mentions the implementation of over 100 contracts implementing the “*Integrity Pacts*” and the role of independent advisors) 57<sup>th</sup> in the world with 3.6 (36) CPI and which rating by 2015 is 95<sup>th</sup> in the world with CPI of 35 (3.5), we can’t be really sure about the effect of the independent advisors without further research which is not the main topic of this paper.

As the Transparency International states, fighting corruption is a step-by-step process which can’t be done in one single sweep. Therefore creating accurate tools for combating such an element is very hard and has its limits. However, we can safely say that corruption is one of the biggest problems (judging from the low ranking of both Transparency International and Heritage Foundation EFI) in Czech Republic and should be addressed with urgency. Most of the other compounds of EFI are very much influenced by the corrupt or good working government infrastructure.

According to Transparency International, Poland went from the score of 58 and rank 41 in 2012 to the score of 62 and rank 30 in 2015. This shows that even a slight improvement in the corruption situation is highly praised by the Transparency International and therefore even by Heritage Foundation EFI. Surveys among Polish citizens show that corruption is perceived as a major problem, the same can be said about the surveys conducted in the Czech Republic. Poland is actively trying to fight the corruption (joining OECD Anti-Bribery Convention in 2000, establishing the Central Anti-Corruption Bureau in 2002), Czech Republic is also member of the OECD Anti-Bribery Convention since 2000 and is relying mostly on existing institutions and police sections like the organized crime unit and corruption and financial criminality unit. The last mentioned is to be united with several other police units in 2016, making this a controversial decision of the Czech government. This is supposed to make the work of these units more effective – however as mentioned before, this is a controversial topic.

Following the advice of the OECD found in Phase 3 report on Czech Republic in Anti-Bribery Convention, maintaining a detailed statistics on the sanctions imposed in domestic and foreign bribery cases is one of the first step in battling corruption. Following

this would surely improve the ground for application and implementation of other rules, while making the issue more approachable and comprehensible. As this is very deep problem, which is hard to predict, it is difficult to say what change this step would have in the EFI standing. But it is certainly step advocated by the OECD and therefore we can assume that it is the right step forward. Assuming Czech Republic adopted these OECD advices in 2012, it could achieve slight improvement, we are talking about the spread of one to two points.

While Czech Republic has made improvements between the years of 2012 and 2015, following the above mentioned would yield even bigger ones. It went from 49 points in 2012 to 56 in 2015 which is above the average change/year, while partially applying the OECD suggestions (as stated by the OECD). Should the Czech Republic apply all of the suggestions fully, we could at least fifty percent rise in change/year. Making the Czech Republic number 36 in 2015 with approximately 58 points. And while this would not catapult the country into the top 10 countries in Heritage EFI, it would pave the road for other improvements.

## 4.1.2 Limited Government

**Limited government** is another part of the EFI produced by Heritage Foundation. First of all let us define the size of the government. Judging from Afonso and Furceri (2008) it is a term that describes the “...size and volatility of government revenue and spending...”

### 4.1.2.1 Fiscal Freedom

The first part of the Limited government chapter we are going to talk about is Fiscal Freedom. Which is according to the Heritage Foundation:

*“...a measure of the tax burden imposed by government.”*

In this case, we can safely say that we are talking about government revenues. Following the definition from above mentioned source, we can state what elements compose the “Fiscal Freedom” component. It is 1) “The top marginal tax rate on individual income”, 2) “The top marginal tax rate on corporate income” and 3) “The total tax burden as a percentage of GDP”. Each of these variables is weighted the same (each has the weight of 1/3 of the whole component). Therefore, as mentioned by Heritage Foundation in its explanation of this component,

*“This equal weighting allows a country to achieve a score as high as 67 based on two of the factors even if it receives a score of 0 on the third.”*

Heritage further uses quadratic cost function in order to reflect the diminishing revenue returns from very high rates of taxes. The equation, taken from [www.heritage.org](http://www.heritage.org) (2016), looks like this.

$$\text{Fiscal Freedom}_{ij} = 100 - \alpha (\text{Factor}_{ij})^2$$

What words for description of the formula are better than those of its creators.

*“...where Fiscal Freedom<sub>ij</sub> represents the fiscal freedom in country i for factor j; Factor<sub>ij</sub> represents the value (based on a scale of 0 to 100) in country i for factor j; and  $\alpha$  is a coefficient set equal to 0.03. The minimum score for each factor is zero, which is not represented in the printed equation but was utilized because it means that no single high tax burden will make the other two factors irrelevant.”*

Czech Republic, with dataset including the top private tax of 15% and top corporate tax of 19% along with VAT, inheritance tax and tax burden equivalent to 35,3% of GDP, is ranked with 81,7 grade, which places it on 71<sup>st</sup> place as for the year from which data are compiled.

One can easily judge by the low placement that the state of this indicator is not very positive for Czech Republic, however on the other hand, the world average in this category is a grade around 78. It is not very comforting state of things for the Czech Republic, but at least the numbers are “in green”.

Using the data found at [www.oecdobserver.org](http://www.oecdobserver.org) (2016), we can find at least partial solution for potential tax inefficiency. As the authors of the article mention “*the devil is in the detail*”. OECD related materials love to give advice about property taxation, and no wonder it is a good idea. Owners of the property are usually better off than most of the society, although some middle class members are also owners, so this issue has to be addressed with caution, for it can cause more harm than good.

OECD also suggests that rising tax on high-earners might not work, because of the natural counter-reaction of the population regarding its choice of career, tax avoidance and other forms of behavioral response.

One of the most controversial and radical steps, which Czech Republic recently took in the direction of better taxation is the “electronic sales record” (EET). This system is bringing more effective taxation not by raising taxes, but by improving the tax collection in the country. One of the arguments against this policy can be heard from small scale/medium scale business owners. It is believed that financial burden, which comes with this system in the form of new machine for sales evidence, is way too high for many small/medium businesses and can be the reason why many of these businesses collapse in the end. According to the Czech ministry of finance, the single machine for the small business owners will cost around 5700 CZK and for medium business owners around 9000 CZK.

However, this is not the financial burden that most of the business owners are afraid of. The biggest scarecrow comes in the shape of monthly maintenance, service, amortization and diminishing effectiveness of labor.

The idea of EET comes from the background of more transparent and equal field for everyone, but it also aims at businesses which are actively avoiding taxes, therefore making the redistribution of tax burden imbalanced.

Should the EET succeeds, the raise in the effectiveness of tax collection and fight against tax corruption will be seen in the better grading of EFI for Czech Republic. It is very hard to say, which position would be thinkable with this EET approach, but any improvement for healthy tax environment, with well balanced distribution of tax burden is welcome in any case.

With more effective tax collections, comes more money for the treasury (government revenue). Which leads to very possible scenario of lowering the actual tax on income and/or corporate taxation. We shall take a look on better property taxation in the Czech Republic. Tax on property made 0.45 percent of total GDP in 2014 as showed by OECD (2016). The same source shows that the average percentage of tax on property is 1.851 (percent of GDP) in 2013. As we can see from the data provided by the OECD, many OECD countries have similar problems with taxation like Germany or United Kingdom. Both countries have different levels of tax on property as a percentage of GDP (UK 4.109 and GE 0.865 for the year of 2014). But both have relatively high personal income taxation (UK top 50 percent, GE top 47.5 percent) and both are below the average on Heritage ranking. The difference in corporate taxation is “relatively” small. Czech Republic has lower personal tax than both of these countries and lower tax on property too. Using these two countries did not prove useful, so we took a look at 2014 International Tax Competitiveness Index. We found out that Estonia stands as number one in overall score and in tax on property as well. Following the success of the Estonia and since the OECD advocates use of the tax on property, should the Czech Republic raise the tax on property to the level of Estonia (between 0.1 and 2.5 percent of the value of the land, not the property) it wouldn't, in fact, raise at all, since according to the Heritage EFI the Estonia has worst fiscal freedom than Czech Republic. So not only can't we use some of the biggest players in the “game” but even the best player is not possible to solidly use as an indicator as the EFI contradicts other used sources.

#### 4.1.2.2 Government spending

The Government spending is another part of the “Size of the Government” compound.

*“...considers the level of government expenditures as a percentage of GDP. Government expenditures, including consumption and transfers, account for the entire score.”* (www.heritage.org, 2016)

As the above mentioned sources claims, the ideal level of consumption/transfers is and will be different from country to country – there were even no attempt to characterize or identify the ideal, or optimal, level of expenditures made by government for multiple factor influence the “optimal level” for this unknown. However there is one thing, that Heritage points out, which connects pretty much every country.

*“Excessive government spending that causes chronic budget deficits and the accumulation of sovereign debt is one of the most serious drags on economic growth.”*

Government spending of zero is considered as baseline. That is the reason why some countries, mostly less developed, may get “artificially” higher scores as the results. However it is pointed out that these countries will most probably suffer in the other categories of the EFI because of the low number of provided public goods. The authors created expenditure equation like this.

$$GE_i = 100 - \alpha (\text{Expenditures}_i)^2$$

*“...where  $GE_i$  represents the government expenditure score in country  $i$ ;  $\text{Expenditures}_i$  represents the total amount of government spending at all levels as a portion of GDP (between 0 and 100); and  $\alpha$  is a coefficient to control for variation among scores (set at 0.03). The minimum component score is zero.”*  
(www.heritage.org, 2016)

In most cases, these data include spending of all levels of government. But is government spending a way to damnation or a tool of good and economic growth? Well according to Mitchell (2005) there are two camps that tries to shed some light on the question of government spending.

First there are those who advocates, that higher government spending provide the country with higher number of public goods like education and infrastructure. They also claim that:

*“...government spending can bolster economic growth by putting money into people’s pockets.”*

Second there are those who argue, that less government spending is for the better of the economy. According to their opinion, government is too big and it’s further spending, whilst taking money from the productive private sector, actually undermine the economic growth of the country. Government, in their eyes, uses resources less efficiently than productive, private sector. His paper says, that:

*“...large and growing government is not conducive to better economic performance.”*

Paper uses America as the model country and indeed came up with the result that shows one thing, smaller government would lead to higher incomes and improvements upon competitiveness of the United States of America. He also points out that smaller government is better because of philosophical reasons, however nor his paper, nor this one are philosophical, so we will stick to the economic theory. The author points out an interesting fact, that though both budget deficit and high government spending are detrimental, the spending part is more harmful than the deficit one. The problem according to his research is the fact, that government takes money away from the productive sector and uses them contra productively.

He also shows us the examples from around the world as something as a “benchmark” for quality government behavior. For our case, which is the one of Czech Republic, is important fact, that he mentions Slovakia (eastern neighbor of the country) as a great example of how the size of the government should look like in practice.

Calling the Slovakia “Hong Kong of Europe”, he provides interesting insight into the government of the country. Slovakia managed to reduce government spending from 65 percent of GDP to 43 percent of GDP in just seven years. While his paper works mainly around the United States of America, we can take this case a little more practically to the

case of Czech Republic, since the two countries (Slovakia and Czech Republic) are quite literally sibling countries.

Czech Republic could look over the borders to the east and see at least a blueprint of how things could be, or how things are supposed to be done when it comes to the government spending. We can compare the state of things in both Slovakia and Czech Republic as our way of telling how drastically things would improve should Czech Republic adopt similar approach as Slovakia did.

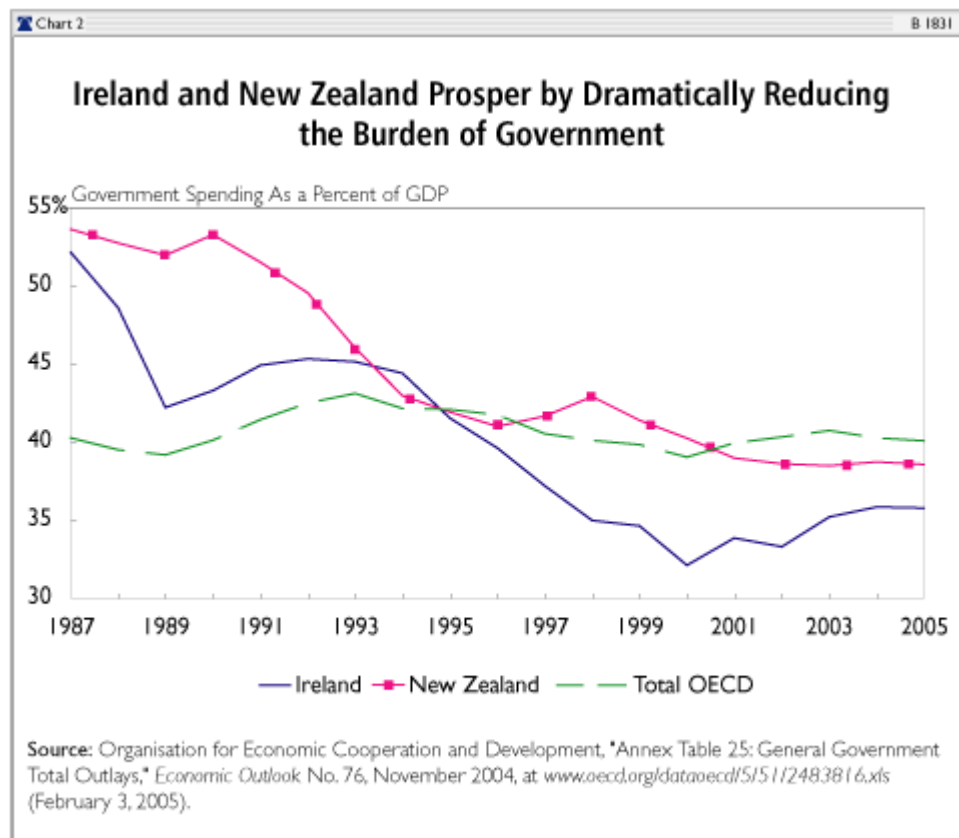
Government spending in 2012 was stabilized at 43 percent of GDP in Czech Republic ([www.heritage.org](http://www.heritage.org), 2016). This grants the Czech Republic 144<sup>th</sup> place which is lacking behind the world average by approximately 17.2 points. Slovakia is also lagging behind the world average, though a little bit less than Czech Republic, with 124<sup>th</sup> place and the grade of 56. And although we can see from the data gathered from the same source, that in 2012 government debt was half of the size of domestic economy, we can apply the findings of Mitchell (2005). The debt is not as important as the size of the government, which was 38.3 of the GDP.

By cuts in government spending and some changes in the tax system, Czech Republic could very possibly reach the same level of government spending as Slovakia. Mitchell (2005) say that:

*“Even a modest degree of discipline can quickly generate a balanced budget.”*

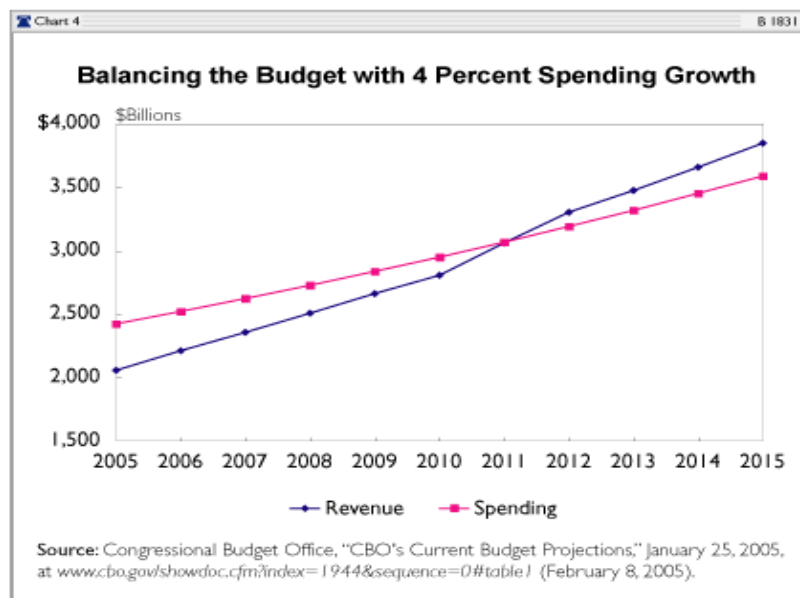
As the Chart, taken from Mitchell (2005) shows, the stop (or freeze as author calls it) in government spending can lead to balanced budget in two to three years of time. While limiting the growth of spending according to inflation rate, *“...balances the budget in four to five years”* Mitchell (2005) as yet another Chart from this author shows.

Graph 1



Source: Daniel J. Mitchell, Ph.D. (March 15, 2005): „The Impact of Government Spending on Economic Growth, Backgrounder No 1831“, Heritage Foundation

Graph 2



Source: Daniel J. Mitchell, Ph.D. (March 15, 2005): „The Impact of Government Spending on Economic Growth, Backgrounder No 1831“, Heritage Foundation

We can see, that there are some possible ways to improve the situation of Czech Republic.

It could profit from the situation of using the EET, which makes tax collecting more efficient and transparent, and try to keep the government spending low, or freeze it. With the current state of things, should the country manage to lower its spending to the level of its neighbor Slovakia (by freezing the spending or by aligning the spending to inflation rate) not only does Mitchell (2005) suggest that it would experience an economic growth, but it would rise its ratings at least to the one of Slovakia in two to five years.

Our data on Czech Republic is from the year of 2012, working with the data provided by Mitchell (2005), we could expect that the country would reach at least the level of Slovakia by 2017. That would mean reaching the grade of 56. That brings the country on point with Finland or Germany (18<sup>th</sup> and 19<sup>th</sup> place). Respectively, brings it on the level of Germany and Finland in 2012. Looking at the graph of Ireland and New Zealand, we can see that Ireland used to have much higher percentage of government spending in the past. Ireland managed to get its spending back from 55% of GDP in 1987 to approximately 35% in 2005. So it is possible to largely reduce the government spending and while Ireland did not managed to maintain this practice, it is a good example of possibilities.

Critical part of the Limited Government compound are equal redistribution of taxes and tax burden and balance government spending. By reworking (or better handling) the tax collection, potentially via EET, and by reducing/rethinking government spending, Czech Republic could step on the right path towards growing and prosperous economy.

### 4.1.3 Regulatory efficiency

Regulatory efficiency compound is another thing that the Heritage Foundation uses. According to [www.worldbank.org](http://www.worldbank.org) (2016):

*“Economies that both improve the efficiency of regulatory procedures and strengthen the legal institutions that support enterprise, trade, and exchange are better able to facilitate growth and development...”*

But first of all, what exactly is regulation? We can use the definition provided by [www.businessdictionary.com](http://www.businessdictionary.com) (2016), which says:

*“Principle or rule (with or without the coercive power of law) employed in controlling, directing, or managing an activity, organization, or system.”*

Generally, this compound is aimed at the regulations, which country imposes at its members. Judging it by effectiveness and by the way it is enforced upon the subjects for whose it is created. Its parts are 1) Business freedom 2) Labor freedom and 3) Monetary freedom.

#### 4.1.3.1 Business freedom

Business freedom is an indicator of government regulations regarding the businesses. It involves the difficulty of starting, maintaining and closing a business ([www.heritage.org](http://www.heritage.org), 2016). Again, the score is set to 0-100, where 100 is the freest environment. All ten factors which comprise this compound are weighted equally, those factors are according to *Table 2*.

Table 2

Numbers of procedures needed to start a business.
Number of days needed to start a business
The cost (percentage of income per capita) to start a business.
Minimum capital (percentage of income per capita) to start a business.
Number of procedures to obtain license.
Number of days to obtain license.
The cost (percentage of income per capita) to obtain license.
Number of years for closing a business.
The cost (percentage of estate) of closing a business.
Recovery rate (cents on the dollars) of closing businesses.

Source: <http://www.heritage.org/index/business-freedom>

First of all, some terms needs to be defined before we continue. Obtaining license stands for the procedures, time and cost needed in getting construction permit. The recovery rate is said to be function of time and cost, but the EFI uses all three variables to

*“...emphasize closing a business, starting a business, and dealing with licenses equally.”*

Each of these are converted to 0 – 100 scale using following equation:

$$\text{Factor Score}_i = 50 \text{ factor}_{\text{average}} / \text{factor}_i$$

Heritage comments on the equation in this manner:

*“Each factor is converted to a scale of 0 to 100 (using the equation) which is based on the ratio of the country data for each factor relative to the world average, multiplied by 50.”*

So how does the Czech Republic stand in this light? Well, above average as we come to expect (most of the time). Business freedom factor was graded 70.1, which places it at the 75<sup>th</sup> place in the world. However Heritage says that the change from the last year (+4.3) is mainly due eased license requirements and less time-consuming incorporation of new businesses. Even capital requirements is now less than 30 percent of the average annual income.

This could be improved by just looking over the border to the west, to Germany. Germany is ranked 13<sup>th</sup> in business freedom element due to its straightforward business start-up process. Even capital requirements are not present there. However, as Malherbe (2015) says, due to nature of free market, crises are too frequent and costly (from social point of view). Therefore the capital requirements are here to ensure safety and health of the economy.

We can assume that getting rid of capital requirements entirely might not be such a good idea, however it seems that Heritage looks kindly upon it, which could actually be harmful.

On the other hand, process of starting-up new business does not need to be complicated. The time needed for starting a new business in Czech Republic is, give or take, 9 (www.worldbank.org, 2016) days. As the Heritage said, the process was eased a little bit, but still there is room for improvement. Perfect competition at which the fundamentals of open market stand, says that the larger barrier to entry (resources needed, time needed etc.) the less is the market competitive. Therefore it is only logical, that decreasing the barriers of entry into the market of the country is beneficial for the idea of perfect competition and in the end for the state itself as it helps to maintain strong and solid business environment. In the end, this would lead to increase in rating from Heritage.

Let us take a look at the United States of America.

*“Incorporating a business takes five days on average, but the overall cost of meeting regulatory requirements has increased...”*( Miller, Kim, Holmes, Roberts, Riley, Olson 2014).

USA is ranked 17<sup>th</sup> with 89.2 points in Business freedom subcomponent. Even though it increased its costs of entering the market, the fact that it takes only about 5 days makes it shine in the top 20. If Czech Republic approaches the handling of businesses in similar manner, we can expect it to rise maybe even higher than USA since the decreasing need for capital (for starting a company). So it is safe to say that lowering the share number of days needed to start a business from 9 to 5 would take Czech Republic to the top 20 countries in the Heritage EFI (as almost all other elements are quite well executed). We can even go the distance and say that, holding all other things constant, Czech Republic could even outrun the United States of America in 2013. Becoming the new number 17.

#### 4.1.3.2. Labor freedom

Labor freedom mainly deals with the idea of measures that work with variety of legal and regulatory framework as Heritage says. It includes minimum wages, laws inhibiting layoffs, severance requirements and regulatory restrains on hiring and hours worked (www.heritage.org, 2016).

As is the common practice of Heritage EFI, all the elements of this compound are equally weighted. Those elements (parts) are: 1) Ratio of minimum wage to the average value added per worker 2) Hindrance to hiring additional workers 3) Rigidity hours 4) Difficulty of firing redundant employees 5) Legally mandated notice period and 6) Mandatory severance pay.

Again, a formula is used to describe the relationship of these elements.

$$\text{Factor Score}_i = 50 \times \text{factor}_{\text{average}} / \text{factor}_i$$

*“...where country i data are calculated relative to the world average and then multiplied by 50. The six factor scores are then averaged for each country, yielding a labor freedom score.”* (www.heritage.org, 2016)

Czech Republic stands quite proudly at 14<sup>th</sup> place in the world, with such a comment:

*“Labor regulations are relatively flexible, although the non-salary cost of employees can be burdensome.”*

Quote taken from the same source as above. This sentence points out to the fact, that Czech Republic requires the businessman to pay variety of non-salary “fees” for its employees. In 2015, Eurostat (ec.europa.eu, 2016) released nice set of data showing the estimated hourly costs of labor in Europe. In EUR, Czech Republic stands at 10EUR / hour for an average worker. The fact that this is below the EU average (around 25EU / hour) is not important to us now. But as is the case for many other European countries, big portion of this sum of “money” for a worker is not actually worker’s salary in the true sense of the word. There are some things in the Czech Republic that the employer has to pay for each of his employee besides taxes. This would be social and medical insurance. As for the year of 2012 social insurance was calculated as 25 percent of gross salary and medical insurance as 9 percent of the gross salary (www.investujeme.cz, 2016).

By following quite recent political theater of Czech Republic, we can see that tackling the problem of retirement, which is included in the above mentioned social insurance, can be very tricky business by itself. In other words, it is a political suicide. By looking at the numbers from 2012, we can see that the retirement support accounted for more than 80 percent of all “social support” spending of the state in 2012 ([www.mpsv.cz](http://www.mpsv.cz), 2016) and this trend is upwards sloping.

But since the number of seniors who are eligible for the retirement support from the government rises from year to year, it is almost impossible for policy makers to do something about the pile of resources that is pumped into the social system. OECD even provides data with the expenditures as the percentage of the GDP, Czech Republic stands at the 8.9 percent ([www.oecd.org](http://www.oecd.org), 2016) “of GDP” spent for pensions.

Reducing this number is almost impossible but it is necessary to work on a way of solving this issue. As the trend is in the western countries, the population is aging and this only adds to the people who will be taking pensions in the future. So the Czech Republic took to delaying the pension age. Trying to reduce the number of people taking the pension from the other side.

Decreasing the percentage of GDP spent on pensions is a good start. OECD advocates that pension cuts is one of the better steps towards budget saving and it would help to keep the social security tax lower. We can see that the 2012 leader on the element, USA, had social security of 6.20% and medical of 1.45% of income. This is much lower than Czech Republic and it keeps the non-salary cost of employee at minimum. WE can predict that cutting the social and medical tax in half (along with various adjustments) for the Czech Republic could yield a dramatic outcome. Setting the social security to 12.5% and medical insurance to 4.5% could lead to the raise of up to 5 places, granting the Czech Republic the rank of 9 for the year of 2013 in the element just by following the example of the USA.

#### **4.1.3.3. Monetary freedom**

Monetary freedom is another aspect of the component. It deals with price stability, while considering “tampering” with the price harmful for the free market. Both inflation and price controls are considered harmful.

The score is based on two factors 1) Weighted average inflation rate for the most recent three years and 2) Price controls.

All of the above information is taken from the Heritage Foundation, which EFI we try to analyze.

This time, the process of assessing the grade is a little bit trickier. I will use the exact wording of the authors, as I consider it best suited for explaining. The formulas are as follows.

$$\text{Weighted Avg. Inflation}_i = \theta_1 \text{ Inflation}_{it} + \theta_2 \text{ Inflation}_{it-1} + \theta_3 \text{ Inflation}_{it-2}$$

$$\text{Monetary Freedom}_i = 100 - \alpha \sqrt{\text{Weighted Avg. Inflation}_i} - \text{PC penalty}_i$$

*“... $\theta_1$  through  $\theta_3$  (thetas 1–3) represent three numbers that sum to 1 and are exponentially smaller in sequence (in this case, values of 0.665, 0.245, and 0.090, respectively);  $\text{Inflation}_{it}$  is the absolute value of the annual inflation rate in country  $i$  during year  $t$  as measured by the consumer price index;  $\alpha$  represents a coefficient that stabilizes the variance of scores; and the price control (PC) penalty is an assigned value of 0–20 points based on the extent of price controls.”*

(www.heritage.org, 2016)

It is needed to add, that Heritage further adds, that the coefficient of  $\alpha$  is set to 6.333, which converts 10 percent inflation into a score of 80.0.

Czech Republic stands at the 42<sup>nd</sup> place in the world with this element. Although the government, according to Heritage, has taken steps in reducing subsidies for state pensions and green energy, there is still a range of price controls. Since the Czech Central Bank (CNB) is the controller of the price stability and inflation targeting policies, it is only logical that we should address it instead of government. According to www.mfcr.cz (2016), the basic direction of the upcoming policies should be the reduction of market interventions and the reduction of the list of products and services, which are subjects to price control.

So it seems that Czech Republic already knows what to do, it is only a matter of observation to judge the outcome of its doing. However as we can see from the grading by Heritage Foundation, the grading for Monetary Freedom element has actually downwards trend, which can tell us something about the success the Czech Republic is having in implementing their plan for reduction of price controls. To be precise the change from the year of 2011 to the year of 2012 was -2.3 points.

Searching the way forward, not backwards, should be the main aim of the policy makers. Current situation in the world market may be inclined towards more controlled environment, we should, however, not forget that liberal, free market is the main goal of the policies.

As we said in the chapters before, taking steps in reducing the percentage of government spending on pensions is a way forward. This subsidy on the state pensions needs to be cut as low as possible in order for Czech Republic to get a decent grading. Subsidies for the green energy has also proven as a bad way of handling things. Should the Czech Republic abandon at least the subsidies for the green energy, it has the potential to reach much higher grades. Giving it the boost of at least 5 points for the year of 2013 and while this is not the price control, it is creating breeding ground for other unwanted elements such as corruption.

#### **4.1.4. The Open Market**

The Open Market compound is the last one of the Heritage foundation EFI. Here we use the definition from [www.investopedia.com](http://www.investopedia.com) (2016) which tells us the basics we need to know.

*“An open market is an economic system with no barriers to free market activity. An open market is characterized by the absence of tariffs, taxes, licensing requirements, subsidies, unionization and any other regulations or practices that interfere with the natural functioning of the free market. Anyone can participate in an open market; there may be competitive barriers to entry, but there are no regulatory barriers to entry.”*

The Open Market pretty much consists of most of above mentioned compounds. We can say, that the less government intervention, the more “free” the market is.

##### **4.1.4.1. Trade freedom**

Trade freedom is the first of the three elements putting The Open Market together. It shows, or measures, the absence of tariff and non-tariff barriers that have an effect on imports and exports to and from country of services and goods. The score is based on the trade-weighted average tariff rate and non-tariff barriers (NTBs). As with the previous compounds,

all of the data concerning the explanation of each respective element is taken from [www.heritage.org](http://www.heritage.org) (2016).

Heritage Foundation realizes the fact that different imports entering country often face different tariffs. So the weighted average is used to determine the score. Following formula is used.

$$\text{Trade Freedom}_i = (((\text{Tariff}_{\max} - \text{Tariff}_i) / (\text{Tariff}_{\max} - \text{Tariff}_{\min})) * 100) - \text{NTB}_i$$

*“...Trade Freedom<sub>i</sub> represents the trade freedom in country i; Tariff<sub>max</sub> and Tariff<sub>min</sub> represent the upper and lower bounds for tariff rates (%); and Tariff<sub>i</sub> represents the weighted average tariff rate (%) in country i.”* ([www.heritage.org](http://www.heritage.org), 2016)

Minimum tariff is logically set to zero and maximum tariff was set to 50 percent. An NTB penalty is then subtracted. The penalty, which can take the form of 5, 10, 15 or 20 points is determined through the following rules.

*Table 3*

<b>20</b> – extensive use of NTBs across many goods and services and/or act to impede a great portion of international trade
<b>15</b> – wide usage of NTBs across many goods and services and/or act to impede a majority of international trade
<b>10</b> – NTBs are used as a protection of certain goods and services and impede some international trade
<b>5</b> – NTBs are rare, protecting few goods and services and/or have very limited effect on international trade
<b>0</b> – NTBs are not used to limit international trade

Source: <http://www.heritage.org/index/trade-freedom>

Extent of NTBs in a country is determined by using qualitative and quantitative information. Since the nature of restrictive rules vary widely, it is difficult to measure their complexity. There are a few categories of NTBs considered in the penalty imposed.

Table 4

<b>Quantitative restrictions</b> – these are import quotas, limitations on export, voluntary export restraints, import/export embargos and bans, countertrade etc.
<b>Price Restrictions</b> – antidumping duties, countervailing duties, border tax adjustments, variable levies/tariffs rate quotas.
<b>Regulatory restrictions</b> – licensing, domestic content and mixing requirements, sanitary and phytosanitary standards (SPSs), safety and industrial standards regulations, packaging, labeling and trademarks regulations, advertising and media regulations.
<b>Investment restriction</b> – exchange and other financial controls.
<b>Customs restrictions</b> – advance deposit requirements, customs valuation procedures, customs classification procedures, customs clearance procedures.
<b>Direct government intervention</b> – subsidies and other aid, industrial policy and regional development measures, financed research and other technology policies, national tax and social insurance, competition policies, immigration policies, government procurement policies, state trading, government monopolies and exclusive franchises.

Source: <http://www.heritage.org/index/trade-freedom>

The Czech Republic was ranked 11<sup>th</sup> in the world in this particular element with the change +1 point in comparison with the previous year of 2011. Heritage addresses this mainly to the fact that Czech Republic is a member of the EU.

*” EU members have a low 1.1 percent tariff rate and, in general, few non-tariff barriers to trade.”* (www.heritage.org, 2016)

We can also assume that the Czech Republic has no interest of variety of trade restrictions since its GDP is strongly depended on international trade (www.cnb.cz, 2016). According to the Czech National Bank, the share of international trade on GDP was, in the year of 2013, around 150%. So it is safe to expect the country to be inclined towards more tariff free environment, which, judging from the change in grading against previous year, is actually the case. Should the country stay its course, we could find ourselves looking at a country with very open market environment.

#### **4.1.4.2. Investment freedom**

Investment freedom is the second part of The Open Market compound. Investment freedom means the free and not constrained flow of capital and resources both inside the country and in/out of the country. Such country would receive 100 points from the Heritage Foundation.

But when it comes down to it, most countries have some restrictions on investment. Regulations on labor, corruption, red tape, weak infrastructure and political security can have a negative effect on freedom that investors have in the market of the specific country.

EFI of Heritage Foundation assigns each country the starting points of 100, from which it subtracts points according to their table of treatment of foreign investment in which they categorize the most commonly used policies. The grade ranges from 5, respectively -5 points, to 25 (-25) points. The variety of approaches to restriction of investment freedom is very broad and it would be of no point for us to name all the categories in here. Should you be interested in detailed list provided by the Heritage foundation, that source of all the data is again [www.heritage.org](http://www.heritage.org) (2016).

Czech Republic stands proudly at 23<sup>rd</sup> place in the world, with yearly change of +10 points, which is quite an achievement considering the severity with which the score points effect the world standing of the country.

This could be caused by the lifted restriction on foreign land ownership, as Miller, Kim, Holmes, Roberts, Riley, Olson (2014) mentions in their look at the Czech Republic. The source [www.czechinvest.org](http://www.czechinvest.org) (2016) used the Czech National Bank source from the year of 2012 and quoted.

*“The Czech Republic is one of the most successful CEE countries in terms of attracting foreign direct investment. Over 173,000 Czech firms across all sectors are now supported by foreign capital. According to the Czech National Bank, a total amount of EUR 77.8 billion worth of FDI has been recorded since 1993 (Source: Czech National Bank, 2012).”*

Here we can see, that Czech Republic is using its central position in Europe very well. The same source claims that since the introduction of business investments incentives in 1998, the massive inflow of FDI going into greenfield projects was detected and this trend of

growing FDI was further bolstered by the entrance of the country into the EU in 2004. The source even mentions the Economist Intelligence Unit database, which shows the high rate of FDI per capita since 2000, further proving the growing attractiveness of Czech Republic for foreign investors.

Judging from the yearly change of +10 points, the country is doing great job of building a healthy and attractive environment for FDI, which, as we can see, is a trend the country follows since the late nineties.

#### **4.1.4.3. Financial Freedom**

The last element we are going to mention in the Heritage EFI is the Financial Freedom. Mostly, this element deals with banking efficiency and with the measure of government control in financial sector. The ideal state of things is characterized as the existence of fully independent central bank and regulations limited to enforcing contractual obligations and preventing frauds. Allocation of credit on market terms and no presence of government owned financial institutions. Free, private financial institutions provide credit, accept deposits and conduct operations in foreign currencies for individuals and companies alike.

Five areas are set as a means of setting score for the creation of IFI. 1) The extent of government regulation of financial market 2) The degree of state intervention in banks and other financial firms through direct and indirect ownership 3) The extent of financial and capital market development 4) Government influence on the allocation of credit and 5) Openness to foreign competition.

These areas are there to assess overall level of financial freedom that ensures easy and effective access to financing opportunities for people and businesses. Again, the score here is set to 100 at the start. Than multiple elements, which represent the “level” of government interference, is subtracted from this number. Ranging from repressive government to negligible government interference.

Czech Republic is graded by 80 points, which stands for the “nominal government interference according to Heritage Foundation. This puts it at the 4<sup>th</sup> place in the world.

*“The banking sector remains competitive and resilient, offering wider range of financial products.” (Miller, Kim, Holmes, Roberts, Riley, Olson 2014)*

Czech banking system is considered very resilient in the face of the last crisis.

*“...the banking sector of the Czech Republic is able to absorb the scenario of the Czech Republic’s GDP hypothetically dropping by 5% - 6%.” (Dubská 2013)*

As the same authors says, after the 1993, the small to medium sized segment of banks almost disappeared from the banking sector due to turbulent development and liquidity crisis. Even the large banks were in trouble because of wild transformation from planned to free market economy. After the fall of one the fourth biggest bank, Czech government cleared the balance sheets of the three biggest banks and sold them to the foreign hands.

The paper from Dubská (2013) also mentions the increasing importance of fees for the banking sector. Another source [www.penize.cz](http://www.penize.cz) (2016) highlights this fact. It claims that up to one third of the profit from Czech banking sector is created through the fees for banking services alone. This is actually one of the reasons, why the banking crisis didn’t hit the Czech Republic as hard, as other countries.

Also, Dubská (2013) says that:

*“...debt of the government sector and the households and also debt of businesses together as a percentage of GDP is the second lowest in the European Union.”*

From all this we can see, that the banking system of Czech Republic is relatively sound and mostly free from government interference, as showed by the 80 points grading by Heritage EFI and by the findings of Dubská (2013). The only recommendation we can make here, is to stay the course.

## 4.2. Fraser Institute Index

Using the information provided by [www.fraserinstitute.org](http://www.fraserinstitute.org) (2016), we can shed some light on the second of our points of interest, the EFI produced by the Fraser Institute. Its first publication was in 1996. Index ranks 159 countries. Data up to 1970 are available for about 100 countries, some countries even have data from the year of 1970.

The Institute emphasize the fact that without exception, studies using the Fraser EFI found out, that institutions and policies more consistent with economic freedom have higher rates on investment, higher income levels and more rapid economic growth along with reduction in poverty.

But what is Fraser Institute?

*“The Fraser Institute is the top think tank in Canada and this year was ranked among the top 20 think tanks worldwide, in the Global Go-To Think Tanks Index published by the University of Pennsylvania.”* ([www.fraserinstitute.org](http://www.fraserinstitute.org), 2016)

Saying that Fraser Institute is the Canadian version of the Heritage Foundation wouldn't be wise, as it would get rid of any sign of originality in both of these organizations, but we can understand both of these “think tanks” as being likely minded.

Variety of areas are included in the Fraser approach to the EFI. 1) Size of the government, expenditures, taxes, and enterprises 2) legal structure and security of property rights 3) access to sound money 4) freedom to trade internationally and 5) regulation of credit, labor and business.

On the first sight we can notice that the similarity in structure of both indexes is very much alike, though both of the groups rate each of the topics differently (hence the different scores for Czech Republic according to both EFIs). We will be using the 2014 publication of Economic Freedom of the World Annual Publication found at [www.freetheworld.com](http://www.freetheworld.com) (2016).

Fraser Institute uses zero to ten points scale as a way to rate countries, where zero is the worst scenario and ten the best one.

## 4.2.1 Size of the government

Size of the government is going to be our first stop with the Fraser EFI. This compound consists of multiple elements.

Table 5

Element	Rating	Data
Government consumption	3.26	28.90% of total consumption
Transfers and subsidies	2.69	27.32% of GDP
Government enterprises and investment	10.0	13.85%
Top marginal income tax rate	10.0	15%
Top marginal income and payroll tax rate	4.0	45%

Source: James Gwartney, Robert Lawson and Joshua Hall (2014): "Economic Freedom of the World: 2014 Annual Report, Fraser Institute 2014"

All of the data and information is taken from Gwartney, Lawson and Hall (2014), from which we can also take a little deeper look at what is behind the numbers the authors supply us with.

All of the elements of the Size of the government section measure the degree to which is country reliant on personal choice and markets rather than government decisions.

Government consumption is the percentage consumption of the government to the whole consumption of the country, the higher it is, the less score the country gets.

*"When government spending increases relative to spending by individuals, households, and businesses, government decision-making is substituted for personal choice and economic freedom is reduced."* (Gwartney, Lawson and Hall 2014)

Transfers and subsidies are considered harmful to economic freedom by taxing one person heavily and transferring the tax cut to the other. This is to harm the freedom of the individual as they can't keep what they earn. This particular number is a percentage of the country's GDP.

Government enterprises and investment shows us how the government directs resources. Either via private companies or through state-owned enterprises. This is

considered to be harmful to the economic freedom. As state owned companies work in the safe markets, they are protected so there is no pressure present as in the case of competitive market.

Top marginal tax rates and top marginal income and payroll tax rates mainly deal with the high taxation. The more the taxation of the relatively low income group is present, the more they are deprived of what they earned thus decreasing the level of economic freedom in the country.

As we can see, the aim is mainly on two topics, taking money away from the people and the government spending and its transfers. The way to improve this particular part could be the same as in the case of Heritage Foundation's EFI. Better approach to tax handling and equal distribution of tax burden as mentioned in the part Size of the government in the Heritage section. Fraser EFI seems to even more emphasize the problem of unequal taxing, followed with transfers of such gained resources.

#### **4.2.1.1 Top marginal income/income and payroll tax**

Czech Republic was graded by the number of 5.74. Again there is no interpretation as to why or for what reason, but we can see that government consumption and transfers and subsidies are the biggest problem the Fraser see. Again, using Mitchell (2005), we can advise Czech Republic in the same way as with the name sake of this compound from the Heritage section. However there can be some degree of advice regarding the Top marginal income tax and Top marginal income and payroll tax rate. With the absence of no other explanation from the Fraser Institute, we have to rely on data provided. We can see from Gwartney, Lawson and Hall (2014), that the tendency is to give lower grading the higher the above mentioned elements rise. Since the Top marginal income tax is graded by the maximum points (10), we have to focus on the second element. The 45 percent of Top marginal income and payroll tax rate is graded with 4 points, while in the previous years, it got one point for the 56 percent. Which we can understand as the change of 1 point per 3.6 percent change in the tax rate. This means that Czech Republic, in order to get full 10 points in this element, needs to lower its Top marginal income and payroll tax rate by 22 percent. Which ultimately leads to the ideal rate of 23 percent. This would lead to the improvement of the whole Size of Government are to 7.19 (from 5.74).

#### 4.2.1.2 Government consumption

Government consumption can be approached in the same manner. Seeing the change in consumption from the year of 2011 (29.10%) to 2012 (28.90%) and the change in grading (from 3.21 to 3.26), we can calculate that every 0.1 percent decrease in consumption of the government leads in Fraser standards to increase in grading by 0.025 points. This means that in order to achieve grading of 10, Czech Republic would have to reduce its spending by 25.66 percent. Which is almost impossible but this would guarantee to increase the rating to the number of 10, creating the overall grading for the area to 8.5, which would catapult Czech Republic to the 5<sup>th</sup> – 7<sup>th</sup> place in the world in 2012.

### 4.2.2 Legal system and Property Rights

Legal system and Property Rights is a second compound we are going to talk about in Fraser EFI. It consists of number of elements, which you can see in the table below.

*Table 6*

Element	Rating
Judicial Independence	4.65
Impartial Courts	3.13
Protection of property rights	4.81
Military interference in rule of law and politics	10.0
Integrity of legal system	8.33
Legal enforcements of contracts	3.85
Regulatory restrictions on sale of real property	8.23
Reliability of police	4.82
Business costs of crime	6.68

*Source: James Gwartney, Robert Lawson and Joshua Hall (2014): "Economic Freedom of the World: 2014 Annual Report, Fraser Institute 2014"*

Using the source Gwartney, Lawson and Hall (2014) for the table above and for the interpretation as well, we can go ahead as to set what each element represents.

Fraser considers this the most important function of the government – the protection of persons and their rightfully acquired property. All of the nine elements of this compound are based around how effectively the protective function of the government is fulfilled. The Fraser Institute in the form of Gwartney, Lawson and Hall (2014) uses the data from the *International Country Risk Guide*, the *Global Competitiveness Report*, and the World Bank's *Doing Business* project.

The authors say, that the property rights and the rule of law are the foundation for both economic freedom and efficient operation of the market. Pretty much the same claims O'Driscoll and Hoskins (2003). Their paper does not talk about the economic freedom specifically, but it discuss the effect of sound property rights as the way or a key to economic development, to which we can add Powell (2002) who says:

*“Private property provides the incentives for individuals to economize on resource use because the user bears the costs of their actions.”*

So not only the economic freedom, but economic growth as well is influenced by the quality and present property rights, therefore making it even more important for the government to take seriously.

Again, making the judicial system more effective, or more independent could prove like a really important way of progress. We can, once more, take the inspiration from the judicial section of Heritage EFI. We can see that judicial affairs are the ones who are hampering the standing of the country. Focusing on the judicial branch as mentioned in the Heritage part could prove very useful, however it is very hard to quantify the process of bettering the system. By looking at the change per year from the year of 2000, we can see that all the judicially focused sub-elements are more or less falling in grading. This signalizes that the country is taking steps in the wrong direction. Rethinking the judicial approach may be of the best interest for the country. Iceland with the grading of 8.2 was ranked 7<sup>th</sup> in the 2012. By studying the judicial system of the country, we can see a few differences from the Czech Republic. Using the paper of Stockholm Institute for Scandinavian Law 1957-2010 on the Iceland's Judicial System ([www.scandinavianlaw.se](http://www.scandinavianlaw.se), 2016) we can notice, that the Minister of Justice appoints the judges to the Supreme Court, not the president as in the case

of the Czech Republic. The other thing that strikes us about the Czech judicial is, that according to Richter (2011) around 1000 judges were members of the Communist Party before the year of 1989. Our suggestion would be to transfer the power of appointing the Supreme Court judges to the hands of the Ministry of Justice, as in the case of Iceland, and making sure that members of no totalitarian regime are appointed into the office. Again, it is hard to quantify the results in this case.

### 4.2.3. Sound Money

Another compound of the Fraser EFI is Sound Money. It has only a handful of elements consisting it. These are, again, displayed in the table below.

*Table 7*

Element	Rating	Data
Money growth	9.10	4,48
Standard deviation of inflation	9.32	1,71
Inflation: most recent year	9.34	3.30
Freedom to own foreign currency bank accounts	10.0	/

*Source: James Gwartney, Robert Lawson and Joshua Hall (2014): "Economic Freedom of the World: 2014 Annual Report, Fraser Institute 2014"*

As the statement of Gwartney, Lawson and Hall (2014) say:

*"Money oils the wheels of exchange".*

They further claim that the absence of sound money hurts the health of the economy by damaging the gains from the trade. By using the Milton Friedman as a source, they call the inflation a monetary phenomenon, which is caused by too much money chasing too few goods. The important thing is the access to sound money, who provides it in of no importance as the authors say. Once the government starts to create new money to support its projects it is expropriating the property and violating the economic freedom of their citizens (by making their money less valuable). The importance of ability of offering to open checking accounts in other currencies or simply opening accounts in foreign banks is very high, as it expands on the economic freedom of the country.

The first three element are meant to show the monetary consistency of the country, while the fourth one is there to see the ease/hardship to use currency via domestic or foreign channels.

From what we can see, the standing of the Czech Republic in this particular compound is solid. This could relate to the Heritage part Open Markets, to be exact to its par called Financial Freedom. In both of these indexes we can see that the country stands quite solidly on the foundations of healthy currency (which is Czech Crown, not Euro) and inflation policies. The Czech National Bank, as tool for handling inflation and interest rates, is set to target the “maintainable economic growth” and a specific level of inflation. As we can see, according to both indexes, it is doing a solid job. And as before, the only advice we are able to produce here is to stay on the right tracks.

## **4.2.4 Freedom to Trade Internationally**

Let us continue to yet another compound of Fraser EFI, the Freedom to Trade Internationally. Again, we are going to use the data provided by Gwartney, Lawson and Hall (2014) and create a table for better orientation. But first of all we need to clarify some adjustments made to the table below. The main elements, which are 1) Tariffs 2) Regulatory Trade Barriers 3) Black market exchange rates 4) Controls of the movement of capital and people, are a little bit adjusted by this paper. All of the before mentioned elements, exception being the Black market exchange rates, contain a variety of components. These are for 1) Revenue from trade taxes (percentage of trade sector), Meant tariff rate and Standard deviation of tariff rates 2) Non-tariff barriers and Compliance cost of importing and exporting and 4) Foreign ownership/investment restrictions, Capital controls and Freedom of foreigners to visit. All of these sub-elements were already calculated as an arithmetic average into their respective categories. So we are going to use only those categories which already contain the numbers from their sub-sections.

Table 8

Element	Rating
Tariffs	8.21
Regulatory trade barriers	6.62
Black market exchange rates	10.0
Controls of the movement of capital and people	6.91

Source: James Gwartney, Robert Lawson and Joshua Hall (2014): “Economic Freedom of the World: 2014 Annual Report, Fraser Institute 2014”

If interest in the respective subsections rises, Gwartney, Lawson and Hall (2014) are the source used and all of the data can be found there.

As the source stays, during our age of low cost and relatively easy communication and transportation, freedom to exchange across national borders is a key component for economic freedom. The fact that many products are made abroad and afterwards imported even more rises the importance of this issue. In ideal scenario, both sides (importer and exporter) gain and the vision of this gain is therefore driving power behind the exchange, making the living standards raise even higher than before.

Tariffs and quotas are named as main factors that hinder the exchange, because they reduce the convertibility of currencies. This also leads to the scenario of controlled exchange rates, which have the same effect on international trade Gwartney, Lawson and Hall (2014). Also the way how customs deal with the goods coming into a country matters – for if their work is time consuming, it also hurts the international trade. This can have multiple reasons. One of those is ineffective administrative apparatus and another one is corruption. In both of these case however, the economic freedom sees reduction

The ideal country stands as a country with

*“...low tariffs, easy clearance and efficient administration of customs, a freely convertible currency, and a few controls on the movement of physical and human capital.”* (Gwartney, Lawson and Hall 2014)

We have to mention, again, that since 2004, Czech Republic is part of the EU. This means it has very low tariffs for other members of the union. Pretty much the same as mentioned in the Heritage part of the Open Markets can be said here. With a few differences.

Where Heritage sees improvement and one of the strong sides of the country, Fraser sees decrease, making this one of the more declining part of the Czech EFI. Again, since Fraser Institute did not provide any explanation as to why this is the case, we have to assume different approach or different set of priorities. Czech Republic as a country located in the center of the Europe without any access to sea ports. It is very deeply connected to international trade mainly with Germany to the west. The big contribution of international trade to GDP was mentioned in the Heritage part. This is part where Fraser and Heritage contradict each other. By using the *World Integrated Trade Solution* (wits.worldbank.org, 2016) we can see that the Imports/Exports actually declined from the year of 2011 to 2012, this could prove the truthfulness of the Fraser EFI while undermining the Heritage EFI. Which way the causation goes is not clear and it is not the aim of this paper. But we can clearly see the stocks markets fall in the August of 2011. This could be the reason behind the sudden drop of imports/exports in the otherwise rising tendency which the Czech Republic had for several years, but it can't explain the drop in rating by the Fraser Institute.

Czech Republic could look to the Denmark, its fellow EU member, for inspiration when it comes to the regulations regarding trade. As mentioned by the United States *Bureau of Economic and Business Affairs* (June 2012), by 2012 Danish investment policies were forward-looking and aimed at developing business. Czech Republic can take a lot just by following the line of thinking which Denmark follows. That is the creation of investment friendly/ier environment and a ground for future expansion for foreign investors and companies. Again as said in the Heritage part, Czech Republic is quite attractive country to invest, as mentioned by the cited sources, but the implementation of the Danish investment-friendly approach with comprehensive and stable system is one of the ways to improve its standing in the Fraser EFI. Judging from the fact that Czech Republic is already considered a solid point of investment, adding the standards and approach of Denmark would certainly uplifted the country above the above mentioned Denmark. This would mean the raise of the rating from 7.9 to at least 8.2, which would guarantee the country 13<sup>th</sup> to 14<sup>th</sup> place in the compound.

## 4.2.5. Regulation

The last part of the Fraser EFI is Regulation part. Our table is going to be a little bit adjusted again. Under 1) Credit market regulations is hidden a few subcategories, which are then averaged and thus create the rating for the first element (Credit market regulations). These are Ownership of banks, Private sector credit and Interest rate controls/investment restrictions. Going forward we have 2) Labor Market Regulations with components like Hiring regulations and minimum wage, Hiring and firing regulations, Centralized collective bargaining, Hours regulation, Mandated cost of worker dismissal and Conscription. And the last section 3) Business regulations which consists of Administrative requirements, Bureaucracy costs, Starting costs, Starting a business, Extra payments/bribes/favoritism, Licensing restrictions and Cost of tax compliance. All of the data including the table below are taken from Gwartney, Lawson and Hall (2014).

*Table 9*

<b>Element</b>	<b>Rating</b>
Credit Market regulations	9.61
Labor Market regulations	8.08
Business regulations	5.50

*Source: James Gwartney, Robert Lawson and Joshua Hall (2014): "Economic Freedom of the World: 2014 Annual Report, Fraser Institute 2014"*

Again, here we can see a little bit of disagreement of Fraser and Heritage. While Fraser considers Business regulations to be quite a low quality in the Czech Republic, mainly due to high number of administrative procedures required (rating of Administration requirements is 2.72) and big number of bureaucracy involved (Bureaucracy costs rating is 2.58) along with extra payments and possibly bribes (Extra payments/bribes/favoritism rating is 4.19). The Heritage sees business environment in the country in better colors.

All this could be summarized in the ease of starting a business. Again this could be tracked back to the sheer volume of time needed to start a company in the country. As we saw in the Heritage chapter, it takes around 9 days ([www.worldbank.org](http://www.worldbank.org), 2016) to start a company, by reducing this number, Czech Republic could not only improve its market condition, but also rise higher in the Fraser Institute EFI.

Here we can take the case of the United States of America and their rating in Starting a Business sub-element. USA scored 9.82, this can be effected by multiple factors. First is the share number of days needed to start a business, which is 5 – 6 ([data.worldbank.org](http://data.worldbank.org), 2016), and second is the number of administration units one need to visit before the startup is created, which is 5 – 6 (in New York City). While we look at Czech Republic, it takes 9 days to start a business and you would need to visit 8 administrative units. The advice here is to lower, or simplify if you will, the time and destinations needed for the company to be created. In the NYC, USA we can see that the cost of starting a business is approximately 750 US dollars ([www.doingbusiness.org](http://www.doingbusiness.org), 2016). While in the Czech Republic it is 23 066 of Czech crowns, which is (using the 2012 exchange rates) around 903 US dollars. Decreasing all of the three above mentioned items would increase the rating in several sub-elements (Administrative requirements, Bureaucracy costs and Starting a Business). Administrative requirements could be expected to raise to the digit of 4 (Czech Republic is known for its bureaucratic procedures and just by lowering the number of offices needed to visit in order to start a company would not increase the rating by a huge portion) from original 2.72. Bureaucracy costs could be expected to raise to 2.59 from 2.58 (for the same reason as mentioned in the first sub-element). Starting a Business has the potential to raise too. This could lead to 9.5 grading, as the Czech Republic wouldn't be on the same level as the USA even after dropping 3-4 days off the time needed to start a company. This could lead to the overall improvement of the compound to 7.9, which is the level of Denmark (28<sup>th</sup>). This is not the top ten, but this process does not need to be complicated and this shows how simply the country can achieve greater ranking without too much trouble.

## 5. Indexes evaluation

By working with both of these indexes, we can ask ourselves which one is more precise, or which one suits the usage for our purposes better? Well the answer is not easy, while Fraser Institute seems to grasp the problem of ranking countries more in numerical details, it lacks the actual explanation. Of course the numbers are “all there” and we can plug them into an equation and the number is born, however the explanation, even a brief one, provided by the Heritage Foundation is very helpful in grasping the idea without reading the whole report to the last chapter (which is often the case while searching for data). So, it could be said that the usage of Heritage EFI is “easier”. That being said, the Fraser Institute manages to work with a wider variety of data and even though these are presented in very skeletal manner, we can see at a first glance that usage of more variables in overall more sub-elements, which make all the main elements more flexible, leads to somehow more believable outcome. But that does not mean the Heritage Foundation does not produce a quality and very accurate tool for research. Additionally Heritage EFI provides a brief insight in the form of a small explanation to how to improve the state of things for the country. Of course it does it in a very discreet way, only pointing at the main problems of the transition period between years, or at the positive sides of the economy.

While working with both of these indexes, we could notice some divergences between them. Most of the compounds are handled very similarly with naming or with the content, however here we have to remark that Fraser EFI uses simply more data to evaluate the country’s standing. The main difference that the paper notices is the divergence in the Open Markets compound on the Heritage part and of the Freedom to trade internationally of the Fraser part. While Fraser sees decline from the past year, the Heritage sees increase and grades the country very solidly with average of 82.6 points (Fraser sees average of 7.94). These numbers do not seem as a big difference and that would be correct to assume, though we do not look at the absolute values, rather at the changes in the numbers over the years. Year change of the Heritage compound was +11 points in total. Change in Fraser compound was – 0.21 points. Again, the difference in numbers may not seem critical, but the important thing is, that both of the organizations see the situation in the country differently and users of these data, or researchers if you will, should be aware of this fact – that using one or the other index may throw country into different light.

## 6. Conclusion

The goal of the paper was fulfilled by finding possible ways of increasing the standing of the Czech Republic in the EFI of both organizations. Advices regarding the cuts in government spending, betterment of judicial system, simpler environment for starting up new companies, tax reforms and battling corruption were presented, this leads to the conclusion of this paper.

We have seen how and partially why, the individual organizations (Heritage Foundation or Fraser Institute) view the state of things in the Czech Republic in 2012. We have managed to provide some advices or propositions, even though sometimes these have been hard to find and somewhat unwieldy – hence the unavoidable subjective approach, to the topic of placement of the above mentioned country in the Fraser Institute and Heritage Foundation Economic Freedom Index. We could see, that there is no need for additional administrative units or creation of whole new framework of institutions. Instead a betterment of the existing institutions and administrative is in order for Czech Republic to rise higher in the grading from both of our subjects.

From our research, we could see that corruption and the state of judicial system is in declining condition in the country. It is almost futile to even try and find some approachable advice while the factor of corruption remains unanswered as it undermines every other aspect of the economy. With increasing quality of the legal environment (lower corruption) we can expect to see improvement in every other aspect of the country, for a low corruption allows for the increase in trust amongst the populace and this, according to the teachings of institutional economics, leads to better state of things in the country – better institutions lead to the inflow of foreign investment, this leads to the creation of new jobs and this in turn leads to the increase in GDP via consumption and eventually via increase in Net Export.

It is without a doubt that every aspect of the EFI, regardless of the creators, is tightly bind to the severity of corruption in the respective country, in our case in the Czech Republic. The main steps forward for the country should be in combating the corruption and improving the public perception of the corruption, which can serve as an indicator of the process of fighting the above mentioned unwanted element.

As we mentioned, there is no need for the creation of instruments as the country already established the necessary means for battling the unwanted phenomena. Institutions handling the government and private contracts needs to be improved as well as the means to enforce these contracts.

All of the aspects of the EFI can be handled once the problem of corruption is at least decreased. Without healthy environment all other measures taken or advices given have very limited effectiveness or are outright impossible.

It is not hard to see the shortcomings of the paper, solely the fact that we focus on one single country makes the evaluation of indexes hard to grasp and somehow narrow. Additionally, in order for the Czech Republic to get to the top ten countries in both of the EFIs it would have to make some very radical changes, which border with the term “impossible”, therefore making the paper more of a theoretical work rather than practical one. Some topics require different form of expertise than the one of the author of the paper, that makes the suggestions or advices of how to approach these problems a little bit problematic and sometimes almost unapproachable - paper tried to minimize this absence of expertise by using different authors, but sometimes it was just not possible, hence the difficulty and challenges. Additionally, big portion of subjectivity, due to the nature of the work, is present.

Taking look at a different country from different continent and different background than the one of the Czech Republic could be useful. Comparing this paper with the one in question would show more accurately the strong and weak sides of each of the index. Future study regarding the difference in each of the chapter for both EFIs would be very useful too – it could be used to see which compound in which index is “more accurate” or flexible. However, we can’t let ourselves be blinded by the Heritage and Fraser EFIs, for there are many other EFIs in the world and looking at the different ones while comparing them (perhaps using this paper) to the EFI of Fraser and Heritage would yield additional data suitable for research.

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