Malawi vs. Sweden: Which has better economic incentives?

Income per person in Sweden averaged $25,921 (2000 $ PPP) in 2000-2004. Income per person in Malawi in the same period averaged $784. (Penn World Tables, 6.2).

Most economists would think this is the result of differing economic incentives between these economies through insecurity of property rights, expropriation risks, and general impediments to economic activity in Malawi.

Thus the Heritage Foundation, in an index constructed in conjunction with the Wall Street Journal, ranks Sweden as 21st in the world in its index of economic freedom (72.6% free), and Malawi as 104th (55.5% free) out of 157 countries.

The index weights equally scores on 10 criteria. Below are shown the criteria and the scores of Malawi and Sweden in 2007 on each criterion (in percent).

Criteria	Sweden	Malawi
Business Freedom	95	54
Trade Freedom	77	60
Fiscal Freedom	54	81
Freedom from Government	32	53
Monetary Freedom	85	66
Investment Freedom	80	50
Financial Freedom	70	50
Property Rights	90	40
Freedom from Corruption	92	28
Labor Freedom	52	73

But the weightings of the components of the index are chosen with the result in mind. Had Heritage and the Wall Street Journal produced an index which ranked economic freedom higher systematically in poor countries, no-one would have liked the index. This is not a scientific enterprise, it is an ideological one.

Thus the features curtailing economic incentives systematically in high income societies – high marginal tax rates, lump sum provision of many social goods independent of effort, strong restrictions on the labor market, legal systems that threaten enterprises with lawsuits from unhappy investors and consumers – are given very modest weight in the overall index.

The features characteristic of low income economies – higher inflation rates, corruption, formal restrictions on business and trade activity – are given relatively high weights.

Yet frequently corruption in low income societies is a way of getting round burdensome bureaucratic requirements. Why should states like those of northern Europe which impose many arbitrary and vexatious requirements on their citizens and businesses be further rewarded in the index of economic freedom by the fact that their soulless bureaucrats are rigid in the enforcement of these regulations? Why should states where such arbitrary exactions can be evaded by the deployment of modest bribes be penalized in the index?

In the table above the entire oppressive weight of the system of taxes and transfers employed in Sweden, where the government collects 51% of all income, results in a penalty of 48 points compared to Malawi where government taxation is a mere 20% of income. But more than counterbalancing this is the penalty of 64 points levied against Malawi because "corruption is perceived as widespread."

Higher inflation rates, characteristic of poorer economies, are also assessed a much higher penalty than any economic losses we would associate with the inflation tax and the reduced value of money as a medium of exchange. Malawi looses 19 points on this basis.

Similarly having assessed Malawi penalties for its legal systems failure to follow the formal rule of law (a whopping 50 points), the Freedom Index then penalizes Malawi a further 41 points under Business Freedom for having a formal set of requirements on business enterprises that are more onerous than in Sweden, even though given the weakness of the legal system we have no idea if any of these rules are applied in practice. The Chinese market traders so evident across countries like Malawi do not seem to have found the formal business requirements of the Malawian legal code too much of an obstacle.

This was an index enterprise whose result was known before it was ever begun, and whose underpinning is an economic ideology that assumes that economic freedom must produce economice growth, so that the absence of growth must be found in a restriction of economic freedom.

Any sensible assessment would say that while their institutions vary, Malawi through its low tax and transfer regime, and its highly unregulated labor market, offers excellent economic incentives for the mass of the population. Sweden with its high marginal tax rates (see below) and its extensive system of government benefits for all, combined with strong restrictions in the labor market, offers very poor economic incentives to the bulk of the population.

Sweden is just one example of an economic type characteristic of northern Europe where marginal tax rates are extremely high, and in addition citizens receive very generous lump sum handouts from the state in the form of education, health, social security, old age pensions. The table below shows that marginal tax rates in many northern European economies in 2000 were even higher.

Tax and Spend in Old Europe

Table 8.2 Taxes and Government Spending by Country

Country	Marginal tax rate (%, 2000)	Social Spending/GNP (%, 1995)	Hours of market employment per adult, 2000
Belgium	66	32	954
Germany	65	29	1,010
France	56	33	1,003
Italy	53	28	1,139
Ireland	53	23	1,240
Netherlands	51	30	1,037
Sweden	**49**	**40**	**1,189**
Denmark	49	37	1,220
Spain	46	25	1,146
UK	41	27	1,245
USA	34	19	1,364
Japan	32	16	1,312

Source: Gregory Clark, A Farewell to Alms, p. 150.