# The Factors that Determine Financial Freedom of a Country: Case of Albania

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**Abstract:** This study is realized to identify the factors that impact a country's financial freedom. The data used in this paper are received from the Heritage Foundation database for 180 countries, aiming at the analysis of financial system freedom as an important measure of banking efficiency and independence from government control and intervention in the financial sector. Study findings showed that trade freedom, government integrity, and investment freedom play an important role in defining financial freedom. The role of government in financial freedom proved to be significant in the model. Legal efficiency and monetary freedom after the study did not prove important for determining the financial freedom of a country and consequently were removed from the model studied. Based on the findings of the study, the respective limits and recommendations are discussed.

**Key Words:** financial freedom, freedom of trade, government integrity, investment freedom

## 1. INTRODUCTION

The importance of the financial system and its impact on the economy is increasing recently. The publications and research in the last decade show that the importance of the financial system in the economy is recently increasing. Some of these studies find a positive correlation between economic freedom in general and economic growth. (Barro, 1991; Barro, 1999; Scully and Slottje, 1991; De Vanssay and Spindler, 1994; Torstensson, 1994). Researchers have used one or two indicators of economic freedom, such as the presence of the black market in foreign trade, as well as different indexes of economic freedom. Even though different indicators show similar results, as well as a high correlation among individual samples with a general index, a very important step, is the sample selection[1]. It is important to find out what factors are important for the growth and the orientation/ direction of these effects. Financial freedom is one of the most discussed topics in that sector because it includes the judgments and findings of several actors. "Heritage Foundation" presented and published the Financial Freedom Index. This indicator is related to the perception of the degree of financial freedom from the business owners and government analysis where "0" is not freedom at all, while "100" is the highest freedom level for 180 states /countries). The financial system offers payment instruments in an economy and influences real sector development through financial intermediation and monetary policy transmission. Albania and other transition economies are often treating the financial systems and banking systems equally. This is because the banking system is almost 90 % of the financial system. According to Heritage's formulation of financial freedom: Financial freedom is a measure of bank effectivity and a measure of independence from government control. Almost in all countries, Banks are offering basic financial services to facilitate economic growth. Banks lend to businesses and households to purchase consumption goods and services. Banks also offer deposits that collect savings and protect these deposits. The direct control of banks by the government is a direct threat to baking functions, as the government intervention might bring ineffective and full corruption[2]. Pressure on the banking system can decrease bank intermediation and limits economic freedom. Economic freedom is limited if the banks are tightened under government pressure, the economic results can be at their lower levels. Almost all countries have prudential supervision for banks and other financial services aiming for two main objectives:

- To guarantee that all countries offer prudential supervision of the financial sector,
- To guarantee that all financial service companies fulfil (meet) fundamental trustworthy responsibilities.

In a trustworthy environment of free banking, the market must be the main hedging source for

[1] Carlsson. F &Lundstrom.S (2002). Economic freedom and growth: Decomposing the effects

[2] Beach. W & Kane, T (2008). Methodology: Measuring the 10 Economic Freedoms

independent audits and services information[3]. Banking services recently are alternatively offered by other financial service companies that are offering products on capital increase and risk diversification. Financial stability and economic growth are considered a binomial with a clear and stable objective. Banks always need specific information from the economic sectors projected to have investments within long-term vision on development[4]. This information will facilitate banks' process in their analysis of lending programs and activity to the economy.

This study deals with the factors that might influence the financial freedom index in different countries during the same period (the data we have considered the period 2008 to 2018). The first factor is monetary freedom–its results are calculated with the weighted inflation rate and price control. The second factor that influences financial freedom is trade freedom – It is achieved when there are no hedging tariffs or non-tariffs that have an impact on imports and exports of goods and services. Legal efficiency is another factor studied because government efficiency requires a juridical system effective and correct that is characterized by the full respect of the law and appropriate legal measures. Another factor is investment freedom because, in a free market economy, the free movement of capital is allowed.

Government integrity is among the factors that influence financial freedom, as a lack of government integrity is happening from practices like corruption, tips, nepotism, etc. This reduces economic vitality from the increased costs and movement of sources in lobbing non-productive activities. This paper is focused on three questions:

- Does the increase in trade freedom affect the increase in financial freedom?
- Does the protection and increase of integrity from the government influence the increase of financial freedom in that county?
- Is it expected that legal efficiency must be an indispensable condition for financial freedom?

## 2. FACTORS THAT INFLUENCE THE FINANCIAL FREEDOM

The main concepts that follow are aiming to present an overview of indicators and main factors used for research. *The economic freedom concept*- The economic freedom concept is focused on the relations of every person (individual) with the government. Normally, state action or government control that intervenes with individual autonomy limits economic freedom. A complete concept of economic freedom must include all kinds of freedom and rights of production, distribution, or consumption of goods and services. The economic freedom objective is the development and protection of free feeling of freedom for all. Individuals enjoy economic freedom benefits, but on the other hand, they have to respect the economic rights and freedom of others. Governments are founded to build up basic protection against the destruction of nature and legal protection that deals with laws and by-laws, created to protect the property rights, and social and individual protection of everyone[5]. In a free market, the government is essential as a forum that decifor "the rules of the game" like a referee that interprets and applies the rules and decisions aiming to reduce direct interventions of the government[6]. *The financial freedom concept* -The financial freedom concept, is a measure of banking system effectivity, as well as a measure of independence from government control and interventions in the financial sector. In an ideal banking and financial environment, where government intervention is at a minimum level, independent supervision of central banks and financial regulation are limited in the fulfilment of contractual regulations and fraud prevention. *The investment freedom concept* - Investment freedom is referred to the limited number of restrictions applied by a country. If there are no restrictions this indicator is valued at 100, which means this country has full freedom to invest. Value 0 means no investment freedom at all. The concept of trade freedom is a decision that takes into consideration the lack (nonexistence) of tariffs or non-tariffs that have an impact on imports and exports of goods and services. *The concept of government integrity* - Government integrity is referring to the quality of public services and degree of independence from government policies, the quality of civil service, and

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[4] Civici.A&Kraja.I (2014). Bankat dhe financimi i politikave të rritjes, modelet bashkëkohore të zhvillimit ekonomik e social.

[5] Weimer.D. (1997). The political economy of property rights

[6] Friedman.M (2002). Capitalism and Freedom

independence degree from political pressures[7]. Government integrity is linked with the bureaucratic structure, separation of the civil system from politics and competencies, and professionalism. Corruption damages economic freedom with the uncertainties in economic links created. Legal efficiency concept - Well-functioning of the legal framework is a key factor in the protection of civil rights for all citizens against the non-legal activity of others (government and private parties). Government efficiency requires a juridical effective system for the protection of the law and appropriate legal measures. Monetary freedom concept- Monetary freedom combines decisions on price stability with evaluations of price control. Inflation and price control in this case can give the wrong evaluation of trade. Freedom with the uncertainties in economic links created. *Legal efficiency concept* - Well-functioning of the legal framework is a key factor in the protection of civil rights for all citizens against the non-legal activity of others (government and private parties). Government efficiency requires a juridical effective system for the protection of the law and appropriate legal measures. *Monetary freedom concept*- Monetary freedom combines decisions on price stability with evaluations of price control. Inflation and price control in this case can give the wrong evaluation of trade.

## 3. LITERATURE REVIEW

Miller and Kim (2016) say that a transparent and open financial system ensures honesty in its approach to finance and promotes entrepreneurship[8]. Markets are having information in real-time on prices in a process driven by demand and supply. A regulatory effective system guarantees information through explanatory information and independent audit. The role of government in the regulations for these institutions is important for transparency, requirements on risk, publication on property rights, and integrity assurance[9].

### 3.1 Financial Freedom

Albanian economy has been facing significant changes after 90's in all sectors of the economy. These changes were contributing to the transition from a planned economy to a free market, having in this way difficulties, redistribution of jobs, fluctuations of revenues, and changes in the economy had been contributing to a full transition to a market economy. In an economic environment, where government intervention is at very low levels, independent central bank supervision and banking regulations are limited in the observance of their contractual liabilities, duties, and fraud prevention[10]. Financial freedom and bank efficiency are closely related[11]. It means that higher the financial freedom in an economy, better the bank's performance on cost advantages and general efficiency. The index evaluates financial freedom, focusing on the following fields:

- The extent of government regulation on financial services,
- The extent of government intervention in banks and other financial firms through the direct or indirect property,
- The degree of the financial and capital market,
- Government influence on credit distribution,
- Liberalization of foreign competition.

These five fields are considered to evaluate the general level of financial freedom in an economy that ensures an easy and effective approach to the possibilities to get financing for individuals and businesses. A general result on a scale from 0 to 100 is given to the financial freedom of an economy through deductions from the ideal result of 100.

### 3.2 Albania from the Viewpoint of Heritage

Albania is one of 180 countries studied from Heritage for the degree of economic freedom. Albania is ranked 65th place according to the 2018 Index, while in Europe it is the 32nd out of 44 countries. This means that Albania is standing under

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[8] Miller.T& Kim. A (2016). Defining Economic Freedom

[9] Chortareas. G. E, Giardone.C&Ventouri.A (2013). Financial freedom and bank efficience: Evidence from the European Union

[10] Ayal.E&Karras.G. 1998). Components of economic freedom and growth

[11] Chortareas.G. E, Girardone.C&Ventouri.A.(2012). Financial Freedom and Bank Efficiency: Evidence from the European Union

the regional (Europe) average, but is over the world average. Albanian transition towards a better open and flexible system is facilitated by more than two decades of restructuring the economy with income increase and poverty reduction. A relatively efficient framework has supported the development of the enter-premiership sector. This progress should be accompanied by a lot of reforms, especially toward the rule of law. Property rights are facing difficulties even with the issue of the deed certificates. Endemic corruption in the judiciary limits seriously the government's reporting. The goodwill of the government is not meeting the requests of the European Union on the application of reforms. Heritage studies show that trade is the most important sector in the Albanian economy. The combined average of exports and imports at the end of 2018 was 74 % of Albanian GDP. The financial system is relatively developed, as well as a banking system that suffers sometimes from problems with non-performing loans. The judiciary efficiency has decreased by 3%. That is explained by political pressure and frightening and limited sources for this sector. At the end of 2018, legal efficiency scored 25,4 % points, while at the end of 2017, it was 28,4 % points.

## 4. MATERIAL AND METHODS

Econometric methods were used to answer the research questions raised in this study. This study aimed to discover the factors that affect financial freedom and to measure the degree of their impact. The hypotheses studied in this paper are:

Hypothesis 1: Ceteris paribus, the higher the freedom of trade in a country, the higher the financial freedom is expected to be in that country.

Hypothesis 2: The stability and the increasing integrity of a country's government affect the increase of financial freedom in that country

Hypothesis 3: Ceteris paribus, legal efficiency is expected to be a necessary condition for financial freedom.

Hypothesis 4: Ceteris paribus, the increase of investment freedom, increases the financial freedom in a certain country.

The issues of this study are related to the role of financial freedom in the economy of a country as a whole and the determination of the factors that affect the financial freedom index. It is of interest and importance to discover and analyze the factors that affect financial freedom, in this way we can work to enable the increase of financial freedom through the improvement of these factors. This study aimed to answer these research questions.

1. Does the increase in trade freedom promote the increase in financial freedom?
2. Does the stability and the increasing of the government integrity of a country affect the increase of financial freedom in that country?
3. Is legal efficiency expected to be a necessary condition for financial freedom?

The quantitative methodology was used for the framework purpose of the study, which was developed in three different phases: In the first phase were collected the quantitative data, the analysis by the EViews program, and in the third phase the interpretation of the results was obtained from quantitative data.

### 4.1 Quantitative Study and Procedure

The quantitative approach was used in the study. According to Daniel (2004), quantitative research deals mainly with the collection and processing of structured data that can be presented numerically[12]. While Creswell (1994) gave a more concise definition of the quantitative study. Quantitative studies are the type of studies that explain a phenomenon by analyzing data with basic statistical methods. The first element is the explanation of the phenomenon. Then the numerical data collection is done and the last step that concludes this definition is the analysis with basic mathematical methods, respectively a statistical analysis is done[13]. The data was obtained from the Heritage organization database. Data were obtained for 180 countries ranked by Heritage, based on the indices for freedom of each of the factors thought to have an impact on the definition of financial freedom. After the collection, the data on financial freedom were analyzed with the EViews program. The data collected for 180 states from 2018 of the dependent variables and the independent variables were tested through multiple regression analysis. Other techniques were also used as part of the study: T-test; Fisher tests.

Since not all countries report their information about variables, it can be said in principle that the degree of financial freedom has decreased.

[12] Mujis.D (2004). Doing Quantitative Research in Education

[13] Creswell J.W (1994) Research Design: Qualitative & Quantitative Approaches

### 4.2 Definitions of Variables

| Financial Freedom (Y) | Monetary Freedom (X1) | Judicial Effectiveness (X3) | Government Integrity (X4) | Investment Freedom (X5) |
|---|---|---|---|---|

The dependent variable used in this study is financial freedom. Heritage (2018) defines financial freedom as "a measure of banking efficiency as well as a measure of independence from government control and intervention in the financial sector" The main variable used is investment freedom which refers to the number of restrictions imposed by a given country. If -there are no restrictions then this indicator gets a value of 100 meaning it is characterized by complete freedom to invest. Otherwise, the value of the indicator is reduced depending on the number of restrictions imposed by the respective country. A value of 0 means no investment freedom at all. The source we referred to for this indicator is the Heritage Organization which includes over 180 countries. The other independent variables are monetary freedom, trade freedom, legal effectiveness, and government integrity which are the main predictors of financial freedom. In this study, the basic assumption is:

$$Financial\ Freedom = f(Monetary\ Freedom, Trade\ Freedom, Legal\ Effectiveness, Government\ Integrity, Investment\ Freedom)$$ (1)

The dependent variable is Financial Freedom which is measured with the Financial Freedom Index (CPI) from 0 (not freedom at all) to 100 (totally free) (Heritage 2018)

The Independent variables are Monetary Freedom, Trade Freedom, Legal Effectiveness, Government Integrity, and Investment Freedom, which measured with the correspondent indexes from 0 (not freedom at all) to 100 (totally free) (Heritage 2018)

Trade Freedom is the lack of tariff and non-tariff barriers affecting imports and exports of goods and services. Takes values from 0 to 100. Government integrity refers to the quality of public services, the quality of civil service and the degree of independence from political pressure, the quality of policy formulation and implementation, and the credibility of government decision-making Kaufman (2006). In other words, government integrity is related to the structure of the bureaucracy, the separation of the civil system from politics, and the professionalism and competencies of public agents in the exercise of public service. Monetary freedom and legal effectiveness were not used for further analysis as they did not prove statistically significant during model testing.

## 5. RESULTS AND DISCUSSION

The results of the study are based on data obtained from the Heritage organization report on economic freedom for 2018. The data is thrown in EViews. The following techniques were used in the paper:

The T-test was used to see if the coefficients near the variables were statistically significant.

The F test was used to determine if the model is statistically significant.

The indicators that will be used in the model are:

- SER01- Y-Financial Freedom;
- SER02-X1-Investment Freedom;
- SER03-X2-Trade Freedom;
- SER04-X3-Monetary Freedom;
- SER05-X4- Government Integrity;
- SER06-X5-Legal Effectiveness

According to the Student (T) test, since the probability near variable C (4) is 0.61> 0.05, this variable can be removed from the model, as it is irrelevant. Based on the test result we say that monetary freedom is insignificant and consequently can be removed from the model, so it is not an important factor in determining financial freedom. We continue testing with the remaining variables to arrive at the final model.

In the next test the variables that will be used will be:

$$Financial\ Freedom = f(\ Trade\ Freedom, Legal\ Effectiveness, Government\ Integrity, Investment\ Freedom)$$ (2)

According to the student test, the probability near the variable Legal Efficiency results in 0.2923, so> that the critical value is 0.05, this variable should be removed from the model as it is not an important factor in determining financial freedom and we should continue testing in a third phase to find a better model.

Only the remaining variables will be included in the third phase of testing.

- SER01- Y-Financial Freedom;
- SER02-X1-Investment Freedom;
- SER03-X2-Trade Freedom;

- SER05-X4- Government Integrity;

The basic assumption of our model will be:

$Financial\ Freedom = f(\ Trade\ Freedom,\ Government\ Integrity,\ \ Investment\ Freedom)$ (3)

According to the T-test, the probabilities near the three independent variables are <that the critical value is 0.05, which means that all three variables are important in determining financial freedom.

According to the Fischer Prob test (F-statistic) = 0.000000 <0.05, therefore the model is important and is taken as a basis in the model studied by us.

After calculations and testing of the model with the multiple regression method, it was agreed to use the model:

$Y = -12.89 + 0.48 * X1 + 0.31 * X2 + 0.22 * X3$ (4)

Estimated based on the variables, the final model will be:

$$Financial\ Freedom = -12.8933 + 0.480562 * Investment\ Freedom + 0.316681 * Trade\ Freedom + 0.226258 * Government\ Integgrity \quad (5)$$

## 5.1 Interpretation and Discussion of Results

- The coefficients near the variables are significant according to the Student test or the Fisher test, P (factual) = 0.000 <P (critical) α = 0.05 therefore the model is significant.
- The coefficient of determination is about 70%, which means that 70% of financial freedom is determined by the factors included in the model and about 30% by other factors. The model is good, but not the best possible.

✓ First, it can be said that -12.89 is a constant which makes no sense.

✓ Second, it can be said that investment freedom is the best determinant of financial freedom. Referring to the model, a 1% increase in favor of Investment Freedom (provided that X2 and X3 do not change), is expected to bring about a 48% increase in financial freedom.

✓ Third, referring to the model, an increase of 1% in Trade Freedom (provided that X1, and X3 do not change), is expected to bring an increase of about 31% in financial freedom.

✓ Finally, a 1% change in government integrity, ceteris paribus, could increase growth by 22% of financial freedom. So, the government plays no less important role in the financial freedom of a country.

The study was preceded by research questions:

1. Does the increase in trade freedom promote the increase in financial freedom?
2. Does the maintenance and the increasing of the government integrity of a country affect the increase of financial freedom in that country?
3. Is legal efficiency expected to be a necessary condition for financial freedom?

And the findings were summarized as follows:

Trade freedom was found important in determining financial freedom where respectively an increase of 1% in Trade Freedom provided that X2 and X3 does not change, would bring an increase of about 31% in financial freedom. It was also established that governmental integrity played an important role in determining financial freedom. The role of government in financial freedom turned out to be significant in the model. In terms of legal efficiency, the study conducted turned out not to be important for determining the economic freedom of a country and consequently was removed from the studied model.

At the end of the study, it was proved that Hypotheses 1, 2, and 4 stand, as the indicators turn out to be statistically significant in the model, while Hypothesis 3 falls. So, legal efficiency did not turn out to be a necessary condition for financial freedom in our study model

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