



CONSTRUCTION OF ECONOMIC FREEDOM INDEX AND ITS NATURE IN NEPAL

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Abstract

This study constructed the Economic Freedom Index for Nepal and analyzed the nature of Economic Freedom Index. Time Series data for the period of 1975 to 2017 taken to construct index. The Economic Freedom Index of Nepal has been constructed using variables representing economic freedom of the country. The set of variables that are expected to have a positive relation with economic freedom is used to construct the Economic Freedom Index of Positive Factors and variables that are expected to have a negative relation with economic freedom is used to construct the Economic Freedom Index of Negative Factors. Indices are compared for major structural changes in the Nepali economy and politics. The trend and nature of index captures the real situation of economic freedom. The ups and down of Nepali economy and politics has been reflected in trend line.

Keywords: Economic freedom index, positive factors, negative factors, monarchy, economic growth

Note:

This article is based on the author's PhD Dissertation "The Effect of Economic Freedom on Economic Growth in Nepal".



INTRODUCTION

Preference for freedom is gradually increasing in modern days because people believe that freer environment would be supportive to get success in every step of life. At the same time government gradually encroaches spirit of freedom through its various mechanisms. One of this field is economic freedom, this has been reduced through different arrangements. Economic freedom focuses on personal choice, allowed for voluntary transactions, the freedom of competition and legal protection on private property. This eventually provides the real foot for other kinds of freedoms, and for the democratic values itself, by liberating individuals, families and society from government control (Gwatney & Lawson, 2009). The Heritage Foundation from its imperial evidence argued that individual right on selection of work and protection of private property is the minimum right to ensure economic freedom of an individual. There must be a protection on each economic decision of an individual through the legal system or provisions (Miller & Holmes, 2010). This has been argued that in economically freer society, governments provide an opportunity for the free movement of labor force, capital and goods and services in and out of the country. This mobility solely based on the interest and benefit of an individual. The Fraser Institute, explained that economic freedom would provide an economic environment, individual would act without any limitation, but they do not violate the same kind of economic liberty of other members of society (Gwartney & Lawson, 2009).

Economic freedom is impacted both from micro-level parameters like individual consumption, investment, trade, production, and other individual economic activities and macroeconomic policies and macroeconomic activities like national production, trade, investment, money supply, governance, tax, government expenditure, etc. In the national context, macroeconomic variables played an important role to determine economic freedom. So, this study focused on macroeconomic parameters in conceptualizing economic freedom and construct an economic freedom index.

In Nepal, the process of economic freedom has been initiated from the second half of ninety seventy. The Panchayat era initiated the economic freedom policy in Nepal. After restoration of multiparty democracy Nepal government aggressively introduced a freer economic policy during ninety nineties. In this context it is relevant to construct economic freedom index and assess the nature of economic freedom index. Globally, economic freedom is measured by constructing economic freedom index and explained the nature of those indices. In these circumstances the research questions are; How to construct the economic freedom index? What is the nature of the economic freedom index and why it has such shape?

LITERATURE REVIEW

Many of the past studies mainly concentrate on cross country analysis of economic freedom index and its implications. Economic freedom combines political and social issues not absolutely economic factors. Researcher developed theoretical background to construct economic freedom index including a large number of economic and freedom promoting variables (De Haan, Lundstrom, & Sturm, 2006).

In an economically free society individuals are allowed to realize their plans on the market. State coercion must be limited: normative restrictions should be imposed on the coercive power of the government and on the manner in which it exercises its power Hayek (1960), in economic freedom each individual enjoyed complete property right. This right ensures the best utilization of resources because the private sector is more efficient than the public sector to earn profit by employing private resources in selective economic activities (Gwartney, Lawson & Block, 1996). Economic freedom refers to the completely free economic activities carried by an individual or group of individuals (De Haan & Sturm, 2000). Economic freedom index has been constructed by using principal component analysis. Various macro variables have been employed while constructing index. Economic freedom as the absence of state control, compulsion and arbitration on economic activities carried by an individual or society (Beach & Miles, 2006). Heritage Foundation's Index of Economic Freedom is comprehensive Hristova (2012) that has been calculated by using principal component analysis and factor analysis which reduce and summarize a large number of variables.

Economic freedom index is constructed by using principal component analysis based on macro variables. The nature of economic freedom index reflects actual feature of national economic and political situation (Powell, 2002). The continuous data better capture the effort of freedom than discrete data Erdal (2004) and index is constructed by using various economic, political and legal frame of national economy (Galan, 2006). Azid and Mahmood (2009), used economic freedom index developed by the Fraser Institute and Heritage Foundation. Economic freedom index reflects the real picture of national economy (Compton, Giedeman & Hoover, 2011). Large number of variables with time series data has been used to construct economic freedom index. The rise and robustness of economic freedom reflect the importance of freedom on economic growth (Tyers, 2014). Economic freedom indices are constructed by using number of economic, political and social factors and which is mostly borrowed from the Heritage Foundation and Fraser Institute (Wulandari, 2015).

Economic freedom information from "Economic Freedom of the World" which reflects the economic and political change of those countries (Lundstrom, 2005). Investment, labor force and terms of trade and other many variables are usable while calculation economic freedom

(Fosu, 2008). The impact of economic freedom developed by the Heritage Foundation (2008), as well as political stability developed by the (World Bank [WB], 2009) have been analyzed in Cebula, (2011) study. Narayan, Smyth and Narayan, (2011) used the democracy index constructed by Freedom House. Peev and Mueller (2012) identifies trade freedom, monetary freedom and freedom from corruption as the most important indicators of the economic freedom for growth in transition countries. Khan (2012) analyzed economic freedom and political freedom in South Asian countries. Turedi (2013) used Index of Economic Freedom (IEF) and the Economic Freedom of the World (EFW) developed by the Heritage Foundation and the Fraser Institute respectively. Zajenkowski, Stolarski and Meisenberg (2013) includes variables; legal system & property rights, sound money, freedom of international trade, business regulation, free trade, monetary freedom, investment freedom, financial freedom and property rights, labor freedom, fiscal policy, and government spending to construct economic freedom index.

The Fraser Institutes economic freedom index and its different indicators namely government size, property rights, access to sound money, freedom to trade and setting proper regulations (Farhadi, Islam & Moslehi, 2015). The economic freedom indices are derived from several sub-indices; trade freedom index, financial freedom, labor freedom, business, and fiscal freedom index. The cumulative economic freedom index shows how open and business-friendly a country is and freedom sub-indices show openness across a different sector of the economy (Hussain and Haque, 2016).

In most of the studies, all variables put together to construct an economic freedom index. Variables with a reverse sign (positive and negative) may produce ambiguous results and prediction may not be realistic. So, the construction of the economic freedom index by using variables with expected positive and negative signs separately give consistent and reliable results. Researcher neither found the study, to this area, nor the separate economic freedom index constructed to Nepal. Based on the situation this study constructed the economic freedom index specific to Nepal. Variables are categorized into two sets; one set of variables that are expected to have a positive contribution to economic freedom and another set of variables that have a negative relation with economic freedom. The study is focused on the period of economic freedom/liberalization that is after the mid-70 of Nepal.

METHODOLOGY

Though Nepal initiated liberal policy since 1975 but this process was massively followed from 1985. This openness increased the access on economic activities to international community as well. The open environment allowed an opportunity to interact between interest variables. This research takes 1975 as cutting point assuming that this is the real starting point

of introduction of free economic policy. The ending point is 2017 because after the promulgation of new constitution nation moved to federalism which establish three tiers of government and newly elected parliament introduced various new policies which changed the direction and priority of economy.

Variables to measure economic freedom

The measurement of economic freedom is complicated because economic freedom is determined by various factors; economic, social and political. The same arguments were presented while discussing about national income accounting to calculate gross domestic product in one and half century ago (Gwartney, Lawson, & Block, 1996). Vital initiation was taken for the last decades for the measurement of economic freedom. Though there is an argument that economic freedom prevails at a micro-level; how individual consumers, producers, economic firm, investors perform in the economy. But to this study macroeconomic variables are used to construct an economic freedom index as a global practice. The Heritage Foundation and Fraser Institute used macroeconomic indicators to construct the economic freedom index assuming that macro variables produce a more consistent result. Multiple variables are included while talking about economic freedom, means that single variable or area has less influence on economic freedom. To avoid the domination of particular variable and captures the influence of multiple sectors this study includes multiple factors. Variables which were used to measure economic freedom in past studies are; government size, intervention to the market, money and banking, capital market, legal and institutional structure, external trade, labor market and leaks in the economy, etc. (Carlsson & Lundstrom, 2002; Erdal, 2004; McAfee, 2009; Ali & Crain, 2001; Altman, 2007; Gwartney, Lawson & Norton, 2008; Rode & Coll, 2012).

In this study, some key variables are taken from global practice to measure the economic freedom of Nepal. Government total expenditure, government consumption expenditure, social transfer, revenue from income and wealth taxes, total tax revenue, tax revenue from custom duties, availability of sound money to the citizen (M2), import, export, total trade, labor force participation rate, labor force growth rate, official development assistance, foreign aid, gross domestic investment and saving and debt are used in this study. These variables are used to construct an economic freedom index.

Variables are categorized into two groups based on their expected contribution (sign) to economic freedom to check the ambiguous result. One includes variables that are expected to have a positive relation with economic freedom and another set has the variables which are expected to have a negative relation. The Group of variables which has expected positive relation with economic freedom is used to calculate positive economic freedom index which is

called an index of positive factors. Group of variables that are expected to have a negative relation with economic freedom is used to calculate negative economic freedom index which is called an index of negative factors.

This study could not able to mention some variables which were used to construct the economic freedom index in various past researches. Those variables are; subsidy as a percentage of GDP, the share of state economic enterprise in total investment, inflation, interest rate, bank credit to government, total capital outflows, a ratio of civil cases finished to the total cases, a ratio of research and development expenditure in GDP, number of new law firms created, the ratio of stock building to GDP. Some are irrelevant to the context of Nepal and some variables have no time-series data during the study period.

Research design, sources of data and construction of index

Variables are selected based on international practice and other similar past studies. Data are collected from secondary sources. Relevant econometrics tools and techniques are used systematically to address the research question. The construction of the economic freedom index is the major contribution of this study. The Min-Max method has been used to construct an economic freedom index.

Considering the uniformity and availability of information regarding all variables taken into the analysis, all the series are starting from 1975 and ending in 2017. Series are presented in annual frequency and converted from nominal to real terms using the GDP deflator (2010=100). Data on GDP, government expenditure, direct tax, total tax, total government revenue, social security amount, expenditure on health, gross domestic investment, saving, foreign aid, official development assistance and gross fixed capital formation are taken from the economic survey. Data on money supply, export, import, total trade, debt are taken from the quarterly economic bulletin of Nepal Rastra Bank (Central Bank of Nepal). Labor force (age 15+ years) participation rate and growth rate is taken from the World Bank.

Construction of economic freedom index

Construction of the composite index is a very daunting task. There is no universally accepted composite index, its relevancy depends on the objective of the research (Mazziotta & Pareto, 2013). There are three indices frequently used by the Fraser Institute index of Gwartney, Lawson, and Block, the Freedom House index of Messick, and the Heritage Foundation index of Johnson, Holmes, and Kirkpatrick, developed to measure economic freedom (Caudill et al., 2000). These institutions used principal component analysis and factor matrix on composite index construction. Min-max method is used to construct the Human

Development Index (HDI) for a long time which is very popular and simple (Stanton, 2007). To construct economic freedom index Erdal (2004) used the Min-Max method. Examination of several index aggregation procedures show that each design may have potential methodological flaws that can greatly affect the empirical findings (Heckelman & Stroup, 2005). Human Poverty Index and other different indexes were constructed by using the Min-Max method (De Muro, Mazziotta & Pareto, 2011; Gheung & Rensvold, 2002; Bandura, 2008). Here, the Min-Max method is followed to construct an economic freedom index. In this study composite index is constructed using the technique of Min-Max method of normalization. The formula used for normalizing the series is given by;

If $X = x_1 x_2 \dots x_n$ be the original series and $X' = x'_1, x'_2, \dots, x'_n$ be the series after Min-Max normalization then x'_j is obtained by the formula (Jain & Bhandare, 2011) as;

$$x'_j = \frac{x_j - x_{jmin}}{x_{jmax} - x_{jmin}}, \quad \forall j = 1, 2, 3, \dots k$$

Where, x_{max} maximum value of the series X and x_{min} is minimum value of series X and x_j is the value of the series for $j = 1, 2, 3 \dots k$ and k is number of variables.

And then the composite index is calculated by using the following formula;

$$CI = w_1 x'_1 + w_2 x'_2 + w_3 x'_3 + \dots + w_k x'_k$$

Where, w_i are weighted, and here it is assumed that all weights are equal.

To make the indices comparable, CIs are converted into new series which has mean equal to 100 and standard deviation equal to 10, the main benefit of this conversion is that these indices are comparable, the new index is named as freedom indices.

For analytical purpose, factors affecting the economic freedom are segregated into two parts. In one part, factors that are expected only to have a positive impact on economic freedom are amalgamated and an index is constructed which is known as an index of positive factor and in short, it is called "PFI". In another part, factors that are expected only to have a negative impact on economic freedom are gathered in one place and index is constructed which is known as an index of negative factor and in short, it is called "NFI". It is expected that, theoretically, the index of positive factors has a positive impact on economic freedom while the index of negative factors has a negative impact on economic freedom. This is the main difference than the methodology used by other researchers in other countries. They have used a single aggregated index that may not capture the inherent nature of economic freedom. When both (positive and negative) factors are combined that could not give the real picture of economic freedom, Thus, the researcher has followed the new methodological procedure to capture the inherent nature of economic freedom.

Factors included in the index of negative factors are; government expenditure, government consumption expenditure, direct tax, social security amount, total tax revenue, trade revenue, government debt. And factors included in the index of positive factors are; money supply (M2), total trade, labor force participation rate, gross domestic investment, official development assistance, foreign aid, domestic saving, labor growth rate. Each group of factors is used to construct positive and negative economic freedom index using the Min-Max method.

Major Policy Changes in Nepal

After the fall of the Rana regime, Nepal gradually entered the liberal socio-political and economic environment, but there remained ups and downs in policy continuation. Nepal has experienced three broader political regimes namely the Panchayat (1960-1990), the constitutional monarchy (1990-2008) and the Federal Republic Democracy (since 2008). Political instability is a major character in Nepal since 1975 (Gyanwaly, 2017). The period between the fall of the Rana regime and the re-establishment of democracy in 1990 develop some conducive environment for economic openness. In the interim, the monarchy struggled to keep the democratic challenge suppressed by a strong-arm method as well as political and ideological maneuvers (Brown, 1996). Entitlement to the tenancy right of the cultivator was introduced in 1964. The first national budget was brought into operation in 1952 which opened various avenues in the Nepali economy. Nepal started planned development in 1956 by introducing the first five-year plan.

As of other developing and least developed countries Nepal also followed the inward and state-led policy and development strategy. The industry and trade sector were controlled by the state and many enterprises were established and run by the government. State licensing and quota system was in operation, the overvalued exchange rate system was in operation for foreign exchange regulation. Agriculture has remained a major sector in Nepal, essential inputs such as; seeds, fertilizer, and institutional credit were subsidized during the period. State-owned agro farms were established to spread the demonstration effect throughout the country. Agricultural Development Bank was established to provide loans to the farmer, agricultural, cottage industries and some service sectors were announced as a priority sector and commercial banks were directed to lend a certain percent on those areas. After demolishing the Rana regime state-led development model was adopted. The state was active and played a lead role in every economic activity.

In the 1960s Party less Panchayat system was introduced by replacing the democratically elected government. Panchayat government controlled all economic activities and the state remained as a key economic agent and the private sector was not encouraged

during the regime. The rise in the magnitude of budgetary deficit gave birth to the current account deficit due to that there was a huge BoP deficit leads to the serious foreign exchange crisis. The BoP crisis reached to the top and remained in the red for three consecutive years from 1982/1983 to 1984/1985. After a series of negotiations with the International Monetary Fund, Structural Adjustment Program (SAP) was adopted and accepted some liberal policy measures in the areas of trade, industry, monetary and investment. During that crisis period, Nepali currency was devalued by 14.7 percent in 1985 (Shrestha, 2004).

The absence of political freedom and the exercise of the controlled economy led to widespread poverty and unemployment throughout the country. Panchayat regime introduced some free economic policy but lopsided and weak liberalization outbreak the people's movement in 1990. In 1990, the Panchayat regime was abolished and multiparty democracy has been established which brought widespread changes in the macroeconomic policy environment. After that, economic reform policies were introduced to promote economic freedom and openness from the 1990s through the implementation of the Enhanced Structural Adjustment Facility Programme. Reforms were made in trade, industry, finance, exchange rate, monetary policy, and fiscal policy and Nepal become the most liberalized economy in South Asia (Upadhyay, 2015).

EMPIRICAL ANALYSIS

Constructing economic freedom index for Nepal

Economic freedom is the absolute absence of any kind of restriction, control or barrier in individual economic, political and social activities (Miles, Holmes, O'Grady, Eiras, Schaefer & Kim, 2006). The definition of economic freedom coined by Fraser Institute is similar to the basic concepts of laissez faire capitalism.

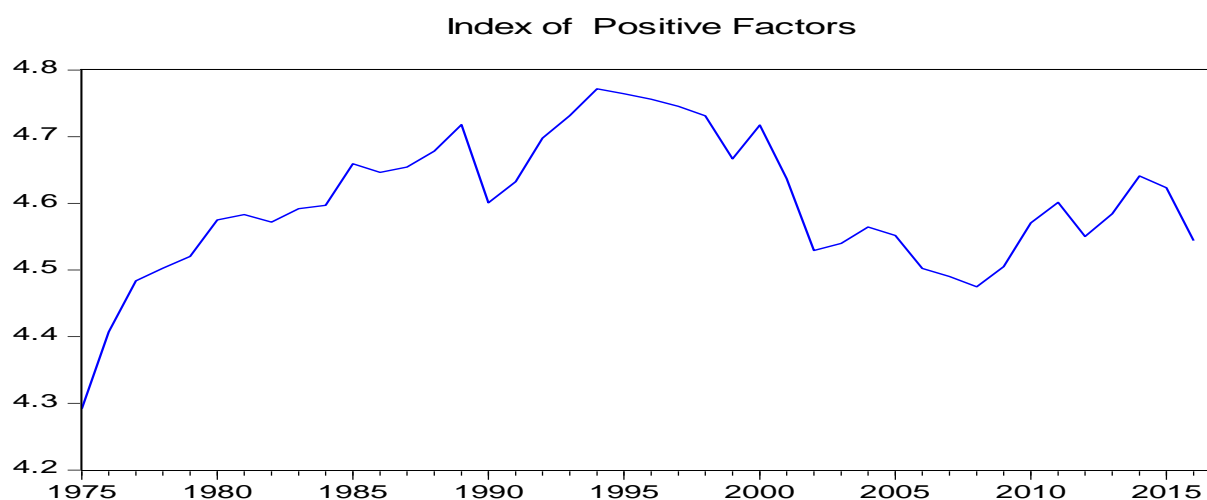
Most of the researchers followed the index developed by the Heritage Foundation and Fraser Institute. But in this study, the researcher tries to calculate the economic freedom index of Nepal. Based on the availability of data and global practice some relevant variables are included to conduct this study. Variables that are supposed to be influential on economic freedom are chosen here.

This is an unique study for Nepal. So, to remain free from ambiguities, as mentioned above, variables are divided into two categories; a first block is a group of variables which are expected to have a positive relation with economic freedom and another block is a group of variables which are expected to have a negative contribution on economic freedom. If we put all variables (positive as well as negative) together that could not produce real scenario of economic freedom index of Nepal. That will deviate the findings of the study.

Economic freedom index of positive factors

Different variables are used to construct the economic freedom index of positive factors. In figure 1, the economic freedom index of positive factors has been presented at level form. The annual index of positive factors is calculated for the period 1975 to 2017. An index is at a minimum point in 1975 and reached the maximum point around the mid-1990s and then starts to decline and reach to minimum point at around 2008. In 1975 Nepal begins to enter into the free economic era.

Figure 1: Economic Freedom Index of Positive Factors



Source: Researcher's calculation using EViews 9.

One after another, Nepal introduced a freer economic policy and program. So, economic freedom has been increasing continuously. The index is representing the policy change process of Nepal. From 1975 to 1985 Nepal introduced various liberal policies. In 1981 it introduced a cash subsidy program to promote export and in 1983 Nepal shifted from pegged exchange rate system to basket currency system. Industrial policy 1981 introduced a duty drawback system, removed quota and licensing system and recommended reducing tariff rates. Trade policy 1983 simplified custom procedure, wave income tax on export earnings, establish trade development council. Commercial banks were allowed to accept a current and fixed deposit on foreign currencies. In 1984 there was partial deregulation of interest rate and completely deregulated in 1989 and in 1984 joint venture bank was established for the first time in Nepal. In 1985, the economic stabilization program was launched and the Structural Adjustment Program (SAP) introduced in 1987. These activities positively support economic freedom and the index of positive factors is growing continuously.

In 1989, there was some disturbance because of trade blockade from India and in 1990, there was people's movement in the climax to reinstate multiparty democracy. The government imposed various restrictive measures to repress people's movement. This political instability was responsible to reduce economic freedom index and reached the lowest point during the period. When multiparty democracy was established democratically elected government introduced various liberal policy, act, program, budget and international relations which were liberal and open. These liberal economic initiations were supporting to promote economic freedom. After the political change, there, was great progress in economic freedom and its index reached the maximum point. Promulgation of a new constitution with various free economic policies helped to introduced various laws, institutions and frameworks after reinstation of multiparty democracy. These incidents helped to increase the index of positive factors.

In 1993 individuals were allowed to open a bank account in foreign currency, in 1992 public enterprises were privatized, in 1993 full convertibility of current account, in 1992 industrial policy, investment policy, trade policy, and labor policy were launched. In 1993 SAARC introduced SAPTA. To implement industrial policy 1992 industrial enterprise act 1992 was introduced which helped to privatize some public enterprises. Investment policy 1992 allowed a foreign investor to hold a hundred percent ownership in the industry. Foreign investment and technology transfer act 1972, single window system 1992, privatization act 1992, etc. were introduced to make the Nepali economy freer. Trade policy 1992, focus on trade diversification, attract investment, and financial policy was liberalized to make international trade easy. There were many freer policy interventions during the period that led to the highest value of the economic freedom index. After 1996 Nepal again entered the political instability that curtailed the many economic freedom of the private sector and government became unsuccessful to protect property rights, to ensure rule of law, to maintain peace and security and to convince the international community for international investment that curb the expectation of higher growth rate. During that period there is a sharp decline in industrial investment, foreign investors were discouraged to invest, many industries shot-down, unemployment increased and major macro indicators were negatively impacted. But during this period also Nepal is continuously working for a freer economy. Only policy introduction was not sufficient to bring a desirable impact on the economy. Probably, the free economic policy protects the economy to reach the trough. For example, even at the adverse political and administrative environment, information technology policy 2000, hydro development policy 2001, telecommunication policy 2004, aviation policy 2006, tourism policy 2008, foreign exchange regulation act 2002, agriculture perspective plan 1995, private investment in infrastructure act 2006 were introduced with various free economic

provisions. South Asia Preferential Agreement started to implement in 1995, Nepal became an observer of WTO in 1995 were responsible to sustain some pace on index of positive factors.

Introduction of SAFTA (2004), membership of WTO (2004), competition promotion act (2007), interim constitution (2007) and constitution (2015) are major policy departures for economic freedom in Nepal. Due to political instability, there was no high progress in economic freedom because, during war and instability, personal freedom was curtailed, and the private sector (internal and external) did not like to invest. There was no security in private property and consequently less capital formation, less industrialization, and less export. But the government's continuous initiation to make economy freer led to positive progress on the economic freedom index. Positive policy intervention to make economy freer has been matched with the freedom index. The positive economic freedom index presents an exact scenario of the Nepali economy. There is good consistency in the calculated economic freedom index and major policy departure in Nepal.

The trend line is very real in the sense that this perfectly able to captures the major political and economic changes of Nepal. For example, freedom index reach to the minimum point in 1990 because there was trade blockade from India, the people's movement was at climax and instability and insecurity spread everywhere. Index increase after restoration of multiparty democracy and this remain positive till 2000. When arm conflict spread sharply it start to decline after 2000. In 2008, when political forces were near to comprehensive peace agreement to end decade long arm conflict, there was high insecurity and index decline sharply.

When the peace agreement was completed, the interim constitution was promulgated the economic freedom index starts to rise and reached a good point. The constitution assembly was dissolved without drafting a constitution in 2012 and took a long time to hold another election of constitution assembly which creates instability and a negative impression in the economy. The devastating earthquake and economic blockade from India again disturb the economy sharply and freedom index decline 2015 onwards. The annual freedom index trend captured every event of Nepali economic change.

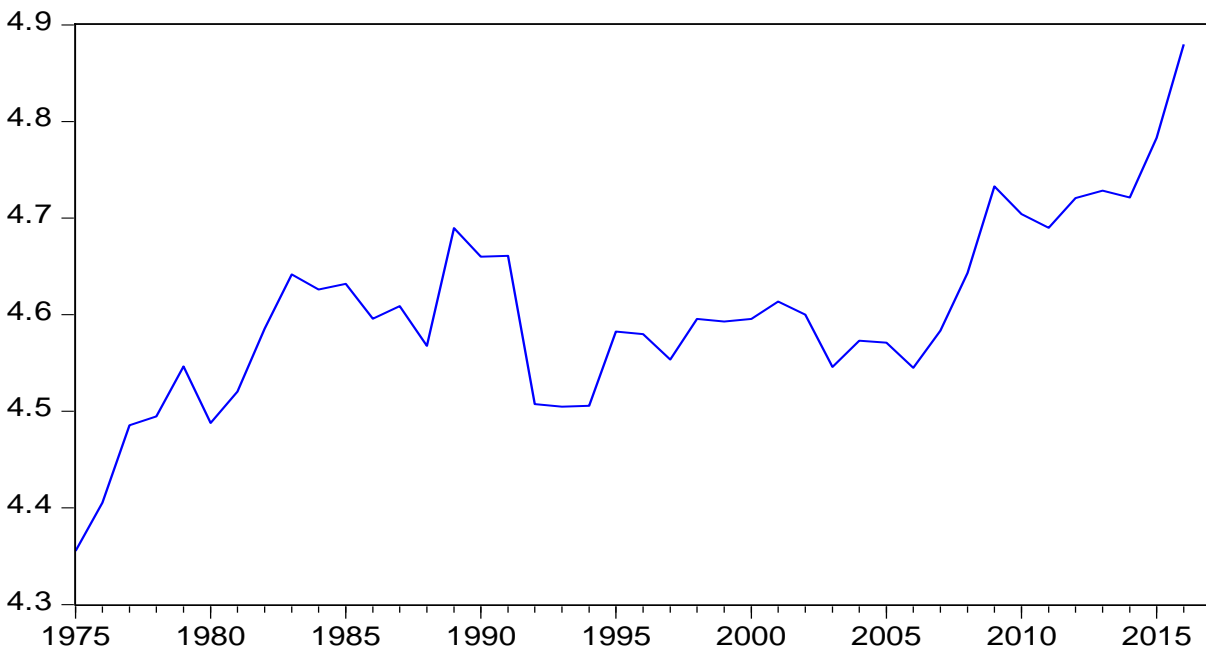
Economic freedom index of negative factors

Economic freedom index of negative factors of Nepal has been calculated based on the defined variables. Nepal introducing liberal economic policies since 1975. This process has been aggravated after the restoration of democracy in nineteen ninety and it is continued till date. The interesting thing to analyze is that to achieve higher growth and development government continuously introduced freer economic policies but on the other hand there is regular increase in expenditure of government. Free economic policy advocates for less

functioning government and more active private sector but ever-growing government budget and intervention raised some question on its free policy.

The economic freedom index of negative factors has been presented in figure 2. On average, the economic freedom index of negative factors is increasing continuously. In 1975 there was a state-led economy and government was the sole actor for development and economic prosperity. That continuously increased up to 1985. After 1985 it declined because, at the time of political instability, the government reduced its development expenditure and government consumption and regulation remained poor.

Figure 2: Economic Freedom Index of Negative Factors
Index of Negative Factors



Source: Researcher's calculation using EViews 9.

Nepal was in absolute monarchy and party less Panchyat System from 1975 to 1990. At this period government the key player of the market even there was some liberal initiation during the period. The increase in government expenditure, government consumption, government debt, tax, and other government-controlled economic activities. These factors were responsible to increase the value of the negative economic freedom index.

In 1980 around there was a referendum on the system of government which offered the choice between non-partisan panchayat system of multiparty democracy. To achieve that goal there was big political movement and unrest. Election held on 2 May 1980 and instability

remained for some time and the government was unable to spend on economic activities and piled collected revenue during that period. That has been reflected in a downturn of the economic freedom index of negative factors in 1980.

In a referendum, the improved party less panchayat system won the election. During the election, they expressed commitment for an improved economic and political system in the name of improved and responsible panchayat system. So, after the election, the government increased its expenditure on various economic activities. To spend on health, education, water supply, infrastructure development, and other various people-centric issues government raises the internal resource mobilization of government.

The entry of the International Monetary Fund to control the continuous deficit balance of payment forced the government to accept some contraction on government economic activities. When there is an introduction of economic stabilization policy and structural adjustment program which minimized the role of government that has been reflected in the contraction of economic freedom index of negative factors in 1985 onwards.

After the reinstatement of the multiparty democracy, the government adopted the free economic policy. In principle, the government tried to reduce its economic activities and encouraged private sectors to invest in every sector by introducing various freer economic policies. After the fall down of the Panchyat era government tried to follow the principle of limited government. This practice leads to reduce government involvement in economic activities means reduce the growth rate of government expenditure, investment, consumption, and social contribution. As a result of that, there is a reduction in internal resource mobilization. This has been reflected in 1991 to 1994. To give the message of economic freedom the government introduced various policies namely; Trade Policy, Industrial Policy, FITTA, Privatization Act, etc. but the government could not remain in this direction for a long time.

But there was high pressure on health, education, infrastructure development, irrigation, drinking water, and other socio-economic activities which compelled the government to increase its role and enlarge the size of the budget. To, spend more on economic, social and welfare activities the government had to mobilize more internal resources. There was high government expenditure in health, education, infrastructure which increased the value of the negative index. From 1995 political instability increased again and government capacity to investment, government consumption, development expenditure reduced. But the reality was that the non-state actor was reluctant to work on economic activities and the government remained in pressure to continue its involvement in socio-economic activities. Even there were various free economic policies and provisions but those remained almost ineffective to attract the private sector, household sector, and international community to actively participate in economic

activities in Nepal. So, the expansionary character of the Nepal government remained unchanged for a long time.

This has been reflected in the graph of the economic freedom index of negative factors. Even at political instability, this did not reach the lower point because there was the introduction of VAT in 1997, market protection act 2007, implementation of various popular social transfer programs, increase in direct and indirect tax, continuous increase in customs revenue, increase in government debt. These factors are responsible for the continuous increase in the economic freedom index of negative factors. There is some slowdown in the value of the index from 2003 to 2006 because of severe conflict and unrest in the country. The government was unable even to implement its annual plan and programs. After peace agreement again government took momentum to spend resources on economic activities the trend of the index after 2006 reflects that fact. The declaration of a republic, federal setup, great political change, madesh movement, indigenous people's movement, the promulgation of constitution heightens the people's aspiration and demand on development and social protection which further expand the role of government.

The major political change, people's aspiration, activeness of private sectors, the role of the international community, policy implementation capacity of government has been reflected in the graph of economic freedom index of negative factors. During the study period, the economic freedom index of negative factors mostly increasing continuously because the value of the variable which is used to construct the economic freedom index of negative factors was increasing continuously. Regular increase in negative factors such as government expenditure, government consumption, the volume of direct tax, custom revenue, and inflation helped to increase the value of negative economic freedom index. This is reflected in chapter five. A liberal policy introduced by the Nepal government did not work to reduce the role of government and increase the activeness of internal and international private sectors. It indicates that Nepal's effort to increase economic freedom by introducing many liberal economic policies did not contribute to achieving higher economic growth. Active and wider role of government becomes a trend and the concept of limited government did not work in Nepal.

RESEARCH FINDINGS

The economic freedom index has been constructed by using some key variables. Two separate indices were developed to make the study clearer. Variables that were supposed to have a positive relation with economic freedom were used to construct economic freedom index of positive factors and variables which were supposed to have a negative relation with economic freedom were used to construct economic freedom index of negative factors. International

research used both types of variables together to construct an economic freedom index which misleads the findings. So, this study categorizes variables into two parts and two different indices were constructed. Most of the researcher (Cannors, 2010; Cebula, 2011; Fabro & Aixala, 2012; Harrold, 2014) used single index to calculate economic freedom index.

The economic freedom indices were precisely able to capture the major turning points of the Nepali economy. Regarding the economic freedom index of positive factors, it was gradually increasing from 1975 to 1989 because various freer economic policies were initiated during that time. Panchayat regime was trying to convince people that they were freeing everything and working for the betterment of people. Due to economic blockade and people's movement, the economic freedom index of positive factors contracted and reached to the minimum point in 1990.

After the restoration of multiparty democracy, the economic freedom index moved upward gradually because the democratic government introduced various policies, acts, and provisions to promote economic freedom. The private sector was also encouraged during the period. When the internal insurgency increased after 2000 this started to decline and reached to the minimum point in 2007. Again, when peace was reinstated in the country the economic freedom index of positive factors started to increase. The small size of FDI, hesitating domestic private sector to invest in manufacturing, high dependency on import, outflux of the economically active population on foreign employment was the major cause to fluctuate and weaken the positive economic freedom index. The empirical reality is that openness increase volume of trade mainly imports but manufacturing sectors, investment and employment reduced sharply and economic growth slack down. The study conducted by Kagochi, Tackie and Thampson (2007) and Justesen (2008) have similar findings.

The economic freedom index of negative factors is also very natural in trend. It captured the major economic and political turmoil of the country. The trend of the economic freedom index of negative factors was positive. The state was gradually tilting to the welfare concept which increased the volume of public expenditure. People's aspirations on development especially on health, education, infrastructure pressurized government to spend more resources. Similarly, the government introduced various social protection schemes which also responsible to increase the value of the economic freedom index of negative factors. To mobilize more resources, the government introduced different types of taxes which increased the volume of internal resource mobilization. The economic freedom index of negative factors was maximum in 1990 and afterward the restoration of democracy pressurized the government to mobilize more resources. This trend declined to some extent when a stable government was introduced through the election from 1992 to 1994. After 1995 this remained mostly stable

because of growing internal conflict government was in pressure to continue its investment in basic sectors but during this period government was unable to carry mega projects due to security reasons and resource crunch. In the last few years, the trend of the increase in the economic freedom index of negative factors was very high because the government was investing massively on health, education, infrastructure, and social protection, etc. This curtails the essence of economic freedom.

CONCLUSIONS

To construct economic freedom indices some key variables which mostly influence the economic freedom of Nepal are taken for this study. Variable are chosen based on other relevant researches conducted by others. Variables are categorized into two parts based on their expected relation (sign) with economic freedom.

Economic freedom indices are constructed by using the Min-Max method. Min-Max method of normalization has been used. To standardize the series, mean and standard deviations were taken as 100 and 10 respectively. Economic freedom index which is calculated by using the variables which are expected to have a positive relationship with GDP is the economic freedom index of positive factors and the next index is called economic freedom index of negative factors. Construction of economic freedom indices is the key achievement of this study because this is the first study that constructs the economic freedom index of Nepal. The economic freedom index captures the major policy changes and other influencing political and social changes in Nepal. The ups and down of both indices are compatible to the major economic, social and political changes of the country. Thus, the indices are realistic and represents the real picture of Nepal. Development of economic freedom index comprising South Asian countries would be the potential areas for future study.

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