

Impact of Trade Barriers and Governmental Regulation on Overall Economic Well Being

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December 2021

Abstract:

This paper aims to determine the impact of trade barriers and the level of government regulation on the economic growth. Further, it also sheds light on the different economic freedom indices that influence a country's GDP per capita and ascertain which index has the most significant impact on the same. We are conducting a comparative analysis of 2017 (pre-COVID) and 2020 (post-COVID). The data for this research paper has been primarily obtained from The Heritage Foundation and additional data from the United Nations and the World Bank. We have used the Ordinary Least Squares (OLS) model in our regression analysis. Our results indicate that countries with lower government regulation and trade barriers experience a higher GDP per capita. Trade freedom and business freedom combined with our dummy variable developed had the most significant impact on our dependent variable. This implies that out of the various economic sectors, being open to foreign trade and the ease of doing business are the most crucial for overall economic well-being.

1. INTRODUCTION

The past few decades have witnessed a rapid growth of the world economy. This is because of technological developments, capital, strenuous efforts and driven by international trade. In the past 20 years, world trade has averaged up to 6% per year, double the rate at which the world output is growing (IMF Staff, 2001). Several countries have opened up to international trade and integrated themselves with the growing world economy causing an accelerated development of their economy and reduction in poverty levels.

According to the World Bank, free international trade is imperative to make a country grow faster and provide higher income with more opportunities for its people (World Bank Group, 2018). Free trade, also known as *laissez-faire*, is a policy through which the government leaves international trade entirely unregulated. The government does not apply any quotas, tariffs, or other restrictions. This case for trade is based on Adam Smith's model stating that countries end up trading with one another as each has an absolute advantage in a particular good or service. This division of labour ends up making countries better off and increases efficiency and production as well (The Editors of Encyclopaedia Britannica, 2006).

However, this trade liberalization can have detrimental effects on a country's domestic production, with people opting for the cheaper foreign alternative. It especially poses a threat to developing economies as they have to compete in a market with stronger, developed nations (Banton, 2021). One of the primary reasons governments impose certain restrictions is to protect the domestic industry from foreign competition; this is known as protectionism.

We also examine the impact of government expenditure on the country's economy. According to Keynesian Economics, increased government expenditure leads to increased output,

increasing the nation's GDP (Jahan et al., 2014). However, higher government expenditure might lead to inflation.

In our paper, we aim to examine this balance between free trade and regulation and government expenditure on a country's growth. We measure the overall economic well-being through its GDP per capita (our dependent variable) with our independent variables: Business Freedom, Investment Freedom, Labour Freedom, Trade Freedom, Government Expenditure, Tariff Rate and whether the country is developed or not. We are conducting a comparative analysis of 2017 (pre-COVID) and 2020 (post-COVID) to study this impact. Along with this, we also aim to find which of our independent variables have the most significant impact on the GDP per capita of the country.

2. LITERATURE REVIEW

Economic Freedom, as defined by (Haan & Sturm, 2000), is the acquisition of property by an individual without the use of theft, fraud and is protected from invasion by others, along with this it is the right that an individual possesses to do anything with the particular property as long as it doesn't transgress the economic Freedom of another individual. They found that although the Heritage Foundation has a variety of indices measuring economic Freedom, which vary in coverage, the outcome of the ranking of the countries come to be similar. Their study showed a positive, direct relationship between economic Freedom and economic growth. The countries below the steady-state were brought to it by increasing the level of Freedom; however, this level of steady-state growth was not impacted by the level of Freedom.

Substantial macroeconomic evidence links the significant, positive impact of trade openness on growth as found by (Singh, 2010). An empirical analysis conducted by (Obadan &

Elizabeth, 2016) using Nigeria as a case study further substantiated this result. This was observed in the case of Nigeria. However, regarding the case of a developing country, political instability due to the budding stage of its democracy had a detrimental impact on its growth.

A study by (Rodríguez & Rodrik, 2000) corroborated that although trade openness is directly linked to positive economic growth, it cannot replace other crucial factors such as good governance and development strategy.

(Wu et al., 2010) state that there is an inverted U-shaped relationship between economic growth and government expenditure. Tests were conducted from 1950-2004 across 182 countries, and from their empirical results, we can infer a strong, positive relationship between economic growth and increased government expenditure. However, it matters where the government is spending. Only productive spending such as investing in infrastructure and education have a significant positive impact. Unproductive spending such as transfer payments had a negative to zero impact on economic growth. The exception to this strong linkage was low-income countries. Due to poor institutions and corrupt governments, they end up hampering their economic growth with increased government expenditure instead of increasing it.

While a lot of literature indicates a positive relationship between higher economic Freedom leading to higher economic growth, in our paper, we wanted to address the ambiguity surrounding which freedom index had the highest impact on the overall economic score. We also consider the variable of government expenditure and other Heritage Foundation Indices. We aim to address these gaps in the literature by conducting a comparative analysis of the years 2017 (pre-COVID) and 2020 (post-COVID) to clarify the same.

3. DATA & METHODOLOGY

The dataset used for this research paper is from the Heritage Foundation, an American think tank based in Washington, D.C, whose vision is to create and endorse policies based on free trade, limited government regulation and individual Freedom. We have also obtained additional data from the United Nations and the World Bank. We obtained raw data in an Excel format and imported the data into STATA software, conducting our econometric analysis.

Economic Freedom is the fundamental right that every individual has over controlling their labour, actions or property. The most widely referred index of economic Freedom is by the Heritage Foundation. In our analysis, GDP Per Capita will be our dependent (y) variable. We will be conducting a Multiple Linear Regression with business freedom, trade freedom, labour freedom and investment freedom as our main independent (x) variables. Furthermore, we will also use the variables 'developing', 'govt expenditure' and 'tariff rate' as control variables.

Business freedom measures the overall ease and efficiency of the government to conduct business. It is generated from various related subfactors from each country, including several procedures needed to start a business, the cost and time of obtaining a business license, and 11 other factors. Labour freedom captures factors influencing the operation of a country's labour market, including mandatory severance pay, difficulty to hire additional workers, and the ratio of minimum wage to average value added per worker. Investment freedom measures the restrictions imposed on the free flow of investment capital. It is generated as a composite of a nation's treatment or screening of foreign investment, foreign investment code, restrictions on land ownership, capital controls, and other factors related to investment. Trade freedom measures "the extent of tariff and non-tariff barriers that affect imports and exports of goods and services" and is calculated based on trade-weighted average tariff rate and rate of non-tariff barriers. Between

these four factors, we have a suitable regulation proxy to test the impact of a government's level of control on the economy's ability to grow and develop.

Each of these variables is measured on a scale from 0-100 with 100 indicating a perfectly free market and 0 indicating a completely regulated or unfree market. We will test the impact of the government's control over the economy's potential to grow through these four variables. Moreover, our dummy variable 'developing' has encapsulated the categorization of whether a country is developed or developing. (Upreti, 2015) researches the difference in economic growth levels between developing and developed countries, hypothesizing that bigger, more developed economies grow slower than developing. We attempt to test this hypothesis in our study.

Moreover, government expenditure is the government's amount on goods and services in one year. As we are taking cross-sectional data for a single year, we feel this is an important variable to consider how much or how little a government invests into their infrastructure and growth should translate into better or worse results. Thus, we have taken 'govexp' as a variable which includes a country wise breakdown of government expenditure as a percentage of GDP for each country.

The Heritage Foundation uses these indices to calculate economic Freedom every year. The method through which these indices are calculated are described in great detail with transparency in a report published by the Heritage Foundation themselves. Therefore, we can be certain that the dataset isn't skewed due to researcher's bias as each value is calculated based on real statistical data collected each year. We are using cross-sectional data of 2017 and 2020 adding up to 176 observations for each year. Overall, the descriptive statistics for our dataset seem to indicate that most nations are in the mid-to-upper tier of economic Freedom.

Table 1: Descriptive Statistics

Year	2017			2020		
Variables	Obs	Mean	Std. Dev.	Obs	Mean	Std. Dev.
gdppc (Main Y)	176	19598.06	21509.650	174	21630.480	23427.690
businessfreedom	176	64.74	14.637	174	63.932	14.924
laborfreedom	176	59.28	14.315	174	59.691	13.959
tradefreedom	176	76.48	10.437	174	74.010	11.831
investmentfreedom	176	57.32	22.803	174	57.845	21.378
govexp	176	33.79	12.413	174	32.191	12.867
developed (Binary)	176	0.2045	0.405	174	0.201	0.402
loggdp (Log of Y)	176	9.258	1.224	174	9.373	1.203
logbus	176	4.141	0.254	174	4.125	0.276
logtrade	176	4.326	0.147	174	4.289	0.183
loginvest	170	3.997	0.473	172	3.971	0.520

Source: Authors' Calculation

4. EMPIRICAL MODEL

For the empirical model, the OLS regression model has been used to understand the effect of the indices as mentioned above on a nation's GDP per capita. As the data is cross-sectional, we cannot assume GDP growth as a dependent variable. We've assumed that zero denotes the lack of a specific event, whereas one denotes the presence of that event. For example, in the variable developed, 0 denotes that the country is developing as per United Nations classification while 1 indicates the country is classified as developed.

Our goal for this study is to examine how economic freedoms influence GDP per capita and observe specific indices known to be traditional factors such as international trade, business, investment & labor Freedom and see how they impact our dependent variable, respectively. Moreover, it is essential to consider that too many independent variables can cause overfitting within the model, causing undesirable results. As Prof. Jeffrey Wooldridge noted, over specifying a model can exacerbate multicollinearity problems, decrease the efficiency of estimators, and result in increased variance of estimators.

Our regression model's are as follows (2017 & 2020):

$$\text{SLR: } gdppc = \beta_0 + \beta_1 \text{tradefreedom}$$

$$\text{MLR1: } gdppc = \beta_0 + \beta_1 \text{tradefreedom} + \beta_2 \text{investmentfreedom} + \beta_3 \text{businessfreedom} + \beta_4 \text{laborfreedom} + \beta_5 \text{govexp} + u$$

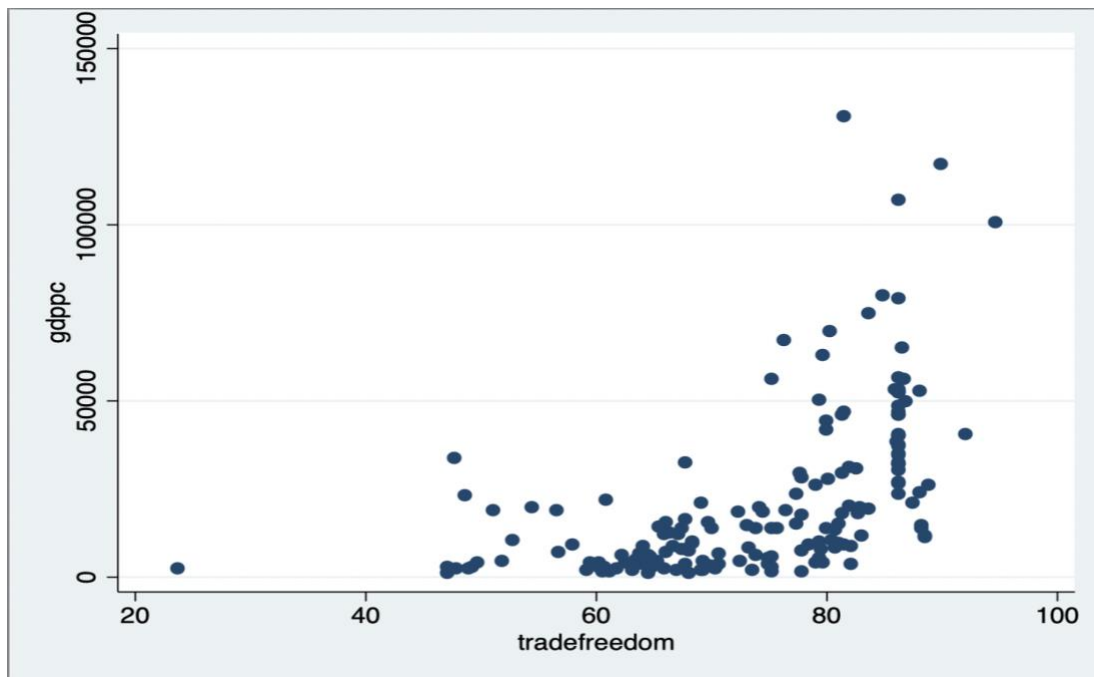
$$\text{MLR2: } \log gdp = \beta_0 + \beta_1 \log \text{trade} + \beta_2 \log \text{bus} + \beta_3 \log \text{invest} + \beta_4 \text{developed} + u$$

The **research hypothesis** is as follows:

We hypothesize that greater economic Freedom will result in higher GDP per capita, and the literature we have reviewed leads us to believe that our hypothesis will be correct. Further, based on our literature review, we believe the Freedom of economic trade to be one of the most impactful indices - which is why we begin our regression analysis with an SLR model examining the impact of trade freedom on GDP per capita. Our paper is unique because it examines various subsets of economic Freedom and analyzes the greatest impact on GDP.

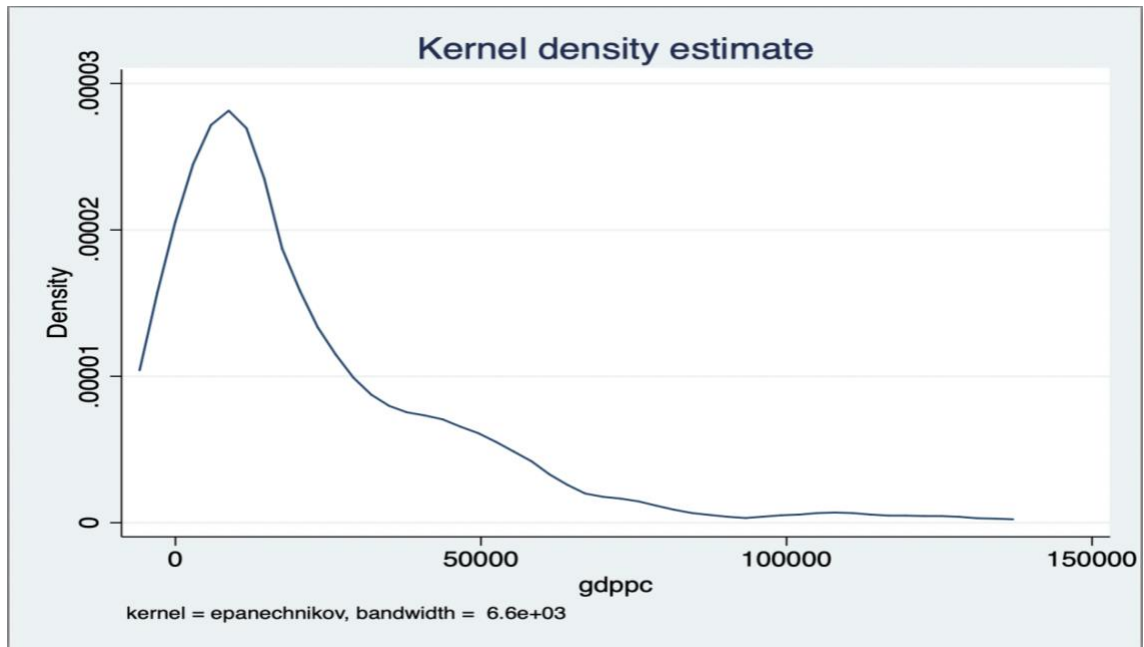
5. GRAPHICAL ANALYSIS

Graph 1: Scatter plot of GDP per capita & Trade Freedom



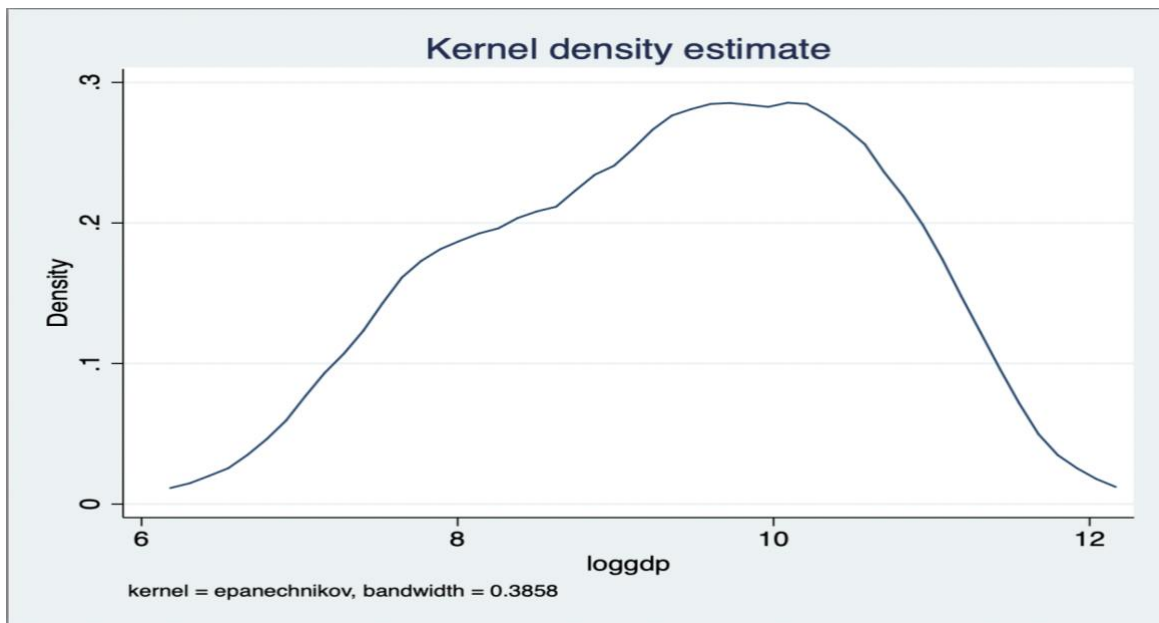
Source: Authors' Calculation

Graph 2: Normality test for GDPPC



Source: Authors' Calculation

Graph 3: Normality test for log GDPPC



Source: Authors' Calculation

6. RESULTS & DISCUSSION

Gauss Markov OLS Assumptions:

The results obtained after running the OLS regression are given in Table 3. The tests conducted on our regression model have been summarized in Table 2. Please note that the following conclusions are valid for both datasets (2017 & 2020). Our data satisfies the Gauss-Markov condition of linearity because the dependent variable, GDP per capita, is assumed to be a linear function of the four indices we have selected as independent variables. The second assumption is also satisfied as the data collected is the entire population of possible data points, thereby having an adequately random sample. Assumption three was also passed as our regression models satisfied the Variance Inflation Factor (VIF) Test for multicollinearity. We also conducted the Durbin–Wu–Hausman test for endogeneity and concluded that our regression model was endogenous (Appendix 2). Thereby, we failed the fourth assumption. Finally, on running the Breusch-Pagan / Cook-Weisberg test for heteroskedasticity, a p-value of 0.000 was obtained for both models. Due to the presence of heteroskedasticity, robust regression models were run throughout our OLS analysis.

The kdensity test conducted on our regression residuals are approximately normal and fit the assumption of normality (Graph 3).

Table 2 - Tests

vif Variance Inflation Factor Test for Collinearity (Assumption 3)		
<i>Model</i>	<i>Mean VIF</i>	<i>Conclusion</i>
MLR1 (2017)	1.48	No multicollinearity
MLR3 (2020)	1.53	No multicollinearity
predict ehat, res Endogeneity Test (Assumption 4)		
<i>Model</i>	<i>Prob > F</i>	<i>Conclusion</i>
MLR1 (2017)	0.0000	Presence of Endogeneity
MLR3 (2020)	0.0000	Presence of Endogeneity
estat hettest H_0: Constant variance Heteroskedasticity Test (Assumption 5)		
<i>Model</i>	<i>Prob > chi2</i>	<i>Conclusion</i>
MLR1 (2017)	0.0007	Reject H_0
MLR3 (2020)	0.0000	Reject H_0

$$\text{SLR: } gdppc = -58352.92 + 1080.706\text{tradefreedom}$$

Our first SLR model indicated that for every one unit increase in trade freedom score, GDP per capita increases by 1080.706 units. Being highly significant at 99%, this observation provided a strong foundation for our subsequent model specifications by proving that even Trade Freedom alone has a strong explanatory effect on GDP per capita, and one that is unquestionably large enough in magnitude to be economically significant. With an R^2 of 0.29, we can conclude 29% of the variation of the dependent variable can be explained based on this foundation. A single-point increase in the trade index leading to a \$1080 increase in GDP per capita is a compelling reason to continue with our existing data and variables.

$$\text{MLR1: } gdppc = -65966.92 + 571.172\text{tradefreedom} + 386.676\text{investmentfreedom} + \\ 35.731\text{businessfreedom} + 188.044\text{laborfreedom} + 235.893\text{govexp}$$

We now conduct an MLR and incorporate the other remaining indices - investment freedom, business freedom and labor freedom along with government expenditure as a % of GDP. Trade and business freedom hold highly significant (significant at 99%) positive relations with GDP per capita. With a 1-unit change in trade freedom, we expect GDP per capita will increase by 571.72 units. Similarly, for a 1-unit change in business freedom, GDP per capita is expected to increase by 386.676 units. Investment freedom and gov. Expenditure is only significant in the 95% confidence interval. A 1-unit change in investment freedom increases GDP per capita by 188.044 and government expenditure as a % of GDP increases GDP per capita by 235.89. Labor freedom was found to be insignificant. With an R^2 value of 0.40 we conclude that the model can explain 40% of the variation of the dependent variable. This gives very encouraging results that point to the significance of trade freedom and business freedom in particular, hinting that it may only be true that Freedom in certain sectors of the economy is beneficial for economic health.

In contrast, others need not be free for an economy to prosper. When concluding our results, it is essential to consider any possible omitted variables that could lead to bias. There certainly are variables not present in the model that could have led to higher correlation and significance for our study. Suppose variables such as education were to be included. In that case, the model might have exhibited both a higher degree of collinearity with the stated explanatory variables and a higher correlation concerning the dependent variable.

$$\text{MLR2: } \text{loggdp} = -5.098 + 1.7333\text{logtrade} + 1.6617\text{logbus} - 0.0015\text{loginvest} + \\ 0.8870\text{developed}$$

We alter its functional form to double log format to tune our model further. This helps us accomplish a useful goal for our dependent variable, GDP per capita, by scaling our coefficients down to a more workable size and easier interpretation of the coefficients. It additionally helps to normalize the dependent variable, which was previously skewed to the right (indicating that the mean GDP per capita exceeds the median GDP per capita, likely because of large outlier values from nations with GDP per capita values that far exceed normal values). We remove the variable from this model because of the insignificant impact of labor freedom.

After conducting the log model reduces the significance of investment freedom from 95% to not significant at all. Theoretically, the logarithmic coefficient results indicate that a 1% increase in the nation's trade freedom score results in a 1.73% in GDP per capita. Similarly, a 1% increase in the log of business freedom increases GDP per capita by 1.66%. Within this model, we also incorporate our dummy variable *developed*. The coefficient on the dummy variable *developed*, which is 0 for developing nations and 1 for developed nations (per the United Nations official classification), is 0.88, and it is highly significant at 99% meaning that increase of 88% in GDP per capita when a nation moves from developing to developed. This allows us to capture some of the variance in GDP per capita that is not government-driven by accounting for the overall nature of the economy rather than the moment-in-time look we get by examining our indices, which can change by year. Based on this model, it is more apparent that investment is a smaller determinant in a nation's GDPPC. There is a benefit to a nation having increased Freedom in international trade and business. We find a new R^2 value of 0.53 indicating that 53% of the variance in log gdp is explained by our model which is a highly significant model. Also, the F-stat for all three models was 0.00 further indicating the high significance of our model.

Table 3: OLS Regression Results - 2020

Variables	SLR1: Regressing gdppc	MLR1: Regressing gdppc (Robust)	MLR2: Regressing loggdp (Robust)
tradefreedom	1080.706*** (126.516)	571.172*** (146.954)	-
businessfreedom	-	386.676*** (102.904)	-
laborfreedom	-	35.731 (108.528)	-
investmentfreedom	-	188.044** (78.388)	-
govexp	-	235.893** (95.223)	-
logbus	-	-	1.6617*** (0.4375)
logtrade	-	-	1.7333*** (0.6284)
loginvest	-	-	-0.0015 (0.1819)
developed	-	-	0.8870*** (0.1394)
_cons	-58352.92*** (9481.724)	-65966.92*** (9695.036)	-5.098** (2.129)
No. of Obs	174	174	172
Prob > F	0.0000	0.0000	0.0000
R-squared	0.2979	0.4079	0.5349
Adj R-squares	0.2938	-	-
Root MSE	19688	18293	0.82829
Standard Deviations are in parenthesis Significant at *10%, **5%, ***1%			

Source: Authors' Calculation

Discussing the Impact of COVID: Comparison to 2017

We conducted the same regression analysis as the above with the same sample set for 2017. All variables and regression equations were identical and the results of the data can be viewed in the appendix (Appendix 1). We found similar results across the SLR and the non-log MLR model. The significance values were also highly similar, and the coefficients were only slightly deviated. In the log model which incorporates our dummy variable 'developed', we found a significant difference between 2017 and 2020. While in 2020, the regression coefficient was highly significant at 99%. An increase of 88% in GDP per capita was observed when a nation moves from developing to developed - we found contradictory results in 2017. In 2017, the regression coefficient only showed an increase of approximately 16%; the variable was not significant at all (not even at 90%).

This provides us with an interesting perspective. Based on international trade theories such as the Ricardian model, we know that being a developing or a developed country is an economically significant factor - leading to variations in technology & resources. However, we can see a change in statistical significance from 2017 to 2020 - meaning that our research reveals that after international trade came to a sizable halt for a period of time during 2020 due to the severe impact of the COVID-19 pandemic, being a developed nation was more beneficial. This could be attributed to many reasons such as having a higher reserve of treasury funds or having more resources & capital to sustain the economy without the contribution from international imports and exports.

7. CONCLUSION & LIMITATIONS

We find persuasive evidence that countries with lower levels of government regulation and fewer trade barriers had higher GDP per capita. The most intriguing takeaway is that, out of all the variables tested during the model specification process, we ended up getting the best results by combining only two of the original indices — trade freedom and business freedom — with our dummy variable indicating whether or not a country is developed. This implies that, of all the sectors in an economy, being open to foreign trade and easy to navigate for entrepreneurs is highly crucial to economic well-being. These factors far outweighed labour and investment freedom. This finding is consistent with the fact that many of the countries with the highest GDP per capita have enacted strict labour market regulations (minimum wage laws, restrictions on hours worked, and so on) as well as strict investment regulations (regulating foreign-direct investment and foreign holdings in domestic industries). Most countries appear to struggle to attain economic growth without free trade and pro-business policies.

Future research could look into even more components of an economy, such as possible indexes for variables like taxation and black markets (which can arise due to under regulation). Future models may even adjust for more characteristics that influence GDP per capita, such as education level, to capture more of the variation of the independent variable within the model.

A major limitation of our study is that OLS can produce biased and inconsistent parameter estimates due to the presence of endogeneity. Hypothesis tests can be seriously misleading. Therefore, we suggest that an additional model be conducted using instrumental variables (IV) techniques to control future endogeneity. Further, our regression study is bound to have omitted variable bias as the goal for this study is to examine how economic freedoms influence GDP per

capita and observe specific indices known to be traditional factors such as international trade, business, investment & labour Freedom.

In conclusion, the findings have important consequences for economic policy and decision-making in a country. Every political entity's principal purpose is to maximize overall economic prosperity for its population. Our research paper is consistent with the literature that fewer barriers and less restrictive economic policies can obtain greater economic welfare.

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9. APPENDIX

Appendix 1: OLS Regression Results - 2017

Variables	SLR2: Regressing gdppc	MLR3: Regressing gdppc (Robust)	MLR4: Regressing loggdp (Robust)
tradefreedom	1037.074*** (135.017)	465.9529*** (161)	-
businessfreedom	-	449.0223*** (91.878)	-
laborfreedom	-	17.1224 (105.2264)	-
investmentfreedom	-	137.866** (64.485)	-
govexp	-	235.893* (95.223)	-
logbus	-	-	2.2062*** (0.5211)
logtrade	-	-	2.1042*** (0.8051)
loginvest	-	-	0.2921 (0.2095)
developed	-	-	0.1695083 (0.1893)
_cons	-59723.15*** (10422.03)	-60766.92*** (9627.925)	-10.197*** (2.503)
No. of Obs	176	176	170
Prob > F	0.0000	0.0000	0.0000
R-squared	0.2532	0.3694	0.4626
Adj R-squares	0.2489	-	-

Root MSE	18641	17330	0.90927
Standard Deviations are in parenthesis Significant at *10%, **5%, ***1%			

Source: Authors' Calculation

Appendix 2: List of Countries

Afghanistan	Brunei Darussalam	Côte d'Ivoire	Guinea
Albania	Bulgaria	Denmark	Guinea-Bissau
Algeria	Burkina Faso	Djibouti	Guyana
Angola	Burma	Dominica	Haiti
Argentina	Burundi	Dominican Republic	Honduras
Armenia	Cabo Verde	Ecuador	Hong Kong SAR
Australia	Cambodia	Egypt	Hungary
Austria	Cameroon	El Salvador	Iceland
Azerbaijan	Canada	Equatorial Guinea	India
Bahamas	Central African Republic	Eritrea	Indonesia
Bahrain	Chad	Estonia	Iran
Bangladesh	Chile	Ethiopia	Ireland
Barbados	China	Fiji	Israel
Belarus	Colombia	Finland	Italy
Belgium	Comoros	France	Jamaica
Belize	Democratic Republic of the	Gabon	Japan
Benin	Congo, Republic of	Gambia	Jordan
Bhutan	Costa Rica	Georgia	Kazakhstan
Bolivia	Croatia	Germany	Kenya
Bosnia and Herzegovina	Cuba	Ghana	Kiribati
Botswana	Cyprus	Greece	Korea, South
Brazil	Czech Republic	Guatemala	Kuwait

Kyrgyz Republic	Montenegro	Russia	Tajikistan
Lao P.D.R.	Morocco	Rwanda	Tanzania
Latvia	Mozambique	Samoa	Thailand
Lebanon	Namibia	Saudi Arabia	Timor-Leste
Lesotho	Nepal	Senegal	Togo
Liberia	Netherlands	Serbia	Tonga
Lithuania	New Zealand	Seychelles	Trinidad and Tobago
Luxembourg	Nicaragua	Sierra Leone	Tunisia
Macau	Niger	Singapore	Turkey
Macedonia	Nigeria	Slovak Republic	Turkmenistan
Madagascar	Norway	Slovenia	Uganda
Malawi	Oman	Solomon Islands	Ukraine
Malaysia	Pakistan	South Africa	United Arab Emirates
Maldives	Panama	Spain	United Kingdom
Mali	Papua New Guinea	Sri Lanka	United States
Malta	Paraguay	Sudan	Uruguay
Mauritania	Peru	Suriname	Uzbekistan
Mauritius	Philippines	Swaziland	Vanuatu
Mexico	Poland	Sweden	Venezuela
Micronesia	Portugal	Switzerland	Vietnam
Moldova	Qatar	São Tomé and Príncipe	Zambia
Mongolia	Romania	Taiwan	Zimbabwe