States of progress

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The discourse on economic reforms, more often than not, tends to focus on policies made (or indeed not made) at the Centre. What gets ignored is the importance of the process of economic reform at the level of state governments. In this context, the latest Economic Freedom Rankings for the States of India, 2009 sheds interesting light on the process of economic reform in the states. The rankings are based on an Index of Economic Freedom to measure the degree of government intervention in a state's economy: the less coercive the intervention, the higher the rank. Specifically, the index, compiled by the Cato Institute and Indicus Analytics in cooperation with Friedrich Naumann Stiftung, encompasses the size of the government (in terms of expenditures, taxes and state-owned enterprises), the legal structures and security of property rights and the regulation of credit, labour and business. Interestingly, Tamil Nadu ranks at the top (as it had in 2005), followed by Gujarat and Andhra Pradesh, both of which improve their rankings sharply (from five and seven to two and three, respectively).

Why do the rankings matter at all? For the simple reason that there seems to be at least some correlation (even if the authors say not very high) between a high rank scored on this index and higher growth. So, for example, Andhra and Gujarat, which showed the biggest improvement in the 2009 rankings from the earlier rankings in 2005, also grew at an average of just over 10 per cent in the same period. The states which saw their indices decline moderately (like Himachal Pradesh, Maharashtra) grew at an average of 8.7 per cent, while the states which saw a sharp decline in their index score (like Punjab, Uttarakhand) grew at an average of only 6.7 per cent in the same period. Importantly, and perhaps a matter of some concern, 12 states have actually seen a decline in their economic freedom scores between 2005 and 2009.

Set aside the statistical construct and read into the causation. There is plenty of economic literature which shows that policies which encourage lower taxes, privatise state-owned companies, secure property rights, ensure faster judicial proceedings, provide flexible labour laws and in general remove barriers to entrepreneurship are good for growth. And all said, there is a considerable difference between a growth rate of 10 per cent and a growth rate of 7 per cent.

