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Freedom means faster growth

How do we measure economic freedom, and how relevant is it for economic growth? Some answers come from Economic Freedom of the States of India 2011, a report just brought out by the Friedrich Naumann Foundation, Cato Institute and Indicus Analytics.

The report shows that measuring economic freedom at the state level is a difficult and inexact exercise, given data limitations. More important than the absolute freedom ranking of any state can be a change in rankings, showing whether economic freedom is improving or worsening over the last five years. While economic freedom can only be one of many factors that influence economic growth, the big picture emerging from the data is that, by and large, states with increasing freedom are growing faster, and those with worsening freedom are growing slower.

The only two states that showed a large increase in economic freedom between 2004-05 and 2008-09

were Andhra Pradesh and Gujarat, and they averaged 10.5% annual state GDP growth. States with a moderate rise in economic freedom averaged 8.1% annual growth. States with a moderate fall in freedom averaged 8.7% annual growth. And those with large falls in freedom averaged only 6.7%. The big picture is clear: more freedom tends to go with faster growth.

However, economic freedom is not the only relevant factor, which is why some states with low rankings - notably Bihar and Chhattisgarh - have grown exceptionally fast. However, they have grown from a low base, and relied very lop-sidedly on construction in Bihar, and on mining and basic industry in Chhattisgarh. This pattern may not be sustainable without improving freedom indicators too. By contrast, improved economic freedom in Kashmir has not yielded fast growth because of terrorism.

It can be no surprise to learn that Gujarat and Andhra Pradesh have been the big improvers. Less well

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known is the fact that Punjab and Maharashtra, once the two richest and fastest growing states, are now sliding downhill in economic freedom. Perhaps this is not really news: industrialists in western India have for a decade preferred Gujarat to Maharashtra. Punjab has lost the plot for some time, but can complain- with justice - that investments that would normally have come to Punjab have gone to neighbouring Himachal Pradesh and Utrakhand because of unwarranted tax breaks given for investments in those states.

There are many statistical problems in measuring freedom. This report attempts to follow the methodology of Economic Freedom of the World, a global comparison of economic freedom brought out annually by the Fraser Institute and others. But the exercise needs extensive modification since the policy tools available to state governments are far fewer than those available to national governments. This report focuses on three categories of freedom at the state level. One is the size of government relative to state GDP. The second is legal structure and property rights. The third is regulation of business and labour.

There are problems in locating data across all states that will help measure these three parameters. Even if better data were available, these three are obviously incomplete measures of freedom. For instance, in Bihar, historically the slough of despond, chief minister Nitish Kumar has generated rapid 10.5% growth. He vastly improved law and order - and hence business confidence - by jailing 38,000 gun-toting criminals. Unfortunately, the report's data cannot pick up this sort of improvement in economic freedom, and so Bihar remains at the bottom of the freedom list.

It was argued by Planning Commission chief, Montek Singh Ahluwalia , at the launch ceremony, that the report should have considered positive as well as negative freedoms. Freedom from hunger, illiteracy and insecurity enables people to become entrepreneurial, and providing these freedoms can often mean more government spending rather than less. Nitish Kumar, for instance, hired over two lakh contract teachers in Bihar to fill huge gaps in schools.

The problem is that we have no data that tell us how much government spending is useful and how much is wasteful. So, while useful spending may indeed provide positive freedoms, it is impossible to measure this. The report measures economic freedom as a falling share of revenue spending to state GDP. This is clearly a rough and ready measure, but looks statistically robust.

The top three states in 2009 were Tamil Nadu, Gujarat and Andhra Pradesh - no surprises there. The bottom states were Bihar, Utrakhand and Assam. The only surprise here is Utrakhand, a once-backward area that has recently done very well, averaging 8.4 growth in 2005-09. This is partly because of tax breaks for investment. But the state has also spent a lot on roads and education, and done those jobs relatively well. To that extent, rising government spending in this state could arguably have provided positive economic freedoms - as hypothesised by Ahluwalia.

A legitimate criticism of the freedom measures in the report, pointed out by chairman of the Committee on Agricultural Costs and Prices , Ashok Gulati, is that they mostly try to measure business freedom, ignoring the freedom of farmers. More than half the population is engaged mainly in agriculture, including most of the poor. Indian agriculture has long been cosseted on the one hand by subsidised power, water and fertilisers, and hamstrung, on the other, by compulsory procurement, export bans and restrictions on the movement and sales of farm products. It will be interesting to see if the inclusion of farmers' freedom in the index will significantly change the rankings of different states.

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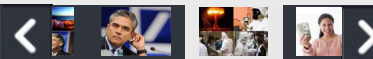
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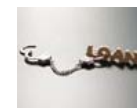
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