



Who gains from freedom?

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In a recent working paper, we focus on the association between economic freedom and growth in the number of newly registered small and medium enterprises (SMEs) in different states of India. We find that a one percentage point increase in economic freedom is associated with an increase of 0.6% in the growth of newly registered SMEs.

While political freedom has been given a lot of importance in India, economic freedom does not make headlines. Economic freedom is often dismissed as an elitist concept benefiting only big business at the expense of labour. In fact, many states in India that adopt a business-friendly approach are often dismissed as supporters of crony capitalists. Not surprisingly, India ranks a low 111th on the world economic freedom index published by the Cato Institute.

In this context, we examine a report, *Economic Freedom in States of India* (co-authored by economists Bibek Debroy, Laveesh Bhandari and Swaminathan S. Anklesaria Aiyar), and relate the average economic freedom index score of a state (based on the last four reports) to the growth in the number of SMEs in the state. We source the data pertaining to SMEs from the annual report published by the ministry of small and medium enterprises. We compute the compound annual average growth rate of SMEs between 2007 and 2012, the time period covered by the annual report of the ministry.

A closer look at the correlations between the two variables in many states provides some interesting insights. Four of the top five states in terms of economic freedom also occupy four of the top five ranks in terms of growth of SMEs. Gujarat, which has the highest score in terms of economic freedom, witnessed a 40.67% annualized growth in the number of newly registered SMEs during the period of our study. This compares very well with the national average of 12.83%. Despite its high base, the state has seen the maximum improvement in the economic freedom index compared to any other state. Tamil Nadu, which has been ranked second, has also

witnessed an impressive 26.94% growth in the number of SMEs. Madhya Pradesh and Andhra Pradesh, which occupy 4th and 5th positions respectively, also beat the national average comfortably. The only exception at the top of the table is Haryana—the state is ranked No. 3 in terms of economic freedom, but the SME growth rate in the state during the period under review is a paltry 2.61%.

States whose political leaders constantly complain that growth-oriented economic models only benefit the rich, perform poorly both in terms of economic freedom and growth in SMEs. Two of the three states at the bottom of the economic freedom index are also at the absolute bottom in terms of growth of SMEs. West Bengal, which is one of the bottom three states in terms of economic freedom, has seen a negative growth of 6.49% in terms of SMEs over the period under study. Assam has done even worse, with a negative growth of 9.44%. Kerala, which is a role model state for some sections of economists, has clocked a negative growth rate of 2.45% when it comes to SME registration.

A caveat is in order at this point: what we have recorded are correlations and hence cannot be the sole basis for establishing causality. Our research paper focuses on establishing causality. However, a closer look at the way the economic freedom index is constituted points towards likely causality. The index is based on variables such as the size of the government, regulation of business and labour, labour unrest, enforcement of contracts, etc.

Let us think of an experiment using one of the variables of the index, the ability of the state to meet peak power demand. Think of a state experiencing power outages where a large soft drink firm operates together with its supplier of bottle caps. For the large firm, power-related expenses are likely to be insignificant compared to its total expenditure; a doubling of power-related expenses (for arranging alternative sources) will not make much of a difference. However, for the small supplier, the increased expenditure may make an existential difference. The large firm has pricing power and can even shift to a different state, should the situation worsen dramatically. The small supplier, on the other hand, operates on thin margins and hence has none of these luxuries. Therefore, economic freedom in a state is more likely to affect the growth of SMEs than the growth of large firms.

In his book *Free To Choose*, economist Milton Friedman made a strong case for judging a policy by its likely consequences rather than its noble intentions. Many of the measures taken so far to protect SMEs in India have ironically made life difficult for SMEs. Given that Gujarat ranks the highest in economic freedom, we sincerely hope that the Narendra Modi government would replicate the same across the country.