Man is born free, but is everywhere in chains.’ That was Jean
Jacques Rousseau (1712-1778) in The Social Contract. In today’s
world, shorn of gender biases, we would often say that man and
woman is born free but is everywhere in chains, although that sounds less
pithy. But the point is that no worker, male or female, desires to be poor.
A desire for upliftment, a desire for well-being, a desire for freedom and
prosperity is an innate human tendency. Unfortunately, this natural desire
is shackled and constrained by governments that actually believe they are
aiding rather than disempowering citizens. The road to hell is paved with
good intentions and nowhere is this truer than of governments. In a
desire to do good, governments often do more harm, and so ensure that
free men (and women) continue to be in chains. They ensure that free
markets do not function. The visible hand of government interferes in
production, trade and consumption. Private property is regarded as theft
and the robbery of public property. Individuals are not allowed freedom to
contract. There is no equality before the law.

Economic freedom is not the only kind of freedom that exists. For
example, political liberties and civil rights are also notions of freedom and
have spillover effects on economic freedom. To name but one example,
Freedom House ranks countries in the world on the basis of such liberties
and rights.1 That “Freedom in the World” survey ‘measures political rights
and civil liberties, or the opportunity for individuals to act spontaneously
in a variety of fields outside the control of the government and other
centers of potential domination. As such, the survey is primarily concerned
with freedom from restrictions or impositions on individuals’ life pursuits.’
However, if development and prosperity are the yardsticks, notwithstanding
those spillovers, it is economic freedom that is of key importance. ‘The

foundations of economic freedom are personal choice, voluntary exchange, and open markets. As Adam Smith, Milton Friedman, and Friedrich Hayek have stressed, freedom of exchange and market coordination provide the fuel for economic progress. Without exchange and entrepreneurial activity coordinated through markets, modern living standards would be impossible. Potentially advantageous exchanges do not always occur. Their realisation is dependent on the presence of sound money, rule of law, and security of property rights, among other factors. *Economic Freedom of the World* seeks to measure the consistency of the institutions and policies of various countries with voluntary exchange and the other dimensions of economic freedom. This quotation comes from an *Economic Freedom of the World* (EFW) report that has been brought out by the Fraser Institute since 1996, and is published by some 70 think tanks across the world including the Cato Institute in Washington DC. For details, see Box 1.1.

**BOX 1.1**

*How the Fraser Institute Measures Economic Freedom*

Admittedly, economic freedom is difficult to pin down, quantify and measure. After a lot of discussion and debate, the Fraser Institute's *Economic Freedom of the World* (EFW) now has a robust and evolved methodology based on five pillars: (1) size of government (expenditures, taxes and enterprises); (2) legal structure and security of property rights; (3) access to sound money; (4) freedom to trade internationally; and (5) regulation of credit, labour and business. Within these five components, there are sub-components—such as general government consumption spending, transfers and subsidies, government enterprises and investment and top marginal income tax rate under (1); judicial independence, impartial courts, protection of property rights, military interference in rule of law and the political process, integrity of the legal system, legal enforcement of contracts and regulatory restrictions on the sale of real property under (2); money growth, standard deviation of inflation, inflation and freedom to own foreign currency bank accounts under (3); taxes on international trade (revenues from trade taxes, mean tariff rates, standard deviation of tariff rates), regulatory trade barriers (non-tariff barriers, compliance costs of trade), size of trade sector, black market exchange rates and international capital market controls (foreign ownership and investment restrictions, capital controls) under (4); and credit market regulations (ownership of banks, foreign bank competition, private sector credit, interest rate controls), labour market regulations (minimum wages, hiring and firing regulations, centralised collective bargaining, mandated cost of hiring, mandated costs of worker dismissal, conscription) and business regulations (price controls, administrative requirements, bureaucracy costs, starting a business, extra payments/bribes, licensing restrictions, cost of tax compliance) under (5).

There is strong correlation (depending on the context, positive or negative) between a country’s score on EFW and assorted measures of

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economic development (life expectancy, percentage of children in the labour force, per capita income, average growth rate, income share of the poorest 10 per cent, income level of the poorest 10 per cent, per capita investment, adult literacy, infant mortality and so on). Admittedly, this is correlation and not causation. However, when the correlation is so strong, across development and deprivation indicators, it does suggest causation. Some studies also suggest that economic freedom has substantial explanatory power for improved economic and social indicators.\textsuperscript{4} High levels of economic freedom are good for economic development and removal of poverty. \textit{Economic Freedom of the World} measures have been criticised on some counts. First, \textit{Economic Freedom of the World} splices some subjective data (like responses to questionnaires) with objective data, and questions can be raised about the quality of subjective data. Second, errors of omission and commission have been alleged in choosing the variables, but the fact is that some desirable variables cannot be used for want of data. Third, weights and formula used for aggregation have been criticised as arbitrary, but simulations show that the results are in fact robust. Fourth, critics argue that of the five core components, some have the bulk of explanatory power, not the others. Fifth, people have argued that high Chinese rates of growth are inexplicable when China does not score very high on economic freedom. The same argument can be advanced about some other fast-growing developing countries too. However, all these countries have rising levels of economic freedom, even if their absolute levels are not high, and it is the improvement in freedom that drives positive economic outcomes. The findings of \textit{Economic Freedom of the World} are fairly robust when subjected to sensitivity tests.

Table 1.1 shows how India scores in the 2009 \textit{Economic Freedom of the World} ratings.\textsuperscript{5} The higher the score, the better it is from the point of

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\textbf{Table 1.1}

\textbf{India’s Scores in Economic Freedom of the World}

\begin{tabular}{lcccccc}
\hline
\hline
Summary Rating & 5.42 & 5.09 & 5.12 & 5.73 & 6.24 & 6.50 \\
Size of Government & 5.00 & 4.50 & 4.88 & 6.26 & 6.83 & 6.98 \\
Legal Structure and Security of Property Rights & 6.32 & 5.38 & 4.79 & 5.87 & 5.99 & 6.41 \\
Freedom to Trade Internationally & 4.32 & 3.68 & 4.02 & 4.67 & 5.54 & 6.67 \\
Regulation of Labour and Business & 5.27 & 5.28 & 5.24 & 5.36 & 5.95 & 5.68 \\
\hline
\end{tabular}

\begin{itemize}
\item \textsuperscript{4} For a review of the evidence on the relationship between economic freedom and growth, see Haan, Lundstrom and Sturm (2006).
\item \textsuperscript{5} Gwartney and Lawson (2009). Table 1.1 only shows the scores and not India’s ranks across countries. The scores drive the ranks and are more indicative of inter-temporal improvements.
\end{itemize}
Economic freedom. Economic reforms began in India in the late 1970s, but became much more comprehensive since 1991. These reforms involve a reliance on the market and reduced government intervention. It is thus understandable that India’s scores should improve over time. One should also mention that Indian growth rates have picked up in the 1990s, more so from 2003-04. Yet again, one notices the positive correlation between higher levels of economic freedom and growth. India is a federal country, and its Constitution has a Seventh Schedule that lists the topics falling under the jurisdiction of the Central government, the topics that are the responsibility of the state governments, and the topics that are the concurrent responsibility of both. The academic literature often refers to first and second generation reforms. First generation reforms include the external sector (where the first flush of reforms was introduced in 1991), while second generation reforms pertain more to the domestic economy. Besides, first generation reforms often refer to agenda items that are the province of the Central government (such as product markets), whereas second generation reforms often concern agenda items falling within the purview of the states (such as markets for land and labour). India continues to perform relatively poor in the regulation of credit, labour and business, and labour is in the Concurrent List of the Seventh Schedule. Indeed, if one disaggregates further than in Table 1.1, and compares the 1995 scores with those of 2007, one finds that India has not improved much on transfers and subsidies, government enterprises and investment, money growth, freedom to own foreign currency bank accounts, non-tariff barriers, capital controls, ownership of banks and hiring and firing regulations and has slipped on general government consumption expenditure, judicial independence, impartial courts, price controls and bureaucracy costs. PSU (public sector undertaking) reforms, reform of PSU banks, targeting of subsidies, dismantling of exchange controls, labour market reforms and judicial reforms are long overdue. Public expenditure and price controls have both increased under the United Progressive Alliance (UPA) government, which has effectively been in power since 2004.

A separate Index of Economic Freedom (IEF) is brought out annually by the Heritage Foundation and the Wall Street Journal. Though the philosophical underpinnings of IEF are similar to those of EFW, the methodology is different. The scores range from 0 to 100 and the higher the score, the better the freedom is. Out of 179 countries, in the latest ratings, India is ranked only 124th. India scored 36.3 on business freedom,

6. The range is from 0 to 10.
7. Ibid.
8. In particular, the Industrial Disputes Act.
67.9 on trade freedom, 73.4 on fiscal freedom, 76.1 on government spending, 67.5 on monetary freedom, 35.0 on investment freedom, 40.0 on financial freedom, 50.0 on property rights, 34.0 on freedom from corruption and 57.7 on labour freedom.9

India is a large and heterogeneous country. Therefore, all-India measures tend to blur differences across states. One effect of post-1991 reforms has been to shift the focus of policy change, and policy hindrance, to the level of the states. Consequently, some states have reformed faster than others and some states have grown faster than others. Some states are economically more free than others. Consequently, economic freedom exercises need to focus on these inter-state differences. There have been regional reports on economic freedom, such as those for North America, Latin America, the Arab world and Francophone countries. But more important are sub-national reports identifying which states have more or less economic freedom. There have been a few such reports, such as the economic freedom index for the provinces of Argentina,10 the index of economic freedom for the European Union and the Italian regions11 and the marketisation index of Chinese provinces.12 To return to the point made about China earlier, it is irrelevant to say that China has a low level of economic freedom: freedom has been improving over the years. There is a great deal of disparity between China’s coastal provinces and internal areas. Indeed, China’s coastal provinces have higher levels of economic freedom than many countries perceived to have high levels of economic freedom.13

This study on India follows earlier work done by two of the authors. The first such study was published in 2004,14 the second in 2005,15 the third in 200616 and the fourth in 2008.17 There was also a parallel exercise that correlated economic freedom in states with the legal infrastructure.18 The methodology has evolved over a period of time, through presentations and consultations at workshops and seminars, and is now fairly robust. While based on Economic Freedom of the World, it needed to be modified to draw out differences between states. For instance, there was not much

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12. Published by the National Economic Research Institute of China.
13. This point has been made in Louw et al. (2008).
point in including Central government subjects. Accordingly, the *Economic Freedom of the World* methodology was modified to cover only three heads: (1) size of government (expenditures, taxes and enterprises); (2) legal structure and security of property rights; and (3) regulation of labour and business. *Economic Freedom of the World* uses subjective data in cross-country comparisons, such as responses to questionnaires. No such comparable databases exist in India, save for specific cities rather than state as a whole.\(^{19}\) Even where such data are available, they can be used meaningfully only if they are available for all states for which the ranking is being done. This constrains our exercise to objective data alone, and limits our choice of variables to those for which comparable data exist across states. Other variables may also be important for measuring economic freedom, but we do not have the necessary data.

All the variables are structured such that a higher value implies more economic freedom. This often requires the inversion of well-known ratios. Accordingly, in the first area of size of government, the variables included are: (1) the inverse of government revenue expenditure as a ratio of gross state domestic product (GSDP); (2) the inverse of administrative GSDP to total GSDP; (3) the inverse of government employment to total organised employment;\(^{20}\) (4) the inverse of state taxes on income as a ratio of GSDP; (5) the inverse of state taxes on property and capital transactions as a ratio of GSDP; (6) the inverse of taxes on commodities and services as a ratio of GSDP; and (7) the inverse of the stamp duty rate. In including each of these variables, the fundamental premise is that the lower the government’s importance and intervention, the better it is from the point of view of economic freedom. In the second area of legal structure and security of property rights, the variables included are: (1) the ratio of the total value of property recovered to the total value of property stolen; (2) the inverse of vacant posts in the judiciary to the total number of sanctioned judicial posts; (3) the inverse of total number of cases under economic offences to the total number of cases;\(^{21}\) (4) the percentage of cases where investigations were completed by the police; (5) the percentage of cases where trials were completed by the courts; and (6) the inverse of violent crimes as a ratio of total crimes. In including each of these variables, the fundamental premise is that ensuring law and order and justice and protecting property is a core governance area. Finally, in the third area of regulation of labour and

\(^{19}\) The World Bank’s doing business indicators is a case in point.

\(^{20}\) There is a substantial chunk of unorganised sector employment in agriculture. Almost all government employment is in the organised sector.

\(^{21}\) These economic offences are under special and local laws and all of them represent unnecessary state intervention in individual rights.
business, the variables included are: (1) the average wage of unskilled workers as a ratio of the minimum notified agricultural wages;\(^{22}\) (2) the inverse of man-days lost in strikes and lock-outs as a ratio of the total number of industrial workers;\(^{23}\) (3) the inverse of the minimum licence fee for traders; (4) the implementation rate of Industrial Entrepreneurs’ Memorandum (IEM);\(^{24}\) (4) the inverse of power shortage as a percentage of total demand;\(^{25}\) and (5) the inverse of cases pending investigation from the earlier year on cases registered under prevention of corruption and related acts as a ratio of the total number of cases registered under such acts. In this category, the inclusion of variables primarily reflects state intervention in labour markets and bureaucratic and procedural costs, including those on physical infrastructure like power. There is little or nothing on credit, which is overwhelmingly a Central government subject. All the variables are normalised, to enable comparison between states that vary enormously in size (area and population).

For each of these three heads, the variables are then aggregated using principal components analysis (PCA). That is, for each head, one obtains a score and a rank for each state. The scores drive the ranks and the scores permit a state’s performance to be tracked over time and the tables give the results for two points in time, 2005 and 2009. Data limitations permit the exercise to be done only for 20 states, the major ones.

As regards size of government, the top three states in 2009 are Gujarat, Jharkhand and Haryana, in that order, and the bottom three states are Uttarakhand, Chhattisgarh and Uttar Pradesh, in reverse order. Jharkhand may seem to be a bit of a surprise. But the point is that Jharkhand has witnessed high economic growth without a concomitant increase in the size of the government, something that characterises all the better-performing states under this head. In legal structure and security of property rights, the top three states in 2009 are Tamil Nadu, Madhya Pradesh and Andhra Pradesh, in that order, and the bottom three states are Bihar, West Bengal and Assam, in reverse order. Madhya Pradesh’s inclusion in the top bracket may seem to be a bit of a surprise. However, Madhya Pradesh has fewer economic offences and its completion rate on trials is fairly good. On regulation of labour and business, the top three states in 2009 are Gujarat, Andhra Pradesh and Tamil Nadu, in that order, and the bottom three states are Chhattisgarh, Bihar and Punjab, in

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22. Male and female.
23. Strikes and lock-outs result from dysfunctional state intervention in industrial relations.
24. When there are high bureaucratic and procedural costs, the implementation rates are lower.
25. This results from low public investments or low private sector generation, and both are policy-induced.
reverse order. Punjab’s inclusion in the bottom league is a bit surprising. But the fact remains that Punjab has been riding on its earlier successes and its present track record on governance, broadly defined, is anything but satisfactory.

The three heads are then aggregated to obtain an overall score and ranking for each state. In doing this, equal weights are used. The top three states in 2009 are Tamil Nadu, Gujarat and Andhra Pradesh, in that order, and there are no great surprises in this listing. The bottom three states, in reverse order, are Bihar, Uttarakhand and Assam. What is worrying is that between 2005 and 2009, not all states have exhibited an increase in economic freedom. Andhra Pradesh and Gujarat show large increases in economic freedom, while Haryana, Tamil Nadu, West Bengal, Rajasthan and Jammu & Kashmir show moderate increases in economic freedom. But on the flip side, Madhya Pradesh, Orissa, Uttarakhand, Punjab and Himachal Pradesh show large declines in economic freedom, while Maharashtra, Kerala, Bihar, Jharkhand, Karnataka, Uttar Pradesh, Assam and Chhattisgarh show moderate declines in economic freedom. Clearly, on their own, governments are reluctant to cede economic freedom to citizens. And despite the euphoria over reforms, countervailing citizen pressure that can trigger change has not yet manifested itself adequately. As is only to be expected, states with higher levels of economic freedom tend to perform better across a range of economic variables. And, as is also to be expected, states with higher levels of economic freedom are associated with higher levels of in-migration, while states with lower levels of economic freedom are associated with higher levels of out-migration. Unfortunately, the migration option is not one that is available to everyone. Therefore, the countervailing pressure to make state governments change needs to be exerted. That requires information dissemination and this study is a contribution towards that end.

26. We experimented with PCA weights too. But there was not much of a difference, so the equal weight results are being reported.