Economic Freedom through Economic Reforms[1]

I am extremely grateful to the Indian Economic Association and also the National Stock Exchange of India Limited for giving me this opportunity to pay my obeisance to Dr. Ramachandra H. Patil. I had the privilege of working under his guidance, but I remember him as a friend and a philosopher who deeply influenced me.

Dr. Patil was one of India's leading practitioners of Economics, particularly of Financial Economics. More importantly, he built a set of fine institutions of post-liberalisation India, yet remained largely an unsung hero. In this memorial lecture for Dr. Patil, I wish to touch upon the following four aspects to trace the provision and promotion of economic freedom since early 1990s:

I. Dr. Patil as an institution builder;

II. Context to the Institutions built by Dr. Patil;

III. Ongoing reforms in the financial markets; and

IV. A possible new role for economists.

I. Dr. Patil: An Institution Builder

Why does an economy develop, while another, though similarly endowed, does not? It has been a puzzle for economists for centuries. Most believe that an economy develops because it has better human resources, financial resources, technology, etc. But why does an economy accumulate such resources and another does not? Why do similar policies yield different outcomes in different economies? Take the example of North Korea and South Korea. These two countries are separated just by an imaginary military demarcation line. The per capita GNP of South Korea is about 20 times of that of North Korea. What explains such difference? While resources - human, financial, technology and so on - are proximate drivers of growth, institutions are deeper determinants or the ultimate drivers of growth and consequently quality of life. In their book "Why Nations Fail?", Acemoglu and Robinson exemplify that a key

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differentiator among nations is the quality of their institutions. Every enquiry into the causes of wealth has reinforced that institutions do matter.

Institutions are broadly of two categories, namely, institutional environment and institutional arrangement. The institutional environment essentially refers to the rules of the game. They define the contours of freedom of economic agents, protect their rights, enforce their obligations, and thereby bring in predictability of their actions and certainty of outcomes. The institutional arrangement, on the other hand, refers to the organizations that develop, modify, administer and enforce the institutional environment and thereby determine the relationship among the participants. Both forms of institutions are equally important and complement each other. Let me give an example of each category of institutions built in modern India.

An example in the first category (institutional environment) is the screen based trading system in the securities market. This is an online, anonymous, order driven trading system, which enables a person to punch into the computer quantities of securities and the prices at which he or she likes to transact. The transaction is executed as soon as it finds a matching order from a counter party. This system is vastly superior to what was there till early 1990s when trading was accessible only to participants present in a trading hall. It yields a number of efficient economic outcomes. Significantly, it

- matches orders electronically on a strict price-time priority and hence cuts down on time, cost and risk of error, as well as of fraud, and eliminates discretion in order matching, thereby resulting in improved operational efficiency;

- allows faster incorporation of price sensitive information into prevailing prices, thus increasing the informational efficiency of markets;

- enables market participants to see the full market on real-time basis, making the market transparent;

- provides full anonymity by accepting orders, big or small, from persons without revealing their identity, thus providing equal access to everybody; and

- allows a large number of participants, irrespective of their geographical locations, to trade with one another simultaneously, improving the depth and liquidity of the market.

An example in the second category (institutional arrangement) is the stock exchange. Traditionally, brokers used to not only own and govern an exchange, but also trade securities on trading platform provided by the exchange. An exchange pursues broadly two sets of interests: (a) public interests, such as market integrity, encompassing the interests of investors, the market and the society, and (b) private interests, such as turnover, encompassing the interests of brokers, shareholders and employees. It is not easy to promote both interests simultaneously. An initiative undertaken by an exchange may not always further both the interests; worse, it may advance one, while hurting the other. Further, an exchange may be prejudiced to adopt measures that give precedence to one interest over the other. Mitigation of such conflict necessitated a transformational institutional arrangement (underlying the stock exchange), called 'demutualization of exchanges' - that entailed segregation of ownership rights and trading rights. This segregation, for the first time, gave a person a choice to have either or both of these rights. This allowed pursuit of public interests and private interests separately and separation of commercial responsibilities of the stock exchanges from their regulatory responsibilities. This made trading rights available on tap, and reduced the influence of the brokers in the governance of the exchanges and thereby, addressed conflict of interests to a large extent.

The institutional environment of screen based trading and the institutional arrangement of demutualisation of exchanges have now become the norm. Recognizing their merits, the regulator has mandated both. Everyone takes pride in these institutions today. These laid the foundation for deeper reforms such as dematerialisation of securities and ultimately led to the transformation of the equity markets in India. The credit for these two institutions goes largely to Dr. Patil. Apart from these, he had also played a catalytic role in building other market institutions such as Central Counter Party, National Securities Depository Limited and Clearing Corporation of India Limited, which I shall not elaborate on because of paucity of time.

Let me now briefly turn to Dr. Patil's role as a practitioner of Economics. The economists often praise the virtues of perfect competition; they theorize models assuming perfect competition, but rarely, have they seen or experienced it. The search for perfect competition has proved to be as elusive as 'search in a dark room for a black cat which may not be there'. The institutions (screen based trading system and demutualisation of stock exchanges) built by Dr. Patil, who in a sense epitomized a practising economist, probably gave us the closest experience of a perfect competition.

So what are the characteristics of perfect competition? Let us examine.

(a) Free entry and free exit: A person is free to enter into and exit from the market - an investor can buy securities and equally freely, sell securities, a broker can register and surrender registration, a company can list and delist securities; etc. - they have unfettered freedom to get in and get out.

(b) Large number of market participants: There are numerous investors - domestic and foreign, retail and institutional, small and big - who buy and sell securities simultaneously. So also, there are numerous issuers of securities and numerous intermediaries (service providers).

(c) Perfect information: Every participant has almost perfect information. Every issuer makes a disclosure of full and accurate information about itself, its securities, and the rules governing transactions of such securities, based on which investors take informed decisions and assume responsibility for the same. Issuers also make continuous disclosures as long as their securities remain listed on stock exchanges. Intermediaries are also obliged to make disclosures.

(d) Everybody is a price taker: No participant has the market power to set the price of the securities, or even influence the price of securities.

The institutions built by Dr. Patil provided the foundations of a market economy and allowed the invisible hands of the market to determine the outcomes.

II. Context to the Institutions

Dr. Patil built these institutions when these were needed the most. It was in early 1990s when India, as part of comprehensive economic reforms, made a decisive paradigm shift from State provision of goods and services to State regulation for provision of goods and services by market. The thrust of the reforms since then has been provision of economic freedom and building institutions to promote and protect such freedom and regulate such freedom only to address market failure(s). India has been enacting a new genre of economic laws, which expand ‘who, what and how to do’ list and repealing enactments that restricted participation such as the Capital Issues (Control) Act, 1947 and the Import and Export (Control) Act, 1947. This expanded the contours of economic freedom and consequently the frontiers of development.

The index of economic freedom, which measures the degree to which the policies and institutions of countries are supportive of economic freedom, has substantially improved for India since the 1990s. The outcome has been astounding; the growth rate since the 1990s has almost doubled as compared to the *Hindu rate of growth* in the preceding period.

Freedom brings out the best in every person, individual or firm. It is well established that economic freedom and performance have very high positive correlation. Countries having higher level of economic freedom generally enjoy higher levels of economic well-being. Depending on the level of economic freedom that participants enjoy at market place, an economy has either of the two broad types of institutions, namely, inclusive institutions or extractive institutions. The inclusive institutions allow everybody to participate in making of the economy. These allow every person to undertake any economic activity or business of his/her choice in the manner and scale he/she is comfortable with. These unleash and realise the full potential of a person to innovate, invest and contribute to the economy. On the other hand, extractive institutions concentrate power and opportunity in the hands of a few or use energy and creativity of a small set of persons. Obviously, an economy with inclusive institutions triumphs over an economy with extractive institutions, as the contribution of all exceeds the contribution of some. Consequently, one of the primary duties of the State is to provide the right institutional milieu to bring out the best from her people.

Market needs freedom broadly at three stages of a business - to start a business (free entry), to continue the business (free competition) and to discontinue the business (free exit). This enables new firms to emerge continuously; and the firms do business when they remain efficient, and vacate the space when they are no longer efficient. This ensures free flow of resources from inefficient uses to efficient uses - the first stage ensures allocation of resources to the most efficient use, the second stage ensures efficient use of resources allocated, and the third stage ensures release of resources from inefficient uses for fresh allocation to efficient uses - and consequently the highest possible growth.

The 1990s focussed on freedom of entry by dismantling the license-permit-quota Raj. The securities market became the torch bearer of reforms, thanks to institutions built by Dr. Patil. Let me illustrate freedom of entry in securities market. Earlier, the number of brokers on a stock exchange was limited to a pre-specified number, which was decided by the owners of the exchange. The size of the trading hall had a great bearing on this decision. A person could become a broker only if another surrendered. Consequently, broking license carried a huge

premium. The screen based trading system expanded the market place from a trading hall to the entire world and thereby removed the limit on the number of brokers. Broking became available on tap. Anybody who met the specified eligibility requirements was entitled to registration. If registration was to be denied, it had to be determined by a reasoned order and that order was made appealable. That is how the move from license to registration ensured freedom of entry. Further, entry requires many facilitators. For instance, one can enter into a business only if it has resources. Accordingly, the securities laws allowed him, subject to meeting the eligibility requirements, to access the securities markets without requiring any approval from any authority.

The reforms then shifted focus to freedom of doing business. To ensure that freedom granted in the first phase of reforms is not misused and to avoid market failure, restraints had to be placed on economic agents. One has freedom to do business, but not to obstruct the freedom of others to do so. At market place, one can restrain freedom of others by taking control of either price and or quantity. For instance, if a business adopts predatory pricing and has the financial muscle to sustain it, it effectively thwarts the competitors' freedom to do business. India came up with laws such as the Competition Act, 2000 that proscribed predatory pricing to protect freedom of firms. The Act also provided level playing field to all firms; for example, it treated a State owned firm at par with a private firm, unlike the erstwhile Monopolies and Restrictive Trades Practices Act, 1969. Further, institutions that support freedom such as competitive neutrality, contract enforcement, etc. were strengthened.

The reforms process of the 1990s transformed the equity markets in India. Dr. Patil then helped shift the focus of policy makers to the debt market. He played a key role in the development of G-sec market. India's G-sec market today is no less developed than that in any other emerging market. Dr. Patil also started looking at the corporate debt market, which unfortunately is still at a nascent state. Many rightly believe that the debt market in India significantly lags behind the equity market in terms of liquidity and vibrancy. Within the debt market, unsecured debt and non-bank debt are negligible. What ails the corporate bond market? Even though economists have very diverse views on this, there is a general consensus that the absence of a well-functioning insolvency and bankruptcy regime has discouraged debt financing by lenders other than bankers who have some legal protection.

III. Ongoing Reforms in Financial Markets

Consider a firm that has freedom of entry and freedom to do business. It may, however, fail to deliver as planned, for a variety of reasons. It could be because of faulty conceptualisation of business, inefficient execution of business, change of business environment, or even *mala fide* design in rare cases. Regardless of the reason, the failure impacts macro economy in multiple of ways and needs to be addressed expeditiously. Such failures usually manifest themselves as default in repayment obligations, indicating the firm in question in a state of insolvency. Default could arise also from a mismatch between cash inflows and outflows. Default is the result of either illiquidity or insolvency and is often a legitimate outcome of business operations. It does not necessarily warrant the closure of a business, which destroys organizational capital. To resolve insolvency in an orderly manner, an appropriate mechanism was necessary. The absence of such a mechanism hitherto cost the economy dear in a number of ways. For example, it denied effective recourse to lenders to recover their debt and thereby discouraged them from lending to genuinely viable projects. In addition, low and delayed recovery pushed up the cost of lending, and consequently, fewer projects became viable.

In some cases, however, it is neither possible nor desirable to resolve insolvency of firms. In a market economy, efficient firms drive out inefficient firms continuously from the market as a part of creative destruction. It is necessary to have a mechanism whereby the inefficient or defunct firms vacate the space and release the idle resources for efficient uses. In the absence of an effective mechanism hitherto, quite a few firms are stuck in unsustainable business or with idle assets and no business. The Economic Survey 2015-16 compares this situation to the '*Chakravyuaha'* of *Mahabharata,* and has documented the cost of such impended exit thereby illustrating the opportunity cost of not allowing *'creative destruction'* in an otherwise dynamic economy.

It has been a paradox that an economy which allowed free entry and free competition did not permit free exit for so long. In fact, freedom of entry is not complete in the absence of freedom of exit. Often non-availability of an orderly and honourable exit deters a person to get in. The Insolvency and Bankruptcy Code, 2016 provides this much needed freedom of exit. It offers a market determined, time bound mechanism for orderly resolution of insolvency, wherever possible, and ease of exit, wherever required, that is, where resolution is not possible under the circumstances. It would ensure optimum utilisation of resources all the time, either by ensuring optimum utilisation within the firm through resolution or release unutilised and underutilised

resources from a firm for fresh allocation through exit. Assume, in the absence of farm data, about 20% of India's resources is unutilised. Utilisation of 80% resources yields a growth rate of 7%. If the Insolvency and Bankruptcy Code, 2016 can utilise 100% of resources all the time at their optimum, the growth rate can be 9%, *ceteris paribus*. Further, the Code enables every person - individual or firm – to join mainstream and get out at his convenience and, therefore, ensures inclusive growth.

The insolvency and bankruptcy regime, which covers all types of lenders and borrowers, whether individuals or corporate, is currently under implementation. The provisions relating to corporate insolvency resolution and liquidation have just come into force. The ecosystem comprising Insolvency Professionals, Insolvency Professional Agencies, Insolvency and Bankruptcy Board of India and National Company Law Tribunal are in place. The mechanism contemplates minimal role for the State. The State does not examine the merits of a transaction (resolution plan); it only ensures that due process is followed. The mechanism empowers the stakeholders to undertake transactions and puts the entire process under their control. To make it happen in time-bound manner, it makes certain institutional facilities available. It provides for insolvency professionals, who would guide the stakeholders throughout the process and information utilities which would be the storehouse of relevant information that one needs for a transaction. It also provides a calm period, technically known as moratorium, during which nobody would disturb the firm undergoing resolution. It provides for interim finance wherever required. Most importantly, it requires the resolution process to be completed within 180 days, as with passing time, the organisational capital may decay and resolution could more be difficult.

Another source of debt funds for firms is external commercial borrowing. There were several restrictions on firms as to who can borrow, for what purposes, on what terms, etc. One could borrow up to $ X for a particular purpose and up to $ Y for another purpose. Even the amount of borrowing was different for the same purpose depending on the source of borrowing or the type of borrower. Most of these restrictions were brought in to meet the specific needs of the hour and have outlived their utility. Many of them did not address any market failure, but restricted freedom of the firms and deprived them of the lowest possible cost of capital, domestic or foreign, for financing projects. Just as trade reforms have allowed Indian firms to buy the cheapest goods available globally, financial reforms should allow Indian firms to obtain the cheapest capital available on a global scale.

Every firm takes on various risks in the course of its business, and some of these risks materialise and generate losses. Generally speaking, losses made by individual firms, and consequent failure of some of them are of little concern. The same, however, is not always true. Consider a situation, where a large number of firms, who undertake foreign currency borrowing, do not hedge their currency exposure. There is clearly a possibility of correlated failure of these firms in the event of a large and adverse exchange rate movement, which may have systemic risk. This can be addressed by requiring firms borrowing in foreign currency to hedge their exchange risk exposure. Of course, those who enjoy natural hedges against currency fluctuations need not worry. Firms not enjoying natural hedges need to use financial derivatives such as currency futures, currency options, etc. to hedge their currency exposure. In addition, rupee denominated debt, which do not carry any systemic risk, could be issued in offshore market. The recent policy changes have substantially softened various restrictions, while requiring hedging for most of the borrowing and allowing issue of rupee denominated bonds, popularly known as masala bonds, to persons resident outside India. So, instead of restricting freedom of firms to borrow from abroad, the policy created market incentives to manage risks with such borrowing or to access alternate funding.

IV. Additional Role for Economists

Through ages, human civilisation has valued freedom and built institutions to preserve and protect it. Our Constitution, for example, as stated in its preamble, secures liberty for all its citizens. It secures liberty of thought, expression, belief, faith and worship, typically referred to as 'civil liberty', mostly through the fundamental rights such as rights to freedom of speech and expression, right to life and liberty, right to freedom of religion, etc. These are inviolable; the judiciary very zealously guards them. Only under extraordinary circumstances, these can be restricted, to a limited extent. Over time, India has developed reasonable institutional capacity to sustain civil liberty. In contrast to civil liberty, economic liberty is of recent vintage; so also organs of the State - the regulators and regulatory tribunals - who deal with this. It is yet to acquire sophistication and sacrosanctity. It is provided or curtailed relatively easily depending on the contemporary economic thought and philosophy and sometimes, even regardless. Take the example of right to property which used to be a fundamental right some time ago. It is not so now. As stated earlier, many statues which restricted, or even denied economic liberty have been repealed and many others modified in sync with a shift from the command and control regime to a market based regime founded on economic liberty.

There is an important distinction between civil liberty and economic liberty. Civil liberty is almost entirely black and white; while economic liberty is many shades of grey. It is so because the economic liberty is the domain of both economics and law. The determination of an issue relating to economic liberty in a given context requires that all possible legal perspectives are taken into account from all possible economic angles. Let me illustrate this with a story. Four persons who had received show cause notices from the competition authority were discussing as to what caused them their predicament. The first person said he charged a price higher than others in the market and has been accused of abuse of market power. The second one said he charged a price lower than anybody else and has been accused of predatory pricing and hurting competition. The third one said he charged zero price and has been accused of creating entry barrier. The last one said he charged the very same price as everybody else and has been accused of cartelisation.

Thus, different conducts such as high price, low price, zero price and even the same price can invite the same outcome under economic laws and the same conduct may yield different outcome in different 'contexts'. Also, there are contexts, where a seemingly wrongful conduct may attract no penalty or indeed may even yield an award. For example, a person, who charges a negative price (example: 'liquidity enhancement programme' of stock exchanges which rewards brokers, instead of charging them for using the exchange platform, on the ground of enhancing liquidity), may go scot free or even be appreciated for promoting competition. So, it is not so much the conduct, as the context - who, why, when, what, where and how - of the conduct that matters. This is the genesis of the 'rule of reason' to guide economic liberty. Further, determination of context relies heavily on economic inputs. Depending on the skill of the user and the kind of economic inputs and tools he uses, the same conduct can yield different outcomes in the same context. This has the danger of ending up more often with either false negatives or false positives in a given context. Punishing a false negative is most damaging to economic liberty.

It is, therefore, necessary to have institutional capacity within the State, particularly regulators and tribunals, and among professionals and market participants for sustenance of economic liberty. Let me illustrate by comparing the questions that arise in case of murder (infringement of civil liberty) vis-à-vis 'market abuse', a violation of economic liberty. In case of an alleged murder, the first question facing the investigators is whether the death is natural or unnatural. Medical science answers this question with reasonable precision. The role of State is limited to

finding out as to who caused the death and gather evidence on the same. This is relatively easier to settle as compared to abuse of dominant position. Abuse means imposing an unfair price or condition. What is unfair to one may not be so to another. What is unfair in the morning may not be so in the afternoon. A conduct otherwise unfair is not unfair if it is adopted to meet competition. Therefore, determination of whether a particular conduct is unfair and, therefore, abuse in a given context becomes difficult needing considerable technical dexterity.

Further, who killed, who was killed, where he was killed, what was the effect of killing, etc. are of little relevance to establish the guilt in the case of murder. On the contrary, who abused the market is material. Only if a dominant player has abused, it is an offence and not, otherwise. One has to take the pains of figuring out the relevant market first and then determine whether the player is dominant in that market. That is why the laws relating to civil liberty prohibit murder, whether it is by X or Y, while economic laws prohibit certain conduct by dominant players only. Similarly, while one does not need to assess the effect of murder, one needs to assess the effect of a particular conduct on the market, which could be positive or adverse or non-existent. And to constitute an offence, that effect must be appreciable and has to be balanced with any positive effect it may have. The economic laws thus allow greater latitude to market participants and the authorities than the laws relating to civil liberty. While no one, not even the State, can encroach civil liberty, the State as well the market participants may encroach economic liberty in certain contexts, and yet not violate the law.

The determination of context - the determination of abuse, dominant position, relevant market, etc. - requires institutions to be adept in appreciating and using economic inputs and tools. The regulators and tribunals should have access to such inputs and tools while determining an issue under economic laws. The easiest means of access is representational services. Along with other professionals such as chartered accountants, cost and management accountants, company secretaries, and advocates, economists should be allowed to provide representational services. In addition to teaching, research, consultancy, analysis, etc. economists could consider *practising* economic laws. In the long run, academics should produce economic lawyers or legal economists who specialise in economic law practice. This will go a long way towards fostering economic liberty. Thank you for your kind attention.