

Strengthening Free Enterprise in India

Dr. Raghuram G. Rajan
(Governor, Reserve Bank of India)

**The Thirteenth Nani A. Palkhivala
Memorial Lecture**

February 2016



Published by
Nani A. Palkhivala Memorial Trust

NANI A. PALKHIVALA MEMORIAL TRUST

We hardly need to introduce you to the life and work of the late Nani A. Palkhivala. He was a legend in his lifetime. An outstanding jurist, an authority on Constitutional and Taxation laws, the late Nani Palkhivala's contribution to these fields and to several others such as economics, diplomacy and philosophy, are of lasting value for the country. He was a passionate democrat and patriot, and above all, he was a great human being.

Friends and admirers of Nani Palkhivala decided to perpetuate his memory through the creation of a public charitable trust to promote and foster the causes and concerns that were close to his heart. Therefore, the Nani A. Palkhivala Memorial Trust was set up in 2004.

The main objects of the Trust are the promotion, support and advancement of the causes that Nani Palkhivala ceaselessly espoused, such as democratic institutions, personal and civil liberties and rights enshrined in the Constitution, a society governed by just, fair and equitable laws and the institutions that oversee them, the primacy of liberal economic thinking for national development and preservation of India's priceless heritage in all its aspects.

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Miss S. K. Bharucha, *Trustee*

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INTRODUCTION

The Nani A. Palkhivala Memorial Trust was privileged to have Dr. Raghuram Rajan, Governor, Reserve Bank of India, deliver the Thirteenth Nani A. Palkhivala Memorial Lecture on 4th February 2016, on the subject “*Strengthening Free Enterprise in India*”.

The success of the economic reforms of 1991 have conclusively established for most Indians the benefits of free enterprise and that is no longer a subject for discussion. It is also now generally accepted that free enterprise encourages the growth of small firms and that they play a significant role in growth and employment. However, while arguing that the possibilities for free enterprise in India today are better than ever before, Dr. Rajan explores a hitherto neglected aspect of free enterprise, namely that the mere existence of small firms in the economy is not sufficient and growth and employment results only when the business environment in which they operate enables them to grow bigger.

Tracing the path of economic growth in Italy and in the United Kingdom, Dr. Rajan notes that while Italy had a larger number of small firms it also had more regulation and inspection while regulation was lighter in the United Kingdom. Consequently while small firms in Italy remained small, they grew bigger much faster in the United Kingdom, leading to a stronger economic growth.

Dr. Rajan has explored in greater detail the four essential features which he believes the business environment must contain. These are first, a level playing field with easy entry and exit, second, the protection of property rights, third, a broad access to the capabilities that allow individuals to function in society and finally, a basic safety net. To this Dr. Rajan has added an important corollary. While it is important that the environment must allow

enterprises to grow, it is equally important that it permits the orderly demise of those enterprises which have failed. This is important, because in the absence of such an environment, the scarce resources of the nation will be wasted and their use denied to enterprises which can use them more productively.

To the elements outlined by Dr. Rajan, we can perhaps add one more, namely, good governance. One of our most perceptive political leaders, C. Rajagopalachari, has recorded in a diary which he maintained when he was jailed in the 1920s, that:

“We all ought to know that Swaraj will not at once or, I think for a long time to come, be better government or greater happiness for the people. Elections and their corruptions, injustice and the power and tyranny of wealth and inefficiency of administration will make a hell of life as soon as freedom is given to us. Men will look regretfully back to the old regime of comparative justice and efficient, peaceful, more or less honest administration. The only thing gained will be that as a race we will be saved from dishonor and subordination.”

Many small business will echo Rajaji’s harsh comments. What is for them a matter of concern is not merely bad laws; it is even more, the manner in which these laws are administered.

The essential elements of an environment which strengthens free enterprise identified by Dr. Rajan find support in many writings by economic analysts. Thus, in **“Why Nations Fail”** Daron Acemoglu and James A. Robinson, after examining the growth paths of a wide range of nations, conclude that growth had been strongest in those nations where political rights are more broadly distributed, where the Government is accountable and

responsible to citizens and where the great mass of people could take advantage of economic opportunities. Similarly in “**Civilization**” the six killer applications identified by Niall Ferguson, that enabled the West to colonise the rest of the world, include competition and the role of law and representative government.

Dr. Rajan’s brilliant lecture is both visionary in its approach and comprehensive in its content and provides almost a blue-print for growth. This should make it compulsory reading for all our legislators. It also has great relevance for our business leaders and for the apex bodies of industry because, as Dr. Rajan has pointed out, business has to increasingly put its weight behind how we can move forward to create a free enterprise system that is not merely looking for specific benefits to a few but that benefits all. It is with this hope that the Nani A. Palkhivala Memorial Trust is printing this important lecture and will give it the widest public distribution.

Y.H. Malegam

Chairman

March 3, 2016

Nani A. Palkhivala Memorial Trust



NANI A. PALKHIVALA

16th January 1920 - 11th December 2002

NANI ARDESHIR PALKHIVALA

In 1972-73 the full Bench of thirteen judges of the Supreme Court of India heard with rapt attention a handsome lawyer argue for five months before them that the Constitution of India, which guaranteed fundamental freedoms to the people, was supreme, and Parliament had no power to abridge those rights. The Judges peppered him with questions. A jam-packed Court, corridors overflowing with members of the Bar and people who had come from far-away places just to hear the lawyer argue, were thrilled to hear him quote in reply, chapter and verse from the U.S., Irish, Canadian, Australian and other democratic Constitutions of the world.

Finally came the judgment in April 1973 in *Kesavananda Bharati v. State of Kerala*, popularly known as the *Fundamental Rights case*. The historic pronouncement was that though Parliament could amend the Constitution, it had no right to alter the basic structure of it.

The doyen of Indian journalists, Durga Das, congratulated the lawyer: "You have salvaged something precious from the wreck of the Constitutional structure which politicians have razed to the ground." This "something precious" - the sanctity of "the basic structure" of the Constitution - saved India from going down the totalitarian way during the dark days of the Emergency (1975-77) imposed by Mrs. Indira Gandhi.

Soon after the proclamation of the Emergency on 25th June 1975, the Government of India sought to get the judgment reversed in an atmosphere of covert terrorization of the judiciary, rigorous press censorship, and mass arrests without trial, so as to pave the way for the suspension of fundamental freedoms and establishment of a totalitarian state. Once again, braving the rulers' wrath, this lawyer came to the defence of the nameless citizen. His six-page

proposition before the Supreme Court and arguments extending over two days were so convincing, that the Bench was dissolved and the Court dropped the matter altogether. Commented a Judge: “Never before in the history of the Court has there been a performance like that. With his passionate plea for human freedoms and irrefutable logic, he convinced the Court that the earlier Kesavananda Bharati case judgment should not be reversed.”

This man who saved the Indian Constitution for generations unborn, was Nani Ardeshir Palkhivala. His greatness as a lawyer is summed up in the words of Justice H.R. Khanna of the Supreme Court: “If a court were to be made of the ten topmost lawyers of the world, I have no doubt that Mr. Palkhivala’s name would find a prominent mention therein”. The late Prime Minister, Morarji Desai, described him to Barun Gupta, the famous journalist, as “the country’s finest intellectual”. Rajaji described him as, “God’s gift to India”.

Nani A. Palkhivala, was for four decades one of the dominant figures in India’s public life. An outstanding jurist, redoubtable champion of freedom and above all a great humanist.

Born on 16th January 1920, Nani Palkhivala had a brilliant academic career. He stood first class first in both his LL.B., (1943) exams and in the Advocate (Original Side) Examination of the Bombay High Court.

Nani Palkhivala was Senior Advocate, Supreme Court of India; Professor of Law at the Government Law College, Mumbai; Tagore Professor of Law at the Calcutta University; and a Member of the First and Second Law Commissions. He was elected in 1975 an Honorary Member of the Academy of Political Science, New York, in recognition of his “outstanding public service and

distinguished contribution to the advancement of political science.”

Nani Palkhivala argued a number of historical cases in the Courts of India and abroad, including the cases between India and Pakistan before the U.N. Special Tribunal in Geneva and the International Court of Justice at the Hague.

He authored a number of books including *The Law and Practice of Income-Tax*, a monumental work, which is the definitive treatise on the subject. His other books included *Taxation in India*, published by the Harvard University in the *World Tax Series*; *The Highest Taxed Nation in the World*; *Our Constitution Defaced and Defiled*; *India's Priceless Heritage*; *We, the People and We, the Nation*.

His expositions on the Union Budget in Mumbai and other places were immensely popular and attracted attendance in excess of 1,00,000. He eloquently espoused the cause for a more rational and equitable tax regime.

Nani Palkhivala was India's Ambassador to the U.S.A. from 1977 to 1979. He was in constant demand during this period and delivered more than 170 speeches in different cities, which included speeches in more than 50 Universities, on subjects as varied as Gandhi, the nuclear issue, human rights, India's foreign policy, civil liberties in India, Indian agriculture, apartheid and the Third World.

Two American Universities – Lawrence University, Wisconsin and Princeton University, New Jersey - bestowed honorary doctorates on him. Princeton was the first to do so on 6th June 1978. The citation reads:

“Defender of constitutional liberties, champion of human rights, he has courageously advanced his conviction that expediency in the name of progress, when at the cost of freedom, is no progress at all, but retrogression. Lawyer,

teacher, author and economic developer, he brings to us as Ambassador of India intelligent good humor, experience, and vision for international understanding. As we see the bonds of trust and respect grow between our two countries, Princeton takes pride in now having one of its own both in New Delhi and in Washington.”

Lawrence University honoured him with a doctorate of Laws on 28th March 1979. The citation said:

“What is human dignity? What rights are fundamental to an open society? What are the limits to political power? Ambassador Palkhivala, you, more than most, have pondered these great questions, and through your achievements have answered them.

As India’s leading author, scholar, teacher and practitioner of constitutional law, you have defended the individual, be he prince or pauper, against the state; you have championed free speech and an unfettered press; you have protected the autonomy of the religious and educational institutions of the minorities; you have fought for the preservation of independent social organizations and multiple centres of civic power.

As past president of the Forum of Free Enterprise and as an industrialist, you have battled stifling economic controls and bureaucratic red tape. You have always believed that even in a poor and developing country, the need for bread is fully compatible with the existence of liberty...

You are also an enlightened patriot and nationalist. You have successfully defended your country’s cause in international disputes before the special tribunal of the United Nations and the World Court at the Hague.

Never more did you live your principles than during the recent 19 month ordeal which India went through in what was called ‘The Emergency’. When those who had eaten

of the insane root, swollen with the pride of absolute political power, threw down the gauntlet, you did not bow or flinch. Under the shadow of near tyranny, at great risk and some cost, you raised the torch of freedom...”

In 1997 Nani Palkhivala was conferred the Dadabhai Naoroji Memorial Award for advancing the interests of India by his contribution towards public education in economic affairs and Constitutional law. In 1998 he was honoured by the Government of India with PADMA VIBHUSHAN. The Mumbai University conferred upon him an honorary Degree of Doctor of Laws (LL.D.) in 1998.

Nani Palkhivala was associated with the Tata group for about four decades. He was Chairman of Tata Consultancy Services, Tata International Ltd., Tata Infotech Ltd., A.C.C. Ltd., and Director of Tata Sons Ltd. He was President of Forum of Free Enterprise from 1968 till 2000, and Chairman of The A. D. Shroff Memorial Trust from 1967 till his death.

DR. RAGHURAM G. RAJAN

Dr. Raghuram Rajan took over charge as the 23rd Governor of the Reserve Bank of India on September 5, 2013. Prior to that, he was the Chief Economic Advisor, Ministry of Finance, Government of India and the Eric J. Gleacher Distinguished Service Professor of Finance at the University of Chicago's Booth School. He was also Chief Economist at the International Monetary Fund (2003-2006). Dr. Rajan had chaired the Indian Government's Committee on Financial Sector Reforms (2007-2008).

Dr. Rajan has attained his B.Tech (Elec.) degree from IIT, Delhi in 1985, MBA from IIM, Ahmedabad in 1987 and Phd from MIT, US in 1991.

His work spans a broad range of areas in financial economics, most important to the development of economies worldwide, ranging from the central role of banks in creating liquidity and the role of finance in economic growth to the nature of corporations and their financing. He co-authored, ***“Saving Capitalism from the Capitalists”*** with Luigi Zingales in 2003. He then wrote ***“Fault Lines: How Hidden Fractures Still Threaten the World Economy”***, for which he was awarded the Financial Times-Goldman Sachs prize for best business book in 2010.

Dr. Rajan is a member of the Group of Thirty. He was the President of the American Finance Association in 2011 and is a member of the American Academy of Arts and Sciences. In January 2003, the American Finance Association awarded Dr. Rajan the inaugural Fischer Black Prize for the best finance researcher under the age of 40. The other awards he has received include the global Indian of the year award from NASSCOM in 2011, the Infosys prize for the Economic Sciences in 2012,

the Center for Financial Studies-Deutsche Bank Prize for Financial Economics in 2013, and the 'Central Bank Governor of the Year' Award by EuroMoney Magazine in 2014.

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I did not have the privilege of meeting Nani Palkhivala, but it is clear that every citizen of India has been affected by his life and his work, and owes him a tremendous debt of gratitude. Now I know you have already heard some of his lifetime achievements over the course of this evening. But let me repeat that he was not only a jurist of the highest calibre, but a tireless champion of constitutional liberties, of human rights and individual rights; of freedom not just of the individual, but economic freedom. As you know he fought the Kesavananda Bharati case that established the principle that the Indian Parliament cannot alter the basic structure of the Constitution. This by itself, as you know, would enshrine him as a founder of modern India. But he did much more. He stood up to the Emergency, one of the few voices raised against authoritarianism when the very character of Indian Democracy was in question. And recognising that political and economic freedom go

* *The author is Governor, Reserve Bank of India. The text is based on the 13th Nani A. Palkhivala Memorial Lecture delivered under the auspices of Nani A. Palkhivala Memorial Trust on 4th February 2016 in Mumbai.*

together, his regular post budget speech was attended by thousands, and listened to by millions in the country.

He was a lonely voice against the socialism, then practiced in India. He argued that it was a fraud, transferring wealth from the honest rich to the dishonest rich. He championed free enterprise. It bears remembering that he was Chairman of TCS – Tata Consultancy Services one of the brightest stars of the Indian economy today. No wonder Rajaji once called him God's own gift to India.

Towards the end of his life he did sour a little bit on the Indian experience. In a speech in Australia when he was dejected by the leak of the IIT entrance exam papers, reflecting in his mind the weakening of yet another once sacrosanct institution, he said, "I don't think India in its entire history of 5000 years has ever reached a lower level of degradation than it has reached now." But in that speech he also said that India always seems to find a way of coming out of the morass. I will argue in my talk that Nani Palkhivala's optimism about India eventually finding the way is probably more warranted today than his pessimism. Yes we have our weaknesses and our excesses. But our democracy is self correcting. And even while some institutions weaken, others come to the fore. And even though little men cast long shadows at sunset, the sun does rise in our country.

Indeed I will argue today, and that's the subject of my talk, that the possibilities for free enterprise in India today are probably better than ever before in its history. Now I don't have a written talk so bear with me.

I am going to talk you through my talk. And to start with, let me talk about the two conditions that historically have been thought of as important for free enterprise to flourish in society. The first is a level playing field with easy entry and exit. And the second is the protection of

property rights. I will discuss these two conditions, first, and then I will add two more that I think are important for free enterprise to be politically viable, especially in a poor country like ours. These are, third, a broad access to the capabilities that allow individuals to function in society, and, fourth, a basic safety net.

Let me come to these in just a bit, but let me start first with the first condition which is a level playing field with easy entry and exit. The idea behind Adam Smith's *The Wealth of Nations* was essentially that competition leads to efficient outcomes. And competition flourishes best when anyone can enter and compete. The best entity then wins, leading to economy wide efficiency. But this is not the main or I would say the only benefit of competition. It is not just that the best entity emerges. It is also that in this kind of structure we have the best chance of combating social prejudice and social biases. The RBI has a term *paisa bolta hai*. Translated into English, money talks. And is it not better in society to have money talking rather than social privilege talking, caste talking, religious background talking. Better that money, which the Romans used to say has no odour, talks than these other elements talk. In fact there is a very nice book by Devesh Kapur from Wharton talking about Dalit entrepreneurs. It's heart-warming how much social improvement can happen in a short time for entrepreneurs who set out and show the way to stand up and make money, and then let that money talk for them. But it's not just empowerment of entrepreneurs. To the extent that money empowers, I think the idea of direct benefit transfers is to give people the ability to use money to have choice, choice among different services. This creates competition between services so that the beneficiary does not just have to go to that single point of delivery which is monopolistic, which is slow, which

sometimes doesn't care for the beneficiary. He does not depend on charity, because he has the money power with which he can command the services of anybody anywhere. That I think is empowerment and to the extent that people can get that empowerment themselves standing up and competing, I think it creates social momentum and social progress.

Now there are many other virtues of free enterprise other than self respect, other than efficiency. But let me leave that for the moment and talk about the conditions that are needed to generate this. When people think of competition, free enterprise, they think of a world without rules. They think of a dog eat dog world. That's not true. For markets to work effectively, you need people like me, regulators to enforce the rules of the game. You need the government to set the rules of the game. These are very important. In well functioning markets there is an entire apparatus making sure that the market behaves, making sure that contracts are enforced, making sure that cartels aren't formed. So you need this entire government and regulatory structure. But the difficulty throughout history has been the very government regulatory structure that enforces rules of the game, can also bias the rules of the game to favour some against the others. And that defeats the whole concept of free enterprise in the market because then you don't have perfect competition or a strong competition. You have very biased and limited competition. You have the possibility of crony capitalism.

Now this is not just theory. In work that I have done with some people at the World Bank in the past, one thing which caught our interest was the fact that Italy had a lot of small firms. There is always the notion that small firms are dynamic, small firms are innovative. And so our thought was why doesn't Italy grow faster? What is going wrong in Italy? Lots of small firms, why isn't it more

dynamic? Well it turns out that there is tremendously more regulation and inspection in Italy than in some other countries. More specifically the United Kingdom had far less business regulation at the time that we were doing the analysis than in Italy. What that meant was because you had to fill in 50 different forms, you had to get permissions from 20 different authorities in order to create a firm in Italy, when you started a firm it had to be pretty big to start with, because the costs of starting a firm were quite high. But because of all this regulation, what happened was the firm started somewhat bigger, but you didn't grow very fast. Firms stayed small. In fact in Italy some firms stay small because they want to hide from the tax authorities. They want to hide from the regulator. They want to hide from the inspector. Sounds familiar, right?

On the other hand in the UK, because there were much fewer regulations to deal with when you entered small firms could afford to incorporate and start up. But then they grew much faster. And therefore average firm size in the United Kingdom was significantly higher in our study than average firm size in Italy. And that led of course to stronger economic growth. There is a myth that goes around which says that small firms are the job creators in the economy. Well yes there are a lot of self employed people. But the true job creators in the economy are small firms that grow big. Not small firms that stay small. And so we need growth in small firms. Yes we need small firms. But we need growing small firms, we don't need to keep them small. And the only way they grow is in a business environment that facilitates enterprise that facilitates growth.

So how have we done on excessive regulation in India? Well we've come a far way. Remember the license permit Raj which we liberalised in a big way in 1990s and

we've seen it happening across sectors. Most recently in the banking sector after a decade or more without new banking licenses, over the last year we've given 23 new banking licenses. Two banks have already started and many more will join this year. So the attitude towards entry, towards competition, is changing across the economy. We are moving, we have moved significantly away from the days of the license permit Raj. But in a previous speech I had argued that we had moved away from the license permit Raj to the resource Raj, that from control over the licenses we moved to control over resources. Resources like spectrum, resources like mines, resources that were necessary to do business, selective allocation of those resources created a unlevel playing field. I think we're changing that also.

It is very hard to think of any area in the country today where authorities can get away through a non-transparent allocation of resources. Increasingly our press, our Supreme Court, our CAG, our CVC, all the watchdog institutions we have will check aberrations in the allocation of resources. Resource allocation is being done far more transparently and in far more competitive fashion than before. So I would argue that the resource Raj has also given way to a much more free and level playing field. And then we had the inspector Raj where you start a firm and the inspector shows up. So this is where I think the new initiative of the government, Start Up India, with the idea of reducing red tape, reducing entry barriers, reducing the inspector Raj, giving firms a three year horizon when no inspector is supposed to show up on your doorstep, is at work. I think that gives us hope that we will also bring down the inspectorate, we will continue making it easier for people to do business. This again does not mean no regulations, it doesn't mean a dog eat dog world. It means the regulations that

are necessary, better regulations, simpler regulations, easy to understand regulations and well enforced regulations. Now regulations that lie on the books but nobody enforces or people take gratification to look the other way is in nobody's interest. We need fewer, better and enforceable regulations. And again this is a direction in which a number of institutions are going, including my own in the RBI, we are trying to simplify the regulations we have on the books; putting out master directions, updating them online. This is the aim in the next few months. So that anybody who wants to undertake any particular activity and wants to know what regulates those activities can go on the web, look for what they are and move forward. So my belief is we've moved a long way. And even though we are certainly nowhere near perfection, we've come a fair distance. We need to continue along this route in simplifying and easing the process of doing business.

But business is not just about government and regulators. It is also about the underlying realities of doing business. And there are some continuing infirmities that we need to remedy in order to make it easy for small young firms to start up. Infrastructure for example, large firms can afford big diesel generators, small firms cannot. So we need to make power more easily available. Large firms can create their own logistics structure. They can create their own access to roads, ports, airports and so on. We need to make it easier for the small firms, which means tremendous investment in infrastructure over the next few years. Again this is work in progress.

Another place which is one of great difficulty in India is finding space. Where do I put my plant down? Where do I put my workshop down because space is so expensive? And again people who have bought land in the past and are sitting on it, have a much better chance of using it,

than the fresh entrepreneur who wants to buy or rent a piece of land to do his business. Here again I think one of the great changes that is happening in India is competition between the states, which is creating the possibility of easing access to land - states are trying to lure entrepreneurship by promising the one thing that is in short supply, access to land. And I think that's a good thing. Most recently in Andhra Pradesh, the Chief Minister has pulled together 33000 acres, not a small amount. 33000 acres working with the farmers, promising them a share in the benefits when the new capital Amaravati is developed. But also in the process creating enough space for the kinds of industries and activities that the new city will require. So I think it is feasible, it is something that people are doing, it is something that hopefully with reforms in the land acquisition act or with different states taking different interpretations of it will become much easier.

A third element is access to finance. Again and again you hear small firms complaining that they don't have access to finance. And once again this is something that is weighted against the new, against the untried entrepreneur, somebody who hasn't established a reputation. And once again things are changing, with new technologies and new institutions. Examples of new institutions – in one of my papers we looked at what is the benefit of small banks? It turns out one of the biggest benefits of small banks is they work with small customers. The small customers find it very hard to get the time of day from a big bank. Often it is because big banks are large sprawling entities with many branches. The branch manager doesn't really have a lot of authority. Any decision on a reasonable loan has to go up to a central office. A lot of banking business is done based on character loans. I shake your hand and see

how strong your handshake is. I look into your eyes and see if you look back or you stare into the ground. Those are elements which are very hard to communicate in a report back to head office. So when you make a loan, you make it on the basis of parameters which may not reflect the true level of information you have about a small entrepreneur. A lot of it is about character. Do you trust this guy to do the job or is he untrustworthy? Hard data is hard to get about small firms, which is why small firms can't really borrow from the big banks. Of course things are changing with the availability of data. But this is where the small banks come in. We see our regional rural banks doing a lot of rural lending. We see our urban cooperatives doing lending to small entities. And our hope is that the small finance banks that we have created will go out and lend to small entities in a way that currently is not being fulfilled by the larger banks.

But then also technological developments will help here. For example the government is in the process of creating a unique firm ID. That unique firm ID, in the same way as Aadhar, will help us identify firms and who is their promoter, and thereby get a sense of the antecedents of firms that will allow them to build up credit histories, will allow us to lend to them. One of the most important things about identity is that it gives you collateral upfront. What is that collateral? It is the credit associated with your identity. It is yours to lose. If you go out and default on your loan after taking a loan giving your unique ID, you will never get a loan again. Because that credit default is associated with your ID. So that collateral, your good name is something you have to lose. Which is why people who have no physical collateral whatsoever can actually go out and borrow once they have unique non-falsifiable IDs. And this applies as well to small firms as it applies to individuals.

So to my mind there is tremendous progress here. One of the things I have said repeatedly that I am looking forward to, is how much information can be generated on the net. Consider small vendors. A carpet seller in Srinagar selling on the internet can that carpet seller establish a reputation for selling good quality carpets? Can the internet marketplace which sees his sales then get a sense of how much financing he can get and arrange for the financing, perhaps through a finance company which is tied to that marketplace? Can we make this happen? This will enable a whole new source of reasonable lending based on technology. And I think we already have all the elements in place. We are seeing some of this start up. And also as a regulator we are also watching it to make sure we understand it fully.

There is still a large place where we have an uneven playing field. And that is on resolution of distress. I said entry was important in a free enterprise system. But exit is also important because once the resources are used in a particular way, if they are not being used effectively it makes sense to take those resources and give them to somebody else who can use them more effectively, or put them to work somewhere else. For example, in India we have a lot of industrial parks which are full of empty sheds. Those sheds are not empty because we don't have entrepreneurs who need space, they are empty because there is some dead firm which is not allowed to die, the living dead. It is not allowed to go out of business. It has a hold over that shed. Can we terminate it for the benefit of all concerned, and put in a new entrepreneurial firm into that shed? What we have unfortunately in India is a very difficult process of resolving firms, including large firms. And this then works to the detriment of all. For the large firms basically the resolution process takes many, many years. Which means that trying to get the

resources that have been captured by that firm, into new better activities, is very difficult.

It also means that we have a very uneven playing field between creditors and borrowers. The large borrowers can basically thumb their noses at the creditors at least till recently, and the creditors found it very hard to get their money back. Now paradoxically studies show this hurts the large borrower. It hurts the large borrower because, upfront, the creditor knowing this will happen charges an enormous interest rate. And I have said this again and again; In India one of the biggest problems is the spread between the risk free rate and the rate that the businesses are charged is enormous. It is enormous not because we don't have competition, but because the risks associated with lending are high, because the ability of the lender to recover money when a firm goes into distress is very weak. Fortunately things are changing.

Now the early way we tried to change it was to make laws more draconian. Sarfaesi is one of the harder laws that we know about. It worked very effectively against small firms. And you talk to any small business owner, I get many letters of this kind, they complain about Sarfaesi being too effective because they lose their plant, they lose their land when the bank experiences loan default. But large owners have found ways around it using the legal system to thwart the process of Sarfaesi and its implementation. And so we have a very bad equilibrium where laws are made more and more draconian in order to try and get the large borrower to pay but the small borrower gets crushed under this law. So we need a better balance. My hope is that the new bankruptcy code which the government is bringing in, and which there is some chance of even being passed in the Union Budget, will make an important improvement especially if the legal apparatus to administer that bankruptcy code comes in

quickly. It will make it much easier for the small firm to get credit without being subject to the kind of draconian laws we've had to put in place, and also allow the large firms to get credit now there is a way for the lenders to recover that money in bankruptcy court.

Couple of other new developments which are important; One of the concerns in a free market society is the emergence of cartels, the emergence of monopoly. And it is very important for a effective free enterprise system to have a competition authority. And I think over the last few years we have seen the Competition Commission of India gain in stature and gain in credibility as its awards are given. And of course some of these awards have to survive appeals. We will see how that process takes place. But fortunately now we have an institution which is looking at the issue of competition, extremely important for a free enterprise system.

Before I go to the next point which is property rights, let me raise the issue, why are all these positive changes happening? Why is the political environment tilting towards a more competitive environment when for many years we were happy with a much more monopolistic or quasi-monopolistic environment? I would argue the reason is that because of young India. The reason is because we have to create millions, tens of millions, crores of jobs every year. Because we need to create those jobs, and because a good job is the best form of inclusion, there is tremendous pressure on the system, on the political system and regulatory system to deliver those jobs. And to my mind it is coming out the right way. This is where democracy works, as pressure towards easing the way to growth, as easing the way towards making it easier to open businesses.

The second element of a free enterprise system as I said was the protection of property rights. It is pretty obvious

we need the protection of property rights to incentivise activity. After all if I don't believe that the fruits of my activity will largely accrue back to me, I may not have the incentive to undertake as much effort. Now broadly property is protected. Of course some of you may recognise that there is a tension between the free entry and exit, and the protection of property. Sometimes property gives people an advantage which those without property don't have. What is very important is that this advantage doesn't become overwhelming. And that is something to keep in mind. Taxation can affect the sanctity of property. Moderate and predictable taxes are important. Moderate estate duties maybe useful. And to some extent again here there has been tremendous improvement over the years, with a focus on tax administration, better tax administration. Many of you who pay your income taxes must have seen over the last so many years a great improvement both in the process of filing, as well as in the process of refunds. And a lot of technology has gone into that. But technology also means transparency and less of the unnecessary demands on you. Significant automation therefore has helped as well as moves to clean up the system to make it more transparent. Again I am not saying this is perfect. There is a long way to go. But the movement has been positive and in the right direction including for example the great debate on retrospective taxation that has allowed us to clarify our thinking on this issue. Certainly, the government has stated its position very clearly and indicated the way forward.

Now that said, let me also say for the benefit of some of our listeners from abroad that sometimes the issues aren't clear cut in the aspect of taxation. Multinational corporations complain all the time about excessive demands, about excessive taxation. But it is also true that

multinational corporations across the world tend to find tax avoidance and sometimes tax evasion as appropriate techniques. And therefore there is a constant fight between governments and multinational corporations. And occasionally there is government excess, but they are not the only ones who commit excess. Some corporations find that all their intellectual property is manufactured in the Cayman Islands. I haven't seen a lot of smart scientists sitting in the Cayman Islands. So there is an issue there that needs to be addressed. More broadly this is an area where we need global agreements which essentially come out with what are reasonable taxation processes, what is reasonable behaviour on the multinational corporations.

I think we have very moderate levels of taxation for the most part in this country. We are moving towards a GST. Our personal taxes are at the most 33%. These are not high by any standards. These are very reasonable. And certainly compared to our historical past where at some point we were paying more than 100% of income, when you took everything into account, we have come a long way. So we are certainly much better off today.

Let me talk about access to capabilities, and this is very important for a country like ours. Aam Aadmi attaches no value to all this lofty talk of free enterprise if he simply doesn't have the capabilities to participate in that free enterprise economy. If he cannot read properly, if he doesn't have good health because he suffered from malnutrition when he was a child, if he doesn't know basic business practice, in that case all this highfalutin talk means nothing because he simply cannot enter the competitive race. So what is really important in a free enterprise system also is that everybody should be able to enter the race. Now in today's world the point of entry is very different than from the world of Adam Smith. In

the world of Adam Smith you probably didn't need an education to become a fairly effective business person.

In today's world you need a basic education. You need to know accounting. You need to know where your markets are. These are all important. And this is where as a society that wants to focus on free enterprise, that wants public support for free enterprise we need to make sure that everyone has access to capabilities, whether it's education, whether it's healthcare, whether it's insurance, whether it's access to finance, and for this we need very effective delivery of social programs. The programs need not be given just by the government. It can be given by the private sector. But it's very important that the government ensures that everybody gets access to these programs. Good schools, good hospitals, good insurance. Broadly what I am arguing is capitalism doesn't start at age zero. Capitalism starts around age 21 when you have the capacity to compete. We shouldn't put little kids in competition, we shouldn't put little kids in workshops working away. We need to get them the skills to be able to compete and that is why we need the basic social infrastructure which is provided by the government, which the government ensures can be provided in order to have an effective free enterprise system.

And finally I would argue we need a safety net. Any free enterprise system has ups and downs. If you don't have a safety net the way down can be steep indeed. You can fall a long way. And what we need is a safety net focused on individuals which protects them from falling too far so that they can actually take some risks, so that they can actually feel confident in day to day activities. So that they are actually kept off the street and don't rebel to overthrow the system when there is adversity. So

we need a safety net. But it's important that two things happen when we create that safety net.

One the safety net is about the individuals. It is not about firms, it is not about institutions. Because the whole purpose of free enterprise is to let the best institution win. Institutions aren't people. Institutions are organisational structures, and the best organisation may not be the best organisation today, may not be the best organisation 20 years ago. We need to let organisations compete. And those that fall behind should be taken out through the bankruptcy process and in other ways. But individuals can't be taken out. Individuals need to survive for another day. So we need individual insurance, individual protection, but not organisational protection. All too often in developing countries we protect the organisation in order to protect the individual and therefore protect inefficiency. We have to move to protecting the individual rather than the organisation.

But the second aspect for a relatively poor country which is walking its way into middle income is we have to be careful about how much insurance we provide and ensure we have the budgetary capacity for that insurance. All too often entitlements that look small to begin with, grow over time and eventually become unaffordable. This has been the experience of Western Europe. They set up huge entitlement programs in the sixties when they were doing very well and are now finding some of those are difficult to maintain. It is the experience of the United States. It is the experience of a number of emerging markets where the amounts that are going out in terms of pensions, in terms of healthcare now are much bigger than was envisaged when the systems were set up. So the safety net has to be there, has to be under every person, but also has to be what the country can afford,

not so much that it eventually creates problems of sustainability in the system.

So broadly I think these are the four aspects of free enterprise that we have to focus on, and again I would state that India has come a long, long way from where it was 10 years ago, 20 years ago, and certainly 50 years ago. From tiny shops, tiny kirana shops to large internet market places; the spirit of entrepreneurship is very much alive in India today. It doesn't matter if you don't see huge manufacturing outfits, that will come. But there is a lot of work happening in the services sector, lot of interesting new enterprises that are being established. And increasingly graduates from the IITs and the IIMs that Mr. Malegam was talking about, want to start businesses or work for start-ups rather than go in to an established reputable consultancy or a bank. And of course one of the biggest changes that has happened in our country is doing business is getting much more reputable, as is getting rich. So for the heroes of some of the kids around here it would be one of the many Bansals that there are in the start-up spectrum.

And I think that is right. We should praise the Narayan Murthys, the Nandan Nilekanis, and the Bansals who start new enterprises and create wealth in the nation.

But of course this is all work in progress. We need to do a lot more work to improve the environment so that everyone has a chance. And this is where it is important that business – that established business also changes. Having been in North Block but also at the RBI, sometimes you get the feeling the whole objective of these meetings with businesses is for businesses to plead for special dispensations. I think that is changing. I think a number of business organisations are now focusing on frameworks, on the environment, how to improve it; and offering good ideas on how we can move forward. But increasingly

business has to put its weight behind that how we can move forward to create a free enterprise system which can benefit all, rather than looking for specific benefits at a particular point in time.

So let me end by saying, I think in the spirit of what Nani Palkhivala said, India always seems to find the way, perhaps not quickly, perhaps not linearly, but eventually in due course. Thank you.

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