THE INDIA FORUM
A JOURNAL-MAGAZINE ON CONTEMPORARY ISSUES

March 11, 2020

What Makes for Economic Growth Persistence?

By: Anoop Singh

'India needs to build quality institutions of the kind that have been associated with the dynamics of growth in the high productivity countries. This also means that India needs to focus on creating constituencies and coalitions for institutional reform.'

In recent months, India has made the news globally, with IMF Chief Economist Gita Gopinath assessing India's slowing growth to be a major factor in their reduced projection of global growth. Almost at the same time, Vijay Kelkar and Ajay Shah step in to consider what delivers persistent high growth, and its application to India. China with its declining growth rate has been at the centre of that international debate for some time, but now India has taken over with international economists and institutions contemplating the nature of India's growth retreat.

The duration of persistent high growth

The debate on the duration of persistent growth has taken several turns over the past decade, and Kelkar and Shah add India's experience compellingly to the debate. At its centre are the findings that steady, sustained catch-up growth is not automatic, and that there are episodes of accelerations and reversals over time. In developing countries, phases of rapid growth are frequently punctuated by discontinuous drop-offs in growth.

Summers and Pritchett added to the debate in 2013 by observing that high-growth episodes often end with an abrupt regression to the average, although China's experience has been remarkably different. Given that India experienced a period of accelerated growth for at least 17 years from the early 1990s, Summers and Pritchett thought the likelihood that Indian growth will continue at 6% per year would require a relatively rare degree of growth persistence. They suggested that India's annual growth rate for the coming decade could instead fall in the 3% to 4% range. This was well before India's growth retreat became evident.

Sudden stops and role of institutional governance

There is much in common between the literature of why sudden stops happen and the assessments by Kelkar and Shah. Most importantly, the evidence cited in the literature is that the risks of sudden stops are much higher with weak institutions and organisations for policy implementation. Continuing with high levels of growth in output per capita would need high levels of institutional quality.

> Institutions are the rules of the game in a society, needed to create an incentive structure with behavioural norms that … build persistent growth.

In his celebrated work of 1990, Nobel laureate Douglass North said that nations develop by building "credible commitment" to strong institutions, and that shifts in institutions can have long-lasting effects. In short, the quality of institutions overrides all other factors. Institutions are the rules of the game in a society, needed to create an incentive structure with behavioural norms that reduce uncertainty, promote efficiency, attract investment, and build persistent growth (Faundez 2016).

Within this broad definition, there are many channels through which institutions could affect investment and growth for countries at different levels of development. Among the factors that influence the length of growth spells, four have attracted the most attention. First, the quality of legal institutions, especially secure property rights and contract enforcement, which limit the discretion and authority of government. Second, market competition and the incentives for innovation, research, and productivity growth. Third, the quality of government services, regulatory agencies, and the bureaucracy. Fourth, the quality of economic institutions that define the constraints under which markets operate and preserve macroeconomic stability.

In this context, the literature also finds that integration with the outside world has typically been a driver of productivity change and income growth. This strengthens domestic ownership of institutional reforms in the channels fundamental to high growth persistence.

> [S]ocieties that become less equal and cohesive typically experience more volatile growth. This is most likely because social conflict breeds populist policies…

Some of these channels acquire particular significance where the informal economy constitutes a significant portion of the overall economy. Results confirm that when businesses are faced with onerous regulation and weak and inconsistent enforcement and corruption, they have an incentive to hide their activities in the informal or underground economy (Singh 2014). This is particularly the case in countries with weak capability for implementation of policies and where there is usually a large divergence between the de jure laws and regulations and the de facto outcomes for specific firms. In this case, the policy implication is that large reductions in tax rates or increasing the number of regulations will not shrink the informal economy. Instead, governments need to strengthen the rule of law, simplify access to the formal economy, and strictly enforce the minimum necessary set of regulations.

Equally, the results show societies that become less equal and cohesive typically experience more volatile growth. This is most likely because social conflict breeds populist policies, or because it leads to weaker and less inclusive institutions and a reduced capacity for managing shocks.

The consensus in this debate is that even the most favourable conditions will ultimately have diminishing impacts on growth. Avoiding this calls for a country to continually adapt and improve its institutional governance, with private innovation and competition being critical to ensure high growth persistence.

Kelkar and Shah's findings

Enter Kelkar and Shah into this debate on the persistence of India's high growth. They bring to it a rare policy, institutional, and research background, with Kelkar having been part of the historic group that successively implemented the 1991 reforms that ultimately led to India's 1991-2011 high private investment and growth phase. Among the successes of that high growth phase, they cite the shrinking for the first time of India's poverty levels and the creation of new pro-institutional reform constituencies, both critical factors for extending growth persistence.

However, a growth persistence did not happen. As they point out, the reasons have more to do with the "art of economic policy," where dialogue and reasoning need to carefully take over when the science of analytical foundations and empirical evidence still need to be developed. This is especially necessary to build reform constituencies during crises when "there are no manuals."

In doing this, Kelkar and Shah cite the retreat of private investment, linked to the inability of India's institutions to adapt to a changing and more complex economy that needed a second generation of reforms. The changing economy needed a judicial system that is independent of state-led regulatory agencies and can build an efficient system of property rights so that individuals can channel their investments into activities that will bring private returns close to the social rate of return. Instead, they assess that there has been rising central regulation of institutions critical for growth, thereby giving governments a high degree of discretion vis-à-vis businesses.

> Overall, Kelkar and Shah assess that India's institutional quality remains weak in key aspects of economic policy…

They find that the constitution of such an "administrative state" increased as the economy became more open and market driven, adding to the likelihood of a growth slowdown. These shifts in institutions went the opposite way from building the "democratisation" of decisions for incentives and market competition needed for private investment and growth persistence.

Given the authors' longstanding, deep association with India's economic, financial, and fiscal institutions, their assessments of their institutional strengths and weaknesses in these areas need special attention. They report that a rising administrative state deepened the conflicts of interest of regulators dealing with these institutions, as well as with government-run banks and enterprises. For example, they say that the Reserve Bank of India (RBI) recently acquired a much-needed inflation-targeting mandate to deal with India's long history of high and unstable inflation, but without the independence needed to fulfil it.

Overall, Kelkar and Shah assess that India's institutional quality remains weak in key aspects of economic policy - toward the long-term nurturing of inflation targeting, building fiscal space through primary fiscal surpluses, establishing sound financial regulation, and developing deep and liquid financial markets. They assess that this has kept the economy crisis-prone, depressing private investment and detracting from the conditions that make for growth persistence.

Equally important, falling institutional quality has failed to build the well-recognised public goods such as information and research and, thereby, the knowledge needed to explore alternative ways of resolving problems and sustaining accelerated growth. Kelkar and Shah give special attention to rising capacity constraints from flaws in the availability of data as a public good and the continuing lack of private research. They point to the many constraints that impede rational analysis, such as the unavailability of comprehensive data, flaws in the standard public data sources, and limited access to analytical models for undertaking the economic assessment of many problems.

Looking ahead

Kelkar and Shah have established a conceptual framework for recognising, understanding, and dealing with the inability of the phase of high growth to persist in India. Their central message, consistent with the international debate on growth persistence, is that India needs to build quality institutions of the kind that have been associated with the dynamics of growth in the high productivity countries. This also means that India needs to focus on creating constituencies and coalitions for institutional reform. One way in which such constituencies might be created is through education. Another is through economic growth that benefits reform-minded groups, for example, groups that seek higher political participation.

However, there is still much to be learnt about the root causes, the triggers, and the policy sequence that the situation needs. The major challenges for policymakers are compounded by the existing gaps in knowledge. These gaps are reflected in the ongoing debates about the needed responses to mitigate and resolve the current situation and move more decisively to rules-based frameworks rather than centralised authority. Finding the way forward from the knowledge gaps, where empirics and analytical foundations are lacking, as Kelkar and Shah emphasise, will depend more on the art of policymaking. This also needs to assure a consistency between the levers of macroeconomic and financial policies amidst the best sequence of reforms.

Learning about the art and science of economic policymaking in today's globalised world with its growing fractures in constituencies must be made a priority in our schools of public policy and for all those seeking to extend the durations of persistent growth. These schools need to make the Kelkar Shah volume part of their core reading.

References:

Berg, Ostry, and Zettelmeyer (2012). "What makes Growth Sustained?" *Journal of Development Economics*, volume 98, issue 2, 149-166.

Faundez, J. (2016). "Douglass North's Theory of Institutions: Lessons for Law and Development". *Hague J Rule Law* 8, 373-419.

North, Douglass C. (1990). *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press).

Pritchett, Lant & Lawrence H. Summers (2013). "Asia-phoria meets regression to the mean," *Proceedings, Federal Reserve Bank of San Francisco*, issue Nov., 1-35.

Singh, Anoop (2014). "Inclusive Growth, Institutions, and the Underground Economy." In *Human Dignity and the Future of Global Institutions*, edited by Lagon Mark P. and Arend Anthony Clark, 103-22. (Washington, DC: Georgetown University Press).