Navigating Spaces of Economic Growth

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The Political Economy of India's Growth Episodes by Sabyasachi Kar and Kunal Sen, *United Kingdom: Palgrave Macmillan, 2016; pp xii + 105, price not indicated.*

It is well known from the voluminous literature on economic growth that national policies and institutions play a major role in driving differences in per capita incomes across countries (Acemoglu 2009). These factors do so by affecting the incentives to invest in technology, and induce households to accumulate physical and human capital. Any institutional analysis of growth outcomes, however, tends to be embedded in a long run framework. Developing countries like India experience episodic growth, which is subject to phase transitions. The challenge becomes how to operationalise the role of institutions on economic growth in the medium run, where the relevant growth cycle may be, say, of a 15-year duration. *The Political Economy of India's Growth Episodes* by Kunal Sen and Sabyasachi Kar does exactly this. It provides a political economy reading of India's growth experience since 1950, using a medium run institutionalist perspective. In Chapter 1, the authors econometrically identify four growth episodes in India using a two-stage procedure. The first stage utilises the well-known Bai–Perron procedure to identify structural breaks. The second stage uses a magnitude-filter (for example, growth regimes must last a minimum of eight years) to further refine the set of candidate break-points estimated in the first stage. This yields four growth episodes: 1950–92; 1993–2001; 2002–10; and the post-2010 period.[1]

States of Growth

The authors emphasise that the focus should be on understanding transition paths between these episodes. To do this, they define four growth states: miracle growth, where per capita income growth is greater than 5%; stable growth, where per capita income growth is between 0% and 5%; stagnant growth, where per capita income growth is 0%; and a growth crisis, where per capita income growth is negative. They then provide a unifying institutional framework to understand the drivers of growth accelerations (movement from the stagnation and crisis states to miracle or stable growth), growth collapses (movement from miracle and stable growth to a poverty trap), and the maintenance of steady state growth.

Chapter 2 outlines the overarching conceptual framework of the book. The first ingredient is the "deals space." The authors' caveat is that for developing countries like India, the appropriate institutions are not so much the formal institutions engaged in, say, property right protection that can be enforced legally. Rather, the institutional environments in these countries are characterised by personalised deals. Developing countries can be thought of as deals-based economies rather than rules-based economies. Deals are further broken up into ordered deals, where the sanctity of contracts is maintained, and disordered deals, where the sanctity of contracts is not maintained. Both kinds of deals can either be open (widely available to investors) or closed (offered to a select economic or political elite). The authors argue that growth accelerations take place when there is a movement in the deals space from disordered to ordered deals. This occurs because maintaining the sanctity of contracts encourages particular forms of investment with large positive spillovers (such as equipment investment), which ultimately drive growth, as seen in the growth recovery of the 1980s. This is, however, a sufficient condition, and not a necessary condition.

The second ingredient is the "rent space." The rent space (p 27: Fig 2.2) partitions the entire production side of the economy based on the degree to which firms can extract excess profits (rents) in their sector. If firms are export-oriented and operate in rent-thick sectors, they are called "rentiers" (for example, natural resource firms). Domestic market-oriented firms in rent-thick sectors are called "powerbrokers" (for example, utility and communication firms). Competitive (low rent) export-oriented firms are called "magicians" (for example, manufacturing and service exporters). Competitive firms oriented towards the domestic market are called "workhorses" (for example, informal manufacturing).

The third ingredient is the "political space," which refers to the balance of power between elites and non-elites. While horizontal power refers to the distribution of power within a particular political group, vertical power refers to the distribution of power between elites and non-elites. Importantly, the nature of political competition matters for the form that growth takes.

The main hypothesis is that changes in these three spheres—the deal space, the rent space, and the political space—drive the four growth episodes estimated for India. Incentives in all three spaces need to be aligned for economic growth to accelerate. Once accelerated, maintaining growth requires structural transformation, or the ability of a country to produce a diverse product mix. The authors also emphasise that while both closed order (pro-business) and open order (pro-market) deals can lead to positive growth episodes, closed ordered deals can lead to crony capitalism, and to negative economic and political feedback loops, which ultimately makes the closed ordered deal disordered, and brings the positive growth episode to an end.

Politics of Stagnation

The rest of the book applies the above framework to understand transitions in India's growth episodes. Chapter 3 discusses why a disordered deals environment prevailed during the first growth episode (1950–92), despite the dominance of the Congress party. This led to low

average per capita income growth during the period (1.86%). The authors argue that in the Nehru–Mahalanobis public sector–centric growth model, distrust of the private sector would have led to a lack of credible commitment, and to disordered deals. The vertical distribution of power also became less concentrated within the Congress party in the early 1980s, with non-Congress parties increasingly beginning to challenge the hegemony of the Congress. Political survival therefore necessitated Indira Gandhi adopt a more growth-oriented strategy. When Rajiv Gandhi came to power in 1985, one can see this as a shift to a more ordered deals environment. This environment was consolidated in the 1990s, leading to a recovery in growth in the 1980s, and a growth acceleration from 1993 onwards.

While the above description is true, I would like to propose an alternative explanation for why growth stagnated. During this period, India was stuck, for lack of a better phrase, in a "political growth trap." Assume, like the authors do, that policymakers are rent-seekers. They exercise discretionary powers to grant privileges. As the economy liberalises, the scope for rent-seeking goes down. But as the economy expands, the scale of rent-seeking expands. Politicians do not want to give up the "scope" for rent-seeking because they do not see the "scale" of rent-seeking clearly (because of too much risk and uncertainty surrounding economic reforms). That is why countries can get stuck in a political growth trap, and need a crisis to motivate reform, in order to get out of such a trap. In India, this crisis occurred in 1991, leading to systematic reforms. This is also possibly why the reforms initiated in the 1980s were piecemeal and tentative.

Chapter 4 discusses the 1993–2001 growth acceleration, which was India's first episode of high growth. Average per capita income growth rose 4.15% compared to 1.86% in the previous episode, driven by a resurgence in corporate sector investment (equipment investment), which led to strong private sector growth. However, more political fragmentation—a changing political landscape with more regional parties—led to more political competition, and a stronger pro-business orientation. There was a surge in ordered deals, which energised the magician (IT and chemical) and workhorse (hotel and restaurant) sectors, and which should have resulted in a further opening up of the deals space because of second round effects. This did not happen due to mitigating changes in the rent and political spaces, which led to a more closed deals environment in the next growth episode, 2002–10.

As discussed in Chapter 5, while average per capita income growth from 2002 to 2010 rose to 6.42%, the industrial structure shifted to more natural resource/rentier sectors as political fragmentation changed the nature of deals. This also led to a decline in structural transformation. Corruption stemming from closed deals increasingly became the norm across sectors (for example, telecommunications and the 2G scam). The drivers of growth also shifted to the non-tradable sectors.

Closed Deals and Corruption

What is less clear in Chapters 4 and 5 is how closed/open/ordered/disordered deals generally relate to corruption. While the authors do mention that closed ordered deals do not necessarily imply corruption (p 88), casual empirical evidence suggests that routine corruption costs something like 1%–3% of total production expenditure in many economic sectors, and is budgeted in as such by businesses. This is a cost, but not a binding constraint, except at the margin, although there are additional costs connected with the social erosion that come with corruption. In this regard, an international comparison is also appropriate. Comparing the economic trajectories of Mauritius and Madagascar, Mauritius was more dirigiste than Madagascar, but subjectively, civil servants were more interested in economic growth and therefore willing to cut corners and remove obstacles positively. The same point can be made about local party officials in China and Vietnam, whose level of control is high, but whose motivation towards economic growth (a lot of which is selfish) is also high. In other words, closed deals need not be a hindrance to growth per se, even in a dynamic long run sense. Further, in India, there is also the politics of relative corruption: the incumbent is constantly trying to prove that the opposition is more corrupt than the incumbent. Would this be a force for the emergence of more open ordered deals? Redistribution could also be covering for market failure, not just providing political patronage, but the authors do not develop this point.

Chapter 6 discusses the post-2010 growth slowdown, the fourth growth episode for India. The main result is that the economy in this phase witnesses a secular slowdown in most sectors, but especially in those identified with closed deals. There is a sharp drop in investor perception of institutional quality in India, and a rise in rent-seeking and corruption, leading to negative feedback loops that characterised the 2002–10 growth episode. The primary culprit is political fragmentation, which led to a breakdown of the political settlement and a more disordered deals environment. Chapter 7 provides concluding observations. The book ends on a somewhat ominous note given the Indian experience with institutional decline and political fragmentation, and changes in the deals space.

New Perspectives

I have a few suggestions on how to make the arguments in an already interesting book more compelling. First, the authors need more precise statistical indicators

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of the deal/rent/political environments outlined in the book. In the absence of this, the arguments remain wordy and untested. Second, the book has more of a national focus, and less of an interstate perspective, although arguably, a lot of the interesting economic policy experimentation has been taking place at the state level, certainly post 2000. This suggests that the forces of competitive federalism are likely to underlie India's future growth trajectory. Third, and somewhat surprisingly, the book takes an overt factor accumulation perspective on Indian economic growth, with barely any discussion of the role of productivity or efficiency (total factor productivity or TFP) in the Indian growth process. This is possibly because of the burst of investment that occurred in the aftermath of the 1991 reforms in capital-intensive sectors, due to the prevalence of labour laws. This led to higher growth rates of capital, and a slower growth rate of TFP. This certainly seems to be borne out in the recent KLEMS data,[2] which is now publicly available for the 1980–2011 time period. A plot of growth in output per worker against growth in capital per worker from 1980–2011 using the KLEMS data set shows an uncannily close co-movement. This implies that the dynamics of growth in India—at least to a first approximation—appears to follow a Solow–Swan style growth model in the medium run.[3] Some more discussion, however, of how a deals-based institutional framework impinges on productivity, and therefore on prospects for productivity-led growth would have been useful.

Having said this, the view that economic reforms are the dominant instrument behind rapid growth in India—especially in many pre- and post-1991 comparisons—has become jaded, and needs fresh consideration. The institutional approach taken in this book provides this perspective. The book is short and well written. The authors must be congratulated for producing an insightful book on how to think about institutional quality in the Indian context, its interplay with economic growth, and what this implies for India's future growth transitions.

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NOTES

1 These growth regimes are different than what has been estimated in the vast literature on Indian economic growth (see Ghate and Wright 2012, 2013; Das et al 2015). In the first decade after independence, Indian aggregate real GDP growth averaged approximately 3.9%. This performance compared favourably to the pre-independence growth stagnation from 1900 onwards. After the first decade, growth began to decline and got stuck in the "Hindu rate of growth." The over-regulation of the economy with the goal of redistributing wealth ultimately led to rampant corruption and crony capitalism. The second phase of India's growth was in the 1980s–90s. There was ad hoc liberalisation starting in the mid- to late-1980s, which increased growth. Expansionary fiscal policy also stimulated growth in the late 1980s, although this led to fiscal profligacy and laid the seeds of the 1991 balance of payments crisis. The third phase of growth occurs in the 2000s because it took time for entrepreneurs to think that the reform process initiated in 1991 were permanent. As a result, a lot of the benefits of the 1991 reforms in terms of higher growth were experienced in the 2000s.

2 KLEMS data relates gross output to capital (K), labour (L), energy (E), material (M) and services (S) inputs.

3 Ghate et al (2016) calibrate a 2-sector growth model to India and show how public–private capital complementarities, labour laws, and TFP growth affect long run growth outcomes.

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