Research Programme Consortium for Improving Institutions for Pro-Poor Growth

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Formal versus Informal Institutional Change in India's Growth Acceleration

The Indian economy has been growing at a faster pace in recent decades than it has done so in the first few decades after independence, and has been one of the three fastest growing nations along with China and Vietnam in the past couple of decades. The standard tale of India's recent economic ascendancy as told by the international financial press is that the radical economic reforms of 1991 initiated by the Government of Prime Minister Narasimha Rao was the primary cause of India's strong economic growth. However, it is now commonly understood that India's growth acceleration began in the late 1970s to early 1980s and predates the 1991 economic reforms. While India's rapid rise as an economic power in the world is widely recognised, the reasons for India's recent economic growth remains fiercely contested.

In an influential set of papers, economists such as De Long (2003)[1] and Rodrik and Subramanian (2004)[2] and political scientists such as Kohli (2006)[3] have argued that the acceleration in India's growth occurred primarily due to a change in the attitudes of the national government under the Prime Ministership of Indira Gandhi towards the private sector from being anti-business to being pro-business and less to do with economic policies. As Rodrik and Subramanian state, 'the trigger for India's economic growth was an attitudinal shift on the part of the national government in 1980 in favour of private business.' They argue that this attitudinal shift 'left little paper trail in actual policies but had an important impact on investors' psychology.' Similarly, Kohli states that 'Indira Gandhi shifted India's political economy around 1980 in the direction of a state and business alliance for economic growth'. De Long argues that 'the most important factor that changed in India over the 1980s had more to do with entrepreneurial attitudes and a belief that the rules of the game had changed than with individual policy moves.'[4]

The argument that India's growth acceleration can be attributed more to the attitudinal shifts of the government than to substantial policy moves has interested not only India-observers but a wider audience as well: moreover, this view has been influential in the literature on the political economy of economic growth. India's growth experience suggests that it may not be necessary for other countries to undertake significant formal institutional reforms in order to bring about growth accelerations. The 'attitudinal shift' story of India's economic growth seems to suggest that informal institutional change related to changes in attitudes and beliefs may be sufficient to ignite economic growth without any need for significant changes in formal institutions – changes in the *actual* rules of the game such as reforms in laws and regulations that influence economic activity. How valid is such a reading of the Indian growth experience?

A more systematic analysis of the determinants of India's economic growth suggests that those who have focused on informal institutional change as the cause India's growth acceleration have overstated its importance.[5] The determinants of India's growth acceleration were three-fold: the bank nationalisation of 1969, the increase in public investment from the mid 1970s to the mid 1980s and the trade reforms of the late 1970s onwards. The bank nationalisation of 1969 brought India's leading commercial banks under state control and these banks were directed by the state to open branches in rural and semi-urban areas. This led to the spread of banking in the country, and a sharp increase in financial deepening, and consequently, augmented resources for investment. The increased rates of public investment went mostly to many infrastructural industries that were important for the private sector. The trade reforms allowed Indian firms to import many intermediate and capital goods, and led to a sustained decline in the price of machines, after a period from the 1960s to the late 1970s, when prices of machinery in India was among the highest in the world. Financial deepening, the increased rates of public investment and the decline of the price of capital goods due to the trade reforms led to a remarkable increase in private investment, particularly in machinery. This was the reason why India's growth accelerated in the late 1970s to early 1980s, and why this growth was sustained all through the 1990s and beyond.

To what extent can the policies above be attributed to a pro-business attitudinal shift of the state? The bank nationalisation episode of 1969 was motivated by Indira Gandhi's attempt to win political support for her Garibi Hatao (remove poverty) campaign and to be seen as 'an angel of the poor', and was therefore, a throwback to the socialist policies of the past. The motive for the increase in public investment from the mid-1970s is less clear, but it had do in some measure with a redress of the underinvestment in the public sector that had occurred from the mid-1960s to the mid-1970s. The changes in trade policy can be attributed at least in part to a change in the attitude of the economic bureaucracy towards import controls. Therefore, among the key growth-enhancing poli¬cies, it was the set of policies pertaining to international trade that can be unambiguously linked to 'the abandonment of left-leaning anti-capitalist rhetoric and policies, and prioritising of economic growth.'[6]

Both the bank nationalisation and the trade reforms were examples of significant formal institutional change. In the case of bank nationalisation, there was a large transfer of property rights in the Indian financial system from the private sector to the public sector, perhaps among the most important changes in formal institutional reform that has happened in India since independence. The trade policy changes of the late 1970s and early 1980s, which though much smaller in scope as compared to the 1991 reforms, led to a significant alteration of 'the rules of the game' for Indian firms with respect to their relationship with the world economy, facing both external competition and access to imported capital goods for the first time since independence.

While informal institutional change related to the attitudinal change of the state and bureaucracy to the private sector certainly aided the growth of private investment that was observed from the late 1970s by sending positive signals to entrepreneurs, the attitudinal shift of the state cannot in itself explain the surge in private investment and consequently, the acceleration in economic growth. Thus, while informal institutional change was complementary to formal institutional change in bringing about India's growth acceleration, it was not a substitute for formal institutional change in their effects on economic growth. Formal institutional changes was the key to India's growth acceleration, even though these changes did not seem particularly growth enhancing (as in the case of bank nationalisation) or that radical (as in the case of trade reforms) at that time, and in the context of the major economic reforms of 1991.

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1 De Long, J.B. (2003) 'India since independence: an analytical growth narrative', in D. Rodrick, ed., *In Search of Prosperity: Analytical Narratives on Economic Growth*. New Jersey: Princeton University Press.
2 Rodrik, D. and A. Subramanian (2004) 'from Hindu growth to productivity surge: the myth of the Indian growth transition'. NBER Working Paper no. W10376.
3 Kohli, A. (2006) 'Politics of Economic Growth in India: 1980–2005'. *Economic and Political Weekly*, April 1, pp. 1251–1259.
4 De Lon puts the timing of the acceleraton to the mid 1980s, and not the early 1980s as Rodrik and Subramanian, and Kohli.
5 Sen, K. (2007) 'Why did the elephant start to trot? India's growth acceleration re-examined'. *Economic and Political Weekly*, October 27, vol. 43, pp. 37–49.
6 Kohli, A. (2006) as above, pp. 1252

IPPG: The IPPG Programme is the shorthand name for the inter-disciplinary Research Programme Consortium on Improving Institutions for Pro-Poor Growth. The DFID-funded IPPG supports innovative scholarly research, and seeks to influence development policy and practice that contributes to the UN Millennium Development Goals (MDGs). IPPG Programme partners are based in South Asia, Sub-Saharan Africa and Latin America. IPPG funds research projects across all these regions.

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