

Governance Growth Nexus

Dissertation

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Year	Educational Qualification	Institution	Subjects	CGPA/%
2010	MBA	FMS, Delhi	Finance, Marketing	68% (Rank 5)
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2002	XII (CBSE)	Delhi Public School R.K.Puram, Delhi	Physics, Chemistry, English Mathematics, Computers Sc.	88% (Rank2)
2000	X (CBSE)	Salwan Public School, New Delhi	English, French, Mathematics, Social Studies, Science	88.8% (Rank 3)

Academic Awards

- Awarded **Institute's Gold Medal** for securing **1st position amongst 450 students** at IIT-BHU
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- Secured **2nd Rank** in **All India Paper Presentation Contest (IMI- Opession'09)**
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- Awarded **2nd most perfect person** in **Panchtantrika, Pan India rigorous multi-skill event**
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- **Event Manager** for **Technex 2005 (All India technical festival** of IT-BHU)
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Table of Contents

EXECUTIVE SUMMARY	3
INTRODUCTION	4
Governance and Growth - Causality	
GROWTH AND GOVERNANCE – INDIA	6
Explaining the development surprise!	
Disconnect between Growth and Institutions	
THE FUTURE CHALLENGES: NEED FOR INNOVATIVE APPROACH	8
CONCLUDING REMARKS	9
REFERENCES	11

EXECUTIVE SUMMARY

Governance is one of the critical factors explaining the divergence in performance across developing countries. A reality check in India reveals that while governance is worsening, GDP growth has continued at about 8 per cent for the last four years.

The paper explores the governance growth causality relationship. It further examines the governance-growth nexus as affecting the pace and quality of growth and its inclusiveness. The governance agenda is large and cuts across a wide range of institutions and threatens powerful vested interests. Developing a strategic, sequenced approach that relies on success in a few key areas to generate momentum and demand for reform in other areas will be crucial. Compared to the first generation reforms, there is a need for deeper and more complex policy innovations to deal with the emerging binding constraints to growth.

Index Terms - Governance, WGI, State Capture

The Governance-Growth Nexus

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1. INTRODUCTION

There is no accepted definition of governance. There is divergence of opinion about the meaning of governance between the conservatives and the liberals, between socialists and the communists. The World Bank, for example, has sought to take a middle position by defining governance particularly as the traditions and the institutions by which authority in a country is exercised. This includes:

- the process by which governments are selected, monitored and replaced;
- the capacity of the government to effectively formulate and implement sound policies; and
- the respect of citizens and the state for the institutions that govern economic and social interactions among them.

The Worldwide Governance Indicators (WGI) project reports aggregate and individual governance indicators for 212 countries and territories over the period 1996–2008, for six dimensions of governance:

1. *Voice and Accountability (VA)* – Capturing perceptions of the extent to which a country's citizens are able to participate in selecting their

government, as well as freedom of expression, freedom of association, and a free media.

2. *Political Stability and Absence of Violence (PV)* – Capturing perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.

3. *Government Effectiveness (GE)* – Capturing perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

4. *Regulatory Quality (RQ)* – Capturing perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

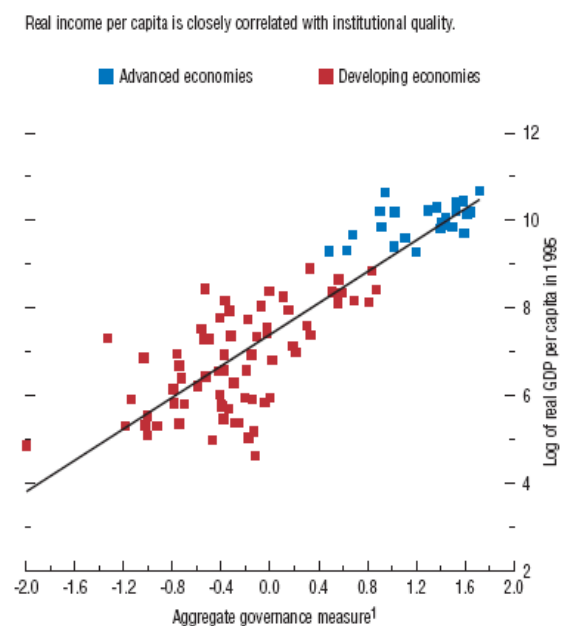
5. *Rule of Law (RL)* – Capturing perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

6. *Control of Corruption (CC)* – capturing perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

1.1 Governance and Growth - Causality

Per capita incomes and the quality of governance are strongly positively correlated across countries.

The below Figure can be interpreted as illustrating the relationship between growth in the very long run and aggregate governance measure.



Sources: Kaufmann, Kraay, and Zoido-Lobaton (1999); World Bank, *World Development Indicators* (2002); and IMF staff calculations.

Three possible explanations can be drawn for this strong positive correlation:

- (1) Better governance exerts a powerful effect on per capita incomes;
- (2) Higher incomes lead to improvements in governance;
- (3) There are other factors which both make countries richer and also are associated with better governance

Untangling the observed high correlation between incomes and governance is important in order to ascertain whether an automatic 'virtuous cycle'

where higher incomes are translated into improved governance is present, or instead very concerted and continuous policy effort to improve governance is needed. By isolating the part of current differences in institutional performance that can be traced back to countries' colonial origins, the studies have identified a powerful effect of initial institutional quality on growth in the very long run. Considering the causation in opposite direction i.e. effect of income on governance, there has been evidence that the effect is actually negative which contradicts the conventional wisdom that richer countries are better able to afford the costs associated with good governance. The phenomenon of "state capture", defined as 'the undue and illicit influence of the elite in shaping the laws, policies and regulations of the state' has been given as a plausible explanation for this negative feedback. When the institutions of the state are "captured" by vested interests in this way, entrenched elites in a country can benefit from a worsening status quo of misgovernance and can successfully resist demands for change even as incomes rise.

This result has two important implications:

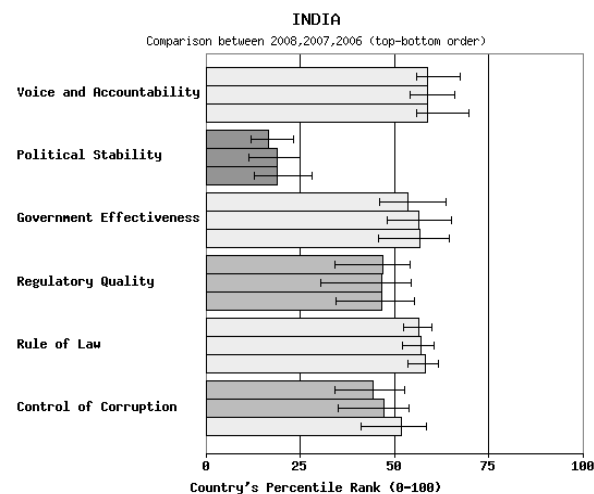
First, a strategy of waiting for improvements to come automatically as countries become richer is unlikely to succeed. Second, in the absence of positive feedback from incomes to governance, we are unlikely to observe "virtuous circles" of when better governance improves incomes this in turn will lead to further automatic improvements in governance. Together, these two implications point

to the fundamental importance of positive and sustained interventions to improve governance in countries where it is lacking.

2. GROWTH AND GOVERNANCE – INDIA

The most striking fact about India’s growth has been the remarkable turnaround in nearly all measures of growth performance since 1980. Output per capita, output per worker, as well as total factor productivity accelerated sharply after 1980. For example, total factor productivity, which grew at about 0.3 per cent per annum during the period 1960–80, grew at close to 2 per cent per annum in the following two decades. However, drawing the same parallel generalization to India’s institutional state is difficult owing to its size and heterogeneity. While the popular perception in India is one of institutional decline, not all signs point to the same. The Election Commission, especially since the late 1980s, has fiercely safeguarded its independence, and presided over many difficult elections. The other referee institution, the Supreme Court, has moved beyond the politicized appointments of the late 1970s that gave India a ‘committed’ rather than an independent judiciary. In a landmark ruling in 1993, the Supreme Court effectively shut out the executive from appointments to the Supreme Court. Through minor tinkering and technological upgrading, the Supreme Court has also reduced the large backlog of undecided cases before it from 120,000 to 20,000 (Mehta, 2005). And, through public-interest litigation, it has moved aggressively,

behaving more like the executive than the judiciary. Further, some of the new institutions, such as the TRAI, SEBI, and IRDA, have performed very respectably, especially considering the novelty of the terrain they have had to navigate. Transparency has been introduced through the Panchayati Raj initiatives and the Right to Information (RTI) Act. And the introduction of computer-based technologies has improved efficiency in a number of areas, with railway users being the most visible beneficiaries of computerized bookings. However, magnitude of reforms, especially from the early 1980s till the mid-to-late 1990s when growth was accelerating, was limited. Ahluwalia (2002), one of the important players in the reform process, himself characterizes the Indian effort as one of ‘gradualism’. Following chart shows India’s percentile rank across the six governance parameters as listed by World Bank.



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2009: Governance Matters VIII: Governance Indicators for 1996-2008
 Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

2.1 Explaining the development surprise!

Stagnant Institutions Rising Growth

Comparing India's growth response with other countries like Latin America with similar reforms, there has been a starking difference. Since 1985, Latin America and sub-Saharan Africa have grown by about 1 per cent per capita per year, while India has grown at about 4–4.5 per cent although both had similar reforms. One possible explanation could be that it is the quality of institutions. Economic development results from the interaction between triggers and fundamentals. The quality of a country's public institutions is the key fundamental of long-run growth. What was holding India back, prior to the 1980s, was a policy regime that was unfavorable to the private sector. Once that was changed through policy reforms, the economic landscape was transformed. The key point here is that even a small trigger—i.e. relatively modest reforms—was sufficient to engender a large growth response because of the considerable under-exploited potential provided by the quality of its institutions. India's institutions, built up through the decades preceding independence, allowed it to get a big bang for the relatively small buck of reforms (at least compared with other countries). Given its level of institutions, its income should have been much greater in 1980, by a factor of four or so. India has thus created considerable growth potential by having done the really hard work of building institutions.

2.2 Disconnect between Growth and Institutions

The process by which rising incomes lead to better institutions is a two-stage one, involving first a greater demand for better institutions, followed by a process whereby this greater demand begets greater and better supply of institutions. The first part of this dynamic has certainly been at play. But public institutions have not been able to meet this increased demand—reflected in the private sector stepping in to fill in the gap left by these unresponsive public institutions. In some ways, the fact that supply lags demand is puzzling because, over this period, India has witnessed a number of developments that should have facilitated, even forced, institutional improvement. Increased transparency, progressive dismantlement of License Raj, increased assertive presence of the civil society, greater decentralization of economic and social power should have led to more accountable institutions. However, although growth has accelerated and poverty has declined substantially, divergences have increased too. Unequal growth has subtler effects on institutions with rich opting out of the public system, turning to the private sector to get essential services. The second major factor contributing to the decline of public institutions is its increasing inability to attract talent. This, too, has deeper causes, including the growing politicization of the bureaucracy, cynicism about its role, and the fading sense of public service.

3. THE FUTURE CHALLENGES: NEED FOR INNOVATIVE APPROACH

Good Governance means securing justice, empowerment, employment and efficient delivery of services.

3.1 Securing Justice

There are several inter-related aspects of securing justice including security of life and property, access to justice, and rule of law.

- The responsibility of the Indian nation-state to protect the life and property of every citizen is being seriously threatened. The Indian nation-state is aware of complexities of the situation and the need is to show greater determination and relentless in support to its instruments of law and forces of democracy and social cohesion to defeat the elements of terror, insurgency and naxalite violence.
- The most severe challenge relates to complexity of adjudication as legal proceedings are lengthy and costly and the judiciary lacks personnel and logistics to deal with these matters.
- The rule of law is expressed through the axiom that no one is above the law. A necessary corollary of this phenomenon is called 'judicial activism' whereby PIL is being misused by people agitating private

grievances in the garb of public interest, in settling political scores and seeking publicity than espousing public causes and defending the deprived

3.2 Empowerment

An empowering approach to poverty reduction needs to be based on the conviction that poor people have to be both, object of development programmes and principal agency for development. Empowerment of the poor people would create new demands and pressures on services and these would be in nature of quality. An effective administrative system alone can manage these new demands.

3.3 Employment

Generation of gainful employment for the youth is the most challenging task facing India's political economy. India's working age population is over 50 per cent. This share will continue to rise and reach 60 per cent in 2050. If we fail to generate employment and equip the youth with good quality education and skills, India's demographic dividend could become a demographic liability. The need is to prepare the youth with such education that would help them acquire vocational skills and mastery over new technology, including internet. This would make the youth employable in the job-market and also help those who want to work on their own. In addition, there is an imperative requirement to

pay special attention to generation of employment opportunities in agriculture, expand area of coverage of rural employment guarantee schemes, accelerate the pace of implementation of Bharat Nirman schemes and several other programmes. Similarly, it would be essential to encourage private sector partnership and support movement of self-help groups and micro-financing institutions.

3.4 Delivery of Services

The principal feature of the scheme of effective delivery of services needs to be seen in the context of the fact that demands have to flow from the bottom up and not the top down. The three institutions which have played remarkable roles in improving public service delivery in India are: (i) the judiciary; (ii) the media; and (iii) the civil society.

Capacity building at all levels of an organization is widely perceived as the most important approach to achieve quality of services and customer's satisfaction. Access to information, participation, innovation and accountability are needed to build an environment for capacity building.

3.5 Administrative Responses

The Indian administrative scene is marked a large number of pathetic performances. The general weakness of accountability mechanisms

is an impediment to improving services across the board. Bureaucratic complexities and procedures make it difficult for a citizen as well as the civil society to navigate the system for timely and quality delivery of services.

3.6 Criminalization of Politics

The Criminalization of the political process and the unholy nexus between politicians, civil servants, and business houses are having a baneful influence on public policy formulation and governance. Political class as such is losing respect.

3.7 Corruption

The high level of corruption in India has been widely perceived as a major obstacle in improving the quality of governance. While human greed is obviously a driver of corruption, it is the structural incentives and poor enforcement system to punish the corrupt that have contributed to the rising curve of graft in India. The complex and non-transparent system of command and control, monopoly of the government as a service provider, underdeveloped legal framework, lack of information and weak notion of citizens' rights have provided incentives for corruption in India. A conscious programme for strengthening of public awareness and also empowering the existing anti-corruption agencies would be required.

4. CONCLUDING REMARKS

India has been successful thus far in converting the gains of economic stabilization and reforms into sustained and accelerated growth. To consolidate this process and to meet the risks of slippage, it has to address emerging challenges on many fronts. Institutional weaknesses may have already reached the tipping point beyond which they become binding growth constraints. Governance environment is increasingly proving a barrier to putting the economy firmly on a path of modernization, global integration, and poverty reduction.

The challenges of governance in India need to be addressed at two levels. At the central level, the challenges are the provision of an enabling and conducive investment climate and management of the macro-economy to sustain a long term non-inflationary growth path. At the state level, the challenge is to ensure the provisions of public good and improvements in the delivery of services. For this, the states need to shed the activities that are best done by profit and non-profit organisations and only ascertain the compliance of standards and excellence in these areas. By thinking strategically, priorities need to be set which enhance efficiency, effectiveness and responsiveness of actions undertaken; which identify the pacing or sequencing of reforms, which assess what reforms are easier to undertake or produce results in the short term; and

under what conditions particular reforms are most likely to have the desired impact.

Research gives centre stage to the role of public institutions in promoting and sustaining long-run development. First, institutions create markets. By protecting property rights, guaranteeing sanctity of contract, and providing law and order, they create an environment in which business and private investment can flourish. Thus, the judiciary, bureaucracy, and police are key institutions in facilitating the development of markets. Second, institutions regulate and/or substitute for markets. Third, institutions, such as the central banks or fiscal institutions stabilize markets by ensuring low inflation and macroeconomic stability and thus helping to avoid financial crises. Finally, institutions legitimize markets through mechanisms of social protection and insurance, and importantly, through mechanisms for redistribution and managing conflict.

Neglecting institutional reform is tempting because institutions are notoriously difficult to change. Relying on growth and policy reforms to lead automatically to institutional improvement is hardly a serious option. A starting point has to be the recognition that allowing institutional decline could well come back to haunt not just policy-makers but the private sector as well, whose fortunes depend crucially on strong and effective public institutions.

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