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The Return of the Washington Consensus?

WILLIAM EASTERLY, GOOD ECONOMIC POLICY, AND ECONOMIC GROWTH IN INDIA

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"Life used to be relatively simple for peddlers of advice in the tropics. Observing the endless list of policy follies to which poor nations had succumbed, any well-trained and well-intentioned economist could feel justified in uttering the obvious truths of the profession: get your macro balances in order, take the state out of business, give markets free rein." (Rodrik 2006:973).

This paper engages with a specific effort by Easterly (2019) to solve the liberalization–economic growth paradox. This paradox centers on the failure of significant global economic liberalization after 1980 to generate a clear increase in global economic growth—despite the powerful theoretical and empirical predictions of the likely impact of the former. Easterly made a significant contribution to this debate by updating various cross-country measures of economic policy. This report provides an extended discussion of the Easterly paper using India as a case study. India conducted extensive economic liberalization in 1991, but economic growth (and productivity growth) in the 1990s showed no increase over rates in the 1980s. Where did all the growth go? This paper makes four criticisms of the Easterly paper.

First, much of the original growth paradox highlighted by Easterly emerges from using non-rigorous before-and-after liberalization narratives and disappears when using a more rigorous body of empirical work.

Second, even though India conducted extensive liberalization in 1991, the measures of policy reform used by Easterly fail to capture this reform effort.

Third, while Easterly argued that the advent of good policy tends to be delayed, this paper uses the India case study to show that it is the growth payoff from good policy that is likely to be delayed. This is partly because economic liberalization needs complementary policies to be effective, it can have a significant impact at the firm level that takes time to show up at an aggregate, macro level, and liberalization is likely to have a J-curve impact on productivity.

Fourth, Easterly's finding that more rapid economic growth in the 1990s was associated with better economic policy is not very informative. Growth accelerations are widespread across time and space and are associated with various impulses, including but not limited to economic liberalization. The big question, with which Easterly does not engage, is whether this growth can be sustained. Thinking about the interaction between economic growth and institutions instead can allow us to better understand India's economic growth since 1980.

1 INTRODUCTION

A great puzzle of economic development in the past 40 years has been the contradiction between the powerful theoretical predictions of the neoclassical (often neoliberal) economic model, the extensive economic reform inspired by this model, and the disappointing results of this policy reform. Neoclassical economics predicts that economic liberalization (i.e., freer domestic and foreign trade markets, less government regulation and intervention, and more private-sector activity) will boost income by reallocating resources to more efficient uses and spur economic growth through dynamic efficiency. This paper focuses on the latter theoretical claim, economic growth. Many developed and developing countries have conducted extensive economic liberalization since the early 1980s, but global growth performance has been disappointing. Where has all the growth gone?

There is a well-developed body of theory linking liberalizing economic reform to economic growth. Import liberalization provides domestic firms with easier and cheaper access to global markets for capital equipment, embodied with either more advanced or cheaper technology. Trade liberalization permits firms greater liberty to invest and enter new and larger global markets. The increased domestic and global competition compels incumbent and new firms to produce efficiently and upgrade their technology. A competitive economy induces a process of creative destruction as efficient firms drive out inefficient firms and constantly reallocate land, labor, and capital to more productive uses (e.g., from agriculture to industry). Creative destruction also drives productivity growth (Kotwal et al. 2011). These theoretical perspectives have had an enormous practical influence. In 1960, 22 percent of all countries, representing 21 percent of the global population, had open trade policies, according to an index developed by Sachs and Warner (1995). By 2000, 73 percent of countries, representing 46 percent of the world's population, were open (Wacziarg and Welch 2008).

In 2019, William Easterly wrote "In Search of Reforms for Growth: New Stylized Facts on Policy and Growth Outcomes," which asked whether economic liberalization had fulfilled its theoretical predictions and political promises. The paper discussed a long-standing date that these strong theoretical predictions had foundered against a four decade long empirical puzzle. Since the 1980s, many developing countries, especially in Latin America and Africa, have conducted extensive liberalizing economic reforms but not experienced more rapid economic growth (Easterly 2019).

Previous studies had found some relation between poor growth and "extreme" policy outcomes such as hyperinflation above 40 percent (Bruno and Easterly 1996). These studies, including Easterly (2001), failed to find evidence for poor growth performance during periods of less extreme policy, such as inflation between 20 and 40 percent.

Easterly (2019) returned to this effort and replicated the previous research question with updated data, which is reviewed here in Section 3.2. He examined five "bad" policy outcomes: inflation, the black-market premium on foreign exchange, overvaluation of domestic currencies, negative real interest rates on bank savings deposits, and abnormally low ratios of trade volume to gross domestic product (GDP). One evident problem with this effort is that it focuses on policy outcomes that are influenced by but do not directly measure policy tools under the control of the government, though Easterly made some effort to "control for any obvious non-policy factors that affect policy outcomes." A second problem is that these policy outcomes are not necessarily the product of economic liberalization; a rise in the trade ratio, for example, can result from trade liberalization or by extending subsidies to exports.

Easterly (2019) compared the impact of "good" versus "bad" policy on economic growth. These are somewhat arbitrary distinctions whose meaning differs widely across the political and ideological spectrum. Ha-Joon Chang, for example, would define "good" in terms of whether a developmental state provided "co-ordination for change," the "provision of vision," "institution building," and "conflict management" (Chang 1999). By "good" policy, Easterly referred to the policies of the 1990s-era Washington Consensus, as does this paper. The values and practice of "Washington" were most famously captured by John Williamson in his late 1980s compilation of policy prescriptions upon which he thought almost everyone in Washington policy-making circles (such as the US government and the World Bank) would agree upon (Williamson 2004). This list included fiscal discipline, reduction

of subsidies, tax reform, market-determined interest rates, competitive exchange rates, trade liberalization, free flow of foreign direct investment (FDI), privatization of state enterprises, deregulation, and legal protection for property rights (Zhao 2010). The outcome measures referred to above were an attempt by Easterly to quantify the impact of the policies of the Washington Consensus. The case of India, however, shows a country can improve policy dramatically without this showing up as a significant change by Easterly's measures, meaning they are not a reliable way of measuring the efficacy of these policies.

There are difficulties with empirical testing. Easterly (2019) noted that it is "impossible to get good indicators of some major proposed reforms like privatization of state enterprises or deregulation." While budget deficits are important (and here there is decent data), it is not clear what level of deficit is extremely or moderately "bad." A large fiscal deficit during the 2008 Global Financial Crisis could be viewed as "good" policy—but not it if was still present five years later. Fiscal deficits are very much context-specific. For a developing country, the sustainable level of a fiscal deficit depends on whether debt financing is available at concessional interest rates through foreign aid loans. As Easterly noted, "The Washington Consensus did not make clear how 'good' the policy outcomes had to be" to improve economic outcomes.

The new analysis by Easterly (2019) argued that the earlier literature (including his own studies) went too far in proclaiming ignorance about the link between policy and growth. Additional evidence showed robust results linking extreme (and less so moderate) policy with economic growth. The new "stylized facts" are consistent, Easterly argued, with a with a more positive view of reform. Economic liberalization from the 1980s onward helped eliminate the most extreme manifestations of policy-induced distortions of markets in Africa, Latin America, and elsewhere. In a closely related paper, Kremer et al. (2021), found that a global tendency toward divergence in per capita incomes between 1985 and 1995 switched to one of convergence between 2005 to 2015. Moreover, most correlates of growth (e.g., policies, institutions, and culture) have also converged between 2005 to 2015 toward those of rich countries—although these correlates have less of an impact on economic growth after 2005. This paper supports the Easterly view that policies have converged and "gotten better." Kremer et al. (2021) demonstrated that policy convergence (improvement) occurred at the same time that poor countries switched to catch-up economic growth, but the authors did not explicitly focus on that link.

This paper uses an in-depth case study of India to examine the new evidence from Easterly's cross-country datasets. It finds that economic reform in India after 1991 did improve economic policy, as measured by the tenets of the Washington Consensus but not by Easterly's. The paper also asks whether this improvement resulted in faster economic growth. India is chosen as a case study because it has been an exemplar of previous policy skepticism. Despite extensive economic liberalization since 1991, economic growth in the 1990s failed to increase relative to the 1980s. A more recent (post-2003) growth acceleration raises questions about whether this was the delayed payoff to economic liberalization that Easterly's updated data identified in a wide cross-section of countries.

This paper is organized as follows. Section 2 looks at the theoretical link between good policy and economic growth. Section 3 looks at five bodies of empirical literature that test the predictions of economic theory, the costs of intervention, the use of cross-country growth regressions, the impact of trade liberalization, before-and-after studies of liberalization, and the use of episodes of growth and stagnation. Section 4 introduces the India case study, including the promise, practice, and outcome of economic liberalization after 1991. Section 5 discusses the new "stylized facts" from Easterly (2019) in relation to longer-term economic data in India. Section 6 explores the impact of liberalization in India beyond Easterly's rather simplistic proposition that once policy becomes good it boosts economic growth. Section 7 discusses sustainable economic growth and institutions, and Section 8 concludes.

2 GOOD POLICY AND ECONOMIC GROWTH

Early empirical interest in the link between good economic policy and economic growth was underpinned by the revival of the neoclassical paradigm in the 1970s. This paradigm mainly focused on the allocation of resources and the implied implications for economic growth.

Much of the early work focused on a critique of the then-prevailing model of import substitution industrialization (ISI). ISI was based on: import controls,

which raised the prices and profits of producing imports domestically; an overvalued exchange rate, which reduced the cost of imported capital equipment and inputs needed by industry; and underpriced bank credit, which helped manufacturers obtain cheap loans. Higher prices and access to credit and technology, in turn, encourage more domestic production (import substitution) and reduce consumption. However, the first impact of ISI "is redistribution from consumers" (reduced consumer surplus) to producers (higher producer surplus) and the government (via tax revenue). The second is "a decline in efficiency. Higher domestic prices/profits of the good cause resources (land, labour, capital) to be re-allocated from other sectors of the economy to expand production in the now-protected sector" (McCartney 2015, 268–269). The tariff will create an artificial shortage, raise domestic prices, and encourage domestic firms to increase production. The higher prices faced by consumers cause them to shift consumption to less-preferred goods and services (a consumption inefficiency). These two effects represent the net efficiency losses to the economy due to the tariff.

While industrial growth in many developing countries in the 1950s and 1960s was rapid (see Section 3.1), the industrial capacity created by government intervention often had low or even negative economic returns. The continued existence of such capacity was only possible through government subsidies or restrictions on imports. The use of bureaucratic fiat, rather than a market auction, to allocate investment, set import quotas, and extend bank credit created opportunities for both inefficient bureaucratic discretion and corruption, which politicized economic life (Toye 1993). The efficiency impacts of trade policy interventions are likely to be even more damaging in developing countries. The domestically produced alternatives to imported capital goods are likely to be of lower quality and priced higher. The small domestic market of most developing countries cannot support enough firms to sustain a competitive economic structure in industry (Krueger 1998). Deepak Lal scorned this approach in his 1983 book, *The Poverty of Development Economics*. He labeled as "dirigiste dogma" efforts to replace markets with bureaucratic discretion, the neglect of microeconomic aspects of resource allocation, and the belief that the arguments for free trade were not valid for developing countries. As a result of this dogma, the economic failings of developing countries were not market failures but rather policy-induced government failures (Lal 1983, 103).

Many economists argue that there are also dynamic effects of trade protection and liberalization that can offset or reinforce these static effects. For example, trade protection may stimulate higher production in one sector, spilling over to benefit other sectors in the economy. The government may use tariff revenue to invest in infrastructure and education, raising long-run economic growth. Trade protection may cut producers off from world competition, making them less inclined to undertake the effort associated with cutting costs and mastering new technology. There are also dynamic impacts on politics. To the direct costs of bad policy, we can add the indirect costs created by rent seeking. Restrictions give rise to rents (such as higher profits from producing import substitutes) for which firms and individuals compete—both legally and illegally through bribery, smuggling, and black markets (Krueger 1974). These efforts are "directly unproductive profit seeking" that generates profits for a firm (which, for example, is allocated a quota to import goods or benefits from a tariff to protect domestic production) that are not earned from producing more efficiently (Bhagwati 1982). In addition, whenever a government policy has a clear beneficiary or victim, a special interest group has an incentive to lobby for or against the policy—meaning there is an in-built tendency for interventions to proliferate, which Krueger (1990) argued should be counted in the reckoning of costs of the original policy. This tendency was central to Olson's (1982) more general theory of economic stagnation.

The apparent growth since the 1950s of export-oriented economies such as South Korea, Taiwan, Hong Kong, and Japan also helped give import substitution a bad name. However, careful empirical work has shown that in these cases, export-led economic growth was as much a product of state intervention as was import substitution elsewhere (Wade 1990). This is one case (with which Easterly does not engage) of a "bad" policy having "good" outcomes.

Comparative advantage is the key principle of neoclassical economics. Under various assumptions—such as constant returns to scale, full employment of labor (and other factors of production), and perfect competition—free trade should benefit all countries involved (Skarstein 1997, Ch3). Neoclassical economists argued that good policy should "get prices right" so producers have a true measure of the relative opportunity cost of resources (Hunt 1989, Ch10). There was no doubt in the minds of supporters that "trade liberalization is good for growth" and that "the countries following outer-oriented strategies grew faster" (Krueger 1998:1514).

3 EMPIRICAL EVIDENCE: GOOD POLICY AND ECONOMIC GROWTH

This section reviews the pre–Washington Consensus evidence that catalogued and sought to measure "the costs of intervention." This was the empirical backdrop that motivated the shift to economic liberalization in many countries after around 1980 and generated the first part of our paradox: We expect liberalization to boost economic growth. This section then discusses the empirical evidence that forms the second part of the paradox: What happened to economic growth after liberalization? The pessimistic evidence reviewed in section 3.2 below is mainly structured around before-and-after comparisons. The updated evidence presented in Easterly (2019) is rather limited, so this section also reviews evidence from cross-country growth regressions, the impact of trade liberalization, and episodes of growth and stagnation. Our review finds reasons for pessimism when looking at cross-country growth regressions and trade liberalization evidence. However, the more rigorous body of work identifying episodes of growth and stagnation (and then looking for their probable causes) has found a clear link between liberalization and faster economic growth—which Easterly (2019) did not reference and which suggests there is not as much of a paradox as he implied.

3.1. EMPIRICAL EVIDENCE I: THE COSTS OF INTERVENTION

The Organization for Economic Cooperation and Development (OECD) conducted an important empirical contribution in the 1970s that established the merits of the market by looking at trade and industrial policies in developing countries. These studies covered Brazil, Mexico, Taiwan, the Philippines, Argentina, India, and Pakistan, focusing on these countries' efforts to promote industrialization in the post–World War II era so they could achieve both economic growth and self-sufficiency. The typical means included tariffs, import quotas, production by the public sector, and maintaining an overvalued exchange rate so that imports of equipment, spare parts, and inputs were cheaper. The studies found that, free from foreign—and often domestic—competition, an inefficient domestic industrial sector grew up. Such industries were discouraged from exporting and so failed to achieve potential economies of scale. Since imported capital goods were artificially cheap, production techniques were excessively capital-intensive and employment growth was disappointing. As it was often difficult to import raw materials, manufacturers rarely operated at capacity. Government controls slowed up decisionmaking, fed corruption, and consumed scarce administrative capacity (Toye et al. 1971). The OECD summary volume concluded that administrative controls should be dismantled, with resources allocated according to a rational price system, and agriculture and industry should be reorganized to lean into a country's comparative advantage (Little, Scitovsky, and Scott 1970).

To take one example, the OECD study of Pakistan found that gross national product (GNP) growth had been rapid in the 1960s (5 percent per year) and manufacturing growth in the 1950s and 1960s even higher (10–15 percent per year). From being import-dependent in 1947, Pakistan had achieved near self-sufficiency in an array of basic manufactured goods, including sugar, edible oils, tea, beverages, tobacco, soap, footwear, textiles, and matches (Lewis 1970, 107). The economy had shifted over these years from a dependence on exporting raw materials such as cotton and jute to exporting manufactured goods such as cotton and jute textiles and leather products (118). The principal tools of industrial policy were import tariffs, an exchange control system, import licensing, and an overvalued exchange rate. By 1965/66, tariffs reached 34 percent on capital goods, 70 percent on essential consumer goods, and 180 percent on luxury consumer goods (68). This afforded Pakistan an average effective rate of protection of 103 percent in 1954/55 (Lewis and Guisinger 1968). Domestic prices exceeded world prices by enormous margins by 1963/64, averaging 215 percent as much for sugar, 106 percent for edible oils, 94 percent for soap, 225 percent for apparel, 308 percent for electrical appliances, 56 percent for cotton textiles, and 62 percent for matches (Lewis 1970, 80–81). Meanwhile, producers received inputs at prices well below their opportunity cost to the economy. In cotton textiles, the most important industry in Pakistan, more than two-thirds of the value added was due to protective tariffs and taxes. Some industries, including edible oils and automobile assembly, produced output that was valued less than the costs of inputs on the world market. For others, including silk and artificial silk textiles and apparel, the domestic value added was negligible when both output and inputs were valued at world prices (85).

The OECD reports influenced more policy-oriented research, especially by the World Bank, whose

"Agenda for Action" for sub-Saharan Africa, more commonly known as the Berg Report, is a famous example. The report was written in response to the Lagos Plan of Action for the Economic Development of Africa, a policy document backed by the Organization of African Unity that called for intensified import substitution and self-reliance. The Berg Report, by contrast, drew on the OECD studies to advocate outward-looking policies such as freer trade, correction of overvalued exchange rates, a greater reliance on the private sector, and removing pro-industrialization incentives in favor of promoting agriculture (and allocating resources by comparative advantage). The Berg Report significantly influenced the World Bank's structural-adjustment lending in 1980s, whereby loans were conditioned on countries implementing liberalizing economic policies.

In 1994, the World Bank followed up with *Adjustment in Africa: Reforms, Results and the Road Ahead*, which both reiterated the analysis of the Berg Report and evaluated the results of structural adjustment. The new report stated clearly, "The main factors behind the stagnation and decline were poor policies – both macroeconomic and sectoral – emanating from a development paradigm that gave the state a prominent role in production and regulating economic activity" (World Bank 1994, 20). The poor policies included overvalued exchange rates, large budget deficits, protectionist trade policies, and government monopolies. The outcomes of the "policy failure" identified in the report were striking. Between 1965 and 1985, African per capita GDP growth was less than 1 percent per year; by 1985, two-thirds of Africans had per capita income lower than in the 1970s; between 1965 and 1980, agricultural growth of only 2 percent per year was lagging population growth; and during the 1980–85 economic crisis, black-market exchange-rate premiums averaged 300 percent and government consumption averaged 17 percent of GDP, compared to 11 percent in the East Asia–Pacific region (17–23).

3.2. EMPIRICAL EVIDENCE II: BEFORE-AND-AFTER STUDIES OF LIBERALIZATION

As noted in the introduction, Easterly (2019) reviewed a particular strand of literature to support the perception that widespread economic liberalization after around 1980 had failed to boost economic growth. This literature is structured around a before-and-after narrative about the economic (and often social) impact of economic liberalization.

The big set-piece for this approach was the transformation of communist economies into transitional market ones. Russia underwent a dramatic shift to the market in the early 1990s: Extensive price controls were abolished overnight on January 1, 1992; a rigorous import-control regime was almost completely liberalized and replaced with low tariffs; and the ruble underwent a huge depreciation. State-owned farms were privatized, and 92 percent of land was under private ownership by 1993, with apartments sold to tenants (often at no cost). Over one month, Russia undertook more privatization than Margaret Thatcher did in 10 years (Nolan 1995, 276). The net result was a greater loss of GDP than during World War II. Between 1940 and 1946, industrial production had only fallen 24 percent, but between 1990 and 1999, Russian industrial production fell 60 percent and GDP 54 percent (Stiglitz 2002, Ch5). As the World Bank humbly acknowledged,

> The transition from a communist, centrally planned economy to a capitalist one was expected to be difficult. But the depth of the output collapse was not widely predicted. The length of the transition—in which many countries in 2003, more than a decade later, remain far below their previous levels of output—was not widely forecast. Nor was the variability among countries in the depth and duration of the output collapse. (World Bank 2005, 8).

Other studies also noted a widely acknowledged link between economic reform and "frequent and painful financial crises in Latin America, East Asia, Russia, and Turkey" (Rodrik 2006).

Sometimes (as in Russia), dramatic policy was blamed for dramatic failure; in other analyses, the impact of similarly big policy reform seemed hard to identify. During the 1980s, all countries in Latin America significantly liberalized international trade, external capital flows, and the domestic financial sector. Yet the region's overall economic growth and productivity performance between 1980 and 2000 was lower than in 1950 to 1980 (Rodrik 2004). Economic growth did return to Latin America in 1990–97 but sagged again between 1998 and 2002. In most Latin American countries, inflation and budget deficits were brought under control, and some countries showed export dynamism—in the manufacturing sector in Mexico and Central America and mainly agriculture and natural resources elsewhere. The drivers of economic growth, savings, investment, and productivity remained low (Ocampo 2004). In sub-Saharan Africa, reform was less dramatic, "but there too a substantial portion of the new policy agenda was adopted," with

"disappointing" results that meant the region "failed to take off" (Rodrik 2006).

Between 1980 and 1998, the International Monetary Fund (IMF) and World Bank made 958 adjustment loans to developing countries, conditioning them on strengthening the role of the market and promoting "good policy." Financial depth (measured by the ratio of M2 money supply to GDP), real exchange-rate overvaluation, black-market exchange-rate premiums, and fiscal deficits all improved after 1980—though the link between economic reform and adjustment lending is hard to discern (Easterly 2005). The growth payoff was disappointing. Median per capita income growth in developing countries was 0.0 percent between 1980 and 1998, compared to 2.5 percent between 1960 and 1979 (Easterly 2001). During this 20-year period, some countries received numerous structural adjustment loans, including Argentina (30), Ghana (26), Côte D'Ivoire (26), Senegal (21), Pakistan (20), and Mexico (20), suggesting that earlier loans had not had much impact (Easterly 2005).

Not only had "good" economic policy failed to generate economic growth, but much of the economics profession slid into ambivalence about what did cause growth. William Easterly, in an influential book published in 2001, labeled the effort an "Elusive Quest for Growth." He recorded a list of "panaceas that failed" to boost economic growth, including aid for investment, direct investment, education, population control, IMF and World Bank lending to promote policy reform, and debt forgiveness. In an earlier study, Easterly noted that between 1960 and 1988, growth rates were highly unstable across countries over time, while country characteristics such as education or political stability were highly persistent. Growth was dominated by random economic shocks (such as terms-of-trade shocks, the global debt crisis in the 1980s, and war in the 1970s) but was much less well explained by policy factors (such as investment or exchange-rate management) (Easterly et al 1993:471). In fact, it was likely that bad economic policy was heavily driven by random shocks: War, for example, was closely correlated with the size of the black-market premium on the exchange rate (Easterly et al 1993:473).

By the mid-1990s, the World Bank was still optimistic about Africa. Its 1994 report *Adjustment in Africa: Reforms, Results and the Road Ahead* did not include a question mark in the title. This report constructed an index to measure changes in fiscal, monetary, and exchange-rate policies in Africa between 1981–86 and 1987–91. This did not reflect economic liberalization per se but measured changes in the budget deficit, domestic tax revenue, the real effective exchange rate, and inflation. The report noted that almost two-thirds of the countries had managed to put better macroeconomic and agricultural policies in place by the end of the 1980s. Of the 29 countries studied, the six with the most improvement in macroeconomic policies between 1981–86 and 1987–91 enjoyed the strongest resurgence in economic performance. They experienced a median increase of almost 2 percentage points in the growth rate of GDP per capita, bringing this figure up from a negative level to an average of 1.1 percent per year during 1987–89. By contrast, countries that did not improve their policies saw their median GDP growth fall to a level of -2.1 percent a year. The report acknowledged "improvement" but conceded there was a long way to go. No African country had achieved a sound macroeconomic policy stance, defined in the report as having inflation under 10 percent, a very low budget deficit, and a competitive exchange rate. In a third of the countries, macroeconomic policies deteriorated in the 1980s, partly because they were still taxing their farmers heavily, whether through marketing boards or overvalued exchange rates (World Bank 1994, 3–6).

By the mid-2000s, World Bank pessimism about Africa was again palpable, with one report stating:

> The failure of growth in Africa—either of powerful and rapid growth in a single large country or in a substantial number of smaller ones—was a surprise. Despite good policy reforms, debt relief, continued high levels of official assistance, promising developments in governance, and a relatively supportive external climate, no take-off has ensued. (World Bank 2005, 8)

Despite the sweep of contemporary history, the overwhelming number of case studies, and resulting pessimistic gloom, there is a definite lack of rigor in these analyses. The decadal averages (comparing 1960–79 with 1980–98) assume that liberalization happened everywhere, all at once in 1980.

3.3. EMPIRICAL EVIDENCE III: CROSS-COUNTRY REGRESSIONS ON LIBERALIZATION AND GROWTH

A second body of evidence for the link between liberalization and economic growth has been drawn from econometric analysis, specifically cross-country growth regressions. The pioneer was Barro (1991), who looked at various measures of policy and other growth determinants among a cross section of 98 countries

for 1960–85. The study found that human capital and political instability both affected economic growth (positively and negatively, respectively). However, it was more difficult to tease out implications for economic liberalization. Government consumption had a negative correlation with economic growth, lending some support to the liberalization critique that the expansion of the state relative to the private sector is deleterious—but government spending was also responsible for most of the investment in education, which had a positive impact. A proxy for market distortions (based on purchasing power parity and an investment deflator) also had a negative correlation with economic growth. However, in general, Barro was only measuring the outcome of policy interventions, not the policies themselves.

Barro's pioneering work was followed by a burgeoning industry of cross-country growth-regression papers refining his method, data, and sample size. King and Levine (1993) used an 80-country sample for 1960–89, finding a positive relationship between financial development and economic growth. Li and Liu (2005) used a sample of 84 countries for 1970–99, finding that foreign direct investment (FDI) had a positive impact on economic growth, especially in countries with higher levels of educational attainment.

While financial liberalization and greater openness to FDI were both among the pillars of the Washington Consensus, it is not obvious that these two studies (and so many others like them) supported it. The "developmental states" of South Korea, Taiwan, China, and Singapore provided subsidized credit to increase domestic investment—a model of financial development that did not include financial liberalization. Except for South Korea, these states tried to boost FDI even while placing it under very significant restrictions (Wade 1990). As discussed below, the use of policy outcomes as a proxy measure for policy instruments such as economic liberalization (à la Easterly) is fraught with similar ambiguities.

An enduring problem with cross-country regressions has been their failure to produce a coherent body of empirical results. Levine and Renelt (1992) held that "growth and a particular variable could be considered robust if it remains statistically significant and of the theoretically predicted sign when the conditioning set of variables in the regression changes." (943). They found that "cross-country statistical relationships between long-run average growth rates and almost every particular policy indicator are fragile: small alterations in the 'other' explanatory variables overturn past results." (943). In particular, policies related to liberalization—based on new indicators "constructed to capture the exchange rate, trade, tax, and fiscal-expenditure policies"—were not strongly correlated with economic growth. As Barro (1991) had found, the overall size of the government had no robust relationship with economic growth, nor did disaggregated measures of government spending or the growth rate of government expenditures. Likewise, neither corporate tax receipts, income tax receipts, nor social-security tax receipts had any robust relation with GDP. This is not surprising. Government spending could provide infrastructure or education (as Barro noted) or be wasteful, politically motivated, and funded with distortionary taxation. Levine and Renelt (1992) only found a robust correlation between growth and the share of investment in GDP.

Seeking to explain "Why We Learn Nothing from Regressing Economic Growth on Policies," Dani Rodrik (2012) argued that if a government is trying to achieve a particular economic or political objective, then treating policy as exogenous or random is problematic for the sake of an econometric study. For instance, if government spending expands in response to an economic downturn (such as the Covid-19 crisis), then the econometrics will throw up a spurious negative relationship between the two variables.

3.4. EMPIRICAL EVIDENCE IV: TRADE LIBERALIZATION

Despite the problems associated with cross-country growth regressions, a mini industry developed in the early 1990s seeking to answer a very specific question: How did trade liberalization affect economic growth?

Dollar (1992) declared that 'Outward Orientated Economies Really Do Grow More Rapidly' using evidence gathered from 95 developing countries between 1976 and 1985. Dollar constructed an index which measured the extent to which the real exchange rate was distorted away from its free trade level by the trade regime. In addition, Edwards (1998) looked at nine indices of total factor productivity (TFP) growth across 93 countries and found that TFP grew faster in more open economies.

Sachs and Warner (1995) constructed an openness index that declared a country open to international trade if it fulfilled five criteria: 1) average tariffs were less than 40 percent; 2) non-tariff barriers accounted for less than 40 percent of imports; 3) the country did not have a "socialist economic regime;" 4) the state did not have a monopoly on major exports; and 5) the

black-market premium on the exchange rate was less than 20 percent in the 1970s and 1980s. The index recognized that there were multiple ways an economy could be closed to international trade. The study found that a country fulfilling all five criteria had GDP growth rates that were 2.5 percent higher in the 1970s and 1980s than those that did not. The result was based on a large and robust coefficient in growth regressions that used a dummy variable to indicate if and when a country met these criteria.

These early studies faced a problem in that a correlation between trade and income does not imply causation. The fact that geography has an impact on trade uncorrelated with other determinants of income offered one potential empirical solution. Frankel and Romer (1999) constructed a measure of the geographical component of a country's trade to obtain improved (Instrumental Variable) estimates of the effect of trade on income. They found that trade had a large, robust, and positive impact on income.

By the late 1990s, Anne Krueger could reasonably declare, "It is now widely accepted that growth prospects for developing countries are greatly enhanced through an outer-oriented trade regime and fairly uniform incentives (primarily through the exchange rate) for production across exporting and import-competing goods" (Krueger 1997:1).

The response was soon forthcoming. A widely discussed, influential paper unleashed a withering fire on the methodologies, data, and results of the seminal works linking trade liberalization with growth (Rodriguez and Rodrik 2001). For instance, the Dollar (1992) results were contingent on assumption that the extent to which the real exchange rate deviated from its free-trade level was a function of the trade regime. This, Rodriguez and Rodrik argued, was only true under very restrictive conditions. The Sachs and Warner (1995) index relied heavily on measures of the "state monopoly of major exports" and "black-market premium"—variables strongly correlated with location in sub-Saharan Africa and Latin America, respectively. The Sachs-Warner index was, in practice, measuring the geographical location of poor policy rather than trade liberalization per se. The Edwards (1998) results on TFP and trade liberalization were not found to be robust. The Frankel and Romer (1999) results linking geography and trade ignored the direct effects of geography on income, for example through distance, disease, and natural resources.
There are two more recent analyses worth noting here. One study by Estevadeordal and Taylor (2008) made a "painstaking effort" to collect new tariff data on capital and intermediate goods, finding a significant correlation between tariff reductions and subsequent acceleration in economic growth between 1975 and 2004. The study used a "treatment-and-control partition of countries on the basis of whether they engaged in WC-style trade liberalization" to test whether countries cutting tariffs saw an increase in economic growth relative to countries not cutting tariffs. A separate study by Grier and Grier (2021) used the Fraser Institute's Economic Freedom of the World Index—which incorporates free-trade policy, but also property rights, government spending, regulations, and sound money—to find that a discrete jump in the index (reform along the lines of the Washington Consensus) had a positive, sizeable impact on economic growth in 49 countries between 1970 and 2015. The impact lasts up to ten years relative to a counterfactual group of non-reforming countries.

While no study has found trade restrictions to be systematically associated with higher economic growth, economists should be more cautious and humble in interpreting the evidence. In this literature, the link between trade openness and growth tended to be contingent on whether a country was big or small, whether it had a comparative advantage in manufacturing or agriculture, and/or whether it liberalized during a period of rapid or slow growth in international trade. It is easy to overstate the influence of trade policy on economic growth. And giving too much attention to trade reform could easily divert scarce administrative and political capital from other policies that might have a greater impact on growth (Rodriguez and Rodrik 2001).

3.5. EMPIRICAL EVIDENCE V: EPISODES OF GROWTH AND STAGNATION

Another methodology has been to flip the policy-to-growth sequence and instead identify distinct episodes of economic growth or stagnation, then examine what (if any) policy changes are associated with them. This literature has identified a clear link between liberalization and faster economic growth—adding more rigor to the crude methodology of the studies reviewed in section 3.2, which posited that liberalization happened everywhere circa 1980.

Growth rates in developing countries are characterized by instability and volatility. One study by Pritchett (2000), using data for 111 countries beginning in 1960, showed that countries' growth rates often shift in identifiable episodes. Growth in 55 of the 111

countries either accelerated or decelerated by more than 3 percent at some point. Particularly among less-developed countries, the data implied that "shifts and fluctuations are the dominant features of the time-series evolution of GDP per capita." Before and after statistically chosen "structural breaks," the study found distinct patterns of growth: "steep hills," "hills," "mountains" (including "cliffs"), and "plains." For example, "mountains" comprises 33 countries with growth of at least 1.5 percent before a structural break and negative growth after—including oil and commodity exporters such as Côte D'Ivoire, Guyana, Jamaica, and Zambia, as well as "Latin American countries affected by the debt crisis," namely Argentina, Bolivia, and Paraguay (227–32).

A follow-up study by Hausmann, Pritchett, and Rodrik (2005) defined "growth accelerations" as an increase in per capita growth of at least 2 percent, sustained for at least eight years with a post-acceleration growth rate of at least 3.5 percent. To exclude cases of mere recovery, post-acceleration output must exceed the pre-episode peak. Using this filter, the authors identified 83 growth accelerations between 1957 and 1992 in a 110-country sample. Overall, 54.5 percent of countries had one acceleration and 20.9 percent at least two accelerations. The most accelerations occurred in Asia (21), though almost as many occurred in Africa (18) and Latin America (17).

This stylized pattern of episodes of growth and acceleration allows us to examine the conditions that correlate with an episode of growth or stagnation (Pritchett 2000). Many of the results link "good" policy outcomes to faster economic growth. For instance, "the share of GDP that is traded rises substantially with up-breaks… by about 25% over the regime average" because of increasing exports and imports. These income expansions are likely not due to terms of trade shocks (which are small) but to trade liberalizations. Overall, growth accelerations are not strongly correlated with capital accumulation but are strongly associated with international trade—though growth *collapses* are tied to monetary instability (Jones and Olken 2008). Countries that suffered spells of real-income stagnation are more likely to be poor, located in Latin America or sub-Saharan Africa, conflict-ridden, or dependent on primary commodity exports (Reddy and Minoiu 2009). Growth accelerations "coincide with an increase in the export and import ratios," an increase in the investment ratio, and large exchange-rate depreciation (Hausmann, Pritchett, and Rodrik 2005). As noted in the introduction, these outcome measures do not map onto individual policy tools.

Another strand in the literature has examined whether episodes of growth are associated with economic liberalization. Hausmann, Pritchett, and Rodrik (2005) were pessimistic about the link, finding that just 14.5 percent of growth accelerations are associated with liberalization, as measured by the Sachs and Warner (1995) index—meaning "85.5 percent of growth accelerations are *not* preceded or accompanied by liberalizations"—and only 18.8 percent of liberalizations are correlated with subsequent growth takeoffs. However, "financial liberalization has a strong positive impact on the probability of experiencing a growth acceleration."

Wacziarg and Welch (2008) further updated and improved the Sachs and Warner (1995) index, adding new data from Eastern European countries, from a comprehensive survey measuring socialist orientation and the role of export marketing boards, and on the black-market premium. The results, based on within-country variation, suggest that the long-term effects of increased policy openness were "positive, economically large, and statistically significant" (189). Between 1950 and 1998, "countries that liberalized their trade regimes experienced average annual growth rates that were about 1.5 percentage points higher than before liberalization." At first, the effect is not statistically significant, with growth rising by only 0.30 percentage points in the first three years. However, "sustained growth differences become apparent three years after reform, with annual increases in growth of 1.44 points" between three and six years after reform, and "countries that followed through by deepening trade reforms over time did better than countries that did not" (204–209).

These results were replicated by Jong-a-Pin and de Haan (2011), who included a dummy variable set to equal 1 during the first five years after a country has liberalized its markets. They found that "the effect of economic liberalization on the probability for growth accelerations is highly significant across all specifications."

Finally, Berg, Ostry, and Zettelmeyer (2011) found trade liberalization to be associated with both initiating growth and sustaining it, "particularly when combined with competitive exchange rates, current account surpluses and an external capital structure weighted towards foreign domestic investment" rather than, for example, short-term commercial borrowing. In addition, a larger "manufacturing share in exports and, more generally, export product sophistication tend to predict prolonged growth."

4 INDIA: LIBERALIZATION AND ECONOMIC GROWTH

This section introduces the India case study, reflecting on Easterly's wider narratives about good policy and economic growth that were discussed in earlier sections. First, data from India shows that from the 1950s through at least the 1980s, the state intervened heavily; this was accompanied by a widely held narrative that economic liberalization would boost economic growth. Second, it shows that India began extensive liberalization in 1991. Third, it shows that economic growth in India was disappointing in the 1990s (post-liberalization), especially compared to the 1980s (pre-liberalization). At first glance, the India case study prompts the question, where has all the growth gone? Section 5 will discuss new indicators that inform India's performance, and Section 6 will discuss the acceleration in growth in India after 2003.

4.1. INTERVENTION (BAD POLICY) AND THE PROMISE OF ECONOMIC GROWTH

After India's independence, both private- and public-sector industries were subject to extensive government intervention. The Industrial Licensing Act of 1951 mandated that firms acquire a license to establish a new undertaking, expand capacity, use new technology, import materials, exit an industry, or manufacture a new article. Overburdened ministries allocated licenses using simple rules of thumb, such as granting them to firms that already had some manufacturing capacity rather than making the time-consuming effort to evaluate which firms would be able to produce most efficiently. The uncertainties and delays associated with license allocation discouraged long-term planning by industry. From 1967 onward, some areas of industrial production—a list that comprised 180 items by 1977—were reserved exclusively for the (often inefficient) small-scale sector. The Monopoly and Restrictive Trade Practices (MRTP) Act passed in 1969 was intended to reduce the market power of large companies but in practice did little more than add an extra layer of licensing and regulatory controls. Foreign trade was strictly regulated by tariffs and elaborate quotas. Trade protection was granted to all domestic production, regardless of cost, simply to support indigenous capacity. Eighteen important sectors—including iron and steel, heavy industry and machinery, telecommunications and telecom equipment, mineral oils, mining of various ores, air transport services, and electricity generation and distribution—were reserved for the public sector (Bhagwati and Desai 1970; Bhagwati and Srinivasan 1975; Ahluwalia 1985).

Scholars have connected such interventions with resulting inefficiencies and slower economic growth: The "effect of inadequacies in the policy design and framework showed itself in stagnant growth rates" (Bhagwati 1993, 40). An evocative cover of *The Economist* in the early 1990s showed a picture of a caged Bengal tiger, the clear implication being that economic liberalization in India would unleash rapid economic growth.

4.2. ECONOMIC LIBERALIZATION AFTER 1991

By the end of the 1980s, only 12 percent of manufactured imports were subject to neither quotas nor licenses, and the average tariff was around 90 percent. Yet a dramatic shift occurred after 1991, when India accelerated domestic liberalization and opened up to international trade. The share of imported products subject to quantitative restrictions declined from 87 percent in 1987/88 to 45 percent in 1994/95. Average tariffs fell from more than 87 percent in 1990 to 43 percent in 1996, and their standard deviation dropped by about 30 percent during the same period (Topalova and Khandelwal 2011). The effective rates of protection on intermediate goods declined from 88 percent in 1991–95 to 40 percent in 1996–2000, on capital goods from 54 percent to 33 percent, and on consumer goods from 54 percent to 33 percent. The percentage of manufactured goods subject to non-tariff barriers declined from 42 percent in 1991–95 to 28 percent in 1996–2000 for intermediate goods, from 20 percent to 8 percent for capital goods, and from 46 percent to 33 percent for consumer goods (Kotwal, Ramaswami, and Wadhwa 2011, 157–8). The controls on large enterprises under the MRTP Act were abolished and emphasis instead placed on unfair trade practices (though this had little practical effect). Meanwhile, the 18 sectors reserved for the public sector were shrunk to just atomic energy, defense aircraft and warships, and railway transport.

In addition, the Reserve Bank of India (RBI) introduced the concept of automatic approval for FDI and abolished the 40 percent limit on foreign equity. The RBI was initially empowered to approve up to 51 percent foreign ownership in 34 priority industries, and this list grew over time. Infrastructure firms were allowed to be 100 percent foreign-owned to attract

FDI for projects in construction and maintenance of roads, highways, bridges, toll roads, ports, and harbors. And although the public sector continued to dominate banking throughout the 1990s, private banks were permitted to operate with up to 74 percent foreign ownership; by the early 2000s, 150 foreign bank branches were in operation. Until the early 1990s, telecommunications were a state monopoly, but "the 1994 National Telecommunications Policy provided for opening cellular and basic value-added telephone services to the private sector with foreign investors granted entry." The 1999 New Telecom Policy further permitted FDI up to 49 percent without approval, including in cellular services (Panagariya 2004, 2008; Kotwal et al 2011).

4.3. ECONOMIC GROWTH AFTER 1991

As with the general literature on post-reform growth, there is a palpable sense of disappointment about the outcomes of economic liberalization in India, especially when compared to countries such as Vietnam and China. The growth rate throughout the 1980s and 1990s remained at about 6 percent annually (Virmani 2004a; Acharya et al. 2006; Kaur 2007). Liberalization did not appear to grant India a higher growth trajectory. The bigger structural break had occurred in the early 1980s, when annual GDP growth jumped from its longer-term trend of around 3.5 percent in the 1950s through 1970s up to 5–6 percent (Acharya et al. 2006; Wallack 2003; Kaur 2007). Economic growth could best be divided into two sub-periods: 1950/51 to 1979/80 (3.5 percent) and 1980/81 to 2004/05 (5.6 percent). The reforms of 1991 had no discernable impact on this trend (Nayyar 2006).

This pattern of relative stagnation after an upward jump around 1980 survives more elaborate statistical testing. Using a Hodrick-Prescott filtered series, Virmani (2004b) found that economic growth decelerated during the 1950s and 1960s, reaching a low in 1971–73, then accelerating gradually from the mid-1970s to the mid-1990s and decelerating again until 2003/04. Growth after 1979/80 was led not only by manufacturing but also services, in particular hotels and restaurants, transportation, finance, real estate, and community and personal services (Virmani 2004a; Balakrishnan and Parameswaran 2007, 2919). By comparison, growth in both agricultural and manufacturing output declined in the 1990s relative to the 1980s (Acharya et al. 2006, 128).
Scholars have speculated on the driver of the structural break around 1980. Nayyar (2006) argued that the break was driven by the near 13-percent increase in agricultural output in 1980/81, making this growth the result of fortuitous weather rather than any policy change. Sen (2007) argued that the break was caused by an acceleration in the rate of private investment in equipment, which in turn was driven by three policy-influenced factors: a fall in the relative price of equipment, a rise in public fixed investment, and financial deepening. McCartney (2009) argued the break was due to a big increase in public investment in infrastructure.

The 1990s exhibited few signs of economic dynamism. Between 1990 and 1999, India's gross domestic savings increased from 23.1 percent to only 23.2 percent, and investment actually declined from 26.3 percent to 24.3 percent (Acharya et al. 2006, 125). TFP growth increased slightly from 2.0 percent in the 1980s to 2.6 percent in the 1990s, and the proportion of growth explained by TFP barely increased from 37.7 percent to 39.7 percent (Acharya et al, 2006:130). Where was that Bengal tiger, newly unshackled and bounding energetically out of its cage?

Liberalization in 1991 appears to have been a non-event in Indian economic history. Between 1901/02 and 1946/47, average annual economic growth was only 1.15 percent, meaning there was almost no per capita income growth. The most dramatic structural break in India's twentieth-century economic growth occurred in the three decades after 1950, with annual GDP growth rising to 3.6 percent by 1980 (Virmani 2004a; Hatekar and Dongre 2005; Balakrishnan and Parameswaran 2007).

Some argue that growth in the 1990s was distinguished not by any acceleration but by its sustainability. The rapid growth of the 1980s, especially after 1987, was driven by a fiscal expansion that boosted manufacturing and productivity but prompted a rapid buildup of budget and trade deficits (Panagariya 2004). However, there is not much evidence for the claim India had fiscal sustainability in the 1990s. Foreign debt increased from $20.6 billion in 1980/81 to $64.4 billion in 1989/90 (Joshi and Little 1994, 186). The consolidated deficit of the central and state government showed a sharp increase from 6.8 percent of GDP between 1980/81 and 1983/84 to 9.0 percent between 1984/85 to 1990/91. The domestic deficit did briefly decline to 7.1 percent between 1991/92 and 1996/97 but then increased again to 8.9 percent between 1997/98 and 2000/01 (Acharya et al. 2006, 114). A related argument to that of fiscal sustainability in the 1990s was that economic growth became more stable in the 1990s (Panagariya 2004).

While it is true that the variance of economic growth declined from 5.5 in the 1980s to 3.08 in the 1990s, a longer comparison reveals it the real success came in the 1980s, when the variance of economic growth declined sharply from 15.76 in the 1970s and 12.15 in the 1960s (Sinha and Tejani 2004, 5634).

5 NEW EVIDENCE ON POLICY AND GROWTH

The key to Easterly (2019) is the updated evidence on policy he provides. Theory offers no clear guidance as to what constitutes 'good' policy and Easterly acknowledges his own criteria are rather arbitrary. Bruno and Easterly (1996) do offer empirical evidence that distinguishes the economic impact of extreme (40%+) as compared to moderate inflation (20-40%). For the other policies discussed by Easterly he uses a mix of intuition and criteria that ensure the availability of enough examples to run the empirical analysis. Easterly aims to adjust for non-policy determinants of the policy outcomes whenever there was an obvious way to do so. The dependent variable is annual GDP per capita growth from 1961 to 2015.

There is a significant problem with trying to infer "good" policy from "bad" policy outcomes such as inflation, the black-market premium on foreign exchange, overvaluation of the domestic currency, negative real interest rates on bank savings deposits, and abnormally low trade relative to GDP. As noted in the introduction, these outcomes do not map onto specific policy configurations. Rodrik (2004) gave the examples of China and Vietnam, where the property rights of investors have been protected even in the absence of private property rights and exports were promoted using subsidies rather than liberalizing trade. When judged by the Easterly (2019) measures of "good" policy, India appears to be a non-reformer, even though it has demonstrably conducted significant liberalization since 1991. The entirety of India's reform effort is not captured by Easterly's measures of policy reform.

5.1. INFLATION

Any global statistical studies of inflation and economic growth between 1960 and 2015 would be dominated by cases of hyperinflation. The widespread occurrence of moderate and extreme inflation in the 1980s (occurring in around 25 percent of countries) helped induce the widespread acceptance of the need for fundamental reform that culminated in the Washington Consensus around 1990. Hyperinflation in various Latin American countries, such as Bolivia in 1984/85, prepared decisionmakers to consider shock therapy–based market solutions. Inflation did not decline immediately but peaked in 1995, when around 40 percent of countries suffered moderate or extreme inflation (Easterly 2019). After 1995, there was a strong downward trend, and only about 5 percent of countries had "bad" inflation by the late 2010s. This turnaround is particularly striking in Latin America, where almost all countries had inflation above 20 percent in 1991—and a substantial number above 40 percent—but where the incidence of high inflation largely disappeared between 2000 and 2019 (Easterly 2019, 11).

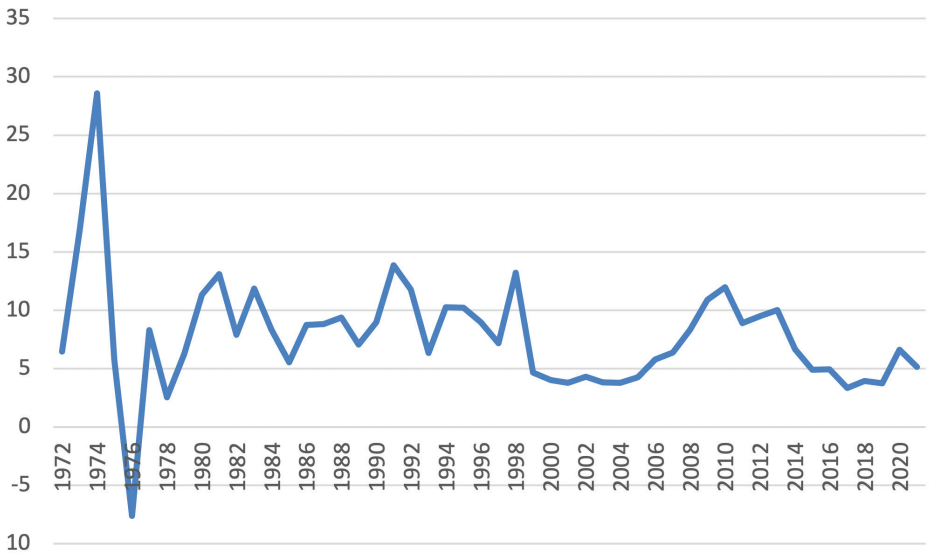
FIGURE 1 shows that by the metric of inflation, and apart from a single year of moderate inflation in 1973, India had long decades of good economic policy outcomes by Easterly's definition. From 1978 to 2010, inflation in India fluctuated at around 5–10 percent, with an interlude of more stable, low inflation between 1999 and 2005.

5.2. THE BLACK-MARKET PREMIUM

The black-market premium is defined as the percentage difference between the black-market exchange rate for a domestic currency (usually denominated in US dollars) and the official exchange rate. "Extremely bad" black-market premiums are defined as those above 40 percent and "moderately bad" as above 20 percent. As with inflation, across Easterly's (2019) global sample there was some worsening of outcomes though the 1980s, peaking at over 40 percent of countries having moderate or extreme black-market premiums. This was another reason for widespread advocacy of reform by the late-1980s. After the early 1990s, moderate and extreme black-market premiums began to decline; sub-Saharan Africa in particular saw a notable decline since the 1980s, and no African countries have recorded black market premiums above 20 percent since 2009 (Easterly 2019).

In contrast to its track record on inflation, India very much reflected these global trends. **TABLE 1** shows that India had "extremely bad" exchange-rate policy in the 1960s by the Easterly (2019) metric, declining to "moderately bad" policy in the 1970s that worsened in the early 1980s and then improved again. India gradually liberalized its currency and loosened controls on capital movements, thereby gradually eliminating the incentive to trade on the black market. In India's

FIGURE I
Inflation in India (Consumer Prices, Annual %)



Source: World Bank (2023)

TABLE I
Black-Market Premium as a Percentage of the Official Exchange Rate

YEAR	BLACK-MARKET PREMIUM
1950-55	5.04
1956-60	21.03
1961-65	58.85
1966-70	50.24
1971-75	30.75
1976-80	16.06
1981-85	56.34
1986-90	34.02
1991-94	15.52
1950-94	**34.39**

Source: Siddiki (2000, 311)

case, it was less that bad policy motivated reforms and more that good policy preceded economic reform. India again demonstrates that good policy (as per Easterly) and economic liberalization are two different concepts.

5.3. EXCHANGE RATE OVERVALUATION

Easterly (2019) first derived a benchmark for exchange-rate overvaluation using purchasing power parity (PPP) data, then corrected it "for the relative cheapness of nontraded goods in poor countries." He defined "extremely bad" overvaluation as being greater than 100 percent and "moderately bad" overvaluation as between 50 and 100 percent. In the global sample, overvaluation had mostly disappeared by the early 2000s, then reappeared between 2008 and 2015, though not at rates as bad as between 1961 and 1980 (Easterly 2019, 15).

While Easterly did not include his calculations for each country, data on India's real effective exchange rate (REER), shown in **TABLE 2**, shows a dramatic depreciation of the rupee after the 1980s, suggesting that a correction of the exchange rate occurred before liberalization in 1991. Meanwhile, the *nominal* exchange rate depreciated from 7.86 to 22.74 rupees to the dollar between 1980 and 1991. The rupee was further devalued by 20 percent in 1991, but the shift to good outcomes (as Easterly measures) clearly pre-dated economic liberalization. After 1991, India maintained a remarkably good policy regime regarding the exchange rate. This success is striking compared to countries such as Brazil, South Korea, Indonesia, Thailand, Malaysia, Russia, China, the Philippines, and South Africa—where, compared to India, the REER fluctuated widely between 1994 and 2020 (Raut 2021). Again, the case of India shows that Easterly's measure of policy reform is different from economic liberalization.

TABLE 2
India's Real Effective Exchange Rate (REER)

PERIOD	REER
1970s	161.3
1980s	153.9
1990s	100.9
2000s	99.9
2000/01	100.1
2001/02	100.9
2002/03	98.2
2003/04	99.6
2004/05	100.1
2005/06	102.4
2006/07	98.5
2007/08	104.8
2008/09	94.4

Source: (Kumar, 2010:47)

5.4. REAL INTEREST RATES

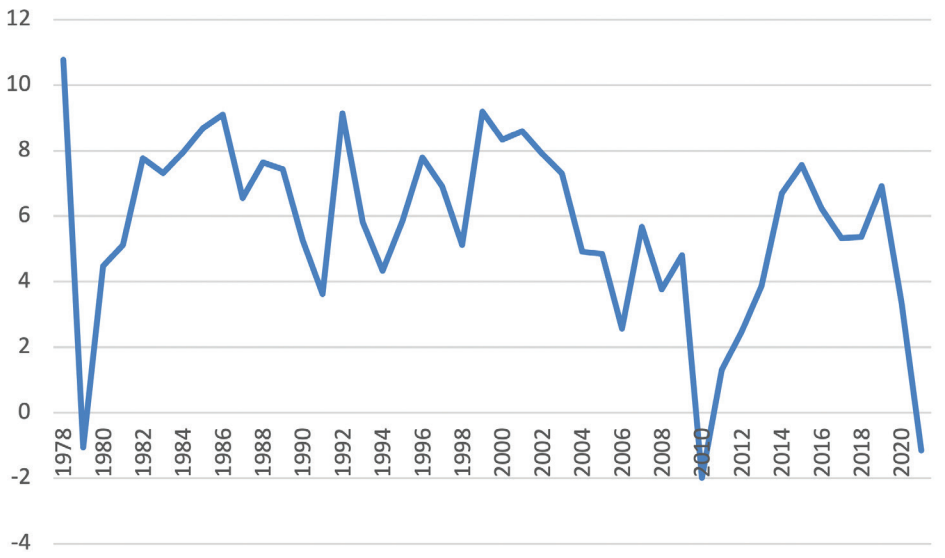
Easterly (2019) defined an "extremely bad" real interest rate as being less than -20 percent and "moderately bad" as between -5 and -20 percent. Globally, there was a downward trend in the "extremely bad" and "moderately bad" real interest rates, except for a spike around the Global Financial Crisis (GFC) in 2009 (Easterly 2019). **FIGURE 2** shows that India had good policy outcomes, as per the Easterly criteria, from the late 1970s through 2021. There were brief dips into negative interest rates in 1979 (amid global inflation), 2009 (during the GFC), and in 2021 (during the global Covid-19 crisis) but these were quickly corrected. Again, the Easterly measure of good policy is not synonymous with liberalization.

5.5. THE TRADE RATIO

Easterly (2019) acknowledged the policy outcome variable he used that is most distantly related to actual policy (and often criticized on these grounds) is the trade-to-GDP ratio. This ratio captures the impact of trade policy but also of non-policy factors such as endowments of raw materials (especially oil) and the falling costs of transport and communication. The trade-to-GDP ratio (the sum of exports and imports of goods and services measured as a share of GDP) also needs to be "corrected for population size, since small countries tend to trade more." Therefore, per Easterly, "An extremely bad ratio is defined as more than 40 percentage points less than the predicted trade ratio based on log population size. A moderately bad trade ratio is defined as between 30 and 40 percentage points below the predicted value." Worldwide, there has been "a downward trend in abnormally low trade ratios" since 1961 (Easterly 2019).

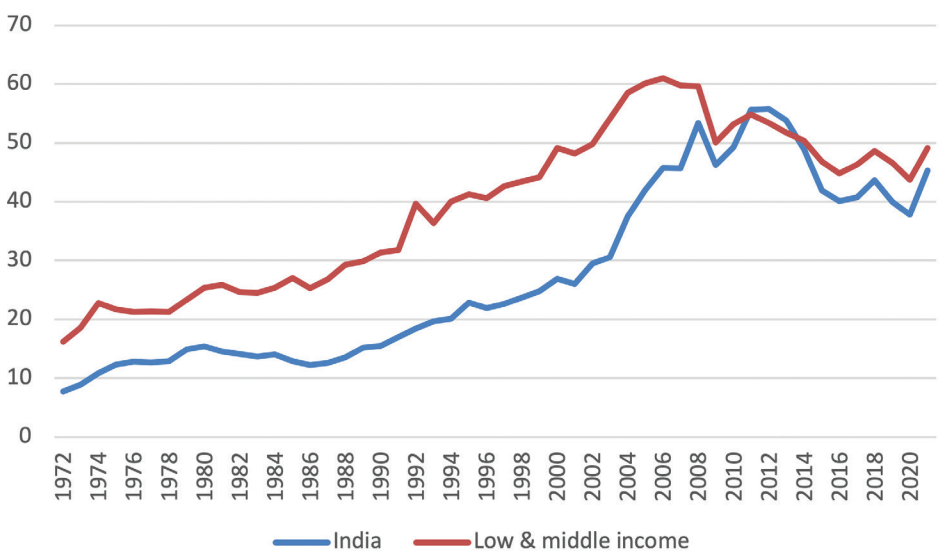
FIGURE 3 shows that India did have an unusually low and stagnating trade ratio in the 1970s and 1980s, below average for low- and middle-income countries. However, given India's size and the empirical evidence that large countries trade less, this gap was smaller than suggested here. India followed the rising trend

FIGURE 2
India's Real Interest Rate (%)



Source: World Bank (2023)

FIGURE 3
Trade (% of GDP)



Source: World Bank (2023)

of other low- and middle-income countries from the early 1990s onward, though the gap showed no signs of diminishing until around 2002. Thereafter, the trade share grew rapidly, and India converged with other low- and middle-income countries, which together shared a decline in the trade ratio after 2010. In this case, there is clearer evidence that economic liberalization after 1991 was associated with a rising trade share in India.

5.6. SUMMARY

Summarizing the number of countries with any bad policy (defined as having any measured policy outcomes be "extremely" or "moderately" bad), Easterly documented a downward trend—both globally and in Latin America and sub-Saharan Africa—with the sharpest break occurring around the mid-1990s. The decline in the prevalence of "extremely bad" policy outcomes is even more dramatic, going from around 35 percent of countries in the early 1990s to being almost nonexistent in the 2010s (Easterly 2019, 18). Economists' early disappointment with reform in Africa and Latin America was arguably premature because not enough reform had happened and not enough post-reform growth data was available (Easterly 2019, 19).

Easterly compared a group of 92 countries that improved policy outcomes in 1999–2015 to a group of 52 countries that had no "extremely bad" policies to eliminate. "Extremely bad" outcomes for the black-market premium, inflation, overvaluation, and the trade share are all significantly correlated with low growth—though negative real interest rates are not significant even for the extreme of less than -20 percent. "Moderately bad" policy outcomes on inflation and the trade ratio are also significant when controlling for all other policies—but "moderately bad" black-market premiums, overvaluation, and real interest rates do not, and there is less evidence overall for the negative effects of "moderately bad" policies than there is for "extremely bad" policies. Countries that had the opportunity to reduce "extremely bad" policies did so, leading average per capita growth to increase by 1.4 percentage points between 1980–1998 and 1999–2015. Countries with no "extremely bad" policies to reduce saw growth fall by 0.5 percentage points between the same two periods (Easterly 2019). India did have "extremely bad" policies (largely due to extensive government intervention), many of which were eliminated after 1991, but this is missed by the Easterly analysis.

The results partly confirm earlier pessimism that there was little growth payoff to economic reform in the 1980s. For some scholars, this necessitated research into deeper determinants of economic growth, such as geography, institutions, and governance. Easterly (2019) returned attention back to policy, highlighting that there was much less reform than earlier assumed, as demonstrated with the addition of data from 1990 to 2015. The most robust evidence for the dearth of reform was that the gradual elimination of "extremely bad" policies did eventually boost economic growth. The finding that "moderately bad" policies are not very robust predictors of growth could possibly even support a criticism of the Washington Consensus that it was too obsessive about getting policies exactly right. Despite these caveats, the new "stylized facts" are consistent with a more positive view of reform compared to the previous skeptical consensus. The reform critics, including Easterly, failed to emphasize the dangers of "extremely bad" policies in the previous reform literature or to note how common they were. By now, the reform movement seems to have accomplished the elimination of policies generating the most extreme market distortions, a trend associated with the revival of growth in sub-Saharan Africa, Latin America, and other regions (Easterly 2019).

The India case study continues to raise a big question. India had generally "good" policy outcomes in 1991 as judged by Easterly (2019) but "extremely bad" policies as judged by the Washington Consensus. India did conduct extensive liberalization after 1991, so where did all the growth go?

6 WHAT DID LIBERALIZATION DO?

Easterly's answer to the paradox of liberalization without economic growth was that it took much longer for developing countries to implement good economic policy than previously accounted for and that economic growth increased once they did. Yet despite his innovative thinking, Easterly (2019) retained the common assumption that liberalization should have an immediate impact on economic growth.

There is voluminous evidence that India conducted significant economic reforms in line with the Washington Consensus in the 1990s (as summarized in Section 4.2). India's economic reform can also

be benchmarked against the original checklist of the ten policies of the Washington Consensus (Williamson 2000). In the 1990s, India made little progress compared to the 1980s in terms of "fiscal discipline;" "privatization;" and "redirection of public expenditure priorities toward fields… such as primary health care, primary education, and infrastructure." India made substantial progress in "tax reform," "trade liberalization," "interest rate liberalization," "deregulation (to abolish barriers to entry and exit)," and "liberalization of inflows" of FDI. (In 1991, India already had relatively "secure property rights" and a "competitive exchange rate.") So, what happened to the predicted impact on India's economic growth?

The answer is that the growth impact of better policy is delayed. There is some limited cross-sectional evidence to support this contention. As discussed in Section 3.6, Wacziarg and Welch (2008) found trade liberalization had minimal impact in the first three years, but a growth benefit became apparent between three and six years after reform. There is detailed evidence for a lagged growth impact in the case of India. This section provides evidence for three reasons: 1) before affecting economic growth, liberalization had to wait for complementary policy reforms; 2) liberalization did have a significant impact at the firm level; and 3) liberalization had a J-curve impact on productivity. Easterly argued that good policy takes time to emerge; this paper argues that good policy takes time to have an effect.

6.1. LIBERALIZATION AND COMPLEMENTARY REFORMS

Dreze and Sen (2013) argued that liberalization is necessary but needs to be supported by vigorous improvements in health, education, empowerment, and infrastructure to realize the positive impacts on economic growth. Easterly (2019), however, did not explore the role of complementary policy reforms or, by extension, state capacity.

For example, it is often (reasonably) assumed that literacy is a precondition for employment in export-oriented factories, even sweatshops. Yet a survey of textile factories in the Indian town of Tiruppur found that by the late 1990s 96 percent of workers were employed as "casual" labor in predominantly small-scale enterprises, 99.7 percent of whom were literate (Neetha 2002). A constraint on incumbent and new firms (whether domestic or foreign) producing goods for export in India in the 1990s was the low level of literacy. Census data shows that literacy rates increased from 41 percent in 1981 to 48 percent in 1991, 61 percent in 2001, and 69 percent in 2011 (World Bank 2023).

A second factor is the (culturally determined) constraint on women leaving the household to work in export-oriented factories. India has one of the lowest rates of female labor-force participation (FLFP) in the world. In 2008, only 30 percent of women of working age participated in the Indian labor market. By comparison, FLFP for women aged 15 or older was 68 percent in China and Vietnam, 35 percent in Sri Lanka, 63 percent in Bangladesh, and 58 percent in Nepal (Thomas 2012). FLFP in India had been declining since the 1990s and worsened further after these figures were collected for 2008 (World Bank 2023).

Liberalization may increase incentives to export, as well as increase competition, thereby inducing firms to upgrade technology or switch to more efficient input suppliers. However, poor logistics and transport may undermine the concrete impact of these incentives. As documented by Ghani, Goswami, and Kerr (2016), India's large-scale investment in transport infrastructure in the 2000s helped alleviate this constraint:

> Road transport is the principal mode of movement of goods and people in India, accounting for 65% of freight movement and 80% of passenger traffic… While national highways constitute about 1.7% of the road network, they carry more than 40% of the total traffic volume. To meet its transportation needs, India launched its National Highways Development Project (NHDP) in 2001…, aimed at improving the Golden Quadrilateral (GQ) network.

This project sought to improve the quality and width of almost 6,000 kilometers (3,700 miles) of existing highways connecting the four largest cities in India: Mumbai, Delhi, Chennai, and Kolkata. As a result of these upgrades, there was significant growth in formal-sector manufacturing in districts within 10 kilometers (7 miles) of the highway network, with output growing by 49 percent in the decade since construction began. As these districts contained a third of India's initial manufacturing base, this output growth represented a substantial increase in activity that easily outweighed the costs of the upgrade (Ghani, Goswami, and Kerr 2016).

In a different study, Datta (2012) used World Bank Enterprise Survey data for India, comparing a representative sample of 1,091 firms in 37 Indian cities in 2002 (when the NHDP had just begun) to the same firms in 2005 (when it was approximately

two-thirds complete). Firms near the GQ network reduced their average input inventory (the number of days of production for which the inventory on hand was sufficient) by 7.5 days more than other firms—they could more easily restock their inputs. Firms that gained better highway access were also more likely to have "switched the supplier who provided them with their primary input," suggesting that better suppliers became easier to access. In addition, "Firms in cities affected by the highway project became 7.6 percentage points, or about 60 per cent, less likely to report that transportation constituted a 'major' or 'severe' obstacle to production, while there was no significant change in the responses of firms in off-Golden Quadrilateral cities" (Datta 2012).

6.2. WHAT IS LIBERALIZATION DOING AT THE FIRM LEVEL?

The aggregate, macro-level data used by Easterly (2019) does not shed light on the channels through which policy reform can transform the economy at the micro or firm level.

Deregulation is one of the ten policies of the Washington Consensus that Easterly (2019) did not explicitly study. The impact of deregulation is best examined by using firm-level data for a particular industry, not aggregate, macro-level data on GDP. In the case of India, this allows us to look at industry-specific examples of deregulation. For instance, Chari (2011) analyzed India's 1985 deregulation of industrial licensing in the manufacturing sector. Prior to 1985, firms required licenses before setting up a factory or expanding output in an existing one. Factory-level data from before and after the deregulation of 211 industries, 41 of which were deregulated in 1985, showed that these industries experienced both new entry and productivity growth. Alfaro and Chari (2012) examined the impact of another round of deregulation that occurred in 1991, when licensing was abolished for all but 18 industries and large companies no longer needed MRTP Act approval to increase their production capacity. Data on more than 10,800 firms, constituting more than 70 percent of industrial output, showed that average firm size declined significantly in deregulated industries, consistent with greater competition. There were also significant changes in the distribution of firm size, with more (small) firms entering and (large) incumbents getting larger. Alfaro and Chari (2013) subsequently used a measure of industry concentration (the Herfindahl index) to show that the domestic market in India became more competitive during the 1990s: Incumbent firms' average market share declined from 99 percent to 79 percent between 1989 and 2005; incumbent firms got bigger after liberalization; and the entry of new small firms ensured that the average manufacturing firm was growing smaller in terms of assets and sales.

Trade liberalization is another pillar of the Washington Consensus, one Easterly (2019) only indirectly measured by looking at the trade-to-GDP ratio—which as he acknowledged is influenced by both policy and other factors. Firm-level evidence allows us to examine the impact of trade liberalization on economic growth in India much more directly. Using data from 4,100 Indian manufacturing companies for 1989 to 2001, Topalova (2004) found that reductions in tariffs led to higher productivity. The result is "robust and highly statistically significant for private companies" but not for government-owned or foreign companies. Further research showed that two forces drove this outcome: 1) increases in competition resulting from lower output tariffs caused firms to increase their efficiency, and 2) lower tariffs on inputs led to an increase in the number and volume of imported inputs, which boosted firm-level productivity. The efficiency gains from trade reforms were largest in industries that also experienced the most deregulation and the biggest progress in FDI liberalization (Topalova and Khandelwal 2011). A related study found that trade liberalization in India affected economic growth via the price of imported equipment rather than imported intermediate goods more generally. Specific episodes of trade liberalization in 1977, 1985, and 1991 all had the effect of reducing the domestic price of imported equipment, thereby increasing private equipment investment and contributing to GDP growth (Sen 2002). This finding is in accordance with other empirical work that documented a strong link between equipment investment and economic growth (De Long and Summers 1991, De Long and Summers 1992). The industrial and trade policies imposed by India in the 1970s and 1980s raised the price of imported machinery, compelling firms to use high-cost, low-productivity machinery made by domestic firms (De Long and Summers 1993).

By contrast, India made little progress in the 1990s on the privatization pillar of the Washington Consensus. Liberalization did allow some new domestic and foreign private firms to enter the market and gradually erode the dominance of the state. In 1988–90, state-owned enterprises and traditional private firms accounted for 94 percent of total assets, 87 percent of sales, and 91 percent of profits; by 2003–05 these figures had fallen to 77 percent, 73 percent,

and 78 percent, respectively. Yet in 2005, the state largely remained in control of financial services, food processing, textile and paper manufacturing, and heavy industry. Private and foreign firms had more success expanding their presence in transportation, utilities, construction, retail, business and information technology (IT) services, hospitality, tourism, media, and healthcare (Alfaro and Chari, 2009).

In the 1990s, the service sector showed rapid economic growth that is largely missed in the aggregate, macro-level data used by Easterly (2019). The share of services in FDI rose from 10.5 percent in the early 1990s to nearly 30 percent in the later 1990s (Kotwal, Ramaswami, and Wadhwa 2011). In particular, the growth of the telecommunications sector and diffusion of the internet were clearly linked to liberalization, specifically the breakup of the government monopoly of telecommunications. Under Prime Minister Rajiv Gandhi, the number of telephone lines only rose slightly, from 0.4 per 100 people in 1984/5 to 0.6 in 1989/90—but after liberalization it surged to 18 by 2007 (Panagariya 2008, xxvii).

Greater openness to FDI permitted the entry of a subsidiary of Texas Instruments (TI) in Bangalore in 1985. TI forged strong links with various local universities and research laboratories and stimulated the growth of local firms such as Tata Consultancy Services (TCS), Infosys, and Wipro (all located in Bangalore). This successful entry was replicated by other firms. Hewlett-Packard (HP), which was employing 1,100 engineers in Bangalore by the late 1990s, developed strong research and development (R&D) ties with the Indian Institute of Science. The presence of multinational corporations (MNCs) in the sector had a positive correlation with the productivity of domestic software firms (Patibandla and Petersen 2002).

In the early 1990s, Indian software firms often sent testing and debugging professionals to overseas clients; this work, which focused on low-value services such as testing and debugging, became known as "body shopping" and comprised about 70 percent of service exports by the 1990s (Chakraborty and Jayachandran 2001). Indian firms began moving toward "turnkey projects" for large companies, and the proportion of onsite activities declined from 90 percent of India's software service exports in 1988 to 56 percent in 2000/01. By 2001, Indian companies had "managed to develop and launch a number of proprietary software products" that gave them a niche in banking, financial, and accounting software, and 250 Indian companies had obtained International Standards Organization (ISO) 9000 certification (Kumar 2001). The rapid productivity-led growth of the software sector had been too small to make much impression on the aggregate, macro-level data for the 1990s. This was no longer true by 2021/22, when Indian exports of IT services and other business process outsourcing (BPO) reached $157 billion (EY India 2023).

A similar story can be told in the air transportation sector. The Air Corporations Act of 1953 merged all existing domestic airlines to form Air India, granting the government a monopoly over domestic and international flights. In 1991, India permitted entry into the industry, which led to the proliferation of companies such as SpiceJet, Sahara, GoAir, IndiGo, and Kingfisher. India also granted these domestic airlines permission to fly overseas and allowed greater reciprocal market access for airlines from other countries. As with the software sector, this rapid growth had little impact on aggregate, macro-level outcomes in the 1990s. However, the airline sector continued to boom in the early 2000s, with the total number of domestic passengers reaching 22.7 million in 2005 (Panagariya 2008, 398–99). By the mid-2000s, India had 125 airports, including 11 international ones, mostly either constructed or run under public-private partnerships (97). By 2017, the sector was making an aggregate impact; India had become the world's fastest growing aviation market and was poised to overtake the United Kingdom as the world's third largest market behind the United States and China (India Briefing, 2022)

6.3. A J-CURVE IMPACT ON PRODUCTIVITY

Factory-level data collected by the Indian Annual Survey of Industries showed that between 1987 and 1994, plants in India showed little improvement in efficiency and that capital and labor were allocated inefficiently compared to both the United States and China (Hsieh and Klenow 2009).

As liberalization continues, India's transition toward a more efficient structure is even likely to be characterized by an initial slowdown in productivity growth. Firms' products and machinery will become obsolete due to competition from imports, leading to lower capacity utilization. It will take companies time to boost productivity through "learning by doing, exploitation of scale economies, R&D, and positive spillover effects from participation in foreign trade and from the operation of multinationals in the domestic industry." This is why liberalization in India has had a J-curve impact on the growth of productivity

and output in manufacturing. India's TFP grew by 0.6 percent per year in the 1980s, slowed to 0.25 percent after liberalization in 1991 until 1997/98, turned negative between 1997/98 and 2001/02, and then accelerated. By the mid-2000s, there was still enormous potential for efficiency and productivity gains (Virmani and Hashim 2011:26).

One reason for this is the persistence of bad management practices. A 2007 survey of long-established, large textile firms found that surveyed factories had only implemented between 8 percent and 55 percent of a set of recommended management practices. For instance, "Many of the plants did not have any formalized system for recording or improving production quality, which meant that the same quality defect could arise repeatedly" (Bloom et al. 2013).

6.4. THE DELAYED IMPACT ON ECONOMIC GROWTH

After 2003, economic growth in India accelerated—much to the surprise of contemporary observers. India was still suffering from a number of significant external shocks, including the 1997 Asian Financial Crisis, international sanctions for conducting nuclear tests in 1998, and the bursting of the U.S. dot-com bubble in the early 2000s.

Yet this growth boom should not have been a surprise. Liberalization in 1991 (and, in some sectors, earlier) had made the economy more competitive by allowing the entry of numerous new firms; this boosted firm-level productivity, and rapid growth in the service sector started becoming large enough to show up in the aggregate, macro-level data. Between 2003 and 2009, India's GDP expanded by 9 percent annually, reflecting 10 percent annual growth in manufacturing, 5 percent in agriculture, and 10 percent in services (Nagaraj 2008, 56).

In addition, India's investment rate increased from around 25 percent of GDP in the late 1990s to 33 percent in 2006/07. This rise in investment was almost entirely financed from domestic savings, which increased from 23.7 percent to 34.8 percent of GDP during the same period (Roy 2016). TFP growth increased from 2.7 percent per year for 1997–2001 to 3.3 percent for 2002–07 and 3.6 percent for 2008–11 (Mishra 2013, 57).

7 SUSTAINABLE ECONOMIC GROWTH AND INSTITUTIONS

Easterly (2019) argued that the widespread adoption of good economic policy in the 1990s was associated with faster economic growth. Yet in terms of economic history, an acceleration of economic growth is not necessarily significant. As discussed in Section 3.5, such accelerations have occurred across time and space (Hausmann, Pritchett, and Rodrik 2005). The big question—with which Easterly does not engage—is whether this growth can be sustained. Historical data shows that growth accelerations generally peter out. Thinking about the interaction between economic growth and institutions, however, can allow us to better understand India's economic growth since 1980.

In 1980, India had good institutions but bad economic policy (as judged by the Washington Consensus if not by Easterly). This meant India had significant growth potential based on its institutional quality. Controlling for other deep determinants of economic growth such as openness and geography, India was an outlier at the time. Based on its level of institutions, India's income should have been around four times higher (Subramanian 2007). In 1980, small policy changes in India triggered a large response in terms of productivity and economic growth. Easterly (2019) was concerned with measuring the moment when "extremely" and "moderately" bad policies are transformed into good policy (see Section 5.6), so missed this kind of interaction between institutions and policy.

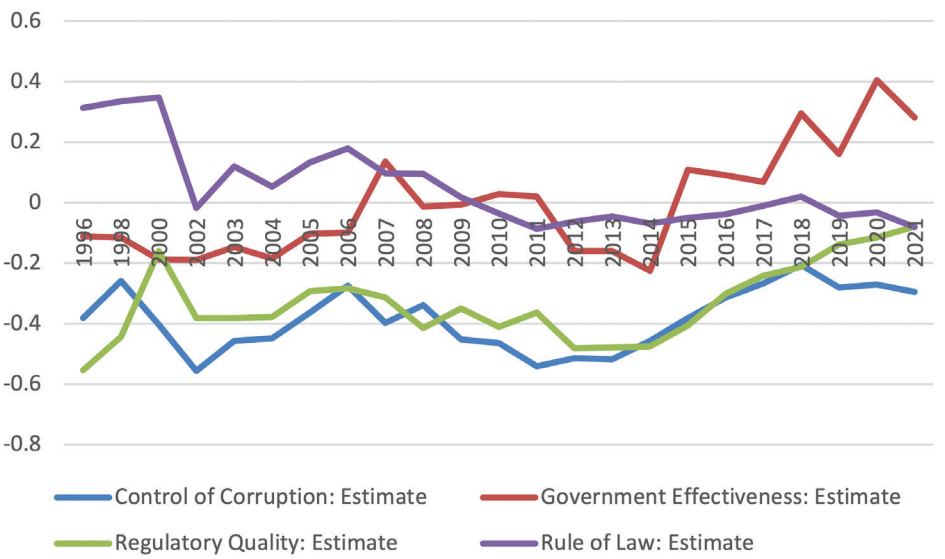
The quality of institutions is important in determining whether growth can be sustained. Countries with sufficiently good institutions are likely to experience persistent episodes of "miracle" (6 percent or higher) catch-up growth. In the long run, countries with the highest observed quality of institutions spend 91 percent of their time experiencing stable growth. Stagnation does occur in these countries but is not persistent; following a period of zero growth due to an economic shock, they are most likely to return to stable and rapid growth. (Jerzmanowski, 2006, 369). In a country with low-quality institutions, both stable growth and stagnation tend to be more persistent; but when such a country experiences an economic shock, stagnation is likely to follow (Jerzmanowski 2006, 371).

What happened to institutional quality in India after 1980? Some institutions, such as the Supreme Court and the Election Commission, were strengthened over the 1990s, becoming more independent (Subramanian 2007). However, India had a more general cause for concern in the 1990s, based on annual World Bank surveys measuring four main indicators. First, "Control of Corruption captures 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." Second, "Government Effectiveness captures 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." Third, "Regulatory Quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development." Finally, "Rule of Law captures 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" (World Bank 2023). A country's scores in these categories can range from -2.5 (bad) to +2.5 (good).

FIGURE 4 shows that while government effectiveness and rule of law began at a higher level, all four indices show a similar downward trend between 1996 and 2014. Paradoxically, the 1980s situation of middling institutions/bad policy outcomes transformed into the 1990s situation of worsening institutions/better policy outcomes. This prompted real and valid concerns about the likely sustainability of growth in India.

Other, more quantitative measures of institutions paint the same picture. Generation and distribution losses in electrical power, such as due to theft or non-payment, can be used as a proxy for institutional quality in India. They reflect the quality of state-level institutions, including whether politicians take part in or abet power theft, as well as state electricity boards' failure to enforce laws. In India in 1971, about 9 percent of generated electricity was lost, lower than in Brazil, Mexico, and Indonesia and about same as in Malaysia and China. By 2003, this figure had reached 27 percent, higher than in the other five countries (Kochhar et al. 2006). Similarly, courtroom data shows there was a sharp decline in the disposal (i.e., closing) of murder cases from 35 percent in 1973 to about 15 percent in 2005—indicating the judicial system's growing incapacity and its mounting backlog of legal cases (Subramanian 2007).

FIGURE 4
Measures of Institutions in India, 1996–2021



Source: World Bank (2023)

The 2014 national election saw the victory of the Bharatiya Janata Party (BJP) and installation of Prime Minister Narendra Modi, who promised to achieve "minimum government, maximum governance". The evidence shown in Figure 4 suggests there have been notable successes in this regard. Three of the World Bank's four indices of good governance have shown a marked improvement since 2014. Though outside the scope of this paper, this trend bodes well for the continued sustainability of economic growth in India.

8 CONCLUSION

This paper has engaged with a specific effort by Easterly (2019) to solve the liberalization–economic growth paradox, which centers on the failure of significant global economic liberalization after 1980 to generate the clear increase in economic growth that theory and evidence had predicted. Easterly made a significant contribution to this debate by updating various cross-country measures of economic policy, finding that "moderately" or "extremely" bad policy configurations persisted much later than was commonly thought (i.e., well into the 1990s) and that economic growth did increase in the 1990s, especially among countries with initially worse policy configurations. These findings, Easterly argued, provide strong evidence in favor of the Washington Consensus.

This report discusses the Easterly paper in depth, using India as a case study. India was chosen because it has become an exemplar of the liberalization-growth paradox: Although it conducted extensive economic liberalization in 1991, economic (and productivity) growth in the 1990s showed no increase over rates in the 1980s. This paper finds that this represented less of a paradox than Easterly had assumed.

The experience of India reveals three critiques of Easterly's method. First, there is a significant problem with trying to infer "good" policy from policy outcomes. The "bad" policy outcomes referenced by Easterly (2019) include high inflation, high black-market premiums on foreign exchange, overvaluation of the domestic currency, negative real interest rates on bank savings deposits, and abnormally low trade-to-GDP ratios. However, outcomes of "good" economic policy do not map onto specific policy configurations. This paper has demonstrated that India conducted significant liberalization in the years after 1991, as judged by the Washington Consensus. But when judged by the Easterly measures of good policy outcomes, India appears to be a non-reformer because the entirety of its reform effort is missed.

Second, although Easterly partly explained the paradox by positing that both good policy and associated growth payoffs were delayed, the wider paradox literature still mainly relies on comparing economic growth before and after liberalization circa 1980. Easterly used the same methods but with the innovation of updating the moment of liberalization to the 1990s. This paper reveals a more rigorous way of studying the delayed growth payoff from economic liberalization. Economic liberalization requires complementary policies to be effective; it can have a significant firm-level impact that takes time to show up on the aggregate, macro level; and liberalization is likely to have a J-curve impact on productivity.

Third, Easterly's finding that more rapid economic growth in the 1990s was associated with better economic policy is not very informative. Growth accelerations are widespread across time and space and can be associated with various drivers, including but not limited to economic liberalization. The big question—with which Easterly does not engage—is whether this growth can be sustained. Thinking about the interaction between economic growth and institutions will allow us to better understand India's economic growth since 1980.

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