

ECONOMIC GROWTH AND ROLE OF LEGISLATION

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“God did not create all of us equal; he created some more equal than others.” - Anon

There is considerable disparity in the economic status of various countries of the world. According to the Human Development Report prepared by the United Nations, in 2007, GDP per capita across the world ranged from a high of USD 103,042 in Luxembourg to a low of USD 115 in Burundi. The question is what causes these differences? Is it merely the availability of natural resources; or is it something more to do with the entrepreneurial nature of its people, or indeed is it to do with different forms of government or legislations? This article seeks to analyse the role of legislation and ‘rule of law’ in economic development. It also includes a short analysis of India and China to give some insight on such experiences.

Economic Growth

‘Economic growth’ is defined in economic terms as the increase in value of goods and services produced by an economy and conventionally measured by the increase in real gross domestic product (GDP). However, since the Rio Declaration of 1992, there has been a growing focus on ‘sustainable economic growth’. The Brundtland Commission or what is formally called the World Commission on Environment and Development in its seminal publication *Our Common Future (1987)* defines Sustainable Development as ‘*Development that meets the needs of the present without compromising the ability of future generations to meet their own needs.*’

Hence, in our context, the real test of development is not only economic growth but what is known as ‘sustainable development’.

Factors of development

While the study of development and inequality in nations has been going on from even before Adam Smith’s *Wealth of Nations*, it was only in the twentieth century that the thinking has moved beyond factors of production or markets.

In the 50s and 60s, when many countries of Asia and Africa were emerging out of colonialism, the path to development was widely believed to lie in capital formation. In the 1970s, awareness grew that physical capital was not enough, and it was at least as important to fulfill basic human needs. When this too did not produce results, the missing link, it was thought, was improving social capital through education and health. Yet again there was no breakthrough. The disappointing experience with the debt crisis in Latin America and chronic poverty in Sub-Saharan Africa and South Asia during the 80s threw up the idea that the path to development lay in improving economic management and giving greater play to market forces.

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Again the results were mixed. Some countries such as those in Latin America posted disappointing results in spite of making the transition to the market fully; on the other hand countries in East Asia performed well despite deviating in important ways from the market model. It is now widely believed that what made the difference was 'institutions' of governance.

The 'institutions' approach

Pioneered by Douglass North, this approach is based on the idea that the productivity of a country's citizenry and resources depends in large part on the quality of that country's social, political, and economic institutions. Competitive markets, freedom of exchange, and secure private property rights are all examples of institutions that contribute to economic growth².

In the late 1990s, the focus of research narrowed further towards 'legal institutions' and understanding the relationship between a country's legal environment, financial sector and economic growth. A seminal paper by La Porta *et al* in 1998³ argued that countries whose legal systems are derived from the English common law have the strongest legal protection for investors and also higher rates of economic growth than countries whose legal systems are based on civil law. While this finding has been subject to considerable criticism, this and subsequent research on the relationship between law and finance has led to the widespread belief that well-functioning legal institutions (i.e., the 'rule of law') are of utmost importance to economic development.

Rule of Law

The rule of law is fundamental to democratic order. Aristotle said more than two thousand years ago, "*The rule of law is better than that of any individual.*" Lord Chief Justice Coke quoting Bracton said in the case of Proclamations (1610): "*The King himself ought not to be subject to man, but subject to God and the law, because the law makes him King*".

The 'rule of law' means that the laws enacted transparently and are enforced justifiably. In fact, the World Justice Project, an organization specializing in the promotion of Rule of Law, bases its definition as, consisting of 16 factors and 68 sub-factors, organized under the following set of four principles, or bands:

1. The government and its officials and agents are accountable under the law;
2. The laws are clear, publicized, stable and fair, and protect fundamental rights, including the security of persons and property;
3. The process by which the laws are enacted, administered and enforced is accessible, fair and efficient;
4. Access to justice is provided by competent, independent, and ethical adjudicators, attorneys or representatives, and judicial officers who are of sufficient number, have adequate resources, and reflect the makeup of the communities they serve.

² Including James D. Gwartney *et al* who authored "Economic Freedom and the Environment for Economic Growth," 2004

³ Law and Finance, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, Journal of Political Economy, 1998

Legal and Financial Systems

Legal systems that provide strong legal protection for investors have permitted the development of sophisticated financial markets, which enhances the economy's ability to bear risk in turn encouraging entrepreneurship and economic growth. Ross Levine in his paper⁴, takes this hypothesis further and tries to identify a connection between the legal environment and financial development of various countries, and then traces this link to long-run economic growth. The paper shows that the legal and regulatory environment *does matter* for financial development. Countries with legal and regulatory systems that give a high priority to creditors receiving the full present value of their claims on corporations have better functioning financial intermediaries than countries where the legal system provides much weaker support to creditors. Moreover, contract enforcement matters as much as the formal legal and regulatory codes. Countries that impose compliance with laws efficiently and enforce contracts—including government contracts—effectively tend to have much better developed financial intermediaries than countries where enforcement is more lax.

The paper also establishes that information disclosure matters for financial development. Countries where corporations publish relatively comprehensive and accurate financial statements have better developed financial intermediaries than countries where published information on corporations is less reliable. The paper further establishes that the legal and regulatory environment is *positively* associated with economic growth. The results show that legal and regulatory changes that boost financial intermediary development will induce a rapid acceleration in long-run economic growth.

The real challenge

What is important to note in the above analysis is that it was not the mere availability of legislation that ensured economic growth, but the 'institutions' which helped enforce them. Generally, the success of a legislation can be gauged on the following areas:

- (i) **Design** i.e. developing the law in a participatory manner,
- (ii) **Implementation** i.e. mechanism for application or enforcement of the law,
- (iii) **Monitoring** i.e. system of reviewing the performance of law, and
- (iv) **Revision** i.e. modification of law where necessary to achieve the objectives of legislation.

In most countries, while there is understandable enthusiasm in the design phase, the real challenge is the other three areas – most notably in Implementation or enforcement. This is then the real challenge which countries face and on which depends their success or failure.

Sustainable Economic Growth is a product of both process and content of legislation. It demands accountability, transparency, certainty, competitiveness, continuous improvement, efficiency, innovation, integration, evidence-based decision making, and shared responsibility. Economic legislation should hence facilitate these.

⁴ Law, Finance, and Economic Growth, Ross Levine, Journal of Financial Intermediation 8 (1999)

Corruption

Concern about corruption is as old as the history of government. Broadly defined, corruption is the abuse of public office for private gain and includes bribery, nepotism, extortion, black-market etc.. Dr C Rangarajan says that *“the negative consequences of corruption are well known but not well realized. Corruption is anti-national, anti-development and anti-poor. There are documented studies to show that corruption impedes growth, inhibits potential investment, increases inefficiency and breeds vested interests.”*

A study by IMF on corruption (1997)⁵ finds that corruption is negatively linked to the level of investment and economic growth, that is to say, the more corruption, the less investment and the less economic growth. Analysis further shows that if the corruption index improves by one standard deviation (equal to 2.38 in this case—a standard deviation measures variation from the “normal” index), the investment rate increases by more than 4 percentage points and the annual growth rate of per capita GDP increases by over a half percentage point. In effect, a country that improves its standing on the corruption index from, say, 6 to 8 (recall that 0 is most corrupt, 10 least), will enjoy the benefits of an increase of 4 percentage points of investment, with consequent improvement in employment and economic growth.

The case of India

India would be among the most over-legislated countries in the world today. Starting with the Acts left by the British, the government has been over-enthusiastic in promulgating new laws as the solutions for myriad problems. Most recently, the Right of Children to Free and Compulsory Education Act is a case in point. After trying in vain to achieve higher literacy levels and provide free primary education to all, the only response has been to enact a law that will ensure this.

The problem with India is not new – it stems from the earlier practice of using the tax-subsidy continuum to influence behaviour. Ronald Reagan’s quote about government policies is instructive: *“If it moves, tax it; if it keeps moving, regulate it; and if it stops moving, subsidise it.”*

What is sadly missing in the Indian context is the enforcement of these laws thus inhibiting the full utilization and impact of the otherwise robust set of economic laws in the country. In fact, some recent laws including the Right to Information Act have been instrumental in improving governance and decreasing corruption in several states. A recent working paper on Economic Growth, Law and Corruption in India⁶ tries to analyse the impact of recent legislations on governance in 20 states of India and concludes that

- (i) A 4.1 percentage point increase in economic growth in an average state would reduce corruption by 1.8 percentage points. In other words, this model predicts that an increase in the growth rate of Bihar from -4.2 percent in 2005 to 16 percent in 2008 would reduce corruption from 59 percent in 2005 to 50.3 percent in 2008.

⁵ Why Worry About Corruption?, Paolo Mauro, International Monetary Fund, 1997

⁶ Economic Growth, Law and Corruption: Evidence from India, Sambit Bhattacharyya and Raghendra Jha, ASARC Working Paper 2009/15, August, 2009

- (ii) RTI has a negative impact on corruption and the effect is statistically significant. In particular, *ceteris paribus* the RTI Act reduces corruption in an average state by 18.5 percentage points. To put this into perspective, the RTI Act explains approximately 62 percent of the actual decline in corruption in Bihar over the period 2005 to 2008.

Dr C Rangarajan in the Seventh D.P. Kohli Memorial Lecture on Economic Growth and Issues of Governance (2006) analyse the evolution of reforms in the country with the development of a sound legal framework and regulations for financial intermediaries. He identifies three important breaks made by the reform agenda:

- i) The first was to dismantle the complex regime of licences, permits and controls that dictated almost every facet of production and distribution.
- ii) The second was to reverse the strong bias towards state ownership of means of production and proliferation of public sector enterprises in almost every sphere of economic activity.
- iii) The third was to abandon our inward looking trade policy and embrace international trade as a means of encouraging and inviting efficiency and low cost.

All these, of course required legislations and it is evident now that the recent economic legislations have contributed significantly to the current growth trajectory of the country.

The contrary case of China

An interesting case of growth without necessarily having democratic principles of governance is in the case of China. In a recent study by Franklin Allena *et al*⁷ on the law-economic nexus in China, the authors found that the early literature including works of La Porta had omitted China in its analysis. The authors find that China, with one of the largest and fastest growing economies in the world, differs from most of the countries studied in the law, institutions, finance, and growth literature, and is an important counterexample to the existing findings: Its legal and financial systems as well as institutions are all underdeveloped, but its economy has been growing at a very fast rate. More importantly, the growth in the Private Sector, where applicable legal and financial mechanisms are arguably poorer than those in the State and Listed sectors, is much faster than that of the other sectors. The system of alternative mechanisms and institutions plays an important role in supporting the growth in the Private Sector, and they appear to be good substitutes for standard corporate governance mechanisms and financing channels.

Among these 'alternative mechanisms', perhaps the most important is the role of reputation and relationships. Without a dominant religion, the most important force shaping China's social values and institutions is the widely held set of beliefs related to Confucius; these beliefs define family and social orders and trust, and are different from western beliefs on the rule of law. Another important mechanism that drives good management and corporate governance is competition. Given the environment of low survivorship during early stages of a firm's development, firms have a strong incentive to gain a comparative advantage. The third important mechanism is the role of local governments. Within the regions that witnessed the most successful economic growth and

⁷ Law, finance, and economic growth in China, Franklin Allena, Jun Qianb, Meijun Qianb, Journal of Financial Economics 77 (2005)

improvement in living standards, properly motivated government officials support and participate in the growth of Private Sector firms.

Conclusion

This article attempts to analyse the role of legislation in economic growth and based on research evidence, finds that there is a significant linkage between rule of law, legislation and economic growth. In particular, the quality of legislation affects the role of financial intermediaries and financial markets which in turn affect economic growth. But these are on their own not enough – they need ‘good institutions’ i.e. the social, political and economic agencies following the canons of good governance.

A significant point that is made is about successful legislation implementation and particularly for enforcement of the laws. Sustainable economic growth is a product of both the process and the content of legislation. The implementation of laws has been a major challenge for India although there is evidence to show that some recent laws such as the RTI have been exceptionally successful in improving accountability. It also presents a quick analysis of India’s reform initiatives as well as present a contrarian view of China where economic growth has happened despite laws, rather than because of them.

And as the last word, a picture worth a thousand words – a tongue-in-cheek look at India’s penchant for legislation as the solution for all problems, courtesy *Sudhir Tailang* and *The Asian Age* in April 2010:

