CHAPTER II
REVIEW OF LITERATURE AND METHODOLOGY

In this chapter we will first review the relevant literature and then develop a methodology to analyse differences in growth rates of output measured in annual averages for selected years across and within the six South Asian Countries. A review of earlier studies on growth is useful to gain an understanding of what constituted growth according to these early theorists and the methodology they used in their studies to analyse growth. Next, the approach used in this study will be presented. This will be followed by a discussion of the nature and limitations of the data used and its sources.

2.1 REVIEW OF LITERATURE

There are a number of studies on growth which use different theoretical approaches and statistical methods to explain the sources of growth in output and why growth rates differ for developed and developing countries. These studies are classified into two groups here: one that utilizes the neoclassical framework termed (for the purpose of convenience) 'conventional' growth theories, and the second, a set of studies that have sought to examine economic growth and development within a political economy perspective. The latter addresses particular policy issues and the role of government in economic policy-making. In the following section a brief overview of the 'conventional' growth theories is given.
2.1.1 Conventional Growth Theories

In conventional theories on growth we can identify two types of approaches to the inquiry of what contributes to growth, why the rates differ for different countries and why they differ within countries over time. The first approach often implicitly utilizes Harrod’s model in which growth rates are explained in terms of the savings rate and the capital output ratio (Harrod, 1948). The second approach decomposes growth into its sources making use of the neoclassical marginal productivity theory of distribution. A pioneering work on developed country growth employed this approach to examine the role of land, labor, and capital as important factors of production (Denison, 1962). Denison made a composite index of factor inputs giving each input a weight equivalent to its share in national income in the country concerned. Using the same neoclassical approach Kaldor explains the performance in the manufacturing sector which is taken to play a key role in determining the overall growth (Kaldor, 1966). Adelman and Morris have used factor analysis to study the role of a large number of socioeconomic variables in economic development (Adelman and Morris, 1967). The central effort in all these studies was to estimate the increase in total factor productivity which the analysts defined as growth.

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Although neoclassical economic theory has become dominant in economic analysis, development economists have been reluctant to adopt it for many theoretical and empirical reasons. We will mention two reasons, one theoretical and the other empirical. An important theoretical reason is that in neoclassical growth theory, the long run rate of growth is determined by the rate of change of 'disembodied' technology. Disembodied technological change implies that technical progress is exogenous and hence not dependent upon the rate of investment in capital goods (Solow 1956, Scott 1989). Since change in technology is independent of the savings and investment rate in the economy, policies that affect these variables are assumed to have no effect on long-term equilibrium rate of growth.

A second reason is the neoclassical theory's implication that over time income levels and growth rates for different countries will converge. Studies that considered the convergence of growth have found that when a large sample of countries (including developing countries) is used, there is no evidence that growth rates converge (Romer, 1986). Development economists have therefore argued that in practice it is difficult to reconcile the implications of the neoclassical model with realities of the world. Chenery (1968) also makes the case for the inadequacy of

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neoclassical equilibrium approach for developing countries as it does not take into account disequilibrium factors such as internal demand constraints, economies of scale, learning by doing, and imperfect factor markets. This difficulty of reconciling theory and evidence has prompted many economists to reconsider conventional theories of economic growth.

In the 1980's, a set of 'new' theories were developed to address the specification and other issues that have rendered the models of Solow variety less useful to development economists. They were, in fact, modified versions of the conventional models that endogenize growth by removing the fixed factor constraint. A detailed review of these theories is not relevant to this study. However, it will be shown how growth is endogenized in these models. The 'new' growth theorists employed two major approaches to remove the fixed factor constraint of the Solow model to endogenize the growth process. One approach allows constant returns to reproducible factors and the second endogenized technical change by explicitly modeling the introduction of new technologies. A simple model which demonstrates the first approach is that of Rebelo (1987) in which capital is linearly related to output. In this model, the production function takes the form \( Y = AK \) where \( K \) may be considered a composite of physical and human capital. It can be easily demonstrated that sustained per capita output growth is possible without resorting to exogenous factors.

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technical change. However, specifying the production function in this form has its limitations for you cannot accommodate constant returns to reproducible factors when fixed factors are observed.

Romer (1990a, b) has developed a model using the second approach in which he postulated that, at any one time, a given range of intermediate goods are reproduced. Each intermediate good requires a fixed outlay to invest so that an equilibrium with monopolistic competition exists. In this model it is possible to have sustainable growth through the continued introduction of new intermediate goods. However, several problems relating to the specification of the production function and its applications remain. Nonetheless, these models provide the basic framework for considering endogenous growth in a general equilibrium framework. Because of the broad nature of the results, still there is little information for policymakers. Therefore, more recently several models were developed along the above lines to deal with more specific policy issues that are important to developing countries.

9 Assuming maximization of a utility function exhibiting constant relative risk aversion by an infinitely lived consumer yields a perpetual growth rate of \( g = (A - \tau)/\delta \), where \( \delta \) is the discount rate and \( 1/\delta \) is the intertemporal elasticity of substitution. It is quite apparent that economies, where consumers are more patient (low \( \tau \)), and more willing to substitute over time (low \( \delta \)), will grow faster. Rebelo also shows that substantial growth is possible as long as a core of capital goods are able to be produced without fixed factors. The view of Scott (1989) is similar since he argues that all growth occurs through investment and changes in quality adjusted labor.


11 Romer has used the production of the form \( y = \lambda k^{\alpha} (1 - \alpha) + k^\varepsilon (\varepsilon + \varepsilon \leq 1) \) where \( y \), \( k \), and \( I \) represent firm level quantities and \( k \) is aggregate capital. With this function, he shows that stable growth paths are feasible without relying on technical change.

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2.1.2 Growth Models Dealing with Policy Issues

In this section, we will discuss those models of growth that are developed to address particular policy issues. This discussion may serve as a useful introduction to the political economy framework that will be developed in section 2.2.3.

Introducing policy issues and the tools to tackle them inevitably brings with it the notion of the role of government in economic growth, a topic which will be discussed further in section 2.2.2 below. The models developed to address policy issues use either the ratio of government expenditure to GDP or that of revenue to GDP as proxies to the size of government. They found that economic growth and the share of government spending in GDP are negatively related. This negative relationship between government spending and growth may arise because higher spending requires either high taxation or higher levels of deficit financing, both of which imply higher levels of distortion of resource use and more crowding out of private activities. Also, government policies can contribute positively to growth by creating an efficient and stable environment for economic activity that allows resources to be used where they will be more productive, as well as supporting the private sector with the necessary public goods.

Consider two specific areas for government policy: expenditure and revenue mobilization. Although increased public expenditure (as a share of GDP) is usually found to have a negative relationship with growth, there are a number of effects
involved (Landau 1986, Mueller 1987, and Ram 1986a). Capital spending, i.e.,
public investment contributes to growth by supporting the basic infrastructure and
public goods that are essential for economic growth. Such expenditure is
complimentary to private investment and will tend to have a positive effect on growth
performance. Other public investment, however, may have the effect of crowding out
private investment (Balassa 1989).

Economic growth is also influenced by the government’s current spending. The largest percentage of these expenditures goes to subsidies and transfers (World
Bank 1990). Transfers that contribute to the development of and maintenance of
public infrastructure such as transfers to local governments for the maintenance of
roads and for primary education, contribute to growth. In contrast, transfers and
subsidies that distort prices in the economy have negative impact upon growth.

With respect to revenue mobilization, the primary means the government has
for raising the revenue is taxation. The structure of the tax system affects the incentive
to save and invest in an economy. These in turn influence growth. We can see this by
looking at the direct relationship between taxation and growth. While taxation is
essential for financial expenditures, distortion caused by taxation is one of the principal

12 Daniel Landau. “Government and Economic Growth in the Less Developed Countries: An
p. 35-75.
Washington, D.C.
14 Ed. F. Desmond McCarthy. Problems of Developing Countries in the 1990’s. Vol. II. World
ways in which government policy affects growth. If the tax structure significantly affects the relative value of resources in the economy, the resulting distortions could inhibit growth by preventing resources from being used where they could have the highest return to the economy (Barro 1989).\footnote{Robert J. Barro. "A Cross-Country Study of Growth, Savings, and Government." (1989). NBER Working Paper. No. 2855. NBER, Cambridge, MA.}

Putting the expenditure and the revenue side together has also implications for growth. Most developing countries spend more than they receive through taxation. So the balance of their expenditure must somehow be financed. Countries may borrow domestically or try to borrow externally. Alternatively, they can print money. However, excessive deficits will create macroeconomic imbalances that will have a negative effect upon growth. In the case of a government that has little access to external finance and relies largely on borrowing in domestic markets may prompt an increase in real interest rates that is likely to discourage private investment and may hinder growth if the loss of private investment is greater than the benefits provided by increased public investment (Easterly 1990).\footnote{William R. Easterly. "Endogenous Growth in Developing Countries with Government Induced Distortions." (1990). World Bank, Washington, D.C.}

The models discussed above demonstrate that governmental decisions have important influence on growth. They have provided a link between growth and policy variables such as government expenditure and revenue mobilization and the empirical work has confirmed their findings. However, several problems remain. Most of the
empirical work in the literature proceeds without an explicit structural model. Without such a model, the causality and functional form of the relationship remain open to question. It may be that many of the explanatory variables in growth regressions are likely to be endogenous. Therefore, at the present level of their development these theories that address policy issues cannot be used to explain the growth performance of developing countries for any length of time.

2.1.3 Recent Growth Analyses

In recent years there is a growing interest among analysts to apply the concepts of political economy to issues of economic growth in developing countries to better understand them. This interest developed for two important reasons. The first was due to the limitations of policy oriented models as predictive tools and second because of the sharply uneven growth among developing countries during the early eighties. The new interest led to the formation of two major alternate approaches. One employs certain institutional attributes to explain variations in growth performance. The second assesses growth within the framework of an open economy macroeconomic model.

Olson explored the institutional arrangements linking state and society. He argues that these arrangements are critical to economic growth. He views economic development as a problem of collective action. Different social groups may benefit in the long run from cooperative sacrifices. But, in the short run, each has an interest in turning economic policy into a distributive game. If groups are allowed to organize

More recently, the World Bank project on Macroeconomic Policy has reviewed the experience of eighteen countries as they attempted to maintain economic stability in the face of international price, interest rate and demand shocks, or domestic crises in the form of investment booms.\footnote{World Bank Project is titled Boom, Crisis, and Adjustment: The Macroeconomic Experience of Developing Countries (cited in Chapter One).} For instance, the project focused attention to periods when these developing countries experienced oil price shocks, worldwide recessions and external debt problems. Its objective was to collect instructive lessons
by analyzing the stabilization and adjustment policies pursued by these countries and assess the outcomes so that they may be helpful to policymakers.

The World Bank project did not use any single computable macroeconomic model, but the framework of an open-economy macroeconomic model was followed. This exhaustive study of eighteen countries and many episodes generated ideas and suggested relationships showing cause and effect behind policies, the nature of shocks and crises and the governmental responses to them. While the information provided in this study is extremely useful to policy analysts, its central thrust is not to explain the growth differences within the framework of policy formation and implementation. Our study’s central focus is to explain growth within the context of policy formation and implementation. Besides, the explanations of the World Bank Project tend to be more in economic terms and no effort is made to unearth the relevance, if any, of noneconomic variables as this study intends to so.

2.2 THE METHODOLOGY

In this section, we will first discuss two approaches to economic development, the neoclassical view and the dependency perspective. They are presented here with a view to facilitate the subsequent analysis of the role of government in economic policy-making which is an integral part of our methodology. The methodology itself will be outlined in section 2.2.3.
2.2.1 Neoclassical View and the Dependency Perspective: Two Approaches to Economic Development

Since the second World War, two strands of thought have dominated thinking on economic development: the neoclassical view and the dependency perspective. The first emphasizes the role of markets in guiding development. It is based on the proposition that markets create competition and competition in turn stimulates productivity and growth. Though market mechanism has definite advantages over government intervention, there are a number of circumstances in which markets do not perform well on their own. Examples are the existence of widespread monopoly power, external diseconomies, rigidity in factor markets and underdeveloped institutions where governments may intervene. Market economies also require intervention not only because of inherent market failures, but also because societies impose on them national goals that even well functioning markets cannot satisfy. For instance, in Malaysia, policies are formulated by its government that will favor poor majorities (Malays) over entrepreneurially accomplished minorities (Chinese).

Government intervention could ordinarily take two forms. One form is direct, like interventions which set the prices of vital commodities from food grains to fuel and restrictions on private investment. The other form is indirect, like interest rate

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21 For fuller versions of these approaches, see Pathways from Periphery: The Politics of Growth in the Newly Industrialized Countries. (Op. Cited).
22 New Economic Policy (1971) provides this citation.
23 The terms government and state are used interchangeably in this study. This is conceptually incorrect. Also state is referred to as an entity for convenience, though it is actually no more than a system of rules and procedures operated by individuals.
ceilings that reduce and bias investment, and tariffs and import controls that intensify dependence on imports. In any event, because markets are imperfect and governments have political goals that markets must serve, intervention is the rule. Also in many instances the particular interventions chosen may not always be the ideal.

The dependency perspective views the international economy as dominating the less developed countries through a "cluster" of multinational corporations. The theory in its simplest form holds that external factors are responsible for the shortcomings that characterize the economies of the developing world. These shortcomings include neglect of agriculture, inappropriate production process (capital intensive in many developing countries) and patterns of consumption among other things. There are, however, many imperfections to this view also. We will mention only two important ones here. First, dependency interpreted as dependence on foreign firms for technology and other forms of support for investment is as much an effect of national policies as their cause. The second imperfection is concerned with the significance of domestic politics and its absence in dependency writings. It is generally held that "dependency" theorists have focused their attention to an examination of "external" political factors shaping national strategies neglecting the decisive impact of "domestic political" factors affecting such strategies.

However, both the neoclassical and dependency views are unsuitable to explain the development process in the SACs for any length of time. The former assumes that
participants in the economic decision making act rationally whereas in practice policymakers face a set of goals justified on political rationality. Apparently, for various reasons including regime legitimacy, policymakers are presumed to act rational only in a political sense. The later view tends to focus only on international dimensions of policy. Yet, similarly situated states due to domestic political reasons frequently pursue different policies in response to external pressures. Therefore, we need a theory that addresses the incentives facing policymakers who act on political rationality to explain economic decision making. These incentives invariably come from domestic political situations. Both the neoclassical and dependency perspectives are inadequate to address them.

2.2.2 Role of State in Economic Development

In developing countries where social needs are great and cultural and other noneconomic factors greatly influence economic development, policy choices are often difficult to make. In these countries the role of state in promoting development is also extensive. Therefore, a clear understanding of the role of state in the growth process is necessary for outlining our framework below. We will do this by concentrating on four crucial themes. Two comes from the realm of political economy, the theory of state and the association of state, regime and party. The other two come from the area of public choice theory — formulation and implementation of state policies.24

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In the context of South Asia, a general theory of state and its relation to its economy may be envisioned as a coalition of dominant social classes in the economy. The dominant class is the one who can exert pressure on the ‘governing’ elite to receive a large share of the state’s resources for themselves. At any point in time, the conflicts within this ‘dominant coalition’ specify the degree of autonomy possessed by the state. In the SACs included in this study the governing elites that inherited power after independence from British Colonial powers “enjoyed enormous prestige and a sufficiently unified sense of ideological purpose” to redirect and restructure the economy. However, the dominant classes have become better mobilized, over time, and now the constraints on the state’s actions are binding. Conflicts among members of the dominant coalition increasingly revolve around the demand for budgetary subsidies. As the members of the dominant coalition vie for ever larger shares of a slowly growing pie, resources needed for public investment are frited on current consumption. Penetrated by powerful interests and unable independently to implement long term plans, the state becomes a vast machine of patronage and subsidies and by extension inefficient. The loss of efficiency could adversely affect the state’s ability to allocate resources among competing needs so as to promote maximum growth.

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The concept of regime is crucial for the analysis of government policy, because it affects the ability of the state to institute fundamental economic changes. The term regime refers to the changeable aspects of how public authority is structured in relation to society. It draws attention to how political rule is organized (e.g., patterns of legislative-executive relations) and the relationship of the rulers to the ruled (e.g., involving democratic participation or not). The concept of state, on the other hand, refers to the "deep structure" that is of a more permanent nature. Parties, regimes, and state seem to be located on a sliding scale of institutional depth with parties most susceptible and states least susceptible to change. While examining country specific policies and their impact on growth rates of output in later chapters we will draw further on these concepts to explain growth differences among and within the SACs.

The area of public choice theory offers two approaches to understand the general conditions of policy formulation and implementation. One is a society-centered (coalitional) perspective which denies any autonomy for the governing (policy) elites from societal interests. In the case of society-centered explanations of policy change initiatives for change come from conflicts among dominant classes. In contrast, the state-centered approach suggests that governing (policy) elites are virtually unconstrained by societal interest. This approach regards policy changes as coming from public officials. Both approaches, lack realism for, in reality, policymakers have some room for maneuverability. Therefore, our framework adopts
a middle course drawing essentials from both these perspectives and is designed to do
two things. One is to identify the factors that determine the growth policies of the
SACs for selected years with particular emphasis on political and other noneconomic
factors. The second is to investigate whether and how these factors have accounted
for inter-country and intra-country growth differences in the SACs.

2.2.3 The Political Economy Framework of Analysis

A basic premise that underlies our analysis is that policy changes initiated by
the state can significantly alter the magnitude and interrelationships of macroeconomic
variables leading to growth differences. Policy changes are sometimes taken on purely
economic considerations and at other times on noneconomic considerations. It is
necessary to identify what these noneconomic considerations are and assess their
overall impact on growth performance. In this regard, a useful start can be made by
studying the policy formation and implementation process of the SACs to a set of
external and internal events.

The analysis is conducted in three steps. First, we will identify the periods for
which growth differences are examined. By growth, we mean growth of gross
domestic product (GDP) as conventionally measured. The overall period selected for
analysis is 1950-1990. For this period, growth rates for India, Pakistan, and Sri Lanka
will be calculated using time-series data and regression technique. For Bangladesh,
Malaysia, and Nepal, growth rates will be calculated for the years 1970/71 through
1989/90 using the same technique. Then, these rates will be examined in three ways:
(a) they will be compared for each country period-wise, (b) across country for
different and/or same periods, and (c) for differences associated with four selected
episodes (these episodes are explained later in this chapter). To facilitate cross-
country comparisons, the total period will be split into convenient sub-periods and
growth rates of these sub-periods will be worked out and compared.

In the second step, we will discuss the macroeconomic policies that may have
contributed to growth differences within the context of policy-making in the SACs.
Three macroeconomic policies that can alter the growth rates in output are identified:
fiscal, monetary, and trade policies. The fiscal policy and the need to maintain a
reasonable budget deficit consistent with sustained growth have been discussed in
section 2.1.2. The implication of that discussion to the analyses of growth differences
is that those governments which act to keep public sector deficits within manageable
limits will have higher rates of growth in output. The influence of fiscal policies
pursued by various governments of the SACs on growth is examined in terms of the
size of their deficits. Next, we will discuss the importance of monetary policy in
growth by examining how various policy instruments were used by these countries to
provide ‘adequate’ quantity of credit while maintaining ‘reasonable’ amount of price
stability. This will be followed by a brief discussion of the trade policy which will

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27 The following form is used: \( Y = AB^t \) or \( \log Y = \log A + t \log B \).
review the measures taken by them to keep the country's current account deficit at 'appropriate' levels.\(^\text{28}\)

The term monetary policy embraces all measures intended to affect the growth, utilization, efficiency and diversification of the financial system. A wide range of monetary policy instruments are available to policymakers to mobilize the financial resources of the country towards economic development. They involve both direct (quantity) and indirect (price) approaches. The main direct instruments are reserve ratios, quantitative controls on central (reserve) bank lending to commercial banks and quantitative credit controls. The indirect instruments operate through the administrative setting of various interest rates, for example, on Central and Commercial Bank lending and deposits. However, the use of monetary policy for stabilization and growth is much less common in SACs than in developed countries. Even within the SACs, different countries may have adopted different instruments in specific problem solving situations contributing to growth differences among them. For example, some have followed administratively determined interest rates instead of market determined rates. This practice can have too many conflicting objectives and is often inflexible to be used as a tool for stabilizing output in the short run and promote growth in the long run. To cite an illustration, if administered interest rates are used as subsidies, that could lead to higher budget deficits slowing growth in output. We will

\(^{28}\) What is an 'appropriate' level will be explained below when we discuss trade policy.
examine where appropriate the monetary policies of each country for the periods
selected to find out their impact on growth differences.

Trade policy consists of the use of various instruments such as quotas, tariffs,
and export incentives to achieve the external objective of macroeconomic policy, that
is, maintaining a current account deficit consistent with the other objectives of internal
balance and low inflation. Application of this policy to specific countries and
situations will be taken up for discussion in Chapter 4. Here, the importance of
managing an ‘effective exchange’ rate that will maintain a sustainable current account
deficit will be briefly mentioned since a sustainable current account deficit is a
requirement for continued stability in the growth rate of output.

As a policy instrument exchange rate can be used to pursue different
objectives. In most instances, however, it is used to achieve external price
competitiveness. This has required introduction of flexibility into exchange rate
management. In theory, the nominal exchange rate (NER) must be able to adjust to
achieve the desired target real date. In practice, this flexibility has been achieved by a
variety of mechanisms: primarily either stepwise devaluations of a fixed rate, a
crawling peg system involving gradual continuous adjustments to the rate, or a flexible
system where either an auction or an interbank market is used to obtain a market
clearing rate. Careful exchange rate management is required under each system, since
the Central Bank and the government must have an idea of the appropriate real rate at
which to target policy. This will determine the extent and timing of single or stepwise
devaluations and the degree of depreciation in a crawling peg. Even where an
apparently fully flexible market system is used, management of the rate is still required.
The importance of exchange rate management follows from the fact that allowing
exchange rates to rise to inappropriate levels for lengthy periods will have adverse
effects on exports.

Whatever exchange rate strategy is applied, economic management must insure
that the real exchange rate is not significantly out of line with the real rate required for
internal and external balances. Only by achieving internal and external balances can
government policies promote long-run growth in output. Therefore, we will closely
examine the trade and exchange rate policies of the SACs during the selected periods
to find out whether they contributed to growth differences. If for some reason any of
these countries were unable to manage effectively their exchange rate or trade policies,
then they may not have achieved or maintained a current account deficit consistent
with the other objectives of internal balance and low inflation that are necessary for
sustained growth.

In the third step, the reasons why certain macroeconomic policies were actively
pursued by some governments, while others chose to pursue different policies in
response to major problems of stabilization and growth will be examined. It is our
contention that these differences in policy response may have led to growth differences.

In our view of policy-making, development goals are usually defined by the policy-elite\(^{29}\) representing particular regimes. They also make specific policy choices. For example, whether to devalue the national currency in response to a balance of payment crisis or adopt certain control mechanisms. These choices are in turn shaped by a variety of perceptions, commitments, and resources the elite bring to policy-making. A general discussion of policy-making could begin with two sets of factors: One set focuses on background characteristics of the policy-elite, and the second emphasizes the constraints and opportunities for implementing various policies created by the broader contexts within which the elite seek to accomplish their goals. These factors are largely responsible for shaping the perceptions of the policy-elite to a given, macroeconomic problem and to signal the 'correct' solution to it. They will also influence the elites in selecting certain policy options from among a variety of decisional criteria.

To understand better why a particular policy initiative was chosen, it is important to know what the policy-elites who took that particular initiative brought with them in terms of their personal attributes and goals, ideological predispositions, professional expertise and training, position and power resources, political and

\(^{29}\) The policy-elite could be elected officials, bureaucrats, or any person wielding executive powers. In the context of South Asia, each country has its own elites and we will identify them more precisely when we discuss the policy formation and implementation in specific instances.
institutional commitments, and loyalties. We will explain below what these factors are, emphasizing their relevance to policy-making whenever necessary.

The values of the policy-elite such as the relative weight given to individual or social 'good', definitions of public interest and commitment to democracy can all influence what specific goals for economic policies are identified as important by them. Ideological predispositions of the policy-elite are also important factors that shape the policy responses to important development issues. For example, ideological commitments such as those to democratic socialism, or to solutions of the countryside in terms of land reform are all likely to influence what particular policy package will ultimately emerge to deal with diverse issues of economic growth. Professional expertise and training of the elites also influence how they perceive different problems and what solutions they believe ought to be applied to them. In general, the policy-elite, also come to discussions of policy change as representatives of the organizations they serve and whose interests in terms of budgets, prestige and influence they are anxious to serve and protect (members of the armed forces are an example). Their perceptions and recommendations are likely to be colored by their organizational positions, as well as by more general power resources such as their hierarchical position within government and their reputations as politicians and policy-makers. Finally, the political and institutional commitments of the policy-elite also will influence their perceptions about specific policy choices. Their loyalties will help
create the basic orientations about how problems are defined and how they are most appropriately solved.

The policy-elite also face a series of contextual factors that shape the policy options available to them. They are never autonomous and must work within several interlocking contexts. These interlocking contexts, in addition to factors specific to the policy-elite, frequently influence the perceptions, opinions, actions, and effectiveness of policy-elite and are thus important in explaining the policy-making process. The following are four such contextual factors that are related to policy-making environment of the SACs: societal pressures and interests, historical experiences, international economic and political relationship, and administrative capacity.

The first factor refers to the societal pressures and interests in a given country. The extent to which economic, cultural, religious, regional and value interests in a country are mobilized and how efforts to influence authoritative decision-making are manifested are contextual factors that will have significant impact on policy-making. For instance, the policy-elite are rarely insulated from pressures generated by organized interests such as military and civil service. These organized interests are mechanisms through which society penetrate the state and shape the policy choices of the elites.
The second, refers to a number of influences related to the historical circumstances particular to each country that may have influenced the policy options available to decision makers. For example, in many SACs a legacy of colonialism has shaped forms of national and local governance. The struggle for independence or later internal conflicts and political compromises may have defined the role and nature of the state in its efforts to achieve economic development. Therefore, we need to pay close attention to these factors while evaluating specific policy-making processes that deal with economic problems.

The third is the importance of each country's relationship to international economic and political conditions. Many SACs continue to be dependent on international economic environment for the prices of basic commodities they produce, the foreign exchange value of the goods they export and import, and the interest rates at which they borrow capital abroad and repay debts. These factors have created complex interrelationships with multilateral and bilateral institutions, many of whom often prompt changes in existing policy and organizational practice within SACs.

The fourth is the administrative capacity of the state which also sets limits on policy options because it determines which policies or organizational changes can be pursued effectively. The availability of human resources, skills in particular areas, and the way public sector is organized, are all considerations that shape the options available to policymakers, and after decisions are made, the capacity to implement and
sustain them. It is therefore imperative that we examine closely the differences in the 
capacity of each state to achieve certain kinds of policy changes as this may have 
slowed the economic growth.

The above discussion indicates the importance of contextual factors in policy-
making, for they shape the perceptions of policymakers as to what problems need to 
be addressed and how they should be addressed. Based on the discussion of policy-
making, thus far, we could argue that factors that are specific to the policy-elite and 
the interlocking contextual factors in which they operate together can alter the content 
and direction of economic development policy packages leading to growth differences. 
It is to examine whether this argument is a reasonable explanation of the growth 
differences of the SACs, that we undertake the analyses of fiscal, monetary, and trade 
policies of each country period-wise and for all of them except Nepal, cross-country 
for the periods identified. Cross-country comparisons of growth rates will be further 
examined from the point of view of four selected episodes with the expectation that 
this approach will yield additional insight into the causes of growth differences. The 
four episodes are: (i) independence and its aftermath; (ii) the first oil shock (1973-74); (iii) the second oil shock (1979-82); and, (iv) the public sector investment boom 
(PSIB).

(i) Independence and its aftermath. The years 1950-1955 were times of 
major economic disruptions in India, Pakistan, and Sri Lanka. All three countries were
former British Colonies that became independent during the late nineteen forties. The reason for selecting this episode needs clarification. Though independence is the primary cause of disruptions to their economies, it created different sorts of problems for them. In India, independence created the major loss of external markets whereas in Pakistan there was a loss of manufacturing infrastructure that was due to partition (an event related to independence) while Sri Lanka experienced a reduced availability of external finance. It will be useful to know how policymakers reacted to these different problems caused by a similar episode.

We will consider how these countries during the years 1950-55 formulated and implemented economic policies to adjust to the changing circumstances brought about by independence. Then, the growth differences between countries, if any, during the years 1955-60 will be analyzed. In this way, we could compare the effects on growth of policies (designed to manage the post-independence related problems) adopted during the 1950-55 period with the rates of growth of relevant variables for the three countries during a period that follows. A comparative analysis of growth differences for the three countries will show whether factors that are specific to decision-makers in each country and the relevant contextual factors in which they operated were in any way significant in explaining the growth differences.

(ii) **First Oil Shock (1973-1974).** It is also instructive to examine how different countries reacted to a given episode that imposed more or less similar
constraints on all the six countries. This will provide competing explanations as to why a group of countries adopted different policies to a given episode. The first oil shock during the years 1973-74 inflicted severe balance of payment crises on most of the SACs. Yet, different countries seem to have adopted different policy goals and instruments to restructure their economic activities and promote growth.

When facing a serious balance of payments crisis, whatever the reason, be it a decline in export prices or increase in the price of imported goods (as in the case of oil shocks), states normally intervene to solve these problems. For example, some would prefer direct interventions and shift away from primary product exports to import substitution industrialization by promoting manufacturing activity. Fiscal and financial support will be directed towards this effort. Others may seek solutions through adjustments in the market, such as devaluations of their national currencies. These two different approaches, of course, will have different implications for economic growth. We will examine the policy-making process for the years 1973-74 to learn about the various approaches taken by the SACs to the severe shock imposed on them by an increase in the price of imported oil. Then, the growth differences for the years 1974-77 will be analyzed for all the six countries. This analysis will, as in the case of episode one, bring out the role of country specific factors that shaped policies and may explain why a group of countries adopted different policies to the same external shock.
(iii) **Second Oil Shock (1979-82).** The second oil shock is also analyzed for the same reasons as the first oil shock except for an additional and rather significant reason. To many policymakers, the first oil shock was a novel experience from which they learned valuable lessons. The policy-making process itself may have improved as a result of this experience. It is useful, then, to know whether some countries benefited more from this experience than others and why?

As in the case of the first oil shock, effects of policies undertaken during 1979-82 by all the six countries will be compared with growth rates during 1983-85. Those countries that benefited most may have registered higher rates of growth in output than those who benefited the least. This analysis should provide added information regarding the role of noneconomic factors in shaping macroeconomic policies and thereby contributing to growth differences.

(iv) **Public Sector Investment Boom (PSIB).** This episode is different from the three mentioned above in the sense that the main cause of this originated in the domestic arena. Governments in the SACs have, at times, undertaken massive expansion of development projects driving total capital formation to very high levels. (For example, Malaysia, Pakistan, and Sri Lanka in the late 1970’s and early 1980’s undertook massive public sector investment programs.) This was done mainly for two reasons: one, to attract external donor funds (Sri Lanka) and two, to use as a counter-cyclical measure (Malaysia and Pakistan). In all three instances, there was an
enormous upsurge in investment, particularly in public investment, leading to big
current account deficits. We will first see what the impact this PSIB had on the
deficits of all three countries, and then examine how policy measures adopted by each
government to solve the problems created by their respective deficits may have
resulted in growth differences. Specifically, we will analyze the policy-making process
for Malaysia, Pakistan, and Sri Lanka during the years 1983-85 in which higher levels
of investment occurred. This will be followed by a study of growth differences among
the three SACs during 1983-86. This method of analysis will reveal differences in the
responses of policymakers to a similar economic disturbance which they caused
pursuing higher levels of public investment. We will also examine whether the
differences in response of different countries were significant in explaining growth
differences among them during the years 1983-86.

Our framework is flexible enough to offer political economy explanations of
policy changes for two reasons. First, it explicitly recognizes the role of policymakers
who are often constrained by political factors in economic development. Second, it
grants an extensive role for states to promote growth. These considerations allow us
to explain policy choices based on crucial themes borrowed from the political economy
area such as the theory of state, and the association of state, regime, and party. This,
in turn, brings to the analysis deeper insight than is possible by employing narrowly
constructed technical models.
2.3 DATA: SOURCES AND LIMITATIONS

The basic statistics used in this study covers all six SACs for the period 1950-1990 to the extent data is available. Macroeconomic data on employment and income, National Product Accounts, exports and imports are available since 1950 for India, Pakistan, and Sri Lanka, and from 1970 for Bangladesh, Malaysia, and Nepal. However, all data prior to 1960 is at best only suggestive. This is due to flawed reporting procedures, among other things, by various agencies, lack of experienced personnel in collecting data, and the absence of sophisticated National Income Accounting techniques. Data on major social indicators are also available.

The macroeconomic data is assembled from various secondary sources. They are mainly government publications of the respective countries. Bangladesh data is drawn from the annual reports of the Bangladesh Bureau of Statistics (BBS) and Annual Economic Surveys of the Ministry of Finance, published by the government of Bangladesh. India publishes yearly statistical abstracts assembled by the Central Statistical Organization. Malaysian data is available in the Annual Economic Reports issued by the Ministry of Finance, Government of Malaysia. Nepal’s data is available in the Statistical Yearbook of Nepal published by H.M.G. Central Bureau of Statistics and in the Annual Reports of the Nepal Central Bank. Pakistan’s data is provided in the Annual Economic Surveys published by the Ministry of Finance, Government of Pakistan. Sri Lanka’s data is drawn from the Annual Reports of the Central Bank of
Sri Lanka. Cross-checking of the data assembled from country sources has been done with series developed by the World Bank and the United Nations.