Review of DFID's Governance Target Strategy Paper

Mushtaq H. Khan

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DFID's Governance Target Strategy Paper (TSP), published in 2001, identifies seven key governance capabilities that it argues are necessary for effective poverty reduction and the achievement of the International Development Targets. Developing country states must be able to operate political systems responsive to all sections of the population, they must be able to provide macroeconomic stability and facilitate private sector investment, to use fiscal systems for pro-poor policies, to provide effective basic services, to provide security and justice, to resolve and prevent conflicts, and to operate honest and accountable government. These governance capabilities provide the analytical grid for DFID country offices to develop country specific packages of governance reforms. While the seven capabilities identified are extremely ambitious, the document is consistent with support for more limited country-specific reforms. The TSP is careful not to propose a standard blueprint for all developing countries. And it is careful to point out the limited success achieved by many of the ongoing institutional reform programmes that have attempted to improve governance in developing countries along these lines in the recent past. In all these respects, the TSP is a sophisticated document drawing qualified conclusions from its reading of the available theory and evidence on governance. However, this theory and evidence is itself highly contested and in our review, we focus on a number of critical questions that policy-makers have to be aware of in developing governance reforms that can make an impact on poverty reduction.

i) ***Environmental, Redistributive and Transformative State Capabilities.*** The TSP's programme of reform is of course based on judgements about the complex role of institutions of governance in the transition of poor countries from low to high levels of economic and social development. Many of the state capabilities identified in the TSP are derived from a specific analysis of good governance that has enjoyed analytical and policy popularity in recent years. But this analysis also goes against much of the recent case study evidence from developing countries. Many of the key propositions of the good governance approach have powerful counterarguments and DFID practitioners have to be aware of the limitations of the established analysis. It is particularly important to ensure that we do not damage developing countries by being too simplistic in our analysis.

The critical capabilities identified by the good governance approach are all desirable as ends in themselves, but the evidence suggests that many of these characteristics may not be either necessary or sufficient for growth and poverty reduction. Instead, the experience of successful developing countries over the last fifty years tells us that very different governance capacities have been important in the most successful developing countries. These '*transformative*' governance capacities enabled states in these countries to accelerate the transformation of their societies into productive capitalist economies. The capability of East Asian states to induce increases in savings rates and to construct the necessary physical and human infrastructure is well known. But in addition, the transformative capabilities of these states included the capacity to restructure property rights to accelerate the emergence of a capitalist sector, to assist the emerging capitalist sector in accelerating technology acquisition, and to discipline emerging capitalists benefiting from state assistance if they failed to achieve rapid productivity growth.

The TSP recognizes the importance of the state's capacity to facilitate private sector investment and trade, but this capability is defined in a very limited way to mean the ability of the state to create the right *environment for market-led growth*. A number of governance capabilities identified in the TSP aim specifically to ensure that an environment for market-led growth emerges. The assumption is that once an enabling environment exists, markets, even in a backward economy, will attract the appropriate investments and technologies, and provide the appropriate discipline for emerging capitalists. Thus, a dynamic capitalism is expected to emerge once efficient markets and a good investment climate have been achieved. The other capabilities in the TSP are about ensuring that the fruits of the growth that will ensue are fairly *distributed*. This is to be achieved by strengthening the ability of the poor to put pressure on the state and strengthening the state to be able to respond to this pressure. Thus, a further set of governance capabilities are aimed at strengthening the redistributive capacities of developing country states.

The specific environmental conditions necessary for market-led growth that are identified in the TSP are derived from a large literature in institutional economics that establishes the importance of a number of institutional conditions based on *cross-country* econometric evidence. The redistributive governance capabilities are derived from evidence that is much more limited and is based primarily on a commonsensical model of democracy where pressure from the majority is translated into service delivery and the creation of market opportunities for the poor. We will argue that the focus on these environmental and political conditions does not draw sufficiently on the growing *case study* evidence of catching up by East Asian economies over the last fifty years. Poorly performing countries in Asia and Africa are unlikely to be able to replicate the stellar performance of some of the rapidly growing Asian countries. But if the growth of the latter was driven by governance capacities that are significantly different from the good governance ones, even poorly performing countries need to at least try and learn something about the nature of the growth process to move some way towards better performance in their own contexts. If we compare the governance capacities of the high-growth countries with the capabilities identified in the TSP, we find that the latter does not go far enough in identifying the '*transformative capacities*' of these states. Moreover, some of the environmental and redistributive capabilities that the TSP aims to achieve appear to be overly ambitious for some of the poorest countries given that many of the high-growth developers, despite their relatively good administrative and bureaucratic capacities, would have failed on many of these indicators.

ii) ***Democracy and Pro-poor growth.*** The second part of our evaluation looks at the role of democratization in bringing about pro-poor growth. In the TSP, the capacity to run an open competitive political system is identified as an important governance capability for the state. The underlying justification is that democracy is part of a set of redistributive capacities that the TSP identifies as critical for ensuring that the poor can use their numbers to get a fair share of the fruits of growth. Here, the TSP is very optimistic in expecting that all good things go together. It is reasonable to expect that democracy can put pressure on the state to deliver better services to key constituencies, including the poor, if they are appropriately organized. However, whether democracy will be a spur for the painful changes required to accelerate the development of productive capacity in developing countries (the social transformation referred to earlier) is likely to depend on factors specific to each country. A further complication, increasingly recognized in DFID's own Drivers of Change studies, is that the operation of democracy in developing countries is often conditioned by patrimonial political systems that can use democracy to sustain traditional systems of power.

These observations do not deny that democracy is desirable in its own right, and is a goal that is widely aspired to within developing countries. Therefore, our objective has to be to identify the conditions required to make democracy compatible with pro-poor growth, and these may be different in different countries. But looking at viable democracy as a *goal* is different from seeing democracy as a sufficient (or even a necessary) *condition* for pushing institutional change in the direction of pro-poor growth. Democracy can of course perform a functional role *in some limited areas*. If the role of the state is primarily to provide services to the poor, democracy can clearly assist in making existing service-delivery more responsive to demands comparing from the poor. But if the state has to play more difficult but very necessary functions in accelerating social transformations, the role of democracy is more ambivalent. This does *not* mean that non-democratic approaches should be sought where transformations are likely to unleash significant social conflict. Rather, transformation strategies have to be devised that allow rapid growth in the context of real democracy in developing countries, where patrimonial and clientelist structures predominate. This is a much more demanding task than simply promoting democratization and accountability.

iii) *Structural Drivers of Corruption and the challenge of Regulating Rent Seeking.* A third area where the approach of the TSP needs to be extended and refined is in the analysis of corruption. Despite considerable donor investments in anti-corruption strategies in recent years, the results have been disappointing overall. The importance of corruption in the TSP comes from the observation that corruption undermines the development of all other state capabilities, and in particular, the delivery of essential services to the poor. Corruption is clearly a serious problem in every developing country. The question really is whether corruption can really be significantly reduced in these countries, and if so, how. Our concern is that the TSP ignores many of the structural drivers of corruption in developing countries. In particular, important types of corruption in poor countries are driven by the need to achieve political stabilization and by the inability of the state to protect property rights effectively in contexts of fiscal scarcity. These drivers of corruption are not affected by the conventional anti-corruption measures that development agencies support. As a result, developing countries are presented with reform agendas that they are unlikely to be able to fulfil. The unintended result can be a growing demoralization with the political process that is paradoxically often the most severe in the very countries that have made the most concerted attempts to fight corruption.

Given the structural drivers of corruption in developing countries, our approach to fighting corruption should be different. Instead of trying to attack *all* types of corruption simultaneously, a task that may be totally unachievable for structural reasons, reform should try to identify the types of corruption that are most seriously constraining development. One of the most damaging types of corruption is predatory corruption. Policy should target the predatory use of state power, and very concerted action is appropriate here. Other types of corruption can also be potentially damaging because they are illegal forms of rent seeking that are not regulated. In these cases, policy would be more successful if it tried to institutionalize the influence that rent seekers want to have (and will have) over government. Anti-corruption strategy could be more effective if it proceeded by thinking creatively about allowable influence and expenditures on lobbying, political contributions and so on, within a regulatory framework that makes sense for the type of transformation the developing country is going through. Clearly, legalization and regulation of rent seeking rather than its abolition has been the process through which corruption has been reduced in advanced countries. While there are structural problems with legalizing many types of rent seeking in developing countries, progress is possible here by identifying achievable reforms on a country-by-country basis.

iv) *Extending the Drivers of Change Approach.* A fourth issue that emerges in our review of the TSP is the question of the "politics of change". Research on the process of institutional change in developing countries, and DFID's own "Drivers of Change" studies suggest that a more rigorous methodology is required not just for identifying the necessary state capabilities that are required for pro-poor growth in particular countries, but also how best to achieve them in different contexts. The drivers of change approach was aimed to enable DFID country offices identify entry points for reform at the country level. However, the degree to which drivers of change studies have assisted in this has been limited by the fact that they do not appear to follow a common approach and vary considerably in their quality and the relevance of their recommendations.

The idea that policies and reform priorities should be country specific is entirely right, but we still need a common framework to think through how we should identify these priorities country by country. The drivers of change studies assume that the governance priorities identified in the good governance approach are the right ones, and the problem is only to identify the social drivers that can push these desirable changes in specific countries. This analysis aims to identify the *reform priorities* for each country, and the *mechanisms* through which they can be achieved, but the priorities are always being selected *from within the group identified* in the good governance approach. In reality, the problem is likely to be more complex. The historical evidence is that the successful catching-up countries of the last fifty years did not comply with most of the institutions identified in the good governance model. We need to combine the country-specific approach of the drivers of change studies (which is entirely correct) with a more pragmatic approach to identify the institutional capacities that are required for accelerating growth in developing countries. We should ask how productive capacity could be improved in specific countries, and the institutional capacities that would assist this. And only then should we try to identify the change agents and mechanisms through which these reforms can be implemented.

v) ***Setting Achievable Goals.*** Finally, it is important to have achievable goals. The magnitude of the institutional problem in most developing countries suggests that we have to distinguish between governance reforms of different types, and we need to identify reforms that offer the biggest potential payoff given our capacities and resources to implement change. We have to begin by distinguishing between means and ends, that is, reforms that are necessary for achieving pro-poor growth, and reforms that are desirable in their own right. Some important reforms that are desirable in themselves may not be achievable without economic development first being achieved. Of the reforms that are important for pro-poor growth, we need to distinguish between reforms that create the minimum environment for economic growth, reforms that are redistributive, such as service-delivery reforms that directly target the poor and reforms that are transformative. The latter will only indirectly benefit the poor but these reforms may have the biggest pro-poor effect of all because they can accelerate the growth of productive capacity. In principle, reforms can be both redistributive and transformative, such as some types of land reform, for instance, but this overlap is not common. Redistributive reforms can yield immediate benefits but have limited benefits in the long run; transformative reforms provide much bigger and sustainable benefits, but work over time. In principle, both types of reforms are required. But clearly, for sustainable poverty reduction, the governance capacities that are necessary for managing and organizing growth-enhancing social transformations are more important. And yet transformative reforms are particularly difficult to implement because they are most likely to involve political conflicts and face opposition from vested interests.

This raises an important paradox for donors. Redistributive programmes that are overtly pro-poor may paradoxically be easier to sell in terms of the internal politics of developing countries, but many of these reforms have limited long-term effects, and there is little internal urgency by elites to implement them properly. They are also easier to sell to the domestic constituencies of the donor countries. On the other hand, reforms that may accelerate the transition to a dynamic capitalist economy can be much more conflictual in terms of internal politics and/or raise politically problematic questions about the intentions of external donors. This is because growth-enhancing reforms will typically make some elites richer and more powerful than others, and those likely to be left behind will strongly oppose these reforms. It is likely that external donors will be unable or unwilling to play an overt role in pushing conflictual reforms. But donors should not contribute to the perception that achieving broad environmental (investment climate) conditions together with redistributive and service-delivery reforms are sufficient for achieving the prosperity that developing countries demand. Fortunately, even without an overt involvement, donors can play an important role in facilitating gradual moves towards making difficult decisions by raising awareness of the historical processes through which prosperity has been constructed in successful developing countries. This can in turn initiate debates and political re-configurations in currently less successful countries that can, over the medium term, make dynamic transformations more likely. Donors have to take a long view on these processes, and not expect immediate results.

1. Environmental, Redistributive and Transformative Capabilities

The governance capabilities identified in the TSP can be grouped under three different heads. The first consists of capabilities that governments must have in order to be able to create and to maintain the essential *environmental conditions* for an efficient market economy. In much of conventional institutional economics, these environmental conditions are seen as *sufficient* conditions for market-led growth to take off. These conditions are the basic requisites for the operation of a market-based economy, such as secure property rights, the minimum conditions of law and order, the absence of overt conflicts, and particularly of violent conflicts, and low transaction costs. In the first column of Table 1, we see that three of the seven core capabilities in the TSP (capabilities 5, 6 and 7) can be classified as state capabilities that are necessary for ensuring the achievement of some of these critical environmental conditions for economic growth. The second group of capabilities are those that states must have to achieve the *redistributive conditions* for pro-poor growth. Clearly, economic growth by itself need not be pro-poor if the growth is not equitably distributed. To ensure that this happens, the state must have the capacity to convert the aspirations of the majority into service delivery financed by the revenues generated by growth. Three of the TSP capabilities (1, 3 and 4) can be classified as redistributive in this sense. Finally, we define a third set of capabilities as *transformative*, by which we mean capacities that the state must have if it is to accelerate growth if necessary by changing the structure of the economy and society. The only TSP capability that falls into this category is capability 2, the capability of facilitating private sector investment and trade, and even this is largely interpreted in the TSP in terms of creating an environment for private investment. We will argue that the evidence of successful pro-poor economic development, particularly in Asia, suggests that a broader range of transformative capabilities were at play in these countries.

Table 1 Governance Capabilities in the TSP

Classification of TSP State Capabilities		
Environmental Conditions	Redistributive Capabilities	Transformative Capabilities
5. Personal safety, security, access to justice for all 6. National security and conflict resolution between communities 7. Honest and accountable government	1. Democracy: effective political access for all 3. Pro-poor public spending apparatus 4. Universal basic service delivery	2. Facilitation of private sector investment and trade

‘Environmental’ Conditions for Market-Driven Growth According to conventional institutional economics, the major institutional and governance impediments to market-driven economic growth come from economic instability and high transaction costs, which prevent markets from working to generate growth. Markets can only be efficient if *transaction costs* are low. Transaction costs are the costs of protecting assets, negotiating contracts, carrying out the exchanges and enforcing contracts. The theoretical argument is that if these costs are too high, many market transactions will simply not take place. These include in particular the transactions involved in making investments. If investors feel that it would cost too much to protect their investments, they are unlikely to invest. This is simply another way of saying that in these cases the *expropriation risk* is too high. If transaction costs prevent investments, long-term growth in developing countries will be adversely affected. Thus, markets will not work unless the state carries has the critical capabilities to create the right environment for economic growth by ensuring the security of property rights and persons. The policy conclusion from this influential stream of institutional economics is that governance reforms should focus on reducing expropriation risk, stabilizing property rights and fighting corruption (Krueger 1974; North 1990; Murphy, et al. 1993; Shleifer and Vishny 1993; Mauro 1995; Barro 1996; Tullock 1996; Clague, et al. 1997; Olson 1997; Stiglitz 1998; Olson 2000; Acemoglu, et al. 2001; Bates 2001).

The environmental capabilities in the first column contribute to the achievement of economic growth through the creation of an environment for market-driven growth. Capabilities 5 and 6 are required if states are to protect the personal safety of citizens, ensure access to justice and provide them with national security. These conditions are required for protecting not only the life and limbs of citizens, but also their property and incomes so that market transactions can take place. Market transactions require safety and security because they are based on voluntary contracts between parties who have to own clearly defined assets. Thus, market contracts are unlikely if one or both parties are subject to the threat of violence from domestic or external expropriators. Capability 7 is required for achieving honest and accountable government. The absence of corruption is desirable in itself, but in addition, a large body of literature argues that low corruption is necessary to ensure that transaction costs in markets are low. The possibility of corruption raises market transaction costs as participants in market exchanges have to spend extra resources to ensure that contracts will be enforced and their legal rights will not be challenged by others who are willing to bribe public enforcement agencies. Thus, while these three capabilities promote desirable social goals, from the perspective of pro-poor growth, they can be understood primarily as contributing to conditions that are required for a market economy to function. They contribute to create the necessary *environment* for market-driven economic growth.

Redistributive Conditions for Pro-Poor Growth Creating an environment for rapid economic growth is not sufficient for ensuring that this growth is pro-poor. The *redistributive* governance capabilities identified in the TSP are an attempt to address this issue and to ensure that the fruits of growth are more equally shared. These governance capabilities (1, 3 and 4) listed in column 2 of Table 1 arguably convert growth into pro-poor service delivery. Capability 1 is the institutional capability to run a democratic government. Democracy is of course desirable in itself, but in the TSP, it is supported as a mechanism for promoting pro-poor growth. The underlying argument here is that democracy can equalize political access to include the poor. If the poor are to be successful in putting pressure on the government to deliver services to them, equal political access is clearly a necessary condition for this. Thus, a democratic state not only reduces expropriation risk by reducing the control of minority groups over the state (at least in theory), it also gives the poor majority a chance to exert pressure to ensure that service delivery is directed to them (Boone 1996; McGuire and Olson 1996; Ndulu and O'Connell 1999). We will examine the credibility of this particular case for democracy in section 2.

If democracy did work in this way to give the poor a voice in setting national priorities, we need some further capabilities to convert these priorities into services. Capability 3 is about improving the public spending apparatus to ensure that the budgetary mechanism and public financial management can be used to deliver, monitor and manage spending in ways determined by the pro-poor democratic system. Capability 4 ensures that the state has the capacity to deliver universal basic services. This is not just a function of budgetary funding, but also of the quality and internal control mechanisms over the service delivery arms of the state. Together, the three redistributive capabilities are important to ensure that the growth generated by the market (once the environmental conditions are there to drive growth) is converted into pro-poor service delivery by a democratic political process. This happens because the poor are the majority in developing countries. If the state has the capability to operate a democracy, and democracy works to give the poor a proportionate voice in setting national priorities, the poor can mandate basic service delivery. The budgetary management and service delivery capabilities of the state then allow it to transform this mandate into real services delivered to the poor. While the budgetary and service delivery improvements can be justified on their own terms, the weakest link of the redistributive agenda is the assumption that democratization will enable the poor to set national priorities for pro-poor service delivery. We will return to this assumption in our section on democratization.

<u>'Transformative' State Capabilities</u> A third set of state functions necessary for pro-poor growth is suggested by a growing body of theory and evidence that suggests that the state has to do more than create an environment for market-driven growth if markets are to deliver. For one thing, capitalist markets are not self-regulating because capitalists have very strong incentives to use political power to control markets and create monopolies to enhance their profits and restrict competition. Without countervailing action by the state, markets would soon stop delivering productivity growth, new products or competitive prices. The requirement that the state has to respond pro-actively to these anti-competitive tendencies of capitalists has recently been reasserted by Rajan and Zingales (2003). Their observations reiterate the importance of state capacities to regulate markets and impose discipline on capitalists by ensuring high levels of competition. These are the only pro-active regulatory capabilities supported by the TSP subsumed under capability 2, which identifies the importance of regulatory capacities to facilitate private sector investment and trade. This is the closest the TSP comes to identifying pro-active state capacities for ensuring market-led growth in developing countries.

However, when we look at the pro-active role of the state in rapidly growing developing countries, we see that their roles typically went well beyond the regulation of competition (Wade 1988; Amsden 1989; Wade 1990; Aoki, et al. 1997; Khan 2004b, 2004c). This evidence shows that the acceleration of growth in developing countries requires more than just an environment for market-driven growth. Markets primarily create *opportunities* for trade, but this may achieve little if the economy has little *productive capacity* to produce goods in the first place. We can imagine an efficient market economy that is a pre-capitalist economy of peasants, or of informal sector producers or low-technology low-productivity capitalist producers. None of these efficient market economies will deliver the living standards of a high-technology high-productivity capitalist economy. Nor is there a market mechanism that will work fast enough to convert a developing economy of peasant producers into high-technology producers very rapidly. The capacity to ensure reasonably efficient markets is therefore a necessary capacity but is by no means a sufficient capacity for ensuring that private sector investment leads a developing country to prosperity. This transition involves a *social transformation* of low productivity pre-existing production systems and the associated systems of rights and responsibilities into a dynamic high-productivity capitalist one (Khan 2004b, 2004c, 2005). Historically this transformation has required significant changes in the structure of property rights, the organization of firms, banks and other financial institutions and ultimately of the broader society. In all late developers, states have played a critical role in accelerating this transformation. There is no blueprint of success because the types of capitalism that emerged differed in terms of the size of firms, the financing institutions that were developed, the incentives and compulsions that were created for rapid technical progress and so on. Nevertheless, in none of the dramatic development stories of the late twentieth century did advanced capitalism emerge simply because efficient markets had been created. *Table 2 summarizes some of the important transformative capacities of high-growth states based primarily on the East Asian experience* (Khan and Jomo 2000).

Table 2 Transformative Capacities of High Growth States

a) Restructuring Property Rights for Growth (prioritizing the allocation of public land, prioritizing particular types of infrastructure, carrying out pro-growth land reform, selecting beneficiaries of new rights over assets)
b) Assisting technology acquisition (prioritized infrastructure support, technology licensing, training and technology absorption subsidies)
c) Extra-market Disciplining of Capitalists (re-allocating subsidies, closing down support schemes and setting up new ones, restructuring infrastructure provision)
d) Maintaining Political Stability (accommodating and/or constraining powerful factions, redistributing more broadly for social stability)

a) Restructuring Property Rights for Growth. In theory, an efficient market with transfer assets and resources from low productivity to high productivity users through voluntary exchanges. There are at least two powerful reasons why the market on its own can fail to re-allocate assets in this way in developing countries. First, for markets to be able to transfer assets efficiently from low productivity to high productivity users, transaction costs facing individual transactors have to be very low. But this is an unreasonable expectation in developing countries because transaction costs can only be significantly lowered for *individual* transactors if the state already has a substantial tax base that can be used to make courts, policing systems, arbitration systems and so on very efficient. It is worth remembering

Douglass North's observation that in the case of the relatively efficient US economy, something like half of the economy is accounted for by activities in the "transaction" sector (North and Wallis 1987) that is responsible for the protection, transfer and negotiation of property rights. Thus, efficient market economies like the US clearly do not have low transaction costs *in aggregate*, but because many transaction costs are *socialized*, the transaction cost for *individual* transactors are relatively low. For developing countries to try and achieve this while they are still poor is an attempt to put the cart before the horse since a large productive economy is required to pay for the socialization of a significant part of society's transaction costs. Successful developing countries did not attempt to achieve perfect markets, but rather devised strategies to ensure that rapid growth could happen in a context of considerable instability of property rights and relatively high transaction costs facing individual transactors.

Secondly, the re-allocation of property rights during early stages of development is a much more conflictual process than in advanced countries. This makes it very unlikely that many of these conflictual asset re-allocations can be achieved through purely market-based re-allocations that are by definition supposed to be voluntary. While low-productivity users of assets are easy to identify, many potentially high productivity users *may* become efficient managers of assets if they had the chance. This is because a class of established capitalists does not already exist. Many individuals could potentially raise money or political support to try and gain control over assets that they could perhaps manage in a more productive way in the future. As success in this race is likely to give first movers a huge advantage in the future (and potentially for generations to come), the competition to become one of the new 'capitalists' is typically intense. Consequently, the observation that developing countries are often characterized by intense internal insecurity and many descend into civil wars is not at all surprising (Hirshleifer 1982; Cramer 2002). The expectation that markets will suffice to allocate assets to new users in such contexts is therefore rarely borne out in historical observations of early development. The capacity of the state (through accident or design) to assist in the re-allocation of critical assets to productive users has always played an important role in transitions to more productive economic structures in these contexts.

The restructuring of property rights to accelerate the emergence of a capitalist sector has included interventions to allocate land to emerging enterprises, land reforms to accelerate the transfer of land to productive farmers, privatization strategies that have transferred assets to entrepreneurs typically at below market prices, the creation of new property rights over public and natural resources and so on. Historical examples of non-market transfers of assets include the English enclosures, the transfer of public assets in China to TVEs, land reforms in South Korea and Taiwan, and less edifying processes through which emerging capitalists captured resources in countries ranging from the United States (from indigenous peoples) to Thailand (of common property). But in much of the developing world, these non-market transfers have taken the form of plunder and loot, with no viable capitalist sector emerging. The challenge for governance reform is to identify the country-specific reforms that improve the capacity and incentives of states and state leaderships to manage the non-market processes through which rights are inevitably being restructured in developing countries so that viable capitalism is more likely to emerge. Plunder and loot are no longer acceptable, but land use regulations, the development of industrial zones, the prioritization of infrastructure, and the selection of projects and capitalists for these sectors are non-market asset-transfer processes and modern developing countries have to acquire the capacity to manage these processes effectively.

b) Assisting Technology Acquisition. The theoretical expectation that efficient markets will lead to the transfer of technologies to developing countries has rarely been observed in practice. There are good theoretical reasons why this does not happen. The profitability of an investment depends not just on the relative wages of the developing country, but also the average productivity of its workers. The unfortunate fact is that the average productivity of most developing countries is so low that despite their low wages, advanced technologies will not appear in these countries for a very long time, making the low wages very persistent (Khan 2000a: 47-53). In fact, high-growth countries have leapfrogged over the otherwise painfully slow progress that would have happened through the market by creating incentives for investors to invest, sufficient to overcome the disadvantage of low productivity. This is a viable strategy because in very many cases, the lower productivity of developing countries is not due to the lack of education and infrastructure in the conventional sense, but rather by the absence of any experience of industrial production and manufacturing. With a proper system of incentives and sanctions, this disadvantage can be overcome through 'learning-by-doing'. This is particularly the case because the wage differential ensures that a developing country can be internationally competitive even if it achieves a fraction of the productivity of its advanced country competitor.

The ways in which states have assisted these technology acquisition strategies have varied widely across developing countries. These incentives do not require outright financial subsidies to emerging companies in the way the South Koreans provided in the sixties and seventies. Many of these explicit subsidies would today be ruled out by WTO rules on subsidies. However, states have assisted technology acquisition in many other ways where the 'subsidy' has been very subtle. In fact, hidden subsidies for high technology industries like aircraft construction are common in advanced countries too (as witnessed in the current dispute between Boeing and Airbus). In developing countries, technology acquisition assistance has included technology-licensing strategies in Taiwan, where the state took on the risk of licensing new technologies and sub-licensing technologies to smaller firms. In other countries like Malaysia and China, the state has encouraged high technology investors to come in by prioritizing infrastructure support, which effectively amounts to a hidden subsidy for particular sectors. Later developers have to learn from these experiences and develop the capacity to accelerate the acquisition of technologies most appropriate for their development strategy.

c) Disciplining of Capitalists. State support for technology acquisition is nothing new. Incentives for accelerated technology acquisition have been tried in most developing countries (under the generic format of infant industry support) but they only worked in a very small number of cases. In fact, the failure of most of these infant industry strategies led to the abandonment of support for these strategies by the international development community. However, when this significant switch of emphasis occurred, development theorists and practitioners often did not ask why infant industry development had been so unsuccessful in most cases, nor did it address whether the alternative of market-driven technology acquisition would suffice for the rapid development of most developing countries.

Successful transformation states achieved much better outcomes with their technology acquisition strategies because they combined incentives with effective sanctions if emerging capitalists failed to deliver. In each case, success depended not only on the appropriateness of the support, but also on the political capacity of the institutions managing the incentive to re-allocate or withdraw support if performance turned out to be poor. Thus, the extra-market disciplining of capitalists who enjoyed state support for technology acquisition was a critical feature of the success of transformation strategies.

d) Maintaining Political Stability. Given the intense conflicts unleashed by the rapid restructuring of property rights and the emergence of new wealth in developing countries requires specific state capacities for maintaining political stability. Successful developers achieved political stability through both fiscal and off-budget transfers to powerful constituencies, as well as by creating new political organizations to contain or limit the demands of specific constituencies. Stabilization strategies in successful developers have included the construction of new political organizations like UMNO and the National Front coalition that consolidated in Malaysia in the early seventies, and land reform in South Korea and Taiwan that was motivated by political stabilization rather than simply economic considerations. Successful developers also distributed enough to wider constituencies through the fiscal system to maintain broad social support for the strategies of transformation. These capacities are much more situation-specific than a simple promotion of democratization. Developing country states that are attempting to catch up have to develop the institutional and political capacities for dealing with specific stabilization challenges facing their growth strategies.

While there is no blueprint of success, as successful countries achieved these goals using somewhat different institutions and policies, these transformative functions direct our attention to the types of functions that states in less dynamic countries should be trying to achieve.

The Comparative Evidence on State Capabilities Our argument that the TSP misses out on a critical range of transformative state capacities will be countered by those who refer to a voluminous literature establishing the importance of the 'environmental' capacities that TSP focuses on. Unfortunately, these important questions cannot be answered unequivocally by looking at the facts because the facts can be ordered and analysed in different ways. In particular, *cross-sectional econometric evidence* appears to support the importance of the environmental state capabilities stressed in the good governance approach to institutional reform (Barro and Sala-i-Martin 1995; Barro 1996; Clague, et al. 1997; Mauro 1997; Johnson, et al. 1998; Hall and Jones 1999; Kauffman, et al. 1999; Acemoglu, et al. 2001). On the other hand, *case studies* of high-growth developing countries in the last fifty years have shown that they have sustainably reduced poverty *without* many of these governance characteristics that the consensus position (and the TSP) supports (Amsden 1989; Wade 1990; Khan and Jomo 2000; Khan 2004b).

The conflicting evidence can be at least partly reconciled by recognizing that the cross-sectional econometric analysis underplays the significance of the small number of countries that were actually making the transition to advanced capitalism at any time. These countries (shown as group 2 in Figure 1) drop out as “outliers”. The relationship that is picked up between governance indicators and economic performance is determined by the large number of poorly performing countries that score badly on good governance (group 1 in Figure 1), and a number of rich countries that have a high score on good governance (group 3 in Figure 1).

The regression line in Figure 1 does not necessarily tell us anything about causality; in particular, it does not identify the institutional conditions that have allowed a few developing countries to *catch up* with the advanced countries. Nevertheless, it can wrongly suggest support for governance reforms of the type that enhance state capabilities focusing on creating a good environment for market-led growth. Many of these environmental conditions, such as security and stability of property rights, the absence of corruption and the presence of democracy are desirable in their own right. The question is whether the historical evidence supports the prioritization of reforms that develop these environmental conditions and the associated state capabilities (in the direction of C in Figure 1) as necessary or sufficient for pro-poor economic growth to takeoff.

A closer look at the cross-section data and case study evidence suggests that the more likely reform priorities would be to identify the *transformative* state capabilities that allowed group 1 countries to move to group 2 (reforms in the direction of A in Figure 1). This observation does not suggest that moving to group 3 is automatic. There may be critical reforms (B in Figure 1) that are necessary for middle income or more advanced developing countries to take them to group 3, but these reforms may not be the priority for countries that are still in group 1.

The specific institutional conditions that allowed a small number of high-growth developing countries to begin to catch up are best identified by case studies of these countries, and these show that “good governance” institutional capacities played a minor role in the success of the rapid developers (Aoki, et al. 1997; Woo-Cumings 1999; Khan and Jomo 2000; Khan 2004b, 2004c, 2005). States in the rapid developers were generally not politically accountable, low corruption states that responded rapidly to the demands of the poor. Rather, they had the types of "transformation" capacities referred to earlier that allowed their states to intervene to accelerate the emergence of capitalists who could be encouraged to move rapidly up the technology ladder.

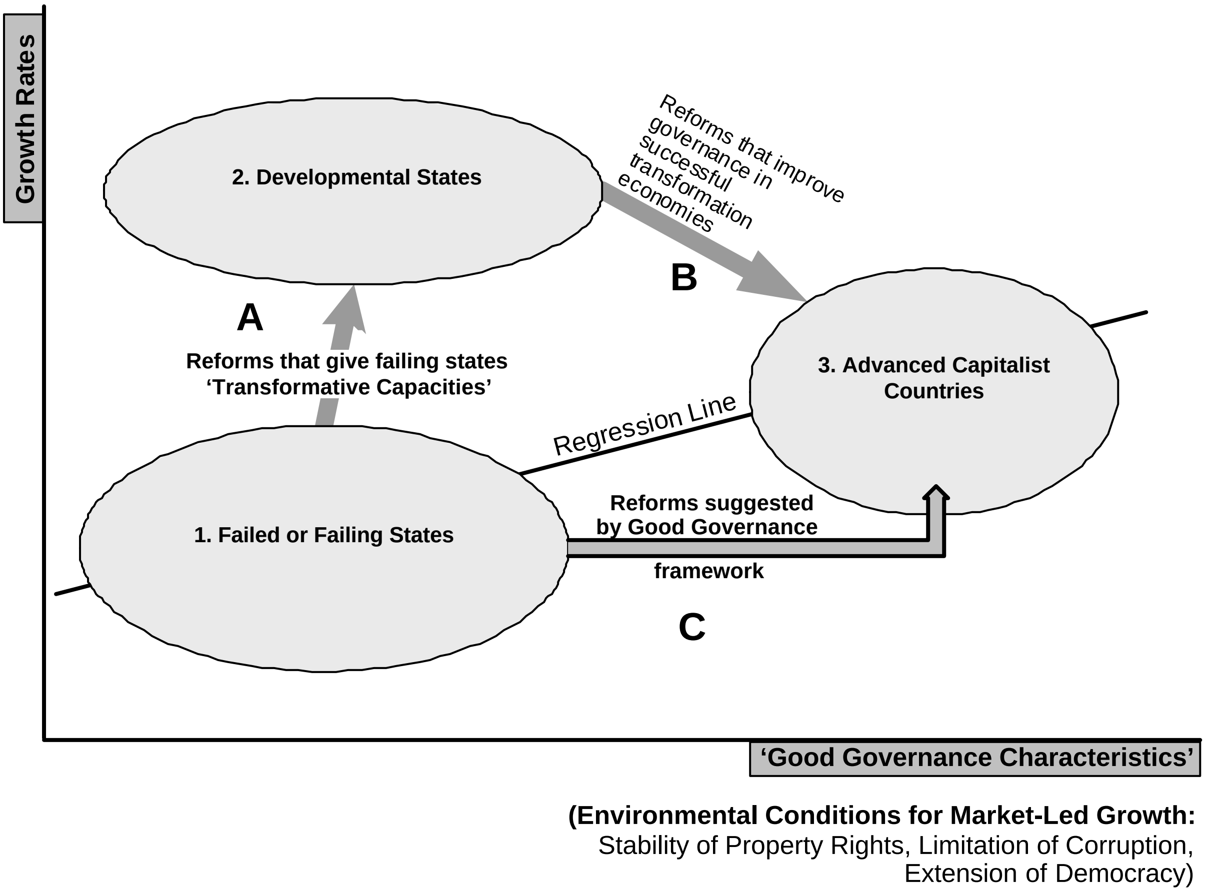

Figure 1 Governance Capabilities and Catching Up

The mix of capabilities in high-growth developers has varied greatly, but if we compare the broad characteristics of these countries with the TSP requirements, we find that most of them would have failed the test of having adequate capabilities for pro-poor growth. These observations are summarized in Table 3, based on the case-study evidence from Asia. High-growth developers did not often score highly on the state capabilities that would be critical for maintaining the environmental conditions for market-led growth. Even though these countries were clearly market-oriented countries, it is not surprising that the environmental conditions for full market efficiency were often not met, given the reasons discussed earlier. They also scored low in terms of the redistributive capabilities that the TSP identifies are important for pro-poor redistribution. All of these countries did have substantial internal redistribution, but this was primarily driven by government concerns to maintain political stability rather than by democratic accountability to the poor. But most importantly, all these countries scored very highly on transformative capabilities, and these went much further than the limited capabilities identified in the TSP.

Table 3 State Capabilities in High-Growth Economies: The Case Study Evidence

Environmental Conditions:
5. Successful countries did have basic security, but not necessarily equal access to justice for all.
6. They did achieve national security but
7. They had high levels of corruption but **not** of the predatory variety
Redistributive Capabilities:
1, 3, 4. They often (but not always) scored poorly on most of the formal redistributive capabilities
Transformative Capabilities:
2+ Many others. They were very strong on transformative capacities that went well beyond the one identified in the TSP

These historical experiences are now well known but there is a valid question about whether we should be learning any lessons at all from the successful developers. A common response from practitioners is that while the capacities and practices of the successful developers were indeed significantly at variance with the good governance model, they were rather exceptional countries whose experiences cannot be replicated. Since some of their underlying characteristics are different from most of Asia and Africa, contemporary poor countries should stay well clear of these types of transformative strategies and try instead to replicate aspects of good governance more common in advanced countries. The first part of this proposition is entirely correct. Developing countries that are not performing well clearly do not have institutional and governance capacities that would allow them to replicate what happened in South Korea or Taiwan, or to follow what is happening today in China. But it does not follow that the market-promoting state capacities as currently understood in the "good governance" approach can actually be implemented in these countries, nor that they could deliver the expected results if they could be implemented. While there are few examples of high-growth countries and each is exceptional, there are *no* examples of successful transitions to prosperity based on following the good governance route to reform. Inadvertently, we may be confusing means and ends here, and not identifying the governance capacities that are critical for pro-poor growth during the transition to prosperity. Even if we agree that with our best efforts a poorly performing country is unlikely to achieve the governance capacities that made South Korea or Malaysia or Thailand rich, it may still be the case that the only way to improve long-run outcomes is to learn some *partial* lessons about critical transformative capacities from these countries.

2. Democracy and Pro-Poor Growth

The very first capability listed in the TSP is the capability to sustain "political systems which provide opportunities for all people to organize and influence state policy and practice". The justification for this is particularly important in the contemporary context of support for democratization in developing countries. The assumption is that a democratic political system will force the state to act for the public good rather than for narrow interests. However, this instrumental claim for democratization is a problematic one. The instrumental role of democracy in achieving specific developmental outcomes is tenuous both in theory and in terms of the available evidence. Nevertheless, a weaker case for democracy can be made on the following grounds. While democracies in the developing world do not necessarily perform better, it is not the case that authoritarian regimes systematically do any better in terms of promoting pro-poor growth. It is possible to find many examples of both democratic and authoritarian regimes that are performing poorly, and examples of high-growth economies that are democratic and others that are authoritarian. Given that democracy does not appear either to accelerate or to retard development, this can be taken as a weaker argument for democratization since democracy is a desirable goal in itself that developing countries aspire to (Przeworski, et al. 2000).

However, the TSP does *not* make the weak case for democracy. Instead, it makes the stronger case that the capability to run a democratic system is a necessary capability for pro-poor growth. There are no compelling theoretical reasons or empirical evidence to suggest that democratization by itself has a significant impact in a pre-determined direction. Careful empirical work suggests that there is no clear evidence that democracy accelerates growth or poverty reduction in developing countries (Przeworski and Limongi 1993; Barro 1996; Przeworski, et al. 2000). It is true that all advanced industrialized countries are democratic, just as they score higher in terms of other governance characteristics shown in Figure 1, but the statistical evidence is that the direction of causality is the other way round. It is not the case that advanced countries are rich *because* they were democratic earlier in their history. Rather, transitions to democracy tend to survive when they happen in countries that are prosperous (Burkhart and Lewis-Beck 1994; Przeworski, et al. 2000). As a result, the statistical observation is that rich countries are democratic. This evidence tells us that it is dangerous to treat democracy as an instrumental variable to enhance pro-poor growth. Rather, we should see democracy as an end in itself, to be promoted as a desirable goal of development.

So how does the TSP justify its stress on participatory political systems as a necessary governance capability for pro-poor growth? The argument seems to be the commonsensical one that democracy allows the poor to exercise political voice to ensure that public service delivery is organized in their interest. It is therefore part of what we have described as the *redistributive* capabilities of the state (Table 1). Since the democratic process is assumed to generate demands for pro-poor public services, two other redistributive capabilities are also required to deliver these services. The first is a pro-poor fiscal apparatus and its associated management system, and the second is the public capacity to deliver universal basic services. The weak link in this chain of argument is the claim that a democratic political system where all groups have the ability to organize to influence the government will result in the poor *setting the agenda* for public service delivery. In no democracy, whether in developing or advanced countries, does the majority in any simple sense set the agenda for government policy. Policy is always the result of compromises between different organizationally powerful groups who set the agenda and spend the resources in winning elections. Indeed, the TSP document itself notes that the dramatic growth in the number of democratic countries in the last three decades has not always resulted in the empowerment of the poor.

In developing countries, organizationally powerful groups are likely to come not from the poor but from different sections of the 'intermediate' classes, the urban middle classes, the middle peasants and the petty-bourgeoisie (Harriss-White 2003). In addition, the emerging capitalists and owners of illicit wealth are also likely to have a disproportionate say in policy-making, just as capitalists do in advanced countries. Democratization can therefore be expected to empower these groups even more. Whether the policy agenda that emerges from the competition between these groups has some pro-poor elements as in the Indian state of West Bengal, or bypasses the poor as in the neighbouring state of Bihar has more to do with the political organizations, the ideologies of political parties and the classes and groups they mobilize. When democracies do manage to engage in pro-growth reform, as in India in recent years, it is often because in reality politicians are engaging in unsavoury practices of obfuscation and patron-client politics to push particular agendas of reform (Jenkins 2000). In the absence of such favourable conjunctures, democracy in developing countries can easily result in policies that are neither pro-poor nor pro-growth. But even if popular participation cannot set the agenda for government priorities in developing countries, we could still expect democratic states to be more accountable in delivering the services that happen to be part of the policy agenda. This is a more credible argument for promoting popular participation but probably not a strong enough one to justify expecting significant results by developing this capability.

So far, we have looked at the (weak) mechanisms linking the extension of democracy to pro-poor service delivery as part of the redistributive component of pro-poor growth. On the one hand, we can agree that democracy is likely to play a positive role in making service delivery more efficient in certain circumstances. For instance, if the service delivery is already on the government's agenda (for whatever reason) and the resources for providing services already exist, the political freedom to organize and demand accountability can help in ensuring that service delivery is as efficient as possible. On the other hand, democratization can also impact on the transformative role of the state and its ability to enhance the productive capacity of society in complex ways that are less well understood. Is it likely that open political competition will mediate conflicts during the process of development where transformative interventions that are deeply conflictual are being implemented? The inclusion and empowerment of all groups may not be as obvious as a solution, and may worsen transformation outcomes in some contexts.

The possible problem here is *not* that democracy empowers the poor because typically, pro-growth transformations in developing countries are not blocked by the poor. In any case, we have argued that democracy does not empower the poor in any simple sense. Rather democracy most usually empowers coalitions of intermediate classes, and these are precisely the classes whose access to rents is most likely to be re-negotiated by growth-enhancing policies. Jenkins' (2000) work on the policy-making process in India during the formulation of its reform agenda shows how progress depended on enough coalitions being assured of their rents and leaders being able to buy out or bypass obstructive coalitions. India was lucky that this democratic reform process was not blocked by powerful constituencies, but it is hard to argue that Indian democracy was instrumental in *ensuring* that the reform agenda moved ahead. Transformative reform processes may be just as easy if not easier in countries like

China where the policy process is much less transparent and disgruntled coalitions find it more difficult to organize.

If greater participation is to contribute to more rapid reform and growth, we need to think of institutional arrangements specific to each country that would allow government to be more effective as well as representing the national interest. This does not necessarily mean *excluding* groups or *insulating* the state, but rather of strengthening and *deepening* the access and influence of *change agents*. Here too, there are no formulae but at best methods of thinking through how specific processes of transformation can be accelerated. Practitioners need to be more aware of the political and organizational process through which democracies operated in successful transformation countries like Thailand and Malaysia, and how these were different from democracies in less dynamic transformation economies (Khan and Jomo 2000). These and other historical experiences enable us to draw a number of tentative conclusions about strategies of promoting democratization in developing countries.

a) Patrimonial Politics is unlikely to be uprooted by Democratization. There is no evidence that democratization uproots patrimonial politics. In India, arguably the most successful democracy in a developing country, the deep inter-penetration of formal politics with informal structures of networks and factions has been powerfully described by Harriss-White (2003) and by Jenkins (2000). In Africa, it used to be argued that neo-patrimonialism was due to the absence of democracy, and authoritarianism allowed the continuation of personalized politics and the use of informal sources of power by the 'big men' (Médard 2002). However, it is now more commonly recognized that neo-patrimonialism and patron-client networks have survived the transition to democracy in Africa, and they continue to operate with relatively slight modifications (Chabal and Daloz 1999).

There are good theoretical reasons why the politics of developing countries should be organized along factional and informal lines. The dominance of formal politics based on interest group representation and redistribution of resources through fiscal processes assumes that there are sufficient fiscal resources to maintain social stability through these mechanisms. This is certainly not true in most developing countries where the fiscal take is often insufficient to pay the salaries of public officials, and is rarely sufficient to pay for the necessary infrastructure and other public investments. Political stability requires redistribution but this cannot be financed through transparent budgetary resources. In such a context, it is not surprising that much of the resources for political stabilization come from off-budget activities. Patron-client factions exist as conduits for the collection and dispersal of off-budget resources, and if they did not exist in any developing country, they would be rapidly invented to perform these functions.

b) Significant Differences exist between Countries in the Organization of their Patron-Client Factions. Even though all developing countries have patron-client factions and maintain political stability through the rent distributed by these factions, their economic and political outcomes are nevertheless very different. These differences in outcomes are *not* primarily related to their degree of democracy or otherwise, but more directly to the organizational structure of factions and the ability of the dominant factions to carry out transformative interventions in the economy (Khan 2000b). Can the dominant factions ensure that productive users get access to assets and resources; that these emerging capitalists have incentives and sanctions for moving up the technology ladder; and that political stability is maintained through the off-budget activities that are feasible? Success depends on factors like the ability of dominant factions to overcome the factional interests of other groups who may want to dislodge them from power. If the dominant factions are secure in taking a long-term view this may induce them to try and enhance social productivity growth as a way of enriching themselves, rather than engaging in looting. They must also have sufficient incentives in the form of pressure from below or threats from neighbouring countries to push them towards growth strategies.

c) Required Reforms may be Changes in Political Organizations. It follows that creating the conditions for growth may require political reforms rather than only institutional reforms of the type suggested by the democratization agenda. Institutional reforms are easier for outside donors to support because they appear to be technical and neutral, but for reasons that we have discussed, the role of these reforms may be very limited in developing countries. Patron-client politics and off-budget transfers are likely to remain dominant whatever happens. The real area of reform may be in the reorganization of factional politics so that a stable dominant faction can emerge and carry out transformative interventions. The emergence of such a coalition may be through democratic politics but we also seen such coalitions emerge in less democratic contexts as in South Korea in the sixties, Taiwan in the fifties and in China today. Democracy is neither necessary nor sufficient for the emergence of such dominant factions. However, since democracy is desirable in itself, we need to ask how we can promote the emergence of such political organizations in democratic contexts. This is a very different approach from promoting democracy as a way to *solve* the problem of unproductive coalitions being in power. We should also note that there might be clear limits to what donors can do when it comes to reforming political organizations, except to disseminate information and analysis about strategies that have worked in different contexts of successful transformation.

3. Structural Drivers of Corruption and the Challenge of Regulating Rent Seeking

Corruption has become a major political concern in developing countries as well for many donors trying to limit the loss of western taxpayers' money in service-delivery activities suffering from corruption. The political importance of corruption in developing countries cannot be denied, nor can the frustration of ordinary citizens in these countries who feel they have achieved very little after well over a decade of anti-corruption activism and policy interventions. Corruption takes place when public officials break the law in pursuit of their private interest. But public officials can break different laws in different ways with different implications for the public good. The factors driving corruption and the effects of corruption can therefore vary widely. This question is particularly significant in developing countries, which almost without exception suffer from high levels of corruption.

The evidence from across the developing world tells us there are very few developing countries that have low levels of corruption. While there are many problems with subjective corruption indices, they suffice to show the broad features of the problem. The earliest year for which corruption data is available across a broad range of countries is 1984, and we use the corruption indices provided by the IRIS centre at the University of Maryland. This index ranges from 0 (the highest level of corruption) to 6 (the lowest level). Data is available for 85 countries. Table 4 summarizes the data and the per capita GDP growth rate of these countries over the period 1980-90. We split the population into three groups. The advanced industrialized countries are our first group. These countries have relatively low corruption indices and moderate rates of growth. Developing countries are split into two further groups: a group of converging developers whose per capita growth rate is higher than the advanced country average, and a third group of developing countries with growth rates below the advanced country average, which were consequently falling behind in relative terms.

Table 4 shows that there is virtually no difference in the median level of corruption between high-growth and low-growth developing countries. These figures are once again consistent with the stylized governance-growth relationship shown in Figure 1. Advanced countries have lower corruption levels than low growth developing countries, but the direction of causality between corruption and economic development is not clear particularly when we look at high-growth developing countries that are on average just as corrupt as low growth developing countries.

Table 4 Corruption and Growth 1980-90

	Median Corruption Index 1984 (Range)	Median per capita growth rate 1980-90 (Range)
Advanced Industrialized Countries n=21	5.4 (3 — 6)	2.2 (1.4—4.4)
Converging Developers n=12	3 (1—5)	3.5 (2.4—8.8)
Other Developing Countries n=52	2.6 (0—6)	-1.0 (-6.3—2)

Source: IRIS-3 (2000), World Bank (1992). The corruption index ranges from 0 (maximum corruption) to 6 (minimum corruption).

An inspection of the crude data is particularly important given the growing number of sophisticated econometric studies that find some relationship between corruption and economic performance (many of these are reviewed in Lambsdorff 2005). The crude data should alert us to examine the theory more closely before accepting the link between corruption and economic performance that has been suggested by a number of frequently quoted econometric studies (Knack and Keefer 1995; Mauro 1995; Knack and Keefer 1997; Mauro 1997; Johnson, et al. 1998; Hall and Jones 1999; Kauffman, et al. 1999). These studies typically establish a strong relationship between corruption (and other governance indicators) and per capita *incomes*. This is entirely consistent with our observation of the data that shows a significant gap in the corruption index between advanced and developing countries. However, for corruption to be a policy target we need to establish a causal relationship between corruption and economic *growth*. This relationship is typically much weaker, and often disappears with the inclusion of variables like the investment rate (Mo 2001). This too is consistent with our observation of features of the crude data, and tells us that the causal relationship between corruption and the economic performance of developing countries is too weak to be the basis of policy efforts without further investigation of the underlying theory (Khan 2004b). *The evidence strongly suggests that developing countries must share some powerful common drivers of corruption that are different from those that affect advanced industrial countries. At the same time, the very diverse economic performance of developing countries suggests that it is likely that not all developing countries suffer from the same types of corruption.*

Corruption describes a variety of different processes with very different causes and effects (Khan 2004a). Table 5 suggests a classification of corruption in developing countries according to whether the underlying state intervention with which the corruption is associated was damaging or beneficial, and whether that underlying intervention was legal or illegal to begin with. Note that while corruption is always illegal, the intervention that the corruption is trying to purchase or the restriction or threat that the bribe-giver may be trying to avoid may be either legal or illegal. The latter has important implications for policy responses to corruption. Much of the anti-corruption strategies of the international aid community are based on the assumption that all corruption can be dealt with using a similar set of strategies. This is unlikely to succeed in reducing corruption and indeed the success of anti-corruption strategies has been very limited. Nevertheless, a better understanding of the drivers of corruption can help us to devise better policies and to avoid doing damage to developing countries by foisting unworkable policies on their governments.

Table 5 A Typology of Corruption in Developing Countries

	Legal Interventions	Illegal Interventions
Potentially Beneficial Interventions	**2) Statist Corruption**. Net effect can be beneficial or damaging depending on how seriously corruption subverts interventions. Policy should seek to legalize rent seeking and strengthen state to prevent subversion of desirable interventions.	**3) Functional Political Corruption and Primitive Accumulation**. Net effect depends on degree of political stability achieved and on whether productive capitalists emerge. Policy should seek to increase fiscal capacity for legal political stabilization and property right protection.
Damaging Interventions	**1) Neoclassical Corruption**. Net effect of intervention always negative. Anti-corruption policy should remove these state capacities through liberalization and privatization.	**4) Destructive Political Corruption and Predation/Theft**. Net effect always negative: possible descent into warlordism. Anti-corruption policy has to strengthen centralized coercive power of the state.

Source: (Khan 2004a)

1) Neoclassical Corruption. The simplest variant of corruption is derived from the analysis of neoclassical (mainstream) economics, and is the type of corruption that is most commonly assumed to exist in developing countries by the policy community. The drivers of this type of corruption are the state's legal powers to intervene in the economy to create damaging rents or introduce damaging restrictions. Examples of damaging rents are the profits that can be earned by some importers when import quotas are imposed or the profits of monopolists when the state limits entry into some markets. Rents in economics are any profits or wages that are higher than they would have been in the absence of intervention, and in this case, the rents are damaging, as the restrictions with which they are associated have no beneficial effects for society. Nevertheless, even though the rents are damaging for society, they are beneficial for those who can capture them, and individuals in society will be willing to pay bribes to capture these rents. Apart from damaging rents, states can also create damaging restrictions. Examples of damaging restrictions are unnecessary paperwork and red tape for investors or owners of assets. Once again, individuals may be willing to pay bribes, in this case to avoid the damaging restrictions. The outcome of this type of corruption is always negative for society since society ends up with two distinct costs: the social cost of the damaging rent or restriction that the state creates *plus* the social cost of the resources lost in bribes to corrupt public officials.

There are two drivers of corruption in this case: the legal interventionist capacities of the state that allow it to intervene in damaging ways, and the low opportunity cost of being corrupt that encourage public officials to collect bribes. The latter in turn can be traced back to low bureaucratic salaries, the low probability of being caught in acts of corruption, the low probability of being prosecuted if caught and/or the low probability of being punished if convicted. Mainstream economic theory therefore recommends that to fight corruption, policy should attack both these drivers of corruption. *Policy against this type of corruption should support liberalization (to reduce the capacity of the state to intervene), and simultaneously support higher bureaucratic salaries, greater transparency and accountability, and a better judicial system to prosecute and punish offenders (to increase the opportunity cost of corruption).* Clearly, anti-corruption policy in developing countries has implicitly assumed that this is the only or the predominant type of corruption in developing countries. This type of corruption clearly exists in developing countries and is very onerous particularly to the poor. However, our contention is that it is not the only or even the most important type of corruption in these countries.

Recent empirical work on corruption supports the argument that systematic attention to these drivers of corruption have had very limited effect on the extent of corruption in developing countries. For instance, empirical work finds little relationship between democratic accountability, liberalization or bureaucratic salary increases and the reduction of corruption (Treisman 2000; Khan 2002, 2004a). But these are precisely the types of policy variables that anti-corruption strategies have been targeting. Frustration with these policies often takes the form of a critique of the 'political will' of developing country leaderships. The TSP is not immune from this when it argues, "More than anything, effective anti-corruption campaigns require leadership and political courage" (TSP p 26). This suggests that where anti-corruption strategies fail, as they have in Pakistan, Bangladesh, Kenya, Indonesia, the Philippines and virtually every other poor developing country, the fault lies with the political will and the courage of the leadership. This may be true in some cases, but leadership quality is not a convincing explanation. If it were, we would occasionally see a developing country where strong leadership achieved sustained reductions in corruption. Interestingly, one of the few (perhaps the only) specific reference to successful good governance in developing countries in the TSP is in the section on corruption where the countries identified as models are Hong Kong, Botswana, Chile and Singapore. But these are not poor countries. Botswana and Chile are middling to upper middle-income countries; Hong Kong and Singapore were richer than some European countries when they began to make serious inroads on corruption. One could equally include contemporary anti-corruption successes in South Korea with similarly questionable implications for anti-corruption strategies in contemporary Bangladesh or Tanzania. Instead, it may be that we have to give serious attention to other drivers of corruption in developing countries.

2) Statist Corruption. In statist corruption, the underlying intervention with which the corruption is associated is still legal, but now the intervention is a potentially beneficial one, associated with developmental or 'statist' interventions. For instance, the state intervention here could be a subsidy for technology acquisition, or a transfer to achieve welfare or political stabilization goals. Once again, rents are created, but this time these are socially beneficial rents. Heterodox economics looking at the economic development of late developers has identified a wide range of rents and interventions that can potentially accelerate economic development if properly managed. These include legally created rents that can create additional incentives for accelerating the acquisition of new technologies or redistributive rents that help development by maintaining political stability (Amsden 1989; Wade 1990; Rodrik 1995; Aoki, et al. 1997; Lall and Teubal 1998; Woo-Cumings 1999; Khan 2000a; Khan and Jomo 2000; Khan 2002; Rodrik 2002; Khan 2004b). Table 6 summarizes these observations from successful developers.

Table 6 Rents and Rent Seeking are not always the problem: Failing to Manage Rents Is

- Developing country states have to create and manage many types of beneficial rents (for instance, to create incentives for technology acquisition, stabilize polities, conserve natural resources, improve welfare)
- These rents create incentives for legal and illegal rent seeking, but as long as the resources contribute to development, neither the rent nor the rent seeking is a problem
- Development can be promoted if this rent seeking is regulated, and if state capacity for regulation and disciplining can be strengthened (examples of regulatory capacity include the capacity for managing oil rents in most OPEC countries, industrial subsidies in South Korea, redistributive transfers and infrastructural prioritization in Malaysia)

The problem even for beneficial rents is that those who capture these rents will benefit even more than the rest of society, and they will be willing to pay bribes to public officials or engage in legal rent seeking to be one of the selected few. As long as the bribes do not protect inefficient rent recipients, or otherwise subvert the policy, corruption in these contexts can coexist with rapid growth. This type of corruption is by no means functional in the way Leff (1964) had argued, since society would be even better off without it, but bribes in this context can operate like a tax that allows public officials to share some of the benefits of rapid growth that can follow from effective rent management. The net effect for society can now be positive or negative. If the rents are very beneficial and if the resources lost to investment because of the bribes are small, the net effect can be that rapid growth continues. Thus, in South Korea, rents created incentives for rapid technology acquisition, and the fact that emerging capitalists were willing or forced to share some of the benefits of growth with public officials did not significantly distort rent management and therefore overall growth. On the other hand, if the rents are not very beneficial and/or the cost of the bribes is very large, the net effect may be negative. In other cases, the bribe may subvert the type of rent by resulting in its allocation to the wrong sector or individual. In this case, too, the outcome could be negative for society. Given the concern with natural resource rents in Africa, it should be remembered that oil rents in OPEC countries were quite effectively managed. Most of these countries managed to reduce poverty in a dramatic fashion even though their success in using this wealth for industrialization has been mixed.

The implications for anti-corruption policy are therefore very different from the neoclassical case. Liberalization would now *not* be a desirable strategy because the loss of these interventionist state capacities would be a significant social loss. Increasing the opportunity cost of corruption for bureaucrats and politicians can still be relevant, but if the potential bribes being offered are large because significant beneficial rents are being created and allocated by the state, no feasible increase in the opportunity cost of corruption is likely to stop it entirely. The most powerful evidence of this comes from countries like China where corruption is widespread despite the regular exercise of the death penalty for corruption. Indeed, given that there are likely to be many types of beneficial rents in developing countries, the long-term strategy must be to legalize the rent seeking associated with these rents. Rent seeking can never be wiped out entirely as long as rents exist for capture, and rents will always exist as long as there is a state that does any socially desirable redistribution or industrial policy. Instead of trying to wipe out corruption, which assumes that the interventionist driver of corruption can also be effectively removed, in this case the strategy has to be the conversion of illegal rent seeking (corruption) into regulated legal rent seeking of the type that is widespread in advanced economies. This was actually the process through which corruption was reduced in advanced countries, but developing countries are typically given little policy advice about progress along these lines.

Given the drivers of what we have called 'statist' corruption, the most important priority for developing countries is to ensure that legal or illegal rent seeking does not subvert developmental policies in these critical areas of beneficial state interventions. *The policy* *focus in the case of statist corruption should therefore primarily be to strengthen the capacity of the state to manage rents and stick to developmental policies so that corruption does not subvert the allocation of rents*. If this could be achieved, even if corruption continued to some extent, it would be more like an illegal tax that was collected by a government that was otherwise making a positive impact on economic development. *In the long run, the policy focus should be to convert this type of corruption into legal rent seeking expenditures like contributions to political parties, lobbying expenditures, and so on.*

3) 'Functional' Political Corruption and Primitive Accumulation. Both the types of corruption considered so far are associated with state interventions that are themselves legal. The two other types of corruption are associated with interventions that are *not* legal and raise much more difficult problems for anti-corruption strategies in developing countries. Box 3 describes corruption associated with state interventions that are illegal but *potentially* beneficial. Clearly, if the intervention is illegal, the rent seeking associated with it is illegal too. Two types of state activities or interventions are likely to be illegal in developing countries and yet have the potential of a positive impact in the sense that the alternative without the intervention is even worse for society. The first is political corruption that is necessary for maintaining political stability in contexts of insufficient fiscal resources for maintaining stability through legal and transparent fiscal transfers. The second is the primitive accumulation that takes place when assets are not being productively used and transaction costs are too high for market transfers. In both cases, the outcomes of illegal state activities can go terribly wrong, and the difference in *outcome* is the main difference between the corruption shown in box 3 and box 4. Before we discuss these two types further, we need to discuss the drivers of political corruption and of primitive accumulation.

Political Corruption and Clientelism. One of the key drivers of corruption in developing countries is the inadequacy of fiscal resources to maintain political stability through transparent fiscal transfers. We have discussed in our last section why the severe scarcity of fiscal resources in developing countries can result in patrimonial politics as a rational response for political leaders and for powerful factions in society. Since political stability cannot be maintained through the fiscal process, political activity typically takes the form of powerful factions being accommodated with off-budget revenues. This results inevitably in political corruption for two reasons. First, most of the resources transferred down these networks are by definition off-budget resources often raised through corruption. In some cases, governing factions engage in corruption and use the proceeds to accommodate clients. In other cases, powerful clients may be allowed to raise resources for themselves through corruption with the state turning a blind eye on these activities. Secondly, even if some of the resources transferred to selected factions come from legal fiscal sources, their allocation to chosen groups is itself often an act of political corruption. This is because the available resources are typically insufficient for general disbursement to all groups so that their allocation to chosen groups often has to be less than transparent, and often has to involve violations of formal rules for the political benefit of the public officials concerned.

This type of political corruption is universal in developing countries, and affects democratic and authoritarian, liberal and statist alike. *The driver of political corruption is the imperative of maintaining political stability in the context of limited, often totally absent fiscal space for political redistribution.* Moreover, even if some fiscal resources are available for redistribution, transparent redistribution to deserving groups does not solve the problem of having to accommodate well-organized factions on a priority basis. Clearly, transparency, higher bureaucratic salaries, better judicial systems of liberalization will have no effect on this type of corruption, which is one of the major types of corruption in developing countries. *The only long-term solution is to acquire the economic development that will allow fiscal resources to increase to the point where political stability can be maintained in these countries in transparent and generalized fiscal transfers.* In the meantime, the outcomes of this type of political corruption are indeterminate. Depending on the degree of fragmentation of domestic political factions, and the history of political conflict, political stability may be effectively maintained with a 'tolerable' degree of political corruption, or it may be that even with political corruption that is very significant and that derails economic growth, political stability cannot be achieved.

Primitive Accumulation and Theft. The most pernicious type of corruption in developing countries is the predatory corruption that some states engage in. In this variant of corruption public officials directly, or indirectly through private factions, grab or assist in the grabbing of public resources like land or mineral resources, or collude in the extraction of 'protection money' from citizens. In extreme cases, this type of corruption could be associated with a descent into warlordism, where warlords become the de facto state. Why are these processes so systematically observed in developing countries? Apart from the greed of public officials and of the mafias they collude with, there is a more systemic driver of this type of corruption in developing countries. Many of the assets of developing countries are *non-viable* in that they are used in pre-capitalist production systems and do not produce a sufficient surplus to pay for their own protection. We have discussed earlier in our section on the transformative functions of states that property rights have to be restructured through non-market mechanisms in developing countries because the low transaction cost market route poses a chicken and egg problem. How can transaction costs be reduced when existing asset users do not produce a sufficient surplus to pay for a socialized protection and enforcement system for property rights? Inevitably, what is likely to happen in these cases is a lot of asset grabbing and asset transfer *outside the realm of voluntary market exchanges.*

Marx had described these non-market transfers of property rights to an emerging capitalist sector as 'primitive accumulation', which included for him processes such as theft, the enclosure of common lands, colonial plunder, the use of political power to engineer unequal exchange, the protection of markets and transfers through the fiscal mechanism (Marx 1979: 873-940). Thus, primitive accumulation involves a lot more than plunder, nor is all plunder primitive accumulation. But equally, these non-market transfers may result not in the emergence of a viable capitalist sector but only in plunder and theft, and the stashing of stolen assets in foreign countries. *The driver of theft and primitive accumulation is not just the greed of all the individuals concerned, but fundamentally the low productivity and non-viability of pre-capitalist production systems that ensure that a social surplus is not available to protect these assets.* Here too, this type of corruption cannot be addressed by the types of responses appropriate for Type 1 corruption, namely transparency, judicial reforms, higher public sector pay or liberalization. The long-term solution is to achieve a transition to a high productivity economy where current asset holders generate a big enough surplus to pay for the protection of their assets. In the meantime, the policy question is how to ensure outcomes where asset transfers are limited as much as possible, and the outcomes are consistent with the rapid emergence of a dynamic capitalist economy.

Returning to type 3 corruption, where illegal state activities are potentially beneficial, this type of corruption can emerge where the mix of political corruption and primitive accumulation is such that there is sufficient political stability for economic activity and accumulation to continue, and the primitive accumulation, while ugly, allows the gradual emergence of a capitalist sector. *The policy response in these cases would be to ensure that fiscal collection increases at the fastest possible rate so that political stabilization can be* *organized through transparent fiscal redistribution, and the protection of property rights can be efficiently organized at the social level.* In the meantime, the politically difficult fact is that there are no short-terms solutions. However, if political stabilization is failing, and if non-market asset transfers result in looting rather than the emergence of a productive sector, this is an indication that the coalitions in power are taking a short-term view, probably because their own positions are not sufficiently secure. There are political responses that can be made in these situations but they are not part of the typical anti-corruption strategies that developing countries are asked to follow.

The problem of political corruption is in fact recognized in the TSP but in the section on participation (p 15) rather than on corruption. The TSP mentions the importance of institutionalizing party funding in order to reduce corruption in developing countries. This is clearly an important aspect of the problem. While it does identify an important driver of corruption, the solution identified probably does not have much immediate mileage in many poor countries because parties spend a lot more on elections than is likely to be raised through formal institutional processes. For instance, despite the best efforts of the Indians (who have better state capacity than most other poor countries) success in keeping mafia bosses and black money out of politics has been minimal. But if the goal is specified somewhat differently and we try to achieve not a significant immediate reduction in corruption, but to ensure that corruption does not damage pro-poor growth, we can perhaps make better progress. For instance, we can try to institutionalize the influence that emerging capitalists want to have (and will have) over government by thinking creatively about allowable influence and expenditures on lobbying, political contributions and so on, within a regulatory framework that makes sense for the type of transformation the developing country is going through. Clearly, legalization and regulation of rent seeking rather than its abolition has been the process through which corruption has been reduced in advanced countries.

4) Destructive Political Corruption and Predation/Theft. The final box describes the most damaging type of corruption facing developing countries. Here, illegal state activities and the associated corruption are associated with damaging outcomes. The problem is that the drivers of these types of corruption are not very different from the drivers of corruption in box 3. In both cases, economic underdevelopment results in the limited fiscal capacity that drives both political corruption and property right instability. But in this case, the political corruption does not achieve political stability, and in extreme cases, the fragmentation of the polity can descend into warlordism. Similarly, non-market transfers of assets leads not to the emergence of a productive sector but to predatory theft. In these cases too, the types of anti-corruption measures suggested by the analysis of neoclassical corruption are inadequate. *The only relevant policy response to this type of corruption is to reconstruct the centralized coercive powers of the state.* This is not a simple institutional programme but essentially a political programme, in which donors can once again play a limited part, apart from opening up an internal policy debate and providing the complementary support for institutional strengthening when and if that becomes necessary.

Our observations on corruption are closely related to our observations on the transformative capacities of the state. It is not possible for developing countries to attain in full the governance characteristics of advanced countries. This is because of systematic structural reasons, and little to do with the absence of political will to implement reforms that may just have worked if only they had been pushed a little harder. Many of the reforms, whether they are about stabilizing property rights, or improving the 'rule of law' or fighting corruption are actually not feasible in the structural conditions of developing countries. Institutional reform should rather seek to strengthen the transformative capacities of states so that these desirable characteristics of governance can be more rapidly achieved as economies become more viable and generate the legal tax revenue for tackling some of these problems.

Table 7 summarizes some of the main points of our discussion.

Table 7 Summary of Policy Responses to Developing Country Corruption

- If predatory corruption dominates, focus on strengthening basic state capacities. Countries in this group face a primarily political not just an institutional crisis.
- If illegal rent seeking around beneficial state interventions is the main problem, focus on trying to legalize and regulate some of this rent seeking while strengthening the state's rent management capacity.
- Political corruption and primitive accumulation are very difficult to address in an effective way in a context of underdevelopment. Policy should focus on identifying the political factors that enable countries to move up the productivity chain rapidly.
- If corruption is due to state rent extraction through the imposition of **unnecessary** red tape and intervention, liberalization and transparency reforms are the right response (neoclassical corruption)
- Confusing the first three with the last can inadvertently destroy transformative state capacities

4. Extending the Drivers of Change Approach

The drivers of change approach was aimed to enable DFID country offices identify entry points for reform at the country level. The approach was responding to a number of theoretical and empirical observations. First, the historical experience showed that the institutions that have been effective in achieving growth and poverty-reduction have varied significantly across countries. Even across the high-growth countries, there are significant differences in the details of governance institutions and policies. The main reason for this is that *formal institutions* are only effective if the rules they embody can in turn be *enforced*, and this depends on local power structures and cultural norms that constitute that society's *informal institutions*. As a result, the institutional ways in which state functions have been achieved (whether environmental, redistributive or transformative) have differed significantly across countries (Whitley 1992; Khan 2000b; Rodrik 2002; Rodrik, et al. 2002; Rodrik 2003b, 2003a). This is a very significant observation because it says that the types of reforms that are likely to work, even from the perspective of market efficiency and service delivery are likely to differ significantly across countries.

The TSP takes a clear stand in recognizing that reform priorities may be quite different in different countries. It argues (p. 10) that "more attention should be paid to the politics of change – reform programmes often fail for want of local ownership". Considerable effort has been expended by DfID to follow through on these observations by commissioning a series of Drivers of Change studies, aimed at identifying country specific processes through which reform could be achieved. As part of this review, we examined the findings of a selection of Drivers of Change studies commissioned by DFID (in particular, we looked at Kenya, Nigeria, Pakistan, Uganda, Zambia, Kyrgyzstan, Malawi, Ghana and Bangladesh). These studies have a number of common features, one of which is that they show that the results that were expected from apparently straightforward institutional and political reforms in less dynamic countries did not always follow. For instance, reforms that allowed civil society to become more active, or political institutions to become more open, often did not result in any of the expected benefits in terms of pro-poor development. These results are not surprising when we put them in the context of the discussion in our previous sections. Political reforms that appear to be desirable or enabling from the perspective of particular service-delivery goals may have ambiguous or even opposite effects for transformation strategies. If reforms inadvertently damage transformative capacities or do nothing about improving them, then over time the ability of a state to respond to and manage the conflicts associated underdevelopment may decline severely enough to affect service delivery as well.

The Drivers of Change approach is essential for identifying country specific priorities and change agents. However, a common thread running through the Drivers of Change studies makes their conclusions somewhat less useful. Implicitly they all assume there are some common underlying good governance reforms that need to be achieved. The only question is the sequencing of these reforms in different countries, and identifying the change agents who will carry out these reforms. Our argument in the previous three sections suggests a more complex problem. If we look at the successful developers of the last fifty years, we do not just find that they achieved the same *environmental conditions* for growth through different mechanisms depending on their initial political conditions and informal institutions. In fact, we find that their states also had very different *transformative capacities* depending on their initial political conditions and informal institutions. This meant that there were significant differences in the *trajectory* of transformation, ranging from the top-down state-led development in South Korea to the bottom-up capitalist-led transformation in Thailand. Governance and institutional capacities were appropriately different. In other words, dynamic states were not just doing *similar things differently*; they were doing *different things differently*. The only common theme is that at a high level of abstraction, we can find some common *functions* that transformative states carried out, and we have summarized the most important of these in Table 2.

Given the importance of these transformative capacities and their variation across countries, the challenge is to extend the Drivers of Change approach, which is essential for dealing with country specific problems. It is not acceptable to ignore transformative state capabilities and rent-management capacities even in the poorest economies given the evidence from all the successful developers. The challenge is to identify the most important areas in which transformative capacities can be strengthened in specific countries and the areas in which rent-management capacities of the state can be most usefully strengthened. Given the state of our knowledge, these suggestions have to be modestly made and carefully considered in practice.

Nevertheless, progress in extending the Drivers of Change approach can be made by

a) Focusing carefully on building state capabilities for promoting the development of productive capacity in the economy (along the lines outlined in Table 2)

b) Disseminating knowledge about the political and institutional conditions that allowed growth in high-growth countries to open up a debate within developing countries about what needs to be done in the specific context of that country.

c) Only then should we try to identify the change agents and mechanisms through which these reforms can be implemented.

5. Setting Achievable Goals

This section will draw together some of these observations to suggest that by distinguishing different types and goals of governance, reform efforts can be improved. Some areas can be influenced by identifying the appropriate institutional capacities and assisting developing countries to develop these further. But many of the most important capacities are political and organizational, and here donors can contribute but only by opening up political debate within developing countries and providing good analyses of the experiences of successful development.

1) Distinguish clearly between means and ends. One of the problems with much of the good governance approach that has influenced the TSP is that easy political support for these reforms can be expected in both developing and donor countries because many of these reforms are desirable as ends in themselves. The problem is that identifying multiple goals and mistakenly believing that some of these goals will further the achievement of other goals dilutes the reform process and prevents us from identifying the critical reform priorities. More seriously, they may result in growing frustration with Western policy recommendations in many political constituencies across the developing world when it transpires (some years later, but the results are already becoming obvious) that these reforms will not deliver pro-poor growth.

2) Distinguish clearly between Environmental, Redistributive and Transformative Capabilities. Different parts of the reform programme are trying to achieve different goals. The environmental conditions for market-led growth are the weakest part of the package because they confuse means with ends to the greatest extent. Many of the environmental conditions are structurally unattainable in most developing countries, and indeed, when we look at the most successful cases of pro-poor growth in the last fifty years, virtually all of them would have failed these governance tests. But they are politically popular because they are ends in themselves even though they are not immediately attainable. Redistributive reforms can have immediate effects but they are not likely to deliver much if the pie is small and not growing very fast. These reforms too enjoy considerable political support. They enjoy support in donor countries because they are consistent with social democratic traditions in Europe. They also enjoy support in developing countries because elites in the poorest countries have no problem with donor-funded service delivery.

The tricky reforms are the transformative ones that are clearly the most critical for the long-term success of pro-poor policies. These involve having to live and work with regimes and processes that do not fit well with advanced country standards, to improve their productive capacity and thereby strengthen unsavoury elites, and to get the political judgement right about how much to tolerate and to decide when excuses become unacceptable. And in developing countries, transformative reforms are deeply conflictual because they change the relative power of different groups and factions as the capitalist transition is accelerated. Not surprisingly, no one likes these reforms and they drop off the table. But unfortunately, without attention to these reforms, Western-funded service delivery to mitigate poverty will have to continue indefinitely.

3) Make the politics explicit. There is no harm in donors saying we are only going to concentrate on service delivery because this is all that our taxpayers will politically support and we will demand associated reforms in public financial management in developing countries to ensure that Western taxpayers' money is not wasted. This is entirely justified. What we should not do is to claim that these very limited reforms (even though they may be difficult enough to achieve) are going to unleash pro-poor growth or anything like that. We could to a great deal of unintended damage to developing countries in insisting on this claim. But equally, we could also potentially do much good by saying that although there is no political stomach in Western countries to engage as partners in social transformations in developing countries, nevertheless, these transformations have to happen. We can then assist in this part of the institutional reform process by providing information about what actually happened in the successful countries, and expose developing country policy-makers, politicians, entrepreneurs and trade unionists to the debates around different interpretations of these transformations. In this way, we can contribute by unleashing the necessary debate and reconfiguration of forces within developing countries that can eventually lead to these difficult transformations being attempted.

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