

Governance and Growth: A Preliminary Report

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(Report proposing new research areas presented to the Department for International Development, (DFID) UK. DFID is currently funding further research along the lines identified in this report. The author alone is responsible for this report).

Objective

This preliminary report outlines the directions of research that could be commissioned to improve our understanding of the governance capabilities that were involved in sustained growth experiences in a number of countries (mainly in Asia). These countries successfully transformed their economies from low to high productivity economies through sustained economic growth. The transformation process involved major institutional and governance challenges including transfers of property rights (to ensure that resources stay in productive hands), the acquisition of new technology, the imposition of discipline on emerging capitalists, and maintaining peace and political stability. The research findings are intended to help low-income countries (particularly in Africa) understand their own contexts better and examine whether the key roles some states have been able to play in these transformational processes present relevant operational lessons that could be adapted now to help countries successfully build capacity to deliver growth and poverty reduction.

Summary

A growing body of theory and evidence suggests that the state must do more than create an environment for market-driven growth if markets are to deliver sustained increases in investment, production and employment needed to reduce poverty. The contemporary focus on good governance reforms in developing countries is based on developing the *market-enhancing governance* capabilities of states. If successful, this type of governance should make markets more efficient. However, the evidence in support of these reforms is poor. The cross-sectional evidence can be used to extract some support for the importance of market-enhancing governance, but we can also examine the data to derive quite different results. The evidence that is available is presented in this paper, and we argue that it actually supports the view that good governance reforms are difficult to implement in any developing country. Rapidly growing countries in general did not enjoy better market-enhancing governance conditions compared to the others. If some developing countries nevertheless did very well in terms of sustained convergence,

they must have had some other governance capabilities that allowed them to achieve this.

We argue that these capabilities are best described as ***growth-enhancing governance*** capabilities. Theory and evidence suggests that growth requires favourable outcomes and therefore governance capabilities in at least three closely interrelated processes. The first involves the governance capabilities that states use to manage the non-market asset transfers that are endemic at early stages of development. The structural drivers behind non-market transfers also help to explain why property right stability is never achieved at early stages of development. Sustainable growth did not depend on the *ex ante* achievement of stable property rights, but did depend on governance capabilities that could manage non-market asset transfers in ways that created incentives for productive investment and allowed productive investors to have stable expectations about their future rewards. Secondly, developing countries have to adapt strategies to acquire technologies and learn new ways of organizing work and using knowledge. These learning processes take time and involve costs that have to be covered either by the state or private investors. By definition, this involves the creation and management of rents. Success or failure in rapid technology acquisition has been closely associated with governance capabilities that allow or prevent states effectively disciplining this learning process and managing the rents involved. Finally, sustained growth requires the maintenance of political stability in a context where patron-client politics is structural and difficult to change in the short run. Success or failure has not depended on the ability to achieve Weberian states at early stages of development, but has depended on governance capabilities that allowed states to manage political stability through patron-client politics at relatively low cost and without these processes excessively disrupting productive investment and learning. All of these governance capabilities are quite different from the ones identified in the market-enhancing approach.

There is no conflict between the development of market-enhancing and growth-enhancing governance, except that a one-sided and exclusive focus on the former can waste resources on unattainable (though highly desirable) objectives while creating frustration and demoralization in developing countries because true sustainability is not being enhanced.

Deepening our understanding of these processes and developing these ideas so that they can be useful in the policy debate requires the development of our understanding in a number of areas.

i) We identify three phases of governance policy in developing countries. Growth-enhancing strategies were followed in the early years, but they were abandoned because the associated growth-enhancing governance capabilities were not well-understood or developed, and sustainable growth was achieved in very few countries. The abandonment of growth-enhancing strategies in some countries also led to growth spurts (in countries like Bangladesh, Uganda, and perhaps more sustainably in India), even though these countries do not perform too well in terms of market-enhancing governance either. One area of research would be to understand better the differences between converging (high-growth) countries that are following market-led growth strategies and those (like China) that are

following growth strategies based on accelerated resource transfers to productive sectors and learning strategies. Existing data on growth in India raises questions about the sustainability of purely market-driven growth strategies, particularly in countries with even weaker technological capabilities. This part of the research would help to identify vulnerabilities in the growth strategies being followed by many of the developing countries in which DFID is working and identify policy areas that require attention.

ii) We argue that the good governance emphasis on property right stability is based on a simplification of the development challenge. Stable property rights are very desirable but are not immediately achievable in most developing countries. The critical development challenge is for developing countries to have the governance capacity to manage this instability and ensure that productive sectors enjoy the stability of expectations required for high-value investments. There is little explicit analysis or identification in the literature of the governance capabilities that allowed the steering of non-market asset transfers in developing countries towards productive or unproductive outcomes. A proposed study could build on case studies of a number of countries, including South Korea, China, Vietnam, India, Bangladesh, and others to identify the governance characteristics that allowed or prevented growth. Are there general characteristics of these capabilities? The significant differences between successful countries suggests that there are no general institutional characteristics that all successful countries possessed but rather that they used different institutional mechanisms to achieve some common outcomes. An important reason why institutional mechanisms have differed is that they were embedded in very different political and historical contexts given differences in political organizations and structures.

iii) Learning strategies also demonstrate a great diversity across countries, using formal institutionally created opportunities and compulsions in some cases, but relying on informal business-government relations in others. A critical research goal here is to identify and classify different strategies for sustainable and successful technology acquisition, and the associated political and institutional capabilities that allowed or prevented their implementation. This classification may help to design viable governance reforms in different contexts that differ in terms of initial political and organizational conditions. Technology acquisition and upgrading is likely to become an increasingly important issue as some of the rapid growers in the market-driven camp (like Bangladesh and Uganda) run out of easy labour-intensive technologies and face growing competition in international markets from countries like China that have viable technology upgrading strategies.

iv) A third area of research that is very closely interdependent with the others is to look more closely at the political stabilization processes in developing countries that inevitably have to use and rely on patron-client structures and off-budget finances. Our argument is that the processes of political stabilization reveal important features of the 'political settlement', and in particular the nature of the patron-client networks that are used to achieve political stabilization.

These patron-client networks in turn impact on the viability of different strategies of managing non-market asset transfers and specific technology acquisition

strategies. To be viable, productive strategies in terms of managing assets and technology acquisition have to be *compatible* with the constraints imposed by the rent seeking strategies of participants in patron-client networks.

For instance, some types of patron-client networks may rule out the feasibility of specific technology acquisition strategies, but may allow other types. Identifying the growth-enhancing governance capabilities that can be feasibly developed in a particular country therefore needs to begin with an analysis of the political settlement and how the political process works through the existing patron-client networks. There may be asset management and technology acquisition strategies that are viable in this context, provided appropriate governance capabilities are developed, but it may also be that feasible improvements require a change in the organization of political networks, a task that is explicitly political and internal to the politics of the developing country. Nevertheless, even here, analysis can help to open up important debates within the developing country and provide analytical frameworks to structure that debate in ways that are more useful than the good governance framework.

The methodology proposed does not identify any simple killer variables that can explain why ‘political will’ emerges in a particular country to carry out transformative changes that lead to sustainable growth paths. Sustainable growth strategies can differ widely in terms of the mix of political stabilization expenditures, the pace and pattern of primitive accumulation, and the technology acquisition strategies followed. Success only requires that each of these processes is viable and achieves positive outcomes. Not everyone has to grow at Chinese or even South Korean rates to be successful. The problem is that when some or all of these processes in a particular country are *not* sustainable, high rates of growth can turn out to be a relatively brief ‘growth spurt’ rather than a sustainable growth path.

An examination of political stabilization can help to identify the patron-client networks in a country that are implicated in the two other processes that we have identified as important in determining the appropriate growth-enhancing governance capabilities of a state. The juxtaposition of specific patron-client networks with the institutions of political stabilization, property right protection and technology acquisition provide critical information about the sustainability of each of these processes and allow us to reach a judgement about the growth-enhancing governance capabilities of the state. This approach can potentially help us design somewhat better institutions and strategies to improve outcomes in each of the processes that we believe are important for the sustainability of growth.

Research and knowledge on these issues is still relatively thin despite many case studies on growth being available for different countries. Rodrik’s team working on the deep determinants of growth using analytical narratives is one of a very few groups working on consistent case studies (Rodrik 2003). However, their analytical framework is different from the one suggested here, which is based on looking at the interdependence of three different processes relevant for sustaining growth. The analytical narrative approach can be usefully expanded to look at the three interdependent processes that we have identified as important, using a number of

comparative cases to initiate a broader case study approach to identify growth-enhancing governance conditions. The selection of these countries would be from Asia and Africa to deepen our knowledge of Asian transformations and to apply these insights to construct a better mapping of African political economy.

While most economists would agree that governance is one of the critical factors determining the growth prospects of countries, there is considerable controversy about governance priorities and the types of governance capabilities that are critical. These disagreements are related to fundamental disagreements on the role of markets versus other social, political and technological characteristics that need to be fulfilled for sustainable growth to take off. The contemporary good governance agenda is based largely on governance capabilities that are required to create the conditions for markets to be efficient. While these are important and desirable conditions, we argue that they are second order conditions, in the sense that without state capacities to promote the technological, social and political conditions required for sustainable growth, market conditions for efficiency are on their own insufficient and ultimately unsustainable.

The good governance agenda is also misguided in believing that significant improvements in market efficiency conditions are possible in developing countries. There are a number of critical structural features of developing countries that prevent the achievement of significant progress on the good governance front. These factors make the good governance agenda doubly problematic: it sets many developing countries goals they cannot achieve, and in addition, even if they could have been achieved, these goals are not sufficient to ensure sustainable growth. The task of this paper is to outline some of the governance issues that we already know about, and identify other areas where more research is necessary to assist policy.

1. Three phases in the history of governance and growth policies

It is useful to recall that the consensus on economic policy and appropriate governance capacities for developing countries has gone through radical changes over the last fifty years. In the first phase of development strategy in the immediate post-war years, economic policy was much more concerned with upgrading the technological capacities of developing countries by accelerating the setting up of new industries and assisting technology acquisition. Not much attention was given to the governance capacities appropriate for achieving these goals, and the results were generally poor.

A second phase of development policy dates roughly from the 1980s when structural adjustment began to be promoted precisely because previous strategies had resulted in serious budgetary crises in many developing countries. Rent seeking, corruption and other governance issues now became policy concerns, but the expectation was that liberalization would resolve these governance issues by removing the incentives for rent seeking. The results of this phase of policy were, if anything, even more disappointing, with no discernible improvements in either the growth prospects of developing countries or their governance conditions.

The third and current phase of development and governance policy followed from these experiences. It placed a governance-related policy agenda at the centre of development policy: the good governance agenda. The emergence and relevance of the new governance policy and the gaps in our understanding can be better understood by placing it in its historical context.

Phase 1. Accelerated transformation strategies that underplayed governance

The first phase of growth and governance policies describes the economic strategies adopted by most developing countries from their decolonization at different stages of the last fifty years to sometime in the early 1980s. The concern of most developing countries and international agencies during this period was to accelerate the creation of growth-enhancing sectors in developing countries. However, they failed to give much attention to the development of governance capabilities appropriate for the effective implementation of these strategies.

The new discipline of development economics emerged in the years following the Second World War and the end of empire. Although there were a few liberal voices advocating free markets for developing countries from the outset, a broadly shared consensus of the time was that developing countries needed to actively promote their productive sectors. It is important to remember where this concern came from. Most developing countries had performed very poorly under the free trade regimes imposed on them by colonial powers. Not only did most non-settler colonies have virtual free trade during their colonial period (with very low or zero tariff protection for domestic industries), they also had virtually free capital movements as there were very few or no restrictions on capital inflow from the colonial power or on profit repatriation.

However, in the non-settler colonies these free trade regimes had not resulted in industrialization or prosperity. Rather, they had served to provide markets for the manufactures of the colonial powers. Nor did unrestricted capital movements and unfettered profit repatriation result in much inward investment by European countries to take advantage of cheap labour in the colonies. Since large colonies like India had stable administrations and relatively stable property rights, it did not cross the minds of post-colonial policy-makers that the concerns of later governance theorists could have been a major constraint preventing the industrialization of their countries.

Instead, the focus of development strategy in the post-colonial period was to address the backwardness of the newly independent countries by using state policies to directly assist the creation of new capitalists in industry (but also in other sectors) and to assist them in acquiring new technologies rapidly. This involved policies of changing internal relative prices to assist resource and asset acquisition by emerging capitalists, followed by a variety of policies to protect them from immediate international competition so that they could improve their productivity and thereby eventually become internationally competitive.

The early development strategists were probably right to believe that the later concerns of good governance theorists such as improvements in the rule of law, anti-corruption or democratization were not the central governance issues that would assist the implementation of their programmes. However, in virtually every developing country attempting these strategies there was little if any discussion of the governance capabilities they would actually require to effectively implement their growth strategies. The governance discussion that did take place came from the modernization school that tried to justify the lack of democracy and the presence of corruption in many of the developing countries that had become Cold War allies of the US during this period.

The argument was that authoritarian regimes were likely to be more successful in managing the political and institutional challenges of modernization (Huntington 1968). This was because authoritarian governments were better suited to managing the conflicts over rapidly emerging capitalists and the maintenance of high rates of

investment. As for corruption, it was argued that post-colonial states were not yet fully geared to the needs of a market economy, and some corruption would allow emerging capitalists to create incentives for the state to work for them more efficiently. In a period of deepening Cold War, the unstated assumption in many western discussions was that strong authoritarian regimes were necessary to protect these countries from possible communist insurgencies. While these arguments provided some cover for particularly unsavoury western allies, the underlying analysis was weak because many authoritarian and corrupt regimes failed to develop.

Critically, there was no discussion within developing countries about the governance capabilities required to effectively implement the different growth strategies they were following. Not surprisingly, success and failure were accidental to pre-existing governance capabilities that allowed some countries to effectively implement these strategies and rapidly grow, while most others had at most a temporary burst of output growth but because their productivity growth was low, they did not achieve international competitiveness and the growth strategies became increasingly unviable.

The results of this first phase of post-colonial growth strategies were therefore very mixed. A few countries did break out of poverty in a sustained way by the late 1960s. These countries, like South Korea and Taiwan, emerged by the late 1960s as emerging economic giants (Amsden 1989; Wade 1990). A number of other countries like Brazil, Pakistan and India initially achieved much higher growth rates through import-substituting industrialization compared to their growth rates in the first half of the twentieth century. But in these countries productivity growth in the emerging industrial sectors was not high enough and there was a growing perception by the mid-sixties that these strategies were becoming unsustainable. But most worrying was a larger group of countries, many of them in Africa, where import-substituting industrialization resulted in much more limited growth and industrialization. The failure to generate productivity growth in these countries resulted in a serious crisis of public finances as subsidies were absorbed in a large number of schemes that did not promise to generate any viable growth.

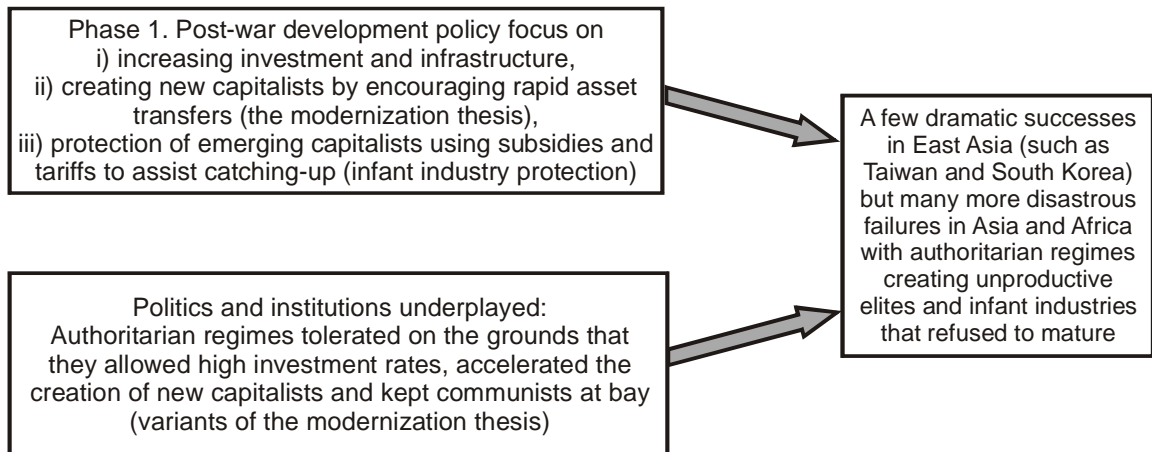


Figure 1 Growth-promoting policies that ignored growth-enhancing governance capabilities

Figure 1 summarizes the strategy and governance combination that characterized the first phase of development strategies in developing countries. The results, while very encouraging for a small number of countries, were not widely-enough shared for this strategy to survive in many developing countries, or receive the continued support of international agencies. With the impending collapse of the Soviet Union, the Cold War imperatives of providing support to undemocratic and corrupt regimes also began to suddenly disappear.

Phase 2. Market-promoting strategies with governance reform as a by-product

The emergence of a second consensus on economic reform and governance amongst a large number of development theorists and practitioners emerged around the 1980s. John Toye described this as the ‘development counterrevolution’ (Toye 1987). The main focus of theory and policy was to show that far from improving the prospects of developing countries; misguided interventions had created a labyrinth of rent seeking and corruption, and pulled these countries far below their developmental potential. The policy response was a radical one. In addition to standard liberal prescriptions such as trade liberalization, a significant reduction in budget deficits had to be achieved in developing countries and subsidies had to be cut back across the board.

The new consensus emerged as a response to the failure of many state-led industrialization policies in developing countries that had only resulted in the emergence of large non-performing industrial sectors in many of these countries by the 1970s. But instead of examining what was different about these cases of failure

compared to the successful developers who had followed similar economic policies, the new consensus argued that the economic problems of these countries were mainly due to their attempt to correct market failures through state interventions. It concluded that the costs of state failure associated with interventions were significantly greater than the costs of market failure they had set out to correct. It would have been better not to intervene, and government policy should only have focused on making markets more efficient (Krueger 1990).

While governance reform was not yet at the centre of the reform agenda, reforming the state was an essential component of the structural adjustment programme. However, it was believed that the reform of the state would follow from and be achieved through the structural adjustment itself. These ideas followed from the development of what came to be known as *new political economy*. This school was the result of many related theoretical contributions (Krueger 1974; Posner 1975; Bhagwati 1982; Bardhan 1984; Colander 1984; Alt and Shepsle 1990; Lal and Myint 1996; Bates 2001).

The dominant argument of the time that emerged from this growing literature was that the multiplication of rents in the economy as a result of the policies of the interventionist states of the sixties and seventies resulted in turn in these states being captured by vested interests. Rent seekers used the state to capture rents for themselves at the expense of the whole economy. While the state in this analysis was clearly a problem, the new agenda was to indirectly reform the state through liberalization and structural adjustment. As rents disappeared, the theoretical expectation was that rent seeking and state capture would decline in proportion. Governance reform would therefore be achieved indirectly through the structural adjustment itself.

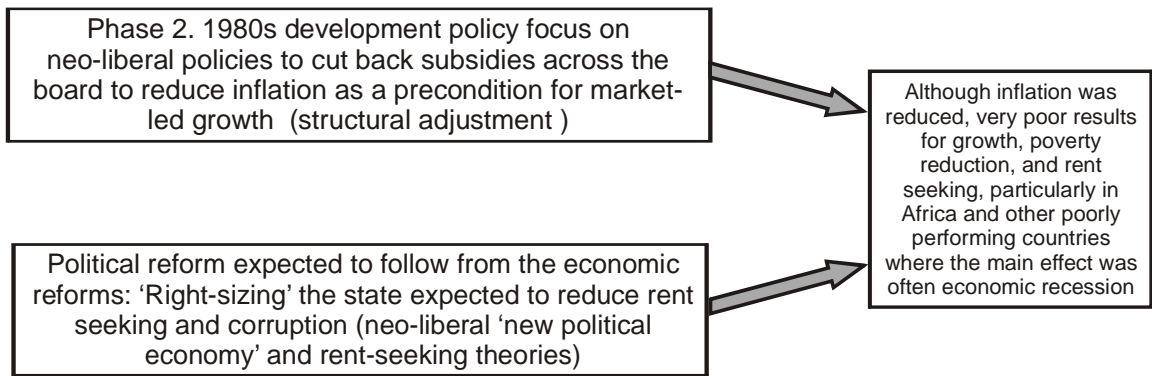


Figure 2 Structural adjustment attempting indirect governance reforms

The results of structural adjustment policies in the eighties were generally very poor. Recessions followed in many African countries, and growth was poor in other countries that adopted these policies. More worrying was that despite significant liberalization and cutbacks in subsidies, together with privatization programmes in some developing countries, there was little apparent reduction in rent seeking anywhere. In almost every country where liberalization was carried out, there appeared to be an *increase* in corruption and rent seeking (Harriss-White 1996; Harriss-White and White 1996). The realization that market-promoting governance capacities on the part of the state required specific attention led to the third, and current stage of governance approaches.

Phase 3. Market-promoting governance as the driver of market strategies

The poor performance of structural adjustment programmes in the 1980s led to the emergence of a new focus on the role of the state to ensure the conditions necessary for market economies to work efficiently. The development of *New Institutional Economics* had brought to the fore economic theories that identified governance capabilities that states needed to have to create the conditions for low transaction cost (efficient) markets. In addition, the poor performance in the 1980s and the growing perception of persistent poverty in developing countries also brought to the fore the requirement of pro-poor service delivery as a necessary capability for developing country states. The convergence of these different perspectives led to the emergence of a set of policy priorities for governance in developing countries that has come to be known as the good governance agenda.

Many of these governance conditions were also desirable on their own: conditions like low corruption, democratic accountability, the rule of law and pro-poor service delivery. With the end of the Cold War, many constituencies, including civil society in developing countries had been demanding these conditions in developing countries. The coming together of a large number of different constituencies behind the good governance agenda explains its impressive influence and hold in the development community. But while many people in developing countries demand good governance as an end, the governance policy agenda sees it as a set of preconditions to enable market-driven development to take off.

The new consensus builds on the earlier commitment to liberalization and market-driven growth, but now the development of good governance capabilities has come to occupy the heart of development strategy. As the good governance approach began to be adopted as the mainstream development agenda in the 1990s, a few countries had already been enjoying accelerated growth since the mid-1980s by finding niches in increasingly integrated global value chains. Most of these growth experiences were, however, based on already existing comparative advantages that some developing countries had developed. On the other hand, economic performance in many of the poorest developing countries remains low, and growth in others is based on vulnerable low technology sectors and commodities that are sensitive to terms of trade changes and are unlikely to display the growth in productivity that is necessary to achieve sustainable improvements in living standards.

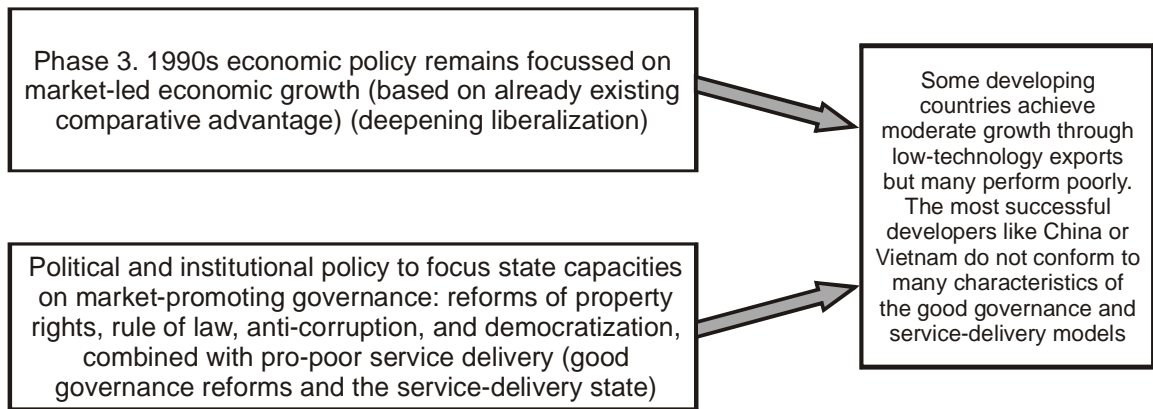


Figure 3 The good governance agenda as a market-promoting governance strategy

This brief historical survey highlights a number of critical observations. Governance capabilities are closely connected to economic development strategies that states are supporting. The strategies many developing countries followed in the sixties and seventies are fundamentally different from the ones they are following now. There were successes and failures in each of our three phases and these can be related to the match or mismatch of the requirements of the economic strategy being followed and the governance capabilities that were required for effectively implementing it. To elaborate this critical observation, and to draw out the research and policy implications, we will first discuss the theory and evidence supporting the good governance agenda. We will then discuss the theory and evidence supporting a more extensive view of governance, and the research that needs to be done to deepen our understanding of these issues.

2. Theory and evidence supporting the good governance agenda.

The dominant analysis of *good governance as a market-promoting governance strategy* that emerged in the third phase argued that these capacities were essential for maintaining efficient markets and restricting the activities of states to the provision of necessary public goods so as to minimize rent seeking and government failure. The relative failure of many developing country states that emerged during the first phase of development strategy is explained by the attempts of their states to do too much. This resulted in the unleashing of unproductive rent seeking activities and the crowding out of productive market ones. Empirical support in favour of this argument

is based on cross-sectional data on governance in developing countries that shows that in general, countries with better governance defined in these terms performed better.

Box 1. Are efficient markets sufficient for development?

The importance of markets in fostering and enabling economic development is not in question. Economic development is likely to be more rapid if markets mediating resource allocation (in any country) become more efficient.

The policy debate is rather about

- i) the *extent* to which markets *can* be made efficient in developing countries, and
- ii) whether maximizing the efficiency of markets (and certainly maximizing their efficiency to the degree that is achievable in developing countries) is *sufficient* to maximize the pace of development.

Heterodox *growth-promoting* approaches to governance have argued that markets are inherently inefficient in developing countries and even with the best political will, structural characteristics of the economy ensure that market efficiency will remain low till a substantial degree of development is achieved. Given the structural limitations of markets in developing countries, successful development requires critical governance capacities of states to accelerate private and public accumulation and ensure productivity growth.

In support of these arguments, heterodox economists point to the evidence of the successful East Asian developers of the last five decades, where governance capacities typically amounted to a lot more than the capacities necessary for ensuring efficient markets. In fact, in terms of the market-enhancing conditions prioritized by the good governance approach, East Asian states often performed rather poorly. Instead, they had effective institutions that could accelerate growth in conditions characterized by technological backwardness and high transaction costs. The alternative approach identifies the importance of a different set of governance capabilities that can be described as *growth-enhancing governance*. Growth-enhancing governance should not be confused with interventionism. Promoting markets also requires intervention and growth can only be promoted through actively developing markets and the capacities of countries to sell in global markets.

The distinction between market-promoting and growth-promoting governance is not necessarily very stark and it is not necessary for policy-makers to choose between two dramatically different strategies. It has been unfortunate that a somewhat artificial chasm emerged between these positions with the growing dominance of the liberal economic consensus of the 1980s. Indeed there may be important complementarities between the two sets of governance requirements in specific areas, provided these can be properly identified and prioritized for policy attention. Our intention in reviewing the evidence is to show that market-promoting governance as a general goal for governance policy is a) difficult to achieve to any significant extent in developing countries and b) is insufficient as a condition for ensuring sustained economic growth in developing countries. We will then review the evidence to see what we know about growth-enhancing governance and the policy implications that follow from this evidence.

Box 2. Market-enhancing versus growth-enhancing governance

Good governance reforms aim to promote governance capabilities that are *market-enhancing*, in the sense that they aim to make markets more efficient by reducing transaction costs for players in the market. There is no question that to the extent that these reforms can be implemented they will improve market outcomes in developing countries.

However, there are structural problems that prevent significant implementation. Moreover, market efficiency does not address significant problems of catching up that require governance capabilities to assist developing countries move rapidly up the technology ladder.

Growth-enhancing governance capabilities are capabilities that allow developing countries to navigate through the property right instability of early development, manage and discipline technological catching up, and maintain political stability in a context of endemic and structural reliance on patron-client politics.

While both sets of governance capabilities are important, the first is not significantly achievable in poor countries and an excessive focus on these market-enhancing capabilities takes our eye off the critical growth-enhancing capabilities that can actually sustain and accelerate development. Ironically, effective growth-enhancing governance capabilities create the preconditions for achieving good governance and market-enhancing governance capabilities.

The consensus behind the good governance agenda draws heavily on the contributions of the New Institutional Economics that pointed out that efficient markets require

elaborate *governance* structures. The goal of governance should therefore be to enhance the *market-enhancing* governance capabilities of the state (North 1990; Kauffman, et al. 1999). The theoretical links identified in New Institutional Economics that explain economic stagnation are summarized in figure 4.

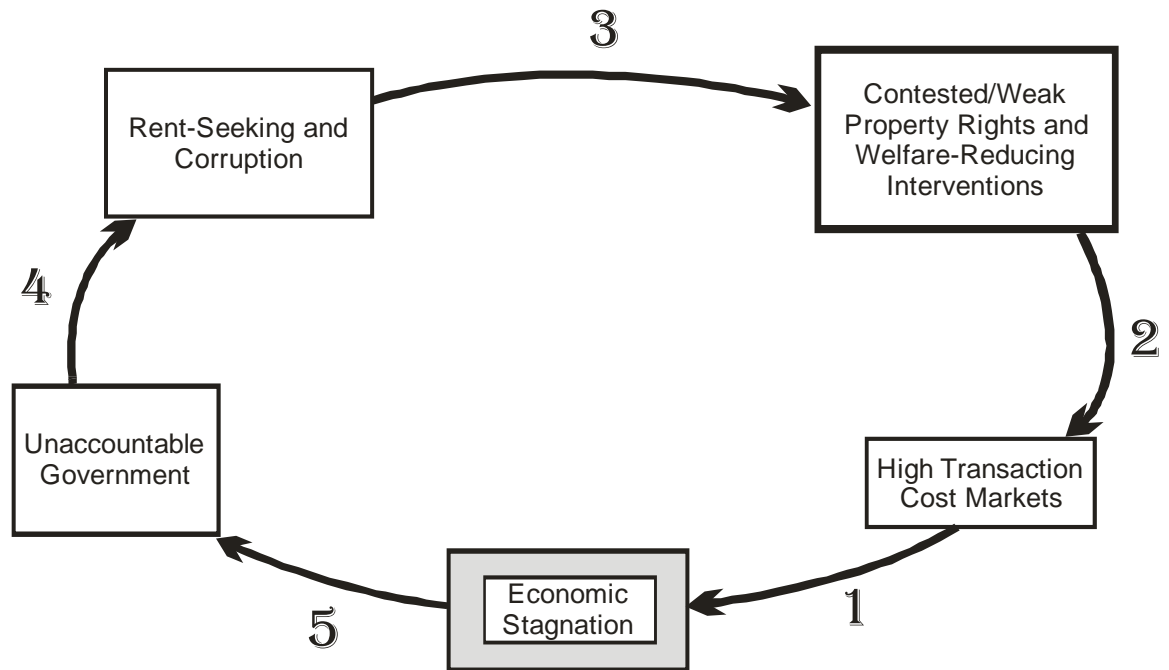


Figure 4 Theoretical linkages in the good governance analysis

The fundamental link in all market-focused approaches to development is link 1 in figure 4: economic stagnation is explained primarily by inefficient markets. High transaction costs are simply a technical description of inefficient markets. These high transaction costs are in turn explained by link 2: weak and contested property rights and unnecessary state interventions. In the second phase of growth-governance policies, the focus of economic policy was limited to link 2 in figure 4 and that too, on the removal of unnecessary state interventions as a way of improving the efficiency of markets. As we discussed earlier, the expectation was that these reforms would suffice to make markets more efficient through link 1, as well as feed back to reduce rent seeking and corruption through link 3 in figure 4 but operating in the reverse direction.

The good governance agenda emerged in the third phase of governance policy to develop an integrated analysis of market efficiency (Khan 2004). For the first time, the argument was that unless *all* the links in figure 4 were simultaneously addressed, market inefficiency would not improve. The logic was that rents and interventions could not be reduced unless rent seeking and corruption were directly addressed, and in turn, these could not be significantly tackled unless the privileges of minorities that harmed the majority could be challenged through accountability and democratization. The policy implication was an integrated reform agenda summarized in figure 5.

The first theoretical difference compared to earlier approaches was the recognition that transaction costs could be high not only because of government interventions, but also because governments lacked the capacity to reduce transaction costs by effectively protecting property rights and enforcing contracts. Progress required an integrated approach on links 3 and 4, to fight corruption and rent seeking that disrupted property rights and contracts, and to ensure the accountability that was the only way to fight corruption and rent seeking. A further theoretical development was the idea that pro-poor service delivery was a way not only of directly attacking poverty, but also of empowering the majority and creating expectations that could only be met through greater accountability.

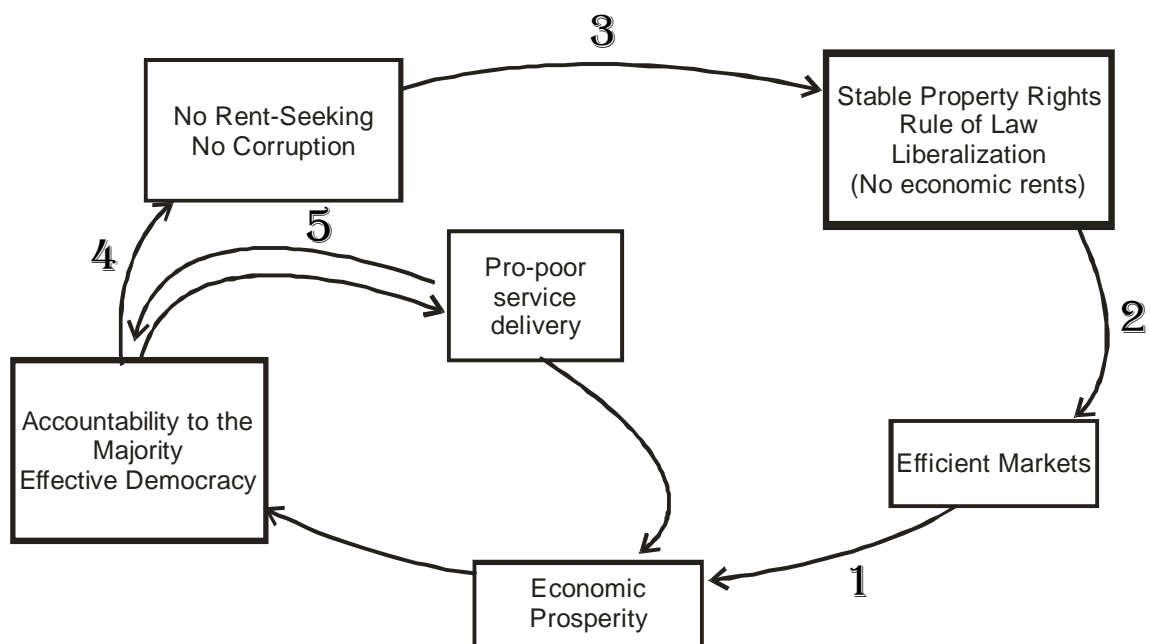


Figure 5 Policy links in the good governance approach

Table 1 shows that all the main policy planks of contemporary governance and economic policy reform strategies are derived from the links shown in figure 5. The contemporary reforms to improve accountability and pro-poor service delivery (links 4 and 5 in figure 5) are the theoretical basis of reforms shown in column 1 in table 1. Policies to counter corruption and rent seeking that are becoming increasingly important in World Bank strategies are derived from link 3, and shown in column 2 of table 1. Finally, policies to strengthen property rights and the rule of law are derived from link 2 and shown in column 3 of table 1.

Table 1 Contemporary governance priorities and their links to theory

Policies to Improve Accountability of Government (arrows 4 and 5 in previous figure)	Policies to Counter Corruption and Rent Seeking (arrow 3 in previous figure)	Policies to Stabilize Property Rights across the board (arrow 2 in previous figure)
PRSP, PGBS (in some countries), Accountability Reforms, Decentralization.	Anti-corruption policies, Liberalization, WTO restrictions on subsidies, IMF fiscal requirements	Policies to improve rule of law, reduce expropriation risk, strengthen judiciaries

The importance of the good governance perspective in informing contemporary development policy and discourse cannot be overemphasized. A powerful way of evaluating the appropriateness of the relationships between growth and governance asserted in the good governance agenda is to look more carefully at some of the data and evidence that is used by proponents of the agenda to support the programme.

The Empirical Evidence

The market-enhancing view of governance appears to explain the observation of *poor* performance in many developing countries attempting import-substituting industrialization in the 1960s and 1970s. Market-enhancing governance capabilities were poor in these countries, as was their long-term economic performance. However, the test that is required is to see if countries that scored higher in terms of market-

enhancing governance characteristics actually did better in terms of *convergence* with advanced countries. When we conduct such a test we find that the evidence supporting the market-enhancing view of governance is weak, even using the largely subjective indicators of governance constructed by researchers broadly sympathetic to the theoretical conclusions of the good governance analysis.

We find that this data tells us that while poorly performing developing countries did indeed fail to meet the governance criteria identified in the market-enhancing view of governance, so did high-growth developing countries. *These observations are fairly systematic, and hold for all the governance indicators and time periods for which we have any evidence.* The evidence suggests that it may actually be difficult for *any* developing country, regardless of its growth performance, to achieve the governance conditions required for efficient markets. This does not mean that market-enhancing conditions are irrelevant, but it does mean that we need to qualify some of the claims made for prioritizing market-enhancing governance reforms in developing countries.

Making sense of this data is particularly important since an extensive academic literature has used the same data to establish a positive relationship between market-enhancing governance conditions and economic performance (Knack and Keefer 1995; Mauro 1995; Barro 1996; Clague, et al. 1997; Knack and Keefer 1997; Johnson, et al. 1998; Hall and Jones 1999; Kauffman, et al. 1999; Lambsdorff 2005). This literature typically finds a positive relationship between the two, supporting the hypothesis that an improvement in market-enhancing governance conditions will promote growth and accelerate convergence with advanced countries. The studies use a number of indices of market-enhancing governance. In particular, they use data provided by Stephen Knack and the IRIS centre at Maryland University, as well as more recent data provided by Kaufmann's team and available on the World Bank's website. If market-enhancing governance were relevant for explaining economic growth, we would expect the quality of market-enhancing governance at the beginning of a period (of say ten years) to have an effect on the economic growth achieved during that period.

However, the Knack-IRIS data set is only available for most countries from 1984 and the Kaufmann-World Bank data set from 1996 onwards. We have to be careful to test

the role of market-enhancing governance by using the governance index at the *beginning* of a period of economic performance to see if differences in market-enhancing governance explain the subsequent difference in performance between countries. This is important, as a correlation between governance indicators at the *end* of a period and economic performance during that period could be picking up the reverse direction of causality, where rising per capita incomes result in an improvement in market-enhancing governance conditions.

There are good theoretical reasons to expect market-enhancing governance to improve as per capita incomes increase (as more resources become available in the budget for securing property rights, running democratic systems, policing human rights and so on). This reverses the direction of causality between growth and governance. Thus, for the Knack-IRIS data, the earliest decade of growth that we can examine would be 1980–90, and even here we have to be careful to remember that the governance data that we have is for a year almost halfway through the growth period. The Knack-IRIS indices are more appropriate for testing the significance of governance for economic growth during 1990–2003. The World Bank data on governance begins in 1996, and therefore these can at best be used for examining growth during 1990–2003, keeping in mind once again that these indices are for a year halfway through the period of growth being considered.

Stephen Knack's IRIS team at the University of Maryland compile their indices using country risk assessments based on the responses of relevant constituencies and expert opinion (IRIS-3 2000). These provide measures of market-enhancing governance quality for a wide set of countries from the early 1980s onwards. This data set provides indices for a number of key variables that measure the performance of states in providing market-enhancing governance. The five indices in this data set are for

1. *Corruption in government*
2. *Rule of law*
3. *Bureaucratic quality*
4. *Repudiation of government contracts* and
5. *Expropriation risk*

These indices provide a measure of the degree to which governance is capable of reducing the relevant transaction costs that are considered necessary for efficient

markets. The IRIS data set then aggregates these indices into a single ‘property rights index’ that ranges from 0 (the poorest conditions for market efficiency) to 50 (the best conditions). This index therefore measures a range of market-enhancing governance conditions and is very useful (within the standard limitations of all subjective data sets) for testing the significance of market-enhancing governance conditions for economic development. Annual data are available from 1984 for most countries.

A second data set that has become very important for testing the role of market-enhancing governance comes from Kaufmann’s team (Kaufmann, et al. 2005) and is available on the World Bank’s website (World Bank 2005a). This data aggregates a large number of indices available in other data sources into six broad governance indicators. These are:

1. *Voice and Accountability* – measuring political, civil and human rights
2. *Political Instability and Violence* – measuring the likelihood of violent threats to, or changes in, government, including terrorism
3. *Government Effectiveness* – measuring the competence of the bureaucracy and the quality of public service delivery
4. *Regulatory Burden* – measuring the incidence of market-unfriendly policies
5. *Rule of Law* – measuring the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence
6. *Control of Corruption* – measuring the exercise of public power for private gain, including both petty and grand corruption and state capture.

We have divided the countries for which data are available into three groups. “Advanced countries” are high-income countries using the World Bank’s classification with the exception of two small oil economies (Kuwait and the UAE), which we classify as developing countries. This is because although they have high levels of per capita income from oil sales, they have low capacities of producing their own wealth compared to other high-income countries. From the perspective of understanding the relationship between governance and growth, the small number of developing countries that have enjoyed significant natural resource windfalls should really be classified as developing countries. We also divide the group of developing countries into a high and low growth group. Convergence is the best and easiest criteria for separating developing countries into high and low growth groups.

“Diverging developing countries” are ones whose per capita GDP *growth rate* is lower than the median growth rate of the advanced country group, and “converging developing countries” are ones whose per capita GDP growth rate is higher than the median advanced country rate.

Table 2 summarizes the available data for the 1980s from the Knack-IRIS dataset. For the decade of the 1980s, the earliest property right index available in this dataset for most countries is for 1984. Table 3 shows data from the same source for the 1990s. Tables 4–9 summarize the data for the 1990s using the six governance indices from the Kaufmann-World Bank data set. Figures 6–13 show the same data in graphical form. These tables and plots show some remarkable patterns across all the indices and demonstrate that the role of market-enhancing governance conditions in explaining differences in growth rates within developing countries is at best very weak.

Box 3. What the data tells us

- i) There is virtually no difference between the median property rights index between converging and diverging developing countries
- ii) The range of governance observed in converging and diverging developing countries almost entirely overlaps
- iii) The positive slope of the regression line in the pooled data is therefore misleading and
- iv) The market-enhancing governance indicators do not help to identify the critical *governance* differences between converging and diverging developing countries.

First, there is virtually no difference between the median property rights index between converging and diverging developing countries (particularly given the relative coarseness of this index and the fact that for most of our data, the governance indicators are for a year halfway through the growth period). Secondly, the range of variation of this index for converging and diverging countries almost entirely overlaps. The absence of any clear separation between converging and diverging developing countries in terms of market-enhancing governance conditions casts doubt on the robustness of the econometric results referred to earlier that find market-enhancing governance conditions have had a significant effect on economic growth.

Third, for all the indices of governance we have available, the data suggest a *very weak* positive relationship between the quality of governance and economic growth. The sign of the relationship is as the market-enhancing governance view requires, but the weakness of the relationship demands a closer look at the underlying data. This demonstrates that the positive relationship depends to a great extent on a large number of *advanced countries* having high scores on market-enhancing governance (the countries in blue in Figures 6–13) and the bulk of developing countries being low-growth and low scoring on market-enhancing governance (the countries in red in Figures 6–13). However, if we only look at these countries, we are unable to say anything about the direction of causality as we have good theoretical reasons to expect market-enhancing governance to improve in countries with high per capita incomes. The critical countries for establishing the direction of causality are the converging developing countries (the countries in green in Figures 6–13). By and large, these countries do not have significantly better market-enhancing governance scores than diverging developing countries. This is particularly striking when we use the Knack-IRIS data on aggregate property rights for the 1990s, which is the only period and data set for which we have a governance indicator *at the beginning* of a relatively long period of growth.

Finally, the policy implications of these observations are rather important. Given the large degree of overlap in the market-enhancing governance scores achieved by converging and diverging developing countries, we need to significantly qualify the claim made in much of the governance literature that an improvement in market-enhancing governance quality in diverging countries will lead to a significant improvement in their growth performance. These conclusions are often derived mechanically from the small positive slope of regression lines, without looking at the weak relationship or the distribution of developing countries in the way we have done.

Table 2. Market-Enhancing Governance: Composite Property Rights Index (Knack-IRIS dataset) and Economic Growth 1980-90

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries

Number of Countries	21	52	12
Median Property Rights Index 1984	45.1	22.5	27.8
Observed range of Property Rights Index	25.1 – 49.6	9.4 – 39.2	16.4 – 37.0
Median Per Capita GDP Growth Rate 1980-90	2.2	-1.0	3.5

The IRIS Property Rights Index can range from a low of 0 for the worst governance conditions to a high of 50 for the best conditions.

Sources: IRIS-3 (2000), World Bank (2005b).

Table 3. Market-Enhancing Governance: Composite Property Rights Index (Knack-IRIS dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Property Rights Index 1990	47.0	25.0	23.7
Observed range of Property Rights Index	32.3 – 50.0	10 – 38.3	9.5 – 40.0
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The IRIS Property Rights Index can range from a low of 0 for the worst governance conditions to a high of 50 for the best conditions.

Sources: IRIS-3 (2000), World Bank (2005b).

Table 4. Market-Enhancing Governance: Voice and Accountability (Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Voice and Accountability Index 1996	1.5	-0.4	-0.3
Observed range of Voice and Accountability Index	0.4 – 1.8	-1.5 – 1.1	-1.7 – 1.4
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The Kaufmann-World Bank index has a normal distribution with mean 0 and standard deviation 1. Sources: World Bank (2005a), World Bank (2005b).

Table 5. Market-Enhancing Governance: Political Instability and Violence
(Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Political Instability and Violence Index 1996	1.2	-0.4	0.0
Observed range of Instability and Violence Index	-0.5 – 1.6	-2.8 – 1.1	-2.7 – 1.0
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The Kaufmann-World Bank index has a normal distribution with mean 0 and standard deviation 1. Sources: World Bank (2005a), World Bank (2005b).

Table 6. Market-Enhancing Governance: Government Effectiveness
(Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Government Effectiveness Index 1996	1.9	-0.5	-0.2
Observed range of Govt Effectiveness Index	0.6 – 2.5	-2.1 – 0.8	-2.2 – 1.8
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The Kaufmann-World Bank index has a normal distribution with mean 0 and standard deviation 1. Sources: World Bank (2005a), World Bank (2005b).

Table 7. Market-Enhancing Governance: Regulatory Quality
(Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Regulatory Quality Index 1996	1.5	-0.1	0.2
Observed range of Regulatory Quality Index	0.8 – 2.3	-2.4 – 1.2	-2.9 – 2.1
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The Kaufmann-World Bank index has a normal distribution with mean 0 and standard deviation 1. Sources: World Bank (2005a), World Bank (2005b).

Table 8. Market-Enhancing Governance: Rule of Law
(Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Rule of Law Index 1996	1.9	-0.4	-0.3
Observed range of Rule of Law Index	0.8 – 2.2	-1.8 – 1.1	-2.2 – 1.7
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The Kaufmann-World Bank index has a normal distribution with mean 0 and standard deviation 1. Sources: World Bank (2005a), World Bank (2005b).

Table 9. Market-Enhancing Governance: Control of Corruption
(Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Control of Corruption Index 1996	1.8	-0.4	-0.3
Observed range of Control of Corruption Index	0.4 – 2.2	-2.0 – 0.8	-1.7 – 1.5
Median Per Capita GDP Growth Rate 1990-2003	2.1	0.4	3.0

The Kaufmann-World Bank index has a normal distribution with mean 0 and standard deviation 1. Sources: World Bank (2005a), World Bank (2005b).

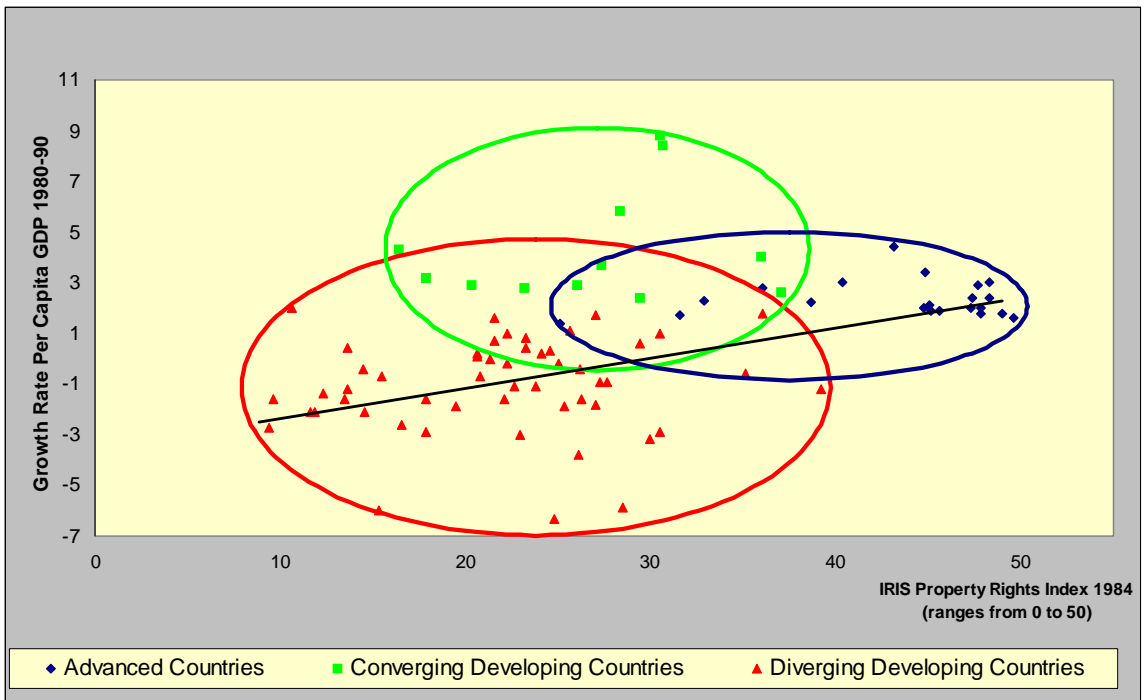


Figure 6 Aggregate property rights and growth 1980-90

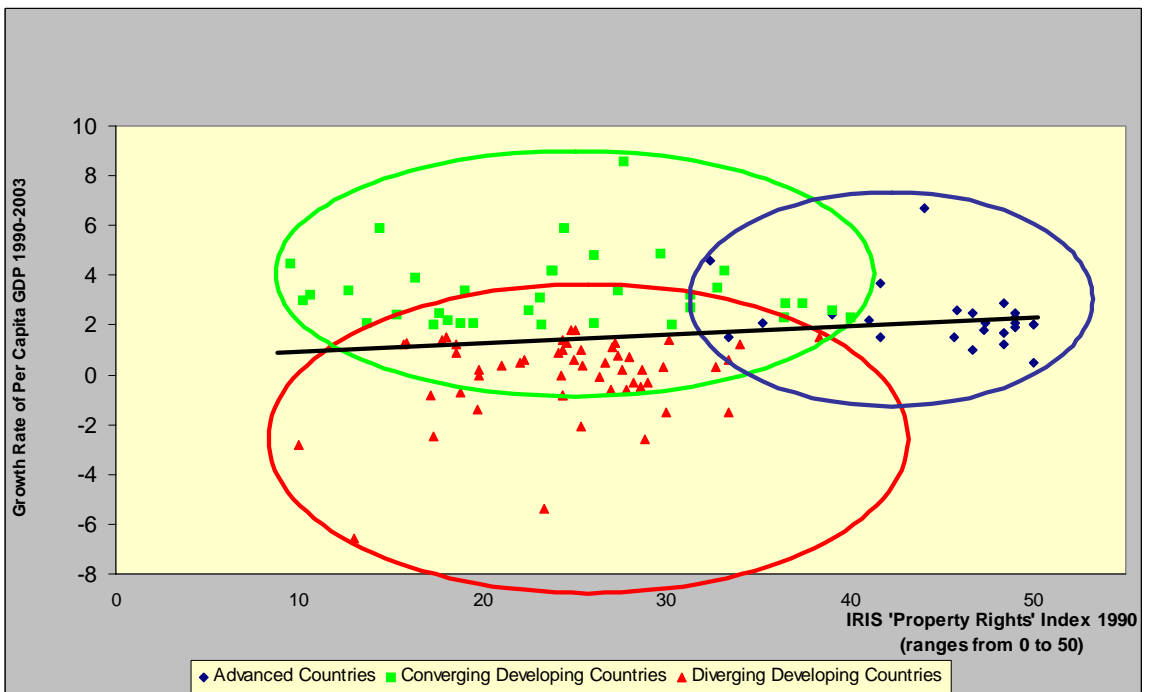


Figure 7 Aggregate property rights and growth 1990-2003

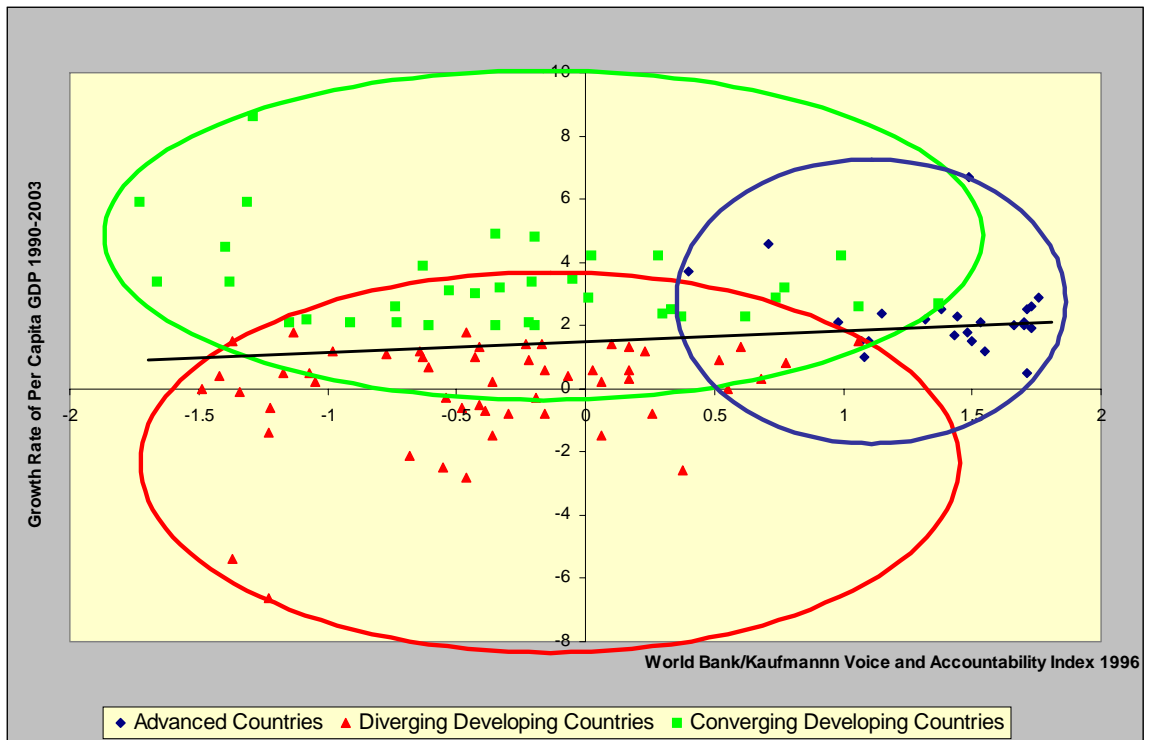


Figure 8 Voice and accountability and growth 1990-2003

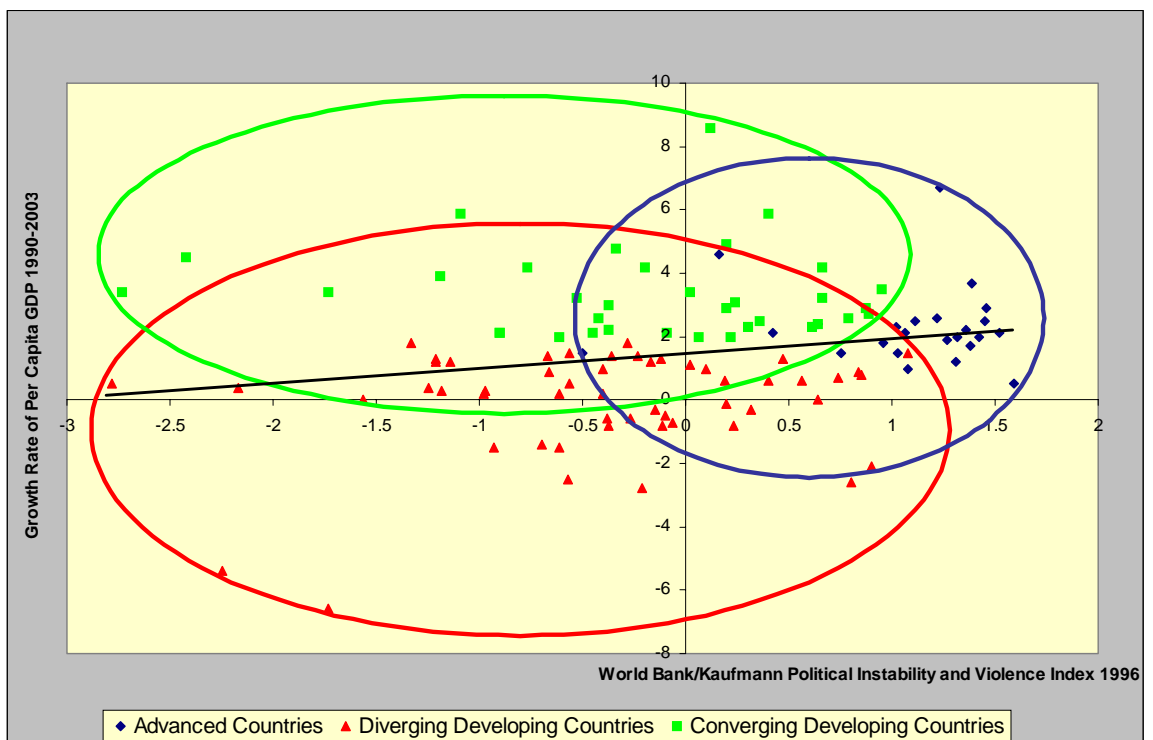


Figure 9 Political instability and growth 1990-2003

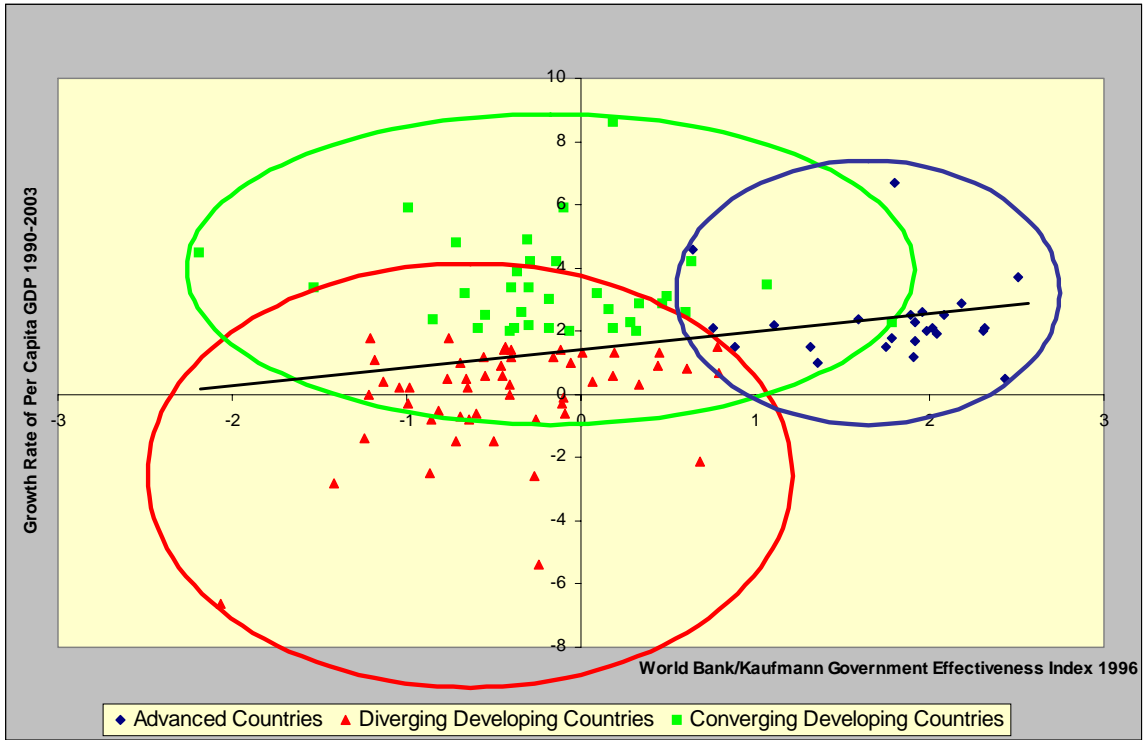


Figure 10 Government effectiveness and growth 1990-2003

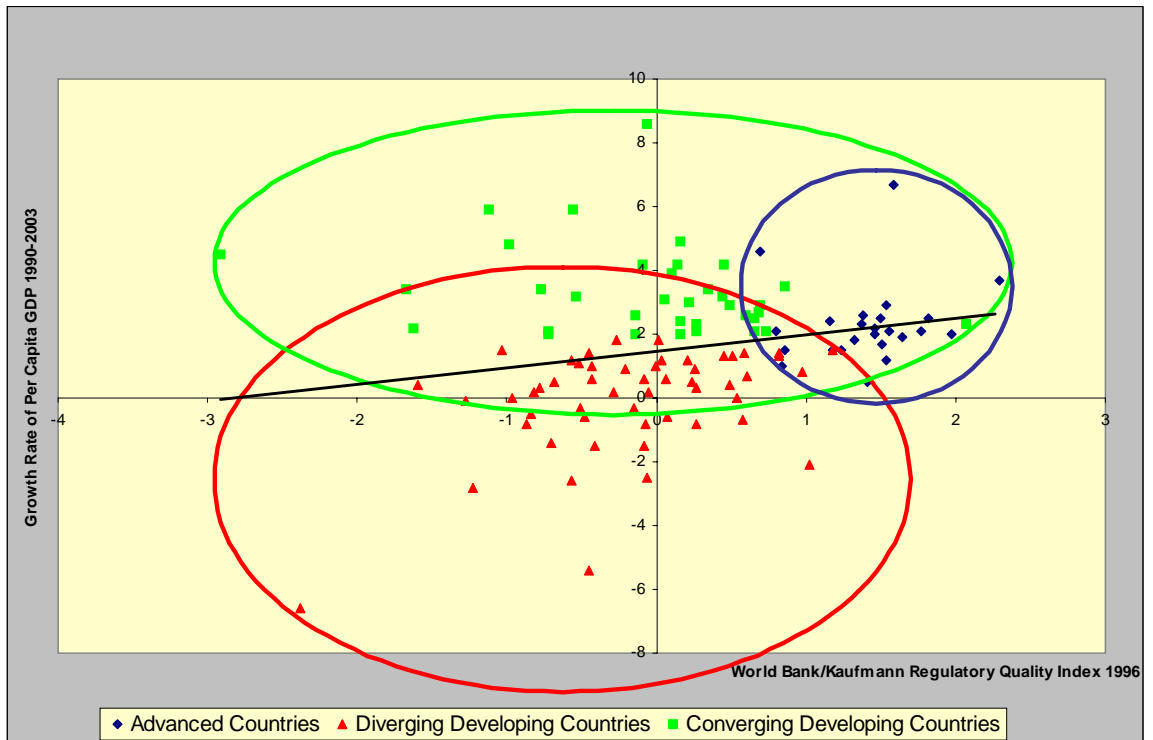


Figure 11 Regulatory quality and growth 1990-2003

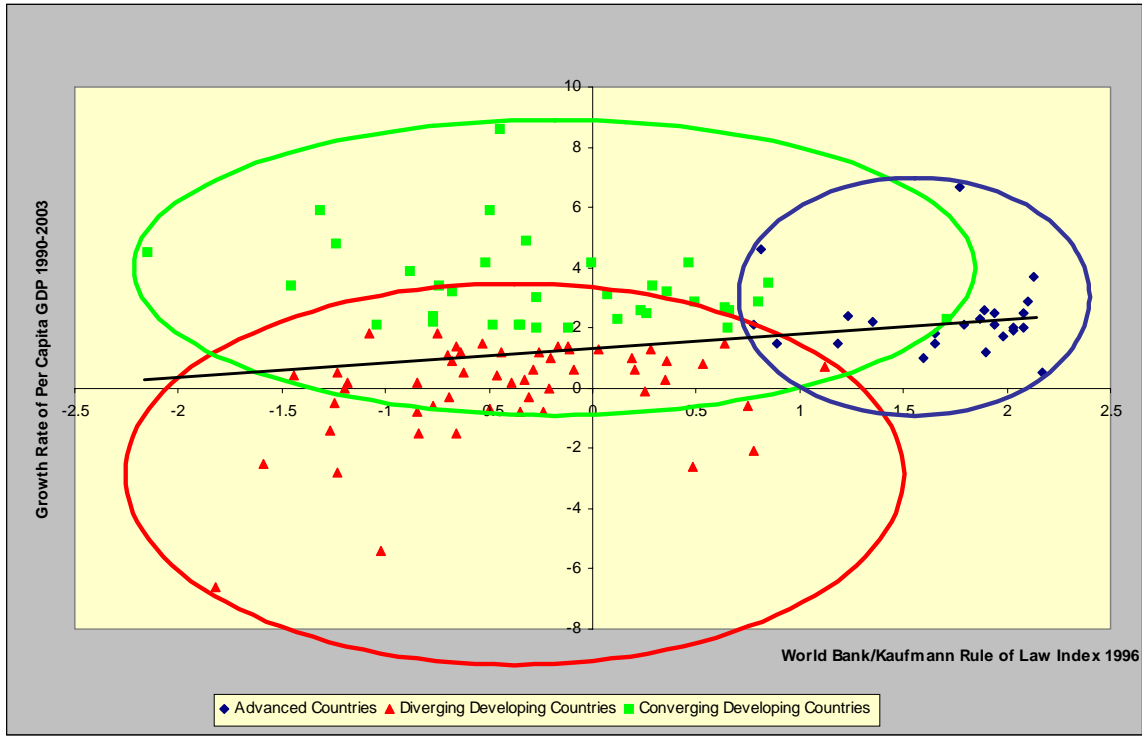


Figure 12 Rule of law and growth 1990-2003

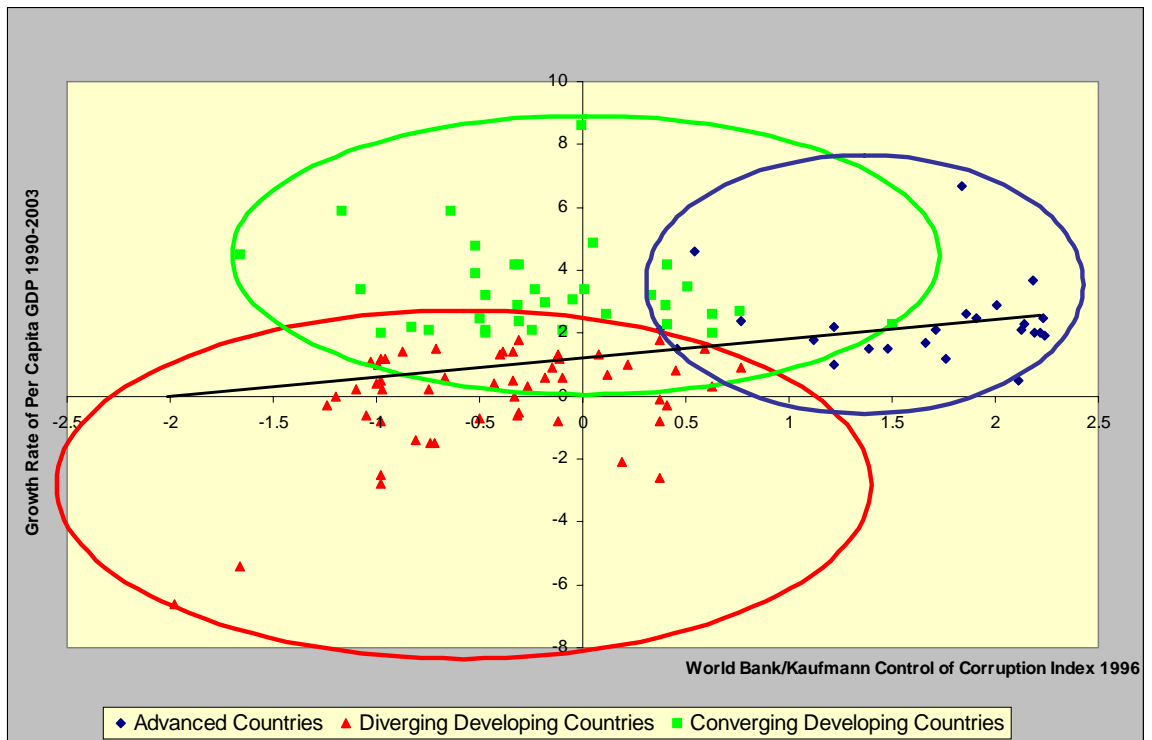


Figure 13 Corruption and growth 1990-2003

Clearly, there are significant differences in growth rates between developing countries, and these suggest significant differences in the efficiency of resource allocation and use. Moreover, we agree with the general premise of institutional and governance policy that these differences are very likely to be related to significant differences in governance capabilities between converging and diverging developing countries. Based on Khan (2004), figure 14 summarizes the data plots in figures 6–13, and also shows what we may be missing by using the data in a particular way. The data suggests that differences in market-enhancing governance capabilities are not significant between converging and diverging countries, and that the relationships within the data may actually be telling us something about the importance of other dimensions of governance capabilities that could explain differences in growth performance.

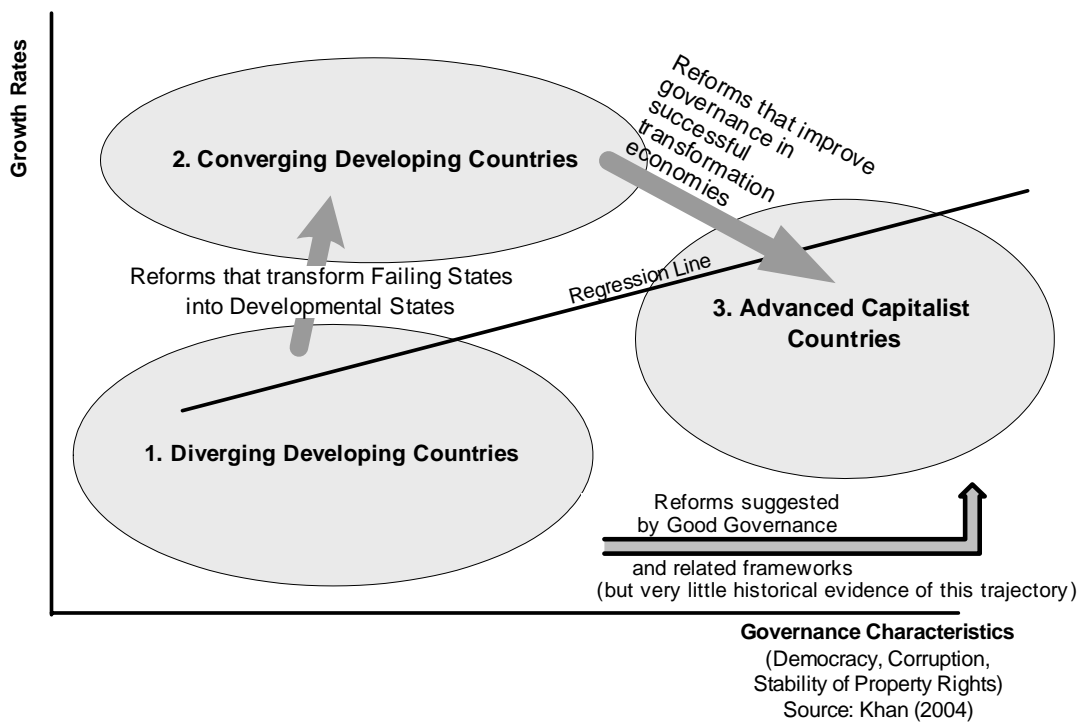


Figure 14 Market-promoting governance versus other governance characteristics explaining growth

The reform agenda identified by the good governance theories uses the data to argue that improvements in growth performance require a *prior improvement* in market-promoting governance. But this conclusion is based on a statistical result that is

misleading as it pools countries and does not adequately adjust for initial conditions. The data is actually telling us that no developing country achieved advanced country governance characteristics as measured by market-promoting governance. But in fact, converging and diverging developing countries do not differ in terms of these indicators. The interesting governance differences are more likely to be ones that have been discussed in the literature on catching up and developmental states, and we need to return to that literature to see if any significant governance differences have been identified there that are consistent with the case study and other empirical evidence.

Box 5. Similarities and differences with Sachs' analysis of governance

Our results are entirely consistent with Sachs et al. (2004) who show that when initial incomes are taken into account, (market-enhancing) governance quality does not explain any significant part of growth differences *within Africa*. A similar conclusion is reached by Glaeser et al. (2004) in a wide ranging examination of market-enhancing governance indicators and economic performance.

However, we do not conclude like Sachs and Glaeser that governance is therefore a red herring. Our argument is that governance does matter, but we are looking at the wrong kinds of governance. There are indeed no significant market-enhancing governance differences between group 1 and group 2 countries in Figure 14, but there may be significant growth-enhancing governance differences that we should be looking for.

Our analysis of the significance of good governance is supported by the analysis of growth in African countries by Sachs and his collaborators (Sachs, et al. 2004). In their study of African countries, they address the problem that countries with higher per capita incomes are expected to have better market-enhancing governance quality and so their better governance indicators should not be used to explain their higher incomes. They do this by not using market-enhancing governance indicators directly as explanatory variables, but instead using the deviation of the governance indicator (in this case the Kaufmann-World Bank index) from the predicted value of the indicator given the country's per capita income at the beginning of the period. This approach is a more sophisticated way of dealing with the two-way causation between governance and growth. If market-enhancing governance matters for growth, we would expect countries that had better governance than would be expected for their

per capita incomes to do better in subsequent periods compared to countries that only achieved average or below average governance for their per capita incomes. By making this correction, the Sachs study finds that market-enhancing governance has no effect on the growth performance of African countries.

Their conclusion is entirely consistent with our own. In both cases, we are reducing the likelihood of a false relationship between governance and growth being picked up as a result of the reverse relationship between high per capita incomes and governance. In our case, we do this by separating out the advanced countries from the developing countries, and examining whether the converging and diverging developing countries display any significant differences in their market-promoting governance indicators. In both cases, the conclusion is that when initial per capita incomes are taken into account, the role of market-promoting governance in explaining growth is much smaller and probably negligible.

However, we do not entirely agree with Sachs when they conclude that these results show that governance reforms are not an immediate priority for African countries. They argue that to trigger growth in Africa what is required instead is a big push in the form of a massive injection of investment in infrastructure and disease control. While the case for a big push in Africa is strong, this does not mean that African countries have the minimum necessary governance conditions to ensure that a viable economic and social transformation will be unleashed by such an investment push.

This is because the evidence of big push experiments in many countries has demonstrated that growth is only sustainable if resources are used to enhance productive capacity and new producers are able to achieve rapid productivity growth. These outcomes are not likely in the absence of institutional support from and regulation by state structures possessing the appropriate governance capabilities given the reasons discussed earlier. The powerful econometric results reported by Sachs et al. (2004) do not actually show that all types of governance are irrelevant for growth, only that the market-enhancing governance that is measured by available governance indicators clearly has less significance in explaining differences in performance between developing countries than is widely believed. Other forms of governance may be very important, as suggested in our figure 14, but indices measuring these

governance capacities are not readily available. In our next section we look at the evidence suggesting the importance of growth-enhancing governance capabilities.

3. Growth-Enhancing Governance and Economic Growth.

The good governance agenda ignores a number of critical structural challenges faced by developing countries going through the transformation from low productivity pre-capitalist societies to higher productivity capitalist ones. We review four structural features of developing countries that require very different governance capabilities if developing countries are to make successful and sustainable transformations into higher productivity economies.

The first governance capability is required to manage the structurally weak property rights that characterize developing countries. Theory and evidence suggests that contrary to good governance theory, the weakness of property rights in developing countries is structural and not due to the greed of political leaderships or their inadequate political will in enforcement. If stable property rights across the board cannot be achieved, the difference between more and less successful transformations is due to more subtle governance differences that allow productive capitalism to emerge in some cases but not others.

Secondly, emerging capitalists in developing countries face a structural problem in competing with more advanced countries. These structural problems are to do with a feature of market competition that has been ignored in recent years, and that is the importance of tacit knowledge and learning in achieving international competitiveness. Achieving these capabilities requires complementary governance capabilities on the part of the state to manage incentives and opportunities for technological catching up, while creating compulsions for capitalists not to waste resources. Countries differ widely in these capabilities, but without any such capability, growth is likely to be limited to relatively few sectors that have already achieved international competitiveness and therefore likely to be low or unsustainable.

Thirdly, developing countries suffer from structural political corruption due to the difficulty of managing political stabilization using transparent fiscal processes. This

explains the widespread role of political corruption and patron-client politics in developing countries. The common analysis of neo-patrimonialism in developing countries points to the need to modernize political systems. But this ignores the fact that modern political systems require significant fiscal resources to be viable, resources that are just not available in any developing country. In fact, we know that successful developing countries have not been characterized by Weberian states. Success in economic transformation has rather required governance capabilities in managing patron-client politics in ways that have allowed capitalist accumulation to continue rapidly.

Box 6 The link between growth-enhancing governance and security

The persistence of structural drivers that prevent good governance from getting entrenched means developing countries face an ongoing and persistent threat of predatory and extortionate behaviour on the part of public officials reaching a point where economic and political stability is threatened. A common feature of successful developing countries is that their states were cohesive and strong enough to prevent the unravelling of development strategies through predation and extortion. Preventing a slide into predation and anarchy is critical, but it cannot be achieved by focusing on security and enforcement alone. Success in improving the enforcement capacities of the state requires simultaneous improvements in the capacity of the state to lead economic development. This is because economic development is the most potent source of legitimacy for developing country states. Without legitimacy, security is unlikely to be sustained, regardless of direct expenditures on policing. We would argue that even in the most vulnerable states, it is never too early to start thinking about growth-enhancing governance capabilities. It is important to remember that significant improvements in growth-enhancing governance capabilities in South Korea, Taiwan, Malaysia and China took place in the context of deep internal crisis and the threat of internal and external insecurity.

Attention to these growth-enhancing governance capabilities is not only required for achieving sustainable growth, but also for ensuring security and stability in developing countries. In the next sub-sections, we look at these issues in turn.

Weak property rights and the prevalence of non-market asset transfers.

A critical structural problem in many developing countries is that property rights are contested and weakly protected because of the *limited public resources* available for adequately defining and protecting property rights. In much of the conventional analysis of governance and corruption in developing countries, it is implicitly

assumed that the protection of property rights can be dramatically improved through governance reforms and by reducing corruption. This analysis ignores the economic fact that constructing a nation-wide system of stable property rights is an extremely costly enterprise. Advanced countries only achieved significant stability in their property rights at a relatively late stage of their development when most assets had achieved high levels of productivity (Khan 2002, 2004, 2006).

Box 7 Why Acemoglu's analysis of property right stability is misleading

Acemoglu et al.'s (2001) article argued that countries that achieved stable property rights a century or more ago are still doing better. They use malaria deaths of white settlers in colonial times as an indicator of property right stability on the grounds that where malaria was limited white settlers did settle and established stable property rights, but where malaria was endemic they established extractive states with weak property rights, and these countries are still paying the price.

Most commentators have focused on the elegance of their proxy indicator of property right stability or they have criticized it as misleading. But in fact there is a more serious criticism of their reading of history.

Even if we accept that where white settlers settled property rights were eventually more stable, while the settlement was taking place, we know that there was violent and widespread non-market expropriation of pre-existing indigenous property rights. *White settler colonies made the transition to capitalism faster, but while they were making the transition, property rights were very unstable for most people.* A very similar transition to capitalism is taking place in other countries but at a much slower pace. They too suffer from unstable property rights and non-market transfers, but in most cases, the instability is actually *less* than in the settler colonies when their rapid transition to capitalism was taking place.

There is considerable controversy within institutional economics about whether stable and well-defined property rights are a precondition for growth. In an influential paper Acemoglu et al. (2001) argue that the achievement of stable property rights centuries ago enabled those countries to become prosperous while others who failed to achieve these conditions did not. This argument uses proxy indicators to measure the stability of property rights a century or more ago. Their now-famous indicator is the relative frequency of deaths of white settlers in different parts of Africa that determined whether Europeans set up settler colonies with stable property rights or extractive colonies where settlers did not come, but where property rights were destabilized by

colonial powers. This analysis is seductive in its use of innovative statistical techniques but suffers from serious historical problems. Most significantly, *the countries where settlers went did not enjoy stable property rights while the settlers were taking over these societies*. Indeed, they suffered from precipitous collapses of traditional property rights as large tracts of land were expropriated by the colonial settlers. In some cases the expropriation was so severe and rapid that indigenous populations collapsed entirely. To describe this as the establishment of stable property rights does violence to the historical facts.

It is more accurate to say that the transformation of property rights to capitalist ones happened very rapidly, so that eventually capitalist economies emerged in these societies earlier than in others where the process of property right transformation is still going on. The rapid emergence of viable capitalist economies then allowed property rights to be protected and become stable in the way we would expect. In one sense, we could even argue that property rights were more stable in the non-settler countries because a precipitous historical rupture did not occur there. The problem for these countries is that similar property right transitions have to be organized today, with less violence and more justice. Of course, once a viable capitalism became established in some countries, property rights become well protected. In settler colonies this happened quite a long time ago, but the stability of property rights across the board in these societies did not *predate* the establishment of a productive capitalism. In other words, Acemoglu et al.'s argument suffers from exactly the type of causality problem as the good governance arguments we discussed earlier, despite their use of some sophisticated econometrics and proxy variables.

The unlikelihood of establishing stable property rights in developing countries *before* the establishment of a productive capitalism is actually well supported by New Institutional Economics even though most researchers subscribing to this school have argued that modern economies emerged as a *result* of stable property rights being established. But in fact, one of the significant conclusions of the New Institutional Economics introduced by Douglass North and others was to point out that the protection and exchange of property rights is an extremely costly business. These costs are part of the transaction costs of a market economy, and New Institutional

Economics pointed out that in advanced economies, transaction costs may account for as much as half of all economic activity (North and Wallis 1987; North 1990).

An efficient economy has slightly lower transaction costs than others, but it never has zero transaction costs or anything approaching that. In addition, in an efficient market economy like the US, transaction costs may be low for individual transactors at the point of exchange (this is the definition of an efficient market) but collective transaction costs for the economy as a whole are not low at all. These collective transaction costs can be paid because almost all assets in an advanced country are very productive (by definition) and so owners can pay the taxes and incur the private expenditures on legal and security systems that ensure that at the point of exchange, transaction costs are low. In a developing country, most assets are of low productivity and cannot pay the cost of their own protection. It is not surprising that *every* developing country suffers from contested and weak property rights.

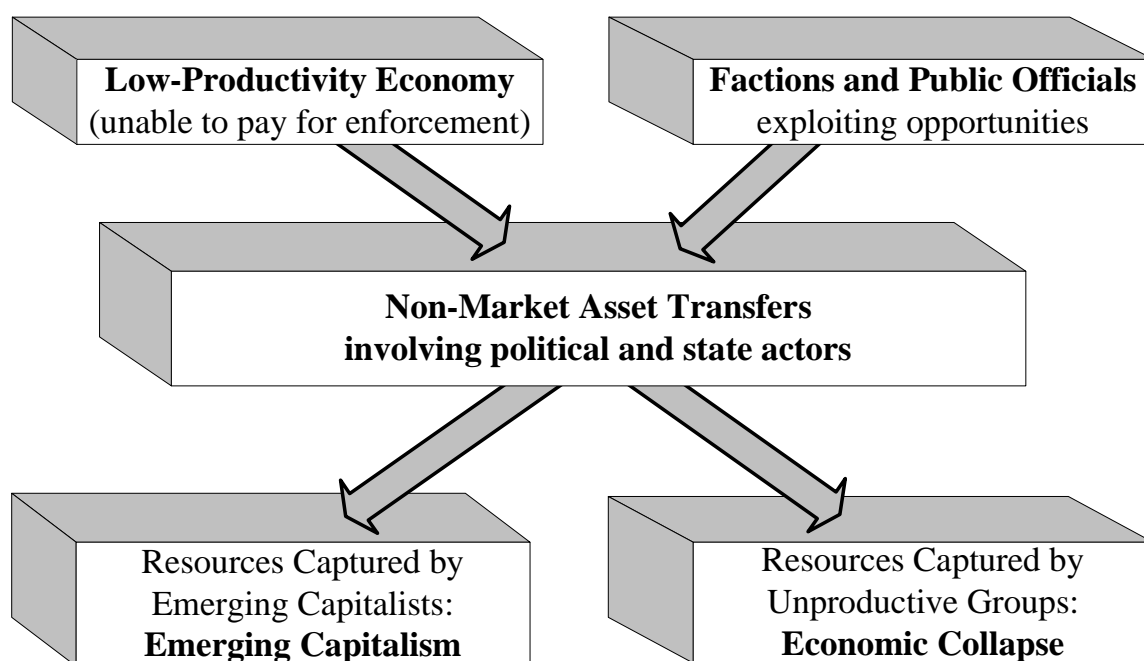


Figure 15 Drivers of property right instability in developing countries

Figure 15 shows the drivers of this governance failure in graphical form. When most of the assets in a country have not yet achieved high productivity uses (which is by definition the case in a developing or transition economy), it is difficult to imagine how the protection of property rights *across the board* can be paid for. Developing

countries have to live with a much higher degree of property right instability compared to advanced countries, but this is not entirely or even largely due to the greed and discretion of their public officials. When property rights are not secure to any satisfactory extent, and transaction costs at the point of exchange are high, inevitably many transactions will be too expensive to conduct through the market. This would be the case even with honest officials and transparent political processes, but in fact officials and politicians are also likely to exploit opportunities provided by such a context. How they do this, and the capacities and incentives they have to govern this process determine the outcomes. Thus, while non-market transfers are ubiquitous and much more significant in developing compared to advanced countries, the outcomes of these processes can be radically different across countries, as figure 15 summarizes.

Non-market transfers include not just high profile cases of appropriation and theft using political power, but also cases of legal non-market transfers through land reform, state allocation of land for development, and the use of the right of *eminent domain* in allocating public resources. The right of eminent domain is regularly used to transfer assets in advanced countries when the transaction costs of market transaction would be too high. For instance, when a road is to be constructed, the transaction cost of purchasing many small plots of land and negotiating prices with individual owners would be too high. In these cases, the state uses its right of eminent domain to fix a price for the affected land through bureaucratic processes and then purchases the land using compulsory purchase orders. The only difference in developing countries is that range of asset transfers where transaction costs would be too high is even greater because of the weak rights that initially exist.

Non-market asset transfers of different types can thus often be structurally necessary in developing countries but do open up the possibility of abuse and corruption. But they are not likely to be stopped by simply addressing the greed and discretion of public officials as there are deeper structural factors driving these processes. Rather, the critical issue for policy is that the outcomes of these non-market asset transfers can result in a successful transition to a modern capitalist economy or to predation and loss of resources to overseas tax havens. The difference between these two outcomes is *not* that in one case there was good governance as defined in the good governance

analysis and in the other there was not. Rather, the difference is a more subtle set of institutional and political factors that create incentives and compulsions for public and private actors benefiting from non-market transfers to ensure investment in productive enterprises.

The case study evidence strongly supports our analysis. Not surprisingly, a significant part of the asset and resource re-allocations necessary for accelerating development in developing countries have taken place through semi-market or entirely non-market processes. These processes have been very diverse. Examples include the English Enclosures from the 16th to the 18th century; the creation of the chaebol in South Korea in the 1960s using transfers of public resources to these privileged groups; the creation of the Chinese TVEs using public resources in the 1980s and their privatization in the 1990s; and the allocation and appropriation of public land and resources for development in Thailand. Successful developers have displayed a range of institutional and political capacities that enabled semi-market and non-market asset and property right re-allocations that were growth enhancing. In contrast, in less successful developers, the absence of necessary governance capabilities meant that non-market transfers descended more frequently into predatory expropriation that impeded development.

This analysis should not give us cause for complacency about the importance of governance. Rather it should direct our attention to a more critical set of governance reforms that are able to create stable expectations for critical sectors to enable accelerated investment and growth. In contrast, trying to implement reforms that attempt to achieve property right stability *across the board* in poor countries that lack the economic resources to make it feasible is likely only to result in frustration and eventually the abandonment of the reform programme.

Research questions: The existing literature identifies many different types of non-market asset transfers in developing countries that played a part in accelerating economic development. But there is little explicit analysis or identification of the governance capabilities that allowed the steering of non-market asset transfers in developing countries towards productive or unproductive outcomes. A proposed study could build on case studies of a number of countries, including South Korea, China,

Vietnam, India, Bangladesh, and others to identify the different governance characteristics that allowed or prevented growth. Are there general characteristics of these capabilities? The significant differences between successful countries suggests that there are no general institutional characteristics that all successful countries possessed but rather that they used different institutional mechanisms to achieve some common outcomes (Rodrik 1999, 2002, 2003). We need to understand better why different institutional capabilities and incentives for non-market transfers have been effective in different contexts given differences in political organizations and structures.

Catching up, technology acquisition and governance capabilities

A significant reason why developing countries, even successful ones, persistently diverge from the efficient market model is that even reasonably efficient markets in developing countries face significant market failures when it comes to *organizing learning* to overcome low productivity in late developers (Khan 2000b). Growth in developing countries requires catching up through the acquisition of new technologies and learning to use these new technologies rapidly. Markets, even the most efficient ones possible in a developing country, are typically inadequate on their own for attracting capital and new technologies in high value-added sectors. Efficient markets can only attract capital and technology to countries where these technologies are *already profitable* because the requisite skills of workers and managers already exist.

In theory, free markets should lead to rapid convergence if capital could flow to developing countries to use their cheap labour. But this theory only works if labour productivity in developing countries is not so low that it wipes out the wage advantage. Unfortunately, there are relatively few sectors in developing countries where this is true, and in some countries, there may be no sectors at all where capital would voluntarily wish to come. The problem is not only to do with infrastructure and governance, but more fundamental. Developing countries have lower technological capabilities and therefore lower labour productivity in most sectors compared to advanced countries, and this low productivity wipes out their wage advantage *even without taking into account problems of infrastructure and governance*.

The reasons for the lower productivity are *not* primarily the lower levels of education of workers in developing countries. The *average* level of education in most developing countries is low, but in absolute numbers, there is typically an excess supply of labour in all skill categories. (This also explains why there is labour migration out of developing countries in all skill categories). The real problem lies elsewhere, in a range of issues that economists have explained in terms of the time and effort it takes to *achieve labour discipline, tacit knowledge and learning-by-doing*. The knowledge about how to operate a modern factory at optimum or near-optimum efficiency has to be learned by both managers and workers by operating in the factory for a time, even if optimum efficiency cannot be immediately achieved.

Box 8 Learning and catching up involves absorbing temporary losses

The productivity gap due to tacit knowledge, learning and labour discipline is fundamental to catching up. Learning to use new technologies inevitably involves a period of risk and financial losses. The potential gain is the promise of significant profitability in the future, but only if there is rapid and disciplined learning. For private investors in developing countries, the uncertainty involved in investing in this type of learning is typically too high to be worth the risk given that alternative investment opportunities are less risky and immediately profitable. Rapid catching up therefore requires public or private rents and complementary support by states with the governance capabilities to ensure that rent management can be effectively enforced (Aoki, et al. 1997; Khan and Jomo 2000).

The economic evidence is that:

i) the productivity gap between advanced and developing countries is typically larger than the wage gap and explains why capital does not flood into developing countries. This productivity gap is persistent even in ‘medium-technology’ fields like cotton spinning. For instance, US productivity per worker in simple cotton spinning *using identical technology* was 7.8 times higher than Indian workers in 1978. And even in 1990 Indian textile workers were achieving 25% of US productivity in 1959 (Clark and Wolcott 2002). These massive differences can help to explain why there was so little inward investment in India during its period of virtually free trade with Britain during the colonial period. In addition, during the colonial period there were virtually no tariffs or restrictions on capital inflow or profit repatriation. Reproducing these colonial free trade conditions in developing countries today is likely to produce

similar outcomes in the absence of growth-enhancing strategies to improve productive capacities in these countries.

ii) the productivity gap is less marked in low technology and low value-added sectors compared to higher technology and higher value-added sectors. This explains why when capital does come, or investment is organized within the developing country, it is almost always in lower technology and lower value-added activities. This is a more convincing explanation of the specialization of developing countries in low technology sectors than one that focuses on the relative prices of different factors. (Relative factor prices cannot explain why firms do not relocate capital equipment that they already own to cheaper wage locations. They do this sometimes, but only when the productivity differential justifies it. In theory capital inflows should be much greater and should not be concentrated in a few developing countries).

iii) Productivity *growth* in low productivity sectors is in general slower than in higher productivity sectors. Imagine the potential productivity growth in stitching garments compared to the potential productivity growth in making fabrics. This is not necessarily true for every sector that starts from a low technology base, but there are theoretical reasons why we would expect it to be true. Technologies that are already very high productivity are by definition technologies that have a lot of embedded technology in them, and these are technologies where incremental technological progress is most likely. This explains why countries can get trapped into low technology sectors from which there is no automatic escape till the productivity gap to the higher level technologies can be jumped.

iv) Overcoming the productivity gap is not just a question of setting up infant industries and letting them run, but also of setting up institutional compulsions that ensure that the effort involved in learning is forthcoming (Khan 2005a). This explains why catching-up strategies failed in almost every country except a few. The few that were different had institutions that could exert the requisite compulsions on learning sectors so that learning did happen and these countries moved rapidly up the technology ladder.

Taken together, these observations can explain why even with complete trade openness and protection of expatriate property rights, colonies like India did not do too well in terms of industrialization or poverty reduction in the 19th and early 20th centuries. Indeed, even in terms of property rights and general governance, India under colonial rule would score reasonably highly. Not only did India not catch up with Britain and other advanced countries during this century and a half, it fell precipitately behind. From 1873 to 1947 Indian per capita income declined from around 25% of US per capita income to under 10 per cent. This experience has been almost entirely forgotten with the resurgence of confidence in liberalization and market openness as strategies that will ensure moving up the technology ladder and reducing poverty in poor countries.

A learning based theory of industrialization can explain why most developing countries specialize in low technology sectors. But it also suggests why this specialization in inferior technologies would not change rapidly if markets became somewhat more efficient. However, if developing countries could accelerate learning, and productivity growth in mid-technology sectors, this would result in an acceleration of the pace of development.

The empirical evidence that is available from relatively successful developing countries suggests that the opportunities and compulsions for learning can be created by very different types of institutions and policies. Opportunities were created using many different mechanisms including tariff protection (in virtually every case but to varying extents), direct subsidies (in particular in South Korea), subsidized and prioritized infrastructure for priority sectors (in China and Malaysia), and subsidizing the licensing of advanced foreign technologies (in Taiwan). With the advent of a new consensus on international trade through the WTO, tariff protection is no longer an option for most developing countries, but historical experience tells us that this is not the only way, or even the most effective way in which to organize support for learning sectors. The common feature of successful learning strategies was the ability to create compulsions for successful learning because states had the institutional and political capacity to ensure that non-performance was not tolerated for too long (Amsden 1989; Khan 2000a).

The mechanisms through which this was achieved were very different in different countries, but the common feature of success was that failure led to corrective action that was effective. For instance, in South Korea, not only could subsidies be withdrawn, but failing enterprises were rapidly transferred to new ownership. In Malaysia, managements of public enterprises could be changed rapidly and private investors faced declining benefits over time. These compulsions were in turn credible because investors knew they could not protect themselves by buying factional political support. The mechanisms that ensured compulsions for learning in successful countries are, however, not well enough understood or studied, and this points to the need for careful research in these areas.

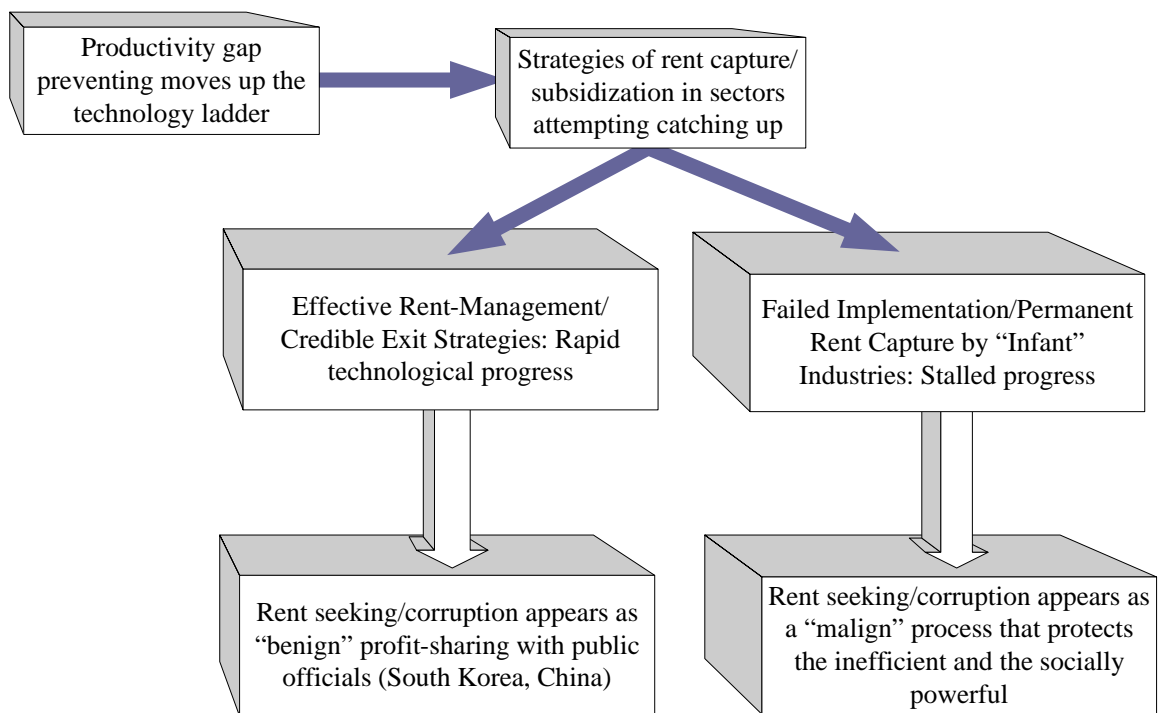


Figure 16 Governance failures in catching up strategies

Our argument changes the focus of enquiry in identifying critical governance failures in developing countries. If catching up involves creating opportunities for specific sectors, the implication is that catching up involves some sectors capturing temporary rents. The evidence suggests that this is indeed the case. But then we should also expect to see substantial rent seeking in these sectors, regardless of outcomes. Figure 16 summarizes this result. The real difference in governance between the successful

and less successful countries is *not* the presence of rent seeking and corruption in some cases and its absence in others (both the left and right hand forks in figure 16 are associated with some rent seeking and corruption). The real difference is rather in the governance capabilities that allow effective management of rents and the capacity to withdraw rents such that opportunities and compulsions for technological progress are created. The identification of these capabilities is critical to see how they can be replicated in different political and institutional contexts.

If the requisite governance capacities for effective rent management are missing, a growth-enhancing strategy may deliver worse outcomes than a market-led strategy, as poorly implemented interventions may worsen resource allocation as well as inducing high rent-seeking costs. But even a failed growth strategy can sometimes have unintended consequences that are potentially useful if it develops human capital even though it fails to profitably employ these resources. If human resources are developed, these can often be exploited in new ways even if the growth strategy fails. The interactive relationship between growth strategies, governance capabilities and technological capabilities of producers can help to explain

- a) why many *different* strategies of industrial catching up were successful in East Asia,
- b) why at the same time apparently *similar* growth-enhancing strategies have worked in some countries and failed dismally in others,
- c) why some countries like India have done reasonably *well* with liberalization by using some of the capacities developed by previous growth strategies in new ways and
- d) why other countries in Africa, the Middle East and Latin America have fared rather *less well* in terms of growth after liberalization when they allowed markets to significantly guide resource allocation to areas of current comparative advantage. In Latin America liberalization has often resulted in a shift towards lower technology manufacturing and commodity production.

The success of liberalization in a number of countries, including India and Chile in the 1980s can also be explained rather better from this perspective. Growth in these newly liberalizing countries occurred in three types of sectors. First, there was growth

in a small number of sectors that had already acquired international competitiveness like parts of India's machine tools or pharmaceutical sectors. These sectors had been beneficiaries of previous technology acquisition strategies, and benefited from the physical and human capital accumulation that had taken place earlier. Secondly, there was growth in low value-added sectors that benefited from the capital accumulation and entrepreneurial skills that had been accumulated in the previous period. Examples of these sectors include ready-made garments and grey cloths. They also include relatively low value-added sectors like call centres that benefited from human capital that had been created for high value uses (such as engineers). And finally, liberalization allowed some countries to grow by exporting commodities or natural resources. Success in these sectors was dramatic in some cases because they benefited from the growth in demand for commodities in the US and China.

Box 9 Liberalization can unleash unused technological capabilities but how sustainable is this growth?

If countries lack governance capabilities to sustain productivity growth in technology acquisition strategies, these strategies can achieve rapid accumulation for a while but with low productivity growth. Eventually the strategy becomes unsustainable. The experience of the Indian subcontinent is instructive. Liberalization can allow the technological capabilities that have been built up to be re-allocated to new uses to meet global demands and can lead to a growth spurt. Indian, Bangladeshi and Pakistani growth in the 1980s had these characteristics.

But there are areas of concern about the sustainability of the new growth model.

In India, we know that productivity growth in the manufacturing sector throughout the eighties was not driven by efficiency improvements in existing manufacturing capabilities, but rather by closing down subsidized sectors and developing new sectors that used human and physical capital in new value chains where India typically fitted in at a lower point in the global chain (Neogi and Ghosh 1998; Das 2004).

For Indian manufacturing as a whole, productivity growth was moderate to low throughout the 1980s, suggesting that growth was not driven by the development of high-technology sectors (Srivastava 2000; Goldar 2004).

Learning in the new model is not driven by the management of rents for learning, but by foreign technology transfers organized by the private sector through foreign linkups. The critical observation here is that even with foreign linkups, productivity growth only happened in the small number of sectors where the Indian partner was already fairly technologically advanced

(Siddhartan and Lal 2004). In contrast, in China, the state can step in to provide incentives and infrastructure on terms that can be used to attract medium-technology manufacturing sectors that allows China to keep expanding its manufacturing learning-by-doing.

These observations are entirely consistent with our argument that the unfettered market works for technology transfers where the developing country partner is already advanced, but does not work for developing country partners where significant learning has to be organized to compensate for large initial productivity differentials. These observations should warn us not to be too sanguine about the rate of spread of high value jobs even in relatively advanced developing countries like India that are now following market-driven technology acquisition strategies. Countries lower down the technology scale like Bangladesh or Uganda are much more vulnerable.

The liberalization in the Indian subcontinental countries has to be distinguished from China, which emerged as the fastest growing economy in recorded history in a context of gradual and measured liberalization. To a far greater extent than other countries, including India, China combined growth-enhancing strategies with market-promoting strategies to move into mid-technology manufacturing. Many aspects of the successful growth-enhancing strategies of the past continue to be effectively implemented and appropriate growth-enhancing governance capabilities exist to implement them effectively. These strategies include the strategies of local and central government in China to make land and infrastructure available on a priority basis to investors in critical sectors, and to offer fiscal incentives and attractive terms to both foreign and overseas Chinese investors engaging in investments critical for economic progress (Qian and Weingast 1997).

These 'subsidized' inputs allow Chinese firms to set up in global production before they have necessarily achieved global competitiveness if all their inputs had to be purchased in the market. Indeed, Indian manufactures complain bitterly at the way in which Chinese manufacturing can enter markets at below cost of production to establish economies of scale and learning advantages. Thus, while compared to the earlier generation of East Asian developers, the Chinese state appears to be doing less in terms of actively supporting technology upgrading, it still has very strong governance capacities to ensure the allocation of land, resources and infrastructure to critical investors and to ensure that unproductive firms are not able to retain support.

With its vast internal market and the broad-based technological capabilities it has already achieved, Chinese manufacturing has been able to acquire scale economies that enable it to compete in price almost without challenge in the low to mid-technology manufacturing industries.

In contrast, the countries of the Indian subcontinent have had a different experience with liberalization. Here, previous growth-enhancing strategies had succeeded in creating technological capabilities that were less broad-based than in China. Political fragmentation was much greater and the governance capabilities of states to direct resources to investors were significantly lower than in China. As in China, liberalization proceeded at a very slow pace, opening up opportunities without precipitately destroying too much of existing capacity by exposing inefficient industries to excessive competition in the local market. Growth has been led by sectors that had already achieved the minimum technological capability for international competition taking the opportunity to start producing aggressively for domestic and international markets. The results were higher growth rates than in the past, led by a small number of sectors that had acquired enough technological capability to enjoy comparative advantage in international markets. These sectors differed across South Asia, ranging from the garment industry and shrimps in Bangladesh, low-end textiles in Pakistan to diamond polishing, call centres and software in India. The growth of internal demand has also sparked off investment in a range of industries that still have not acquired international competitiveness. But South Asia lacks growth-enhancing strategies and capabilities on the part of government, with the result that ongoing technology acquisition is much more narrowly focused, and driven by firms that are already quite advanced engaging in partnerships with foreign firms. This process has resulted in limited learning in new sectors in India compared to China, and much less in less advanced developing countries like Bangladesh and Uganda.

Our analysis suggests that while it is desirable over time to improve market-enhancing governance, the comparison of liberalization in China and India suggests that market-enhancing governance cannot explain their relative performance. Case studies of China and India do not suggest that China performs much better than India (if at all) along critical dimensions of market-enhancing governance such as the stability of

property rights, corruption or the rule of law. Where it does do better is in having governance capacities for accelerating resource allocation to growth sectors, prioritizing infrastructure for these sectors, and in making credible and attractive terms available to investors bringing in advanced technologies, capabilities that we have described as growth-enhancing governance capabilities.

Latin America provides even more compelling evidence that a focus on market-enhancing governance alone cannot provide adequate policy levers for governments interested in accelerating growth and development. Compared to China and the Indian subcontinent, liberalization in Latin America has been more thoroughgoing and has extended in many cases to the liberalization of the capital account and much freer entry conditions for imports into the domestic market. In terms of market-enhancing governance, Latin America on average scores highly compared to other areas of the developing world. This is not surprising given higher per capita incomes, a much longer history of development, and relatively old institutions of political democracy (even though in many cases these institutions were for a while subverted by military governments).

Yet its more developed market-enhancing governance capabilities and deeper liberalization did not help Latin America beat Asia in terms of economic development in the 1990s and beyond. In fact, relative performance was exactly the opposite of what we would expect from the relative depth of its liberalization strategy and its relative governance indicators. This should not be entirely surprising given our analysis. Latin American countries shifted even more rapidly to producing according to their comparative advantage, and in most Latin American countries this meant a shift to lower technology industries and to commodity production. This has produced respectable output growth in some countries, but productivity growth has been low.

Table 10 Technology acquisition strategies and experiences

	Critical Components of Technology Acquisition Strategy	Supportive or Obstructive Governance Capabilities	Economic Outcomes
South Korea 1960s to early 1980s	Non-market asset allocations to growth drivers (consolidations, mergers and restructuring of <i>chaebol</i>). Targeted conditional subsidies for <i>chaebol</i> to accelerate catching-up.	Centralized governance by agencies with long-term stake in development. Effective implementation assisted by weakness of political factions so that inefficient subsidy recipients are unable to buy protection from them.	Very rapid growth and capitalist transformation
Malaysia 1980s 1990s	Public sector technology acquisition by public enterprises with diffusion to private sector firms through subcontracting. Targeted infrastructure and other incentives for MNCs with conditions for technology transfer.	Moderately effective centralized governance. Assisted by centralized transfers to intermediate classes which reduced incentives of political factions to seek rents by protecting inefficient firms.	Rapid growth and capitalist transformation
Indian subcontinent 1960s 1970s (With some variations these characteristics describe many developing countries of that period)	Targeted subsidies to accelerate catching up in critical sectors (using protection, licensing of foreign exchange, price controls and other mechanisms). Public sector technology acquisition in subsidized public enterprises. Resource transfers to growth sectors using licensing and pricing policy.	Moderate to weak governance capacities to discipline non-performing rent recipients. Agencies often have contradictory goals defined by different constituencies. Fragmented political factions help to protect the rents of the inefficient for a share of these rents. State capacities decline as committed public officials leave.	Public and private sector infant industries often fail to grow up. Rent seeking costs are often the most visible effects of intervention. Moderate to low growth and slow transformation
Indian subcontinent 1980s 1990s	Liberalization primarily in the form of a withdrawal of implicit targeted subsidies, in particular through the relaxation of licensing for capital goods imports. Much more gradual withdrawal of protection across the board for domestic markets.	Moderate to weak governance capacities to implement remain but do less damage as the scope of growth enhancing policies decline. Fragmented political factions continue to have an effect on market-enhancing governance by restricting tax revenues and making it difficult to construct adequate infrastructure.	Growth led by investments in sectors that already have comparative advantage. Higher growth but limited to a few sectors.
Latin America 1950s to 1970s	Domestic capacity building through selective tariffs and selective credit allocation.	Governance effective in directing resources to import-substituting industries but weak in disciplining poor performers. Weakness linked to “corporatist” alliances that constrained disciplining powerful sectors.	Initial rapid growth slows down. Many infant industries fail to grow up.
Latin America 1980s onwards	Rapid liberalization across the board.	Breakdown of corporatist alliances allows liberalization to be implemented (to varying extents in different countries).	Output growth in sectors that already have comparative advantage, in particular in commodities.

Table 10 summarizes a selected range of historical observations to highlight some of the key characteristics of successful and less successful technology acquisition strategies and the implications for growth. The technology acquisition strategies of the sixties and seventies across the developing world produced dramatic success but only in countries that by good fortune happened to have the institutional and political

conditions that allowed them to create both opportunities and compulsions for rapid learning. In other developing countries, similar strategies allowed high levels of accumulation and more rapid growth than the ones achieved under imperial rule when free markets dominated. But they did not achieve the productivity growth that would have allowed their emerging industries to become truly viable in their ability to face international competition over time. The eventual fiscal crisis that some of the less successful countries faced as a result of the failure to discipline non-performing industries led to strategies of liberalization being adopted in many of these countries. And finally, liberalization in some countries that had achieved some success with technology acquisition allowed growth spurts to begin in the 1980s in the Indian subcontinent and parts of Latin America.

This complex picture suggests that in figure 14, the group of converging countries shown as group 2 includes countries of several different types and not all of them may be enjoying sustainable growth. Some are countries that have sustainable technology acquisition strategies and are therefore on sustainable growth paths based on continuous productivity growth and the maintenance of competitiveness and improvements in living standards. But group 2 countries could in the past also have included countries attempting technology acquisition without adequate governance capabilities to make this truly sustainable. For instance, Pakistan in the early 1960s was a converging country, but this growth spurt was unsustainable because its growth-enhancing governance capabilities were not appropriate for ensuring the successful implementation of its technology acquisition strategy. And today, group 2 includes a number of countries that have abandoned technology acquisition strategies in the formal sense, but which are growing rapidly because they have already acquired physical and human capital in some niche sectors that give them international competitiveness.

By integrating into global markets and production chains using these competitive sectors, some of the latter group of countries have achieved significant growth rates and joined the converging group in the 1980s and 1990s. The question is whether countries like Bangladesh or Uganda that have enjoyed convergence growth rates in the 1990s have discovered a new growth strategy that dispenses with a technology acquisition strategy, or are these spurts going to prove short-lived, as much of the

historical evidence on purely market-driven growth would suggest. If we assume that some countries in group 2 are on sustainable convergence paths while others are not, we need to identify the governance conditions that differentiate them. Clearly good governance does not help us very much in this respect, because as we have already discussed, the countries in group 2 have the same mean and dispersion as group 1. Our hunch is that the sustainable sub-group within group 2 are the countries that have a sustainable technology acquisition strategy based on effective governance capabilities to police the particular strategy they are following. This is a critical research and policy question that needs to be examined using all the available evidence.

Of course, it would be simplistic to suggest that within group 2 there are countries that do have the governance capabilities to follow a technology acquisition strategy, and others who have *no* capability to implement technology acquisition strategies. Even countries that are following largely market-driven growth strategies have elements of formal or informal strategies to promote technology acquisition and discipline these processes. This is particularly the case in countries like India where government-business relationships are quite well-developed in pockets. But there are elements of informal government-business relationships in countries like Bangladesh that also assist some sectors to acquire technology by gaining temporary advantages that allow them to start producing without achieving international competitiveness. It is also important for policy to identify these processes and examine if policy can assist in deepening these trends.

The real challenge for policy is to address the diverse ways in which technology acquisition has been organized in different countries. Case-study evidence suggests that success in growth-enhancing governance depends critically on success in enforcement. This in turn depends on a number of institutional and political factors that enable the effective implementation of the underlying growth-enhancing strategies. The institutional requirements include the requirement that the agencies involved in monitoring and enforcement are sufficiently centralized to be able to internalize all the costs and benefits of implementing the strategy (Shleifer and Vishny 1993; Khan 2000a). This is to ensure that failing industries or sectors are not

able to offer inducements to monitoring agencies to allow them to continue to receive their rents or occupy their assets without delivering performance.

Just as important if not more is the political requirement that the governance agencies are able to enforce difficult decisions about rent and resource withdrawal from non-performing sectors and firms when required. This in turn requires a compatibility of the required governance tasks with the internal power structures of the country. Table 10 also summarizes how the internal power structures of these countries played an important role in explaining why particular strategies of governance could or could not be effectively implemented.

For instance, growth-enhancing governance of technology acquisition strategies is helped if political factions are too weak to protect non-performing industries and sectors. If political factions are strong and there are many of them, it becomes relatively easy for failing firms to buy themselves protection by offering to share a part of their rents with factions that offer to protect them. The South Korean experience with industrial policy during the 1960s and 1970s demonstrates how the absence of strong political factions can have very beneficial effects for a particular strategy of growth-enhancing governance. In contrast, the South Asian experience during the same decades (like that of many other parts of the developing world) shows how fragmented political factions can prevent effective growth-enhancing governance. But growth-enhancing governance can be moderately effective even in the presence of strong political factions, provided there is a political settlement that allows the political demands of factions to be satisfied through centralized transfers. This can reduce the incentive of factions to capture rents by protecting rent-recipients who are willing to pay. The Malaysian growth strategy of the 1980s and 1990s provides strong support for this hypothesis.

These possibilities can explain why successful countries appear to have very different growth-enhancing strategies when we look at the details of the instruments and mechanisms through which they set out to achieve rapid development. Strategies that can be effectively implemented in one context may be much more difficult to implement somewhere else. Very different policy instruments may be more effective in other contexts if governance capabilities are more appropriate for enforcing

alternative strategies. This can explain why we can observe different successful combinations of policies and growth-enhancing governance capabilities. So, for instance, a strategy of subsidizing credit for large conglomerates as in South Korea may have provided poorer results in a country like Malaysia where the enforcement capacities for such a strategy may have been much weaker. In contrast, the Malaysian strategy of creating incentives for multinational companies to bring in high technology industries and subcontract to local companies proved much more successful because this strategy was more consistent with Malaysian governance capabilities. Thus, while Malaysian economic performance was a little poorer than that of South Korea, given Malaysia's internal institutional and political structure and growth-enhancing governance capabilities, Malaysia's growth was probably higher than if Malaysia had tried to follow South Korean economic strategies precisely.

An analysis of the types of growth-enhancing strategies that can be effectively implemented in particular developing countries could therefore identify somewhat different growth strategies in different countries, even though they address similar problems (of accelerating resource allocation to growth sectors and accelerating technology acquisition). The importance of such an analysis is not only to identify the growth strategies appropriate for the country given its growth-enhancing governance capabilities. In many countries, growth-enhancing governance capabilities may be so poor that no growth strategy can be implemented. In these cases, the policy response should not necessarily be to abandon growth strategies and shift to market-enhancing strategies. It should rather be to examine the type of growth-enhancing governance capabilities that can feasibly be achieved in that country through a process of reforming the organization of power itself. We will discuss this further in our discussion of political stabilization and patron-client networks.

Although much of the technology acquisition strategies in Asia have centred on industry and manufacturing, there is no reason why technology acquisition should not be a strategy that is relevant for agriculture or services. The role of agriculture is likely to be more significant in some countries, particularly in Africa. However, Sachs et al.'s observation (Sachs, et al. 2004) that Africa's environment and geography make it unlikely that agriculture can transform most African countries into high income ones needs to be kept in mind. Agriculture in Africa does have to be promoted

to prevent humanitarian disasters, but in many African countries it would be far too expensive to make agriculture a high value-added sector that can sustain moderate to high living standards. Agriculture, like industry, can only sustain moderate to high living standards if it is highly capitalized and mechanized, and serviced by effective infrastructure. The latter is particularly difficult in Africa, as is the likelihood of developing HYV seeds for many of the types of crops that grow in its relatively harsh environment. The Asian experience is therefore relevant for Africa in pointing out the difficulty of achieving sustained improvements in living standards mainly by focusing on agriculture. But Asia also shows that without agriculture being able to sustain most people in at least steadily improving conditions, it is very difficult to prevent worsening poverty.

Technology acquisition strategies become relevant for agriculture once we have high value-added agricultural sectors that are vying for international markets or competing with high value imports. Just as in industry, moving up the technology ladder by using mechanization, better seeds and techniques also involves learning-by-doing and the financial space to achieve this learning. Exactly the same questions then arise, and the Asian experience shows the importance of agricultural extension services that carried out the task of spreading new technologies and techniques using public funding. However, with very poor peasants, the issues and constraints are different from industrial learning. Poor peasants do not need compulsion and discipline to put in effort in learning new technologies, rather the problem is that they are too risk averse even with subsidized inputs to adopt them because mistakes can cost them their lives. Therefore the issue with very poor peasants, as opposed to emerging capitalist farming, is how to overcome risk aversion and extreme financial constraints. The problems we have discussed of disciplining catching up strategies are more relevant for capitalist farms that do have a chance of surviving in international competition but are constrained by productivity. As Sachs et al. (2004) and others have pointed out, most African farms are even potentially not in this league, and while poor farmers should not be neglected, the long term issues of catching up and achieving sustainable high incomes will have to be largely based on industry and services in most African countries.

Research questions: The first critical research question is to distinguish between different converging developing countries. Some rapid growers are following sustainable technology acquisition strategies, others are growing based on market-driven growth. It is noteworthy that most countries in the latter group (such as Uganda or Bangladesh) would not score highly on either market-enhancing or growth-enhancing governance capabilities. There are structural barriers to improving market-enhancing governance capabilities in these countries, and doubts about whether such capabilities would be sufficient to put these countries on sustainable growth paths involving rapid technology acquisition. We need a better understanding of the sustainability of growth in these countries to identify problems as early as possible.

A second critical research question is to identify and classify different rent management strategies in countries with successful technology acquisition strategies, and the associated political and institutional capabilities that allowed or prevented their implementation. This classification may help to design viable governance reforms that aim to develop governance capabilities for faster technology acquisition in other contexts.

The distinctive feature of the proposed research compared to existing research findings will be to explicitly look for the interface between institutional capabilities for rent management and the political conditions that allow or prevent the effective implementation of these strategies. The assumption behind this research is that catching up strategies that worked in one context will not necessarily work in another if the underlying political conditions are different. Moreover, while some of the most successful countries (like South Korea) had formal institutional mechanisms for supporting technology acquisition, in other countries technology acquisition may be supported informally through specific government-business relationships that are not or cannot be formalized. Nevertheless, here too there is a need to distinguish between informal government-business relationships that create the right opportunities and compulsions for rapid technology acquisition (as in contemporary China) compared to other cases where the results are more in the nature of rent capture by inefficient capitalists. The outcome of the research will be to further our understanding of these interfaces, to identify and suggest the types of institutional and policy reform strategies that may be viable in particular contexts.

Governance and the management of political stability

One of the main reasons why developing countries as a group diverge so significantly from the good governance conditions is that their political systems do not operate with formal and transparent rules for public officials that ensure the accountability of political officials to elected bodies in the way that advanced countries do. There is a large and growing gap between the reality of developing country politics and the policy prescriptions coming from good governance theory. Once again, the question is why this is so systematic.

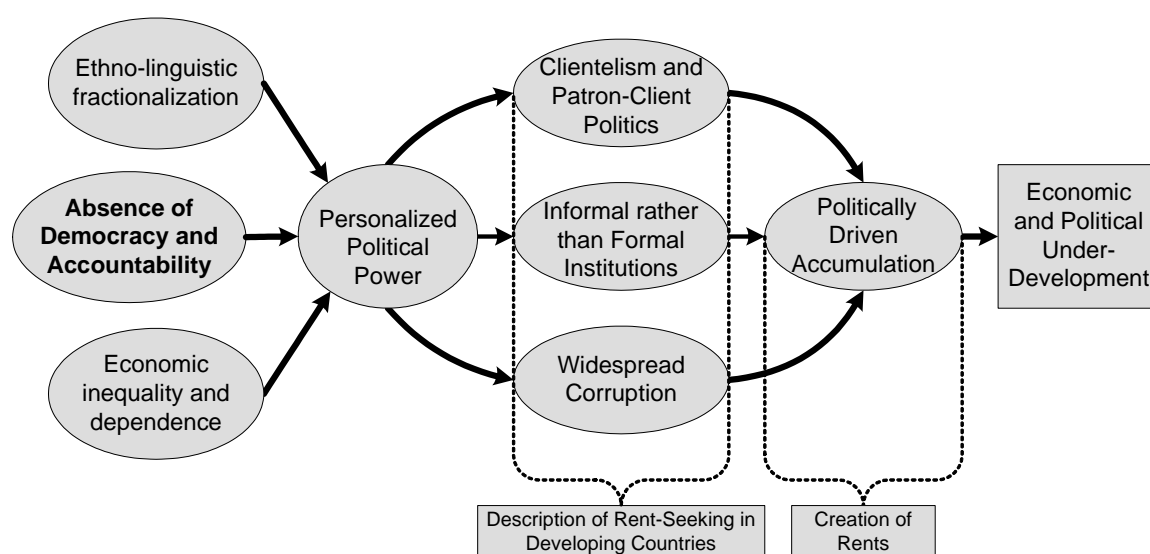


Figure 17 The neo-patrimonial analysis of the causes and effects of patron-client politics

A powerful set of analyses of the political economy problems of developing countries comes from the neo-patrimonial school that sets up a contrast between typical developing country political structures with the Weberian ideal of a rational and formal state based on impersonal political relationships (Eisenstadt 1973; Médard 2002). The core argument of this emerging analysis was that the absence of democracy and accountability in developing countries allowed political bosses to use personalized power to run patron-client networks with their clients. This explained the persistence of patron-client politics, the importance of informal rather than formal institutions, and the widespread corruption that could then be engaged in by the patron and his clients. The result was politically driven accumulation that produced the economic and political underdevelopment of developing countries. The main links in this argument are shown in figure 17. The early theory has been added to by

subsequent analysis that has focused on the contribution of ethno-linguistic fractionalization and economic inequalities in perpetuating personalized politics and its damaging effects (Engerman and Sokoloff 2002; Blair 2005; Barbone, et al. 2006).

The policy conclusion of these approaches is that democratization and other strategies to weaken personalized politics will weaken the hold of patron-client politics and move these economies towards modern polities. However, there is a growing recognition that in the presence of severe ethno-linguistic fractionalization, democratization may not work in weakening patron-client politics, and may even strengthen these tendencies (Barbone, et al. 2006). Moreover, as Barbone et al. point out, sometimes patron-client politics appears to operate even in the absence of fractionalization (as in Tunisia or Bangladesh). However, the expectation is that patron-client politics is *avoidable* in developing countries, that there are specific institutional failures that enable its continuation, and that the *desirable and achievable* state of affairs is a democracy that is accountable, with political institutions that work on principles of impersonal politics (AFD, et al. 2005). Such a political system is an integral part of the good governance framework described in figure 5.

The problem is that no examples exist of such a state of politics in the developing world. Even in India, the world's most attractive model of a working and sustainable democracy in a developing country, we know that the Indian political system is riven with corruption, that patron-client politics rules, and that political reform when it happens, takes place because reformers can work the patron-client system, not because they have overcome its limitations by progressing towards a modern Weberian political system (Jenkins 2000; Harriss-White 2003; Khan 2005b).

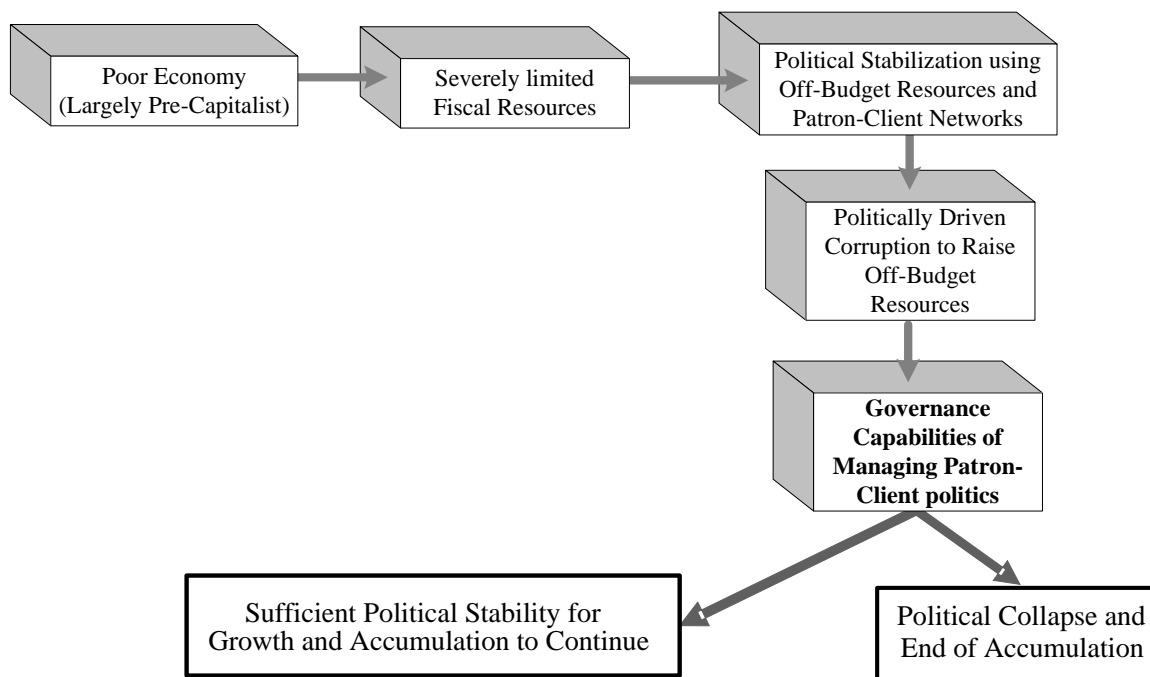


Figure 18 Structural drivers of patron-client politics

An alternative explanation for the persistence of patron-client politics is developed in (Khan 2005b). The alternative argument is that there are significant structural factors that make patron-client politics a rational response to the problem of maintaining political stability in a developing country. The main drivers of this type of politics are shown in figure 18. The critical constraint is that all developing countries suffer from limited fiscal resources because (apart from the political failures to collect tax) by definition the development of their formal taxable sectors is limited. At the same time, managing political stability is even more demanding than in an advanced country because of the deep social dislocations caused by the economic and social transformations of development. The option of managing social stability through transparent and legal transfers through the fiscal system simply does not add up. This does not mean that tax collection cannot be increased and that this would not help the situation. But in most developing countries, feasible increases in tax collection would not solve the fundamental problem that the tax take would still be insufficient to pay for all necessary services and still be able to pay for the necessary political stabilization of society through transparent fiscal transfers.

The recourse to patron-client politics as a universal response in all developing countries regardless of culture, politics or economic strategies can be better explained

by this fundamental structural driver. Patron-client politics makes sense because it allows the governing group to identify the most critical, the best organized, the most troublesome, or simply the most dangerous constituencies and buy them off selectively. By definition, such a selective strategy of buying off specific constituencies cannot be done in a transparent way, and in any case the fiscal resources for satisfying even limited constituencies often do not exist in the budget. The most important politics in developing countries therefore often takes place off-budget, with off-budget resources being raised for redistribution down patron-client networks.

The difference between sustainable growth paths and unsustainable ones is not that in the first there were Weberian states behaving in impersonal and formal ways while the second suffered from patron-client politics. The history of developmental transitions is that both types of countries suffer from patron-client politics, but in the first, governance capabilities allow the maintenance of enough political stability for the muddling through of social transformation to take place (as in contemporary India), while in other countries, political stability cannot be maintained and a more or less rapid descent into political fragmentation takes place. The governance challenge is to understand how in specific contexts, the management of political stability is being achieved using the historical endowments of institutions and power structures, and whether feasible changes in political institutions and political organizations can assist in strengthening political stabilization. Here too, the governance priorities of market-enhancing governance may be misplaced. What we need is a much better understanding of the types of patron-client networks through which political stabilization and political accumulation take place in different countries, so that governance interventions can be designed to improve sustainable growth and development outcomes.

The institutional capabilities that are appropriate for developing countries depend on the pre-existing disposition of organizational power that we have described as the *political settlement* (Khan 1995). We find that theories that have sought to explain success and failure in political management in Asia only in terms of the institutional capacities and leadership qualities of Asian states are seriously lacking in explanatory power (Khan 1995, 2000a). As with the other processes that we have discussed,

success in managing political stabilization has depended on the *compatibility* of institutional structures with pre-existing political structures of political organization and patron-client structures that describe the political settlement. For instance, attempts at authoritarian limitation of patron-client demands worked in South Korea in the sixties but failed in contemporary Pakistan because the organization of patron-client networks in Pakistan in the sixties was much stronger and more fragmented, requiring a degree of repression for this strategy that was ultimately not feasible.

In turn, the feasible strategy of political stabilization that was consistent with the political settlement that prevailed at the time in Pakistan limited the possibility of success of the particular technology acquisition strategies and asset transfer strategies that Pakistan was attempting at the time (Khan 1999). It is often forgotten that the South Korean technology acquisition strategy of providing conditional rents to learning industries was in fact innovated in Pakistan in the 1960s, but proved impossible to effectively implement in Pakistan because the fragmented clientelism in that country allowed individual capitalists to buy themselves protection at a relatively low price. The absence of fragmented clientelism in South Korea, allowed the effective implementation of the same strategy that had failed in Pakistan. Malaysia too initially suffered from fragmented clientelism, but was able in the early 1980s to overcome this constraint when political organizations were changed as a result of changes in the organization of power. The change in the political settlement enabled more centralized version of clientelism to emerge. Malaysia's centralized clientelism of the 1980s, although it was still a costly system to run, allowed the implementation of a different type of learning strategy based on multinational companies with conditions and incentives for technology transfers and learning. These interdependencies between political stabilization strategies, learning strategies and asset transfer strategies are critical for devising feasible improvements in growth-enhancing governance capabilities. Widening our range of case study knowledge will allow us to deepen our analytical understanding of these processes.

Box 10 Political settlements can change

If the organization of political power in political parties and patron-client networks is such that political stability can only be achieved by deploying patron-client networks that damage or limit growth, the country may be stuck in

low growth regardless of the quality of institutions and political leadership. But the situation need not be permanently hopeless. The solution in these cases may be a restructuring of political organizations and parties to change the patterns of stabilization. Malaysia in the early 1980s went through just such a transformation when the threat of civil war led to the emergence of a corporatist party structure in the form of the National Front government. This allowed its previously fragmented clientelism to be converted into a centralized form of clientelism. Redistribution through patron-client networks still happened, but the centralization of political redistribution allowed the state to prevent politically powerful constituencies from forging alliances with individual capitalists and protecting inefficiency. This in turn allowed technology acquisition strategies to be effectively implemented (Khan 2000a). These types of interdependencies between institutional capabilities and political constraints offer a better explanation of Asian takeoffs rather than the magical appearance of 'political will'. Similar interdependences also explain the takeoffs in South Korea and Taiwan. Clearly, political reorganization of patron-client networks is not a task for donors or outsiders, but we can assist in providing analytical frameworks for debate and dialogue within developing countries.

In our analysis of Asian rent seeking processes in Khan (2000a) we looked at how different patterns of patron-client networks helped us to understand why political stabilization in particular political settlements, specific technology acquisition strategies and non-market asset transfers led to different patterns of growth in Asian countries. These insights are likely to be very useful for Africa for a number of reasons. First, there is a large literature that claims that Africa is different in its susceptibility to patron-client politics, the rule of big men and the operation of neo-patrimonialism (Chabal and Daloz 1999; Van de Walle 2003). But in fact, Africa is quite normal from a developing country perspective when we look at the Asian experience of patron-client politics.

The problem in Africa is rather the weakness of some state institutions and the specific features of its patron-client networks. The average African country displays a greater fragmentation of patron-client networks, and a greater difficulty in imposing discipline on clients, not necessarily or only because of greater ethno-linguistic fractionalization, but also because of less developed party organizations, weaker initial conditions in terms of very limited capitalist involvement in these networks and weaker state institutions disciplining and limiting predatory behaviour. In countries like Tanzania, where party organization is more developed, patron-client politics has a recognizably Asian pattern. In other words, if the removal of patron-client politics is

not a feasible strategy (figure 18), Africa would do well to focus its political reforms in learning to manage its patron-client networks better, rather than carry out political reforms that aim to do away with neo-patrimonialism but end up only weakening state capacities to manage these problems while patron-client politics continue to survive. We know that democratization has only strengthened patron-client politics in Africa, yet the response of many policy-makers is to increase the dosage of the same medicine rather than ask whether the solution may lie elsewhere (Chabal and Daloz 1999).

Secondly, improving our understanding of the Asian experience can also help to deepen our understanding of African development by looking at processes of accumulation and transformation through the lens of specific patterns of patron-client politics. Using our approach to Asian rent seeking, the task in specific African countries would be to map the patron-client networks that dominate politics and through which political stabilization has been achieved. These networks have allowed some types of social transformation to take place, as some African countries have also gone through types of property right transformations and accumulation that have enhanced productive capacity in some sectors. In other sectors, these patron-client networks have resulted in predatory or extortionate asset transfers and they have impeded the disciplining of technology acquisition strategies.

The role of patron-client networks is clearly specific to particular countries and needs careful analysis. Only when we have country based analysis of this type can we suggest institutional and organizational changes that may allow faster and more effective social transformations, better and more effective political stabilization and feasible strategies of technology acquisition. In some cases, it may be that the underlying organization of political power is so detrimental that without a change in that distribution of power through the mobilization of new political forces (as in Malaysia in the early 1980s), not much can be done.

A better understanding of patron-client networks is therefore critical for designing governance reform because these networks affect outcomes of all the major processes affecting the sustainability of growth and development. Our proposition is that the organization of patron-client networks is a useful lens through which to study

- i) the processes through which political stabilization is attempted and the likely outcomes in that context (figure 18),
- ii) the likelihood of disciplining different types of technology acquisition strategies in that context (figure 16), and
- iii) the likely outcomes of non-market asset transfers, as patron-client networks are important conduits through which non-market transfers are organized (figure 15).

Research questions. The methodology I propose does not identify any simple killer variables that can explain why ‘political will’ emerges in a particular country to carry out transformative changes that lead to sustainable growth paths. Sustainable growth strategies can differ widely in terms of the mix of political stabilization expenditures, the pace and pattern of primitive accumulation, and the technology acquisition strategies followed. Success only requires that each of these processes is viable and achieves positive outcomes. Not everyone has to grow at Chinese or even South Korean rates to be successful. The problem is that when some or all of these processes in a particular country are not sustainable, high rates of growth can turn out to be a relatively brief ‘growth spurt’ rather than a sustainable growth path.

Political stabilization exposes most transparently the patron-client networks in a country that are implicated in the two other processes that we have identified as important in judging the growth enhancing governance capabilities of a state. The juxtaposition of specific patron-client networks with the institutions of political stabilization, property right protection and technology acquisition provide critical information about the sustainability of each of these processes and allow us to reach a judgement about the growth-enhancing governance capabilities of the state. Given its political inheritance and economic problems, this approach can help us design somewhat better institutions and strategies to improve the sustainability of each of the processes that we believe are important for the sustainability of growth.

Research and knowledge on these issues is still relatively thin despite many case studies on growth being available for different countries. Rodrik’s team working on the deep determinants of growth using analytical narratives is one of a very few groups working on consistent case studies (Rodrik 2003). However, their analytical

focus is different from ours, and while their case studies shed light on the analytical questions we identify, there is a pressing need for case studies to be designed to specifically answer the interdependent questions we are interested in. The analytical narrative approach can however be usefully expanded to look at the three interdependent processes that we have identified as important, using a number of comparative cases to initiate a broader case study approach to identify growth-enhancing governance conditions. The selection of these countries would be from Asia and Africa to deepen our knowledge of Asian transformations and to apply these insights to begin a better mapping of African political economy.

Conclusions

The consensus development orthodoxy of the 1950s and 1960s did not adequately recognize that the successful implementation of catching-up strategies required a complementary set of governance capabilities. This is the problem we summarized in Figure 1. The very lucky presence of these capabilities in a small number of countries resulted in the dramatic success of a small number of East Asian countries at a time when all developing countries were following virtually the same policies. This could not be satisfactorily explained at the time, and resulted eventually in the abandonment of all catching up strategies in the second and third phase of development strategies (summarized in our Figure 2 and 3). We described the governance capabilities required for ensuring the effective implementation of growth-enhancing strategies as *growth-enhancing governance capabilities*, as opposed to the governance capabilities stressed in the good governance approach which we describe as *market-enhancing governance capabilities*.

To the extent that productivity growth depends on better resource allocation, improving market efficiency is clearly desirable. But sustained productivity growth depends on the creation of new technologies or (in the case of developing countries), learning to use existing technologies effectively. Markets by themselves are not sufficient to ensure that productivity growth will be rapid unless appropriate incentives and compulsions exist to induce the creation of new technologies or the learning of old ones. While technical progress is possible along the trajectory set by a market-driven strategy, the climb up the technology ladder is likely to be slower

through diffusion and spontaneous learning compared to an active technology acquisition and learning strategy. Moreover, if technological learning is not sustainable, the market-driven strategy can result in divergence rather than convergence, as was the case when most developing countries followed free market strategies during their colonial periods.

Our analysis suggests that growth outcomes depend on the compatibility of a growth strategy with growth-enhancing governance capabilities. This approach also allows us to explain why many developing countries performed so poorly with growth strategies that appeared to be similar to the ones followed by successful East Asian countries. A growth strategy that cannot be implemented could well provide worse results than if there were no growth strategy at all because any growth strategy overrides some allocations that would otherwise have happened through the existing market system, thereby creating rents and rent seeking opportunities. If these rents fail to accelerate learning and instead result in large rent seeking costs, the economy would be worse off trying to implement these strategies. However, this is not necessarily a failure of the policy in general, but rather an indication of its inappropriateness in a particular country, or the failure of the country to address the necessary governance requirements that would be required to accelerate growth and achieve more rapid development.

The distinction between market-enhancing and growth-enhancing governance can thus allow us to make sense of the complex comparative economic performance of countries since 1960, some of which is summarized in Table 10. It also allows us to reassert the importance of governance even though the types of governance that many institutional economists have focused on do not correlate very well with comparative economic performance. From a policy perspective our analysis points out the limitations of the current governance agenda that focuses almost exclusively on market-enhancing governance. The danger of such an exclusive focus on market-enhancing governance is that we may lose opportunities for carrying out critical reforms that are more likely to produce results. We may also create disillusionment with governance reforms and the emergence of the false perception that governance does not matter that much for economic development.

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