

# Governance and Development: The Perspective of Growth-enhancing Governance

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Most economists would agree that governance is one of the critical factors determining the growth prospects of countries. However, 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 other state capacities that directly promote sustainable growth, market conditions for efficiency are on their own insufficient and ultimately unsustainable.

The point about sustainability of particular reforms is particularly important. 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. 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 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 (Huntington, 1968). Critically, there was no discussion within developing countries about the governance capabilities required to effectively implement the different growth strategies they were following.

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 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 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.

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. John Toye described this as the “development counterrevolution” (Toye, 1987). 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.

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, by removing the incentives for rent seeking and corruption. 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 & Shepsle, 1990; Lal & Myint, 1996; Bates, 2001).

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 & 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.

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: low corruption, democratic accountability, the rule of law and pro-poor service delivery. With the end of the Cold War, many constituencies, including many civil society organizations 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. 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.

This brief look at the historical evolution of the good governance agenda highlights a number of critical observations. Governance capabilities are closely connected to the 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.

## **2. Theory supporting the good governance agenda**

The dominant analysis of *good governance as a market-promoting governance strategy* emerged in what we have described as phase 3 of the development strategies attempted by developing countries. Government capabilities for delivering good governance were now argued to be 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 during the first phase of development strategy could be explained (by good governance theories) in terms of attempts by 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.

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 developing economies 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 to 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 strong governance capacities existed, but these were typically very different from the good governance capacities necessary for ensuring efficient markets. In fact, in terms of the market-enhancing *governance 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 heterodox argument is that Asian success can be better understood in terms of a different set of governance capabilities that can be described as *growth-enhancing governance*. Growth-enhancing governance should not be confused with interventionism. Achieving market-enhancing governance also requires intervention. The question is whether the market efficiency *that can be feasibly achieved* in developing countries (through good governance

reforms) is sufficient for achieving development or is an additional set of governance capabilities required?

Good governance reforms aim to promote governance capabilities that are *market-enhancing*: they aim to make markets more efficient by reducing transaction costs. *To the extent that these reforms can be implemented* they are likely to 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 specific governance capabilities to assist developing countries move up the technology ladder. *Growth-enhancing* governance capabilities are capabilities that allow developing countries to cope with the property right instability of early development, manage 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 can take our eye off critical growth-enhancing capabilities important for development in these contexts. Ironically, effective growth-enhancing governance capabilities can create the preconditions for achieving good governance and greater market efficiency over time.

The distinction between market-promoting and growth-promoting governance does not need to be very starkly drawn, and it is not necessary for policy-makers to choose just one or the other. 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 develop-

ing countries. We will then review the evidence to see what we know about growth-enhancing governance and the policy implications that follow.

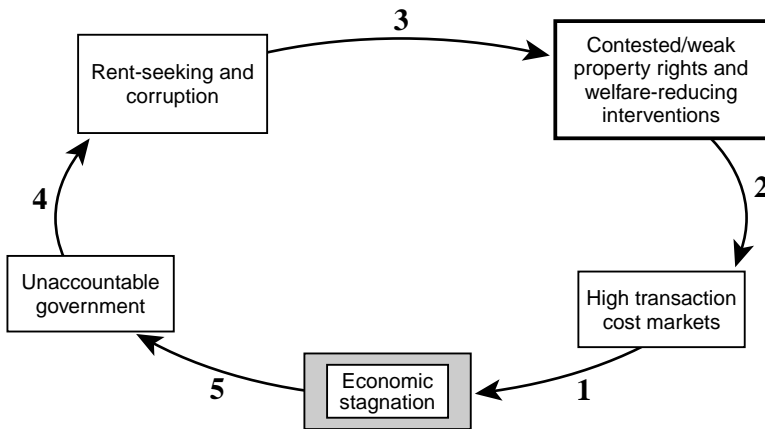
The consensus behind the good governance agenda draws heavily on a large body of theoretical contributions that were part of the New Institutional Economics that emerged in the 1980s. The significant theoretical contribution of this school was to point out that efficient markets actually require elaborate *governance* structures and will not just emerge simply because the government withdraws from the economy. Although the language varies across this literature, there is a broad consensus that the goal of governance should be to enhance these *market-enhancing* governance capabilities of the state (North, 1984; Matthews, 1986; North, 1990, 1995; Clague, et al. 1997; Olson, 1997; Bardhan, 2000; Acemoglu, et al. 2004). The main theoretical links identified in New Institutional Economics that explain economic stagnation are summarized in Figure 5-1.

The fundamental link in all market-focused approaches to development is link 1 in Figure 5-1: 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 5-1 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 5-1 as these links operate in both directions and a reduction of intervention reduces the *incentives* for rent seeking.

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 5-1 were simultaneously addressed, market efficiency would not improve. The logic was that



Figure 5-1: Theoretical Linkages in the Good Governance Analysis



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 engaged in rent seeking and corruption that harmed the majority could be challenged through accountability and democratization. The policy implication was an integrated reform agenda summarized in Figure 5-2.

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 accountability 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 would drive a popular demand for greater accountability.

Table 5-1 shows that all the main policy planks of contemporary governance and economic policy reform strategies are derived from the links shown in

Figure 5-2: Policy Links in the Good Governance Approach

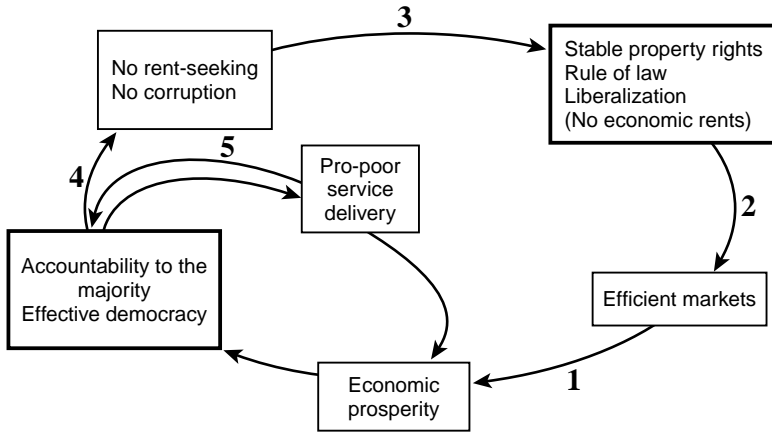


Figure 5-2. The contemporary reforms to improve accountability and pro-poor service delivery (links 4 and 5 in Figure 5-2) are the theoretical basis of reforms shown in column 1 in Table 5-1. Policies to counter corruption and rent seeking that are becoming increasingly important in World Bank strategies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

Table 5-1: Contemporary Governance Priorities and their Links to Theory

Policies to improve accountability of government (arrows 4 and 5 in Figure 5-2)	Policies to counter corruption and rent seeking (arrow 3 in Figure 5-2)	Policies to stabilize property rights across the board (arrow 2 in Figure 5-2)
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.

### 3. 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 growth. If they did, they would be more likely to *converge* 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 & Keefer, 1995; Mauro, 1995; Barro, 1996; Clague, et al., 1997; Knack & Keefer, 1997; Johnson, et al., 1998; Hall & 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 subsequently 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 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 in high growth countries.

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, sustainably 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 (i) *corruption in government*; (ii) *rule of law*; (iii) *bureaucratic quality*; (iv) *repudiation of government contracts*; and (v) *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 for most countries from 1996 onwards 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. We define “diverging developing countries” as the 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 5-2 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 5-3 shows data from the same source for the 1990s. A very similar result is achieved using the six gov-

ernance indices from the Kaufmann-World Bank data set (for a full set of data plots see Khan, 2006b). Figures 5-3 and 5-4 show the same data in graphical form. These tables and plots show some remarkable patterns and demonstrate that market-enhancing governance conditions cannot explain much of the differences in growth rates *between* developing countries. The main empirical features of the available data sets are as follows:

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

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. It suggests that the positive relationship routinely identified in econometric studies depends on different types of specification problems. In many studies, the problem is that the sample includes a large number of *advanced countries* having high scores on market-enhancing governance (shown as diamonds in Figures 5-3 and 5-4) while the bulk of developing countries are low-growth and low scoring on market-enhancing governance (triangles in Figures 5-3 and 5-4). 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 (squares in Figures 5-3 and 5-4). 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 aggre-

gate 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.

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.

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 5-5 summarizes the data plots in Figures 5-3 and 5-4, 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.

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-



**Table 5-2: 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

Note: 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 5-3: 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

Note & Sources: See Table 5-2.

Figure 5-3: Aggregate Property Rights and Growth 1980-90

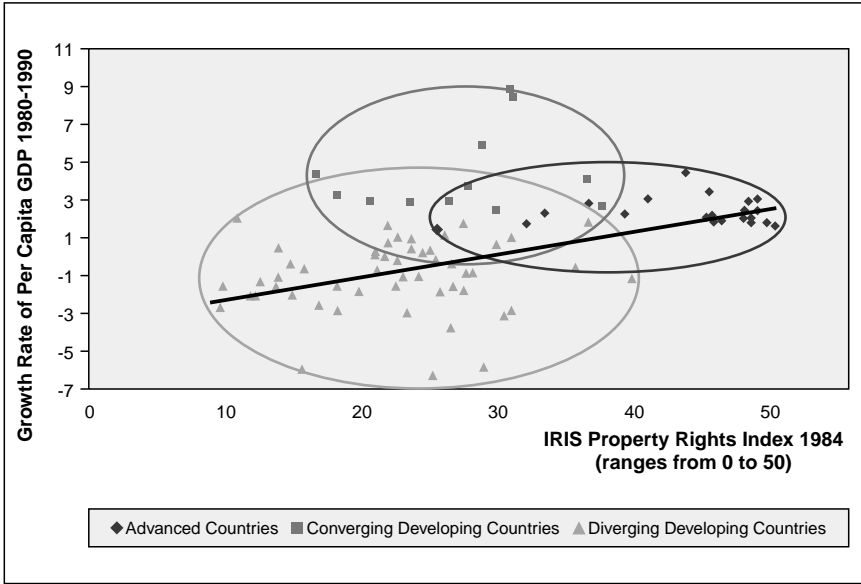
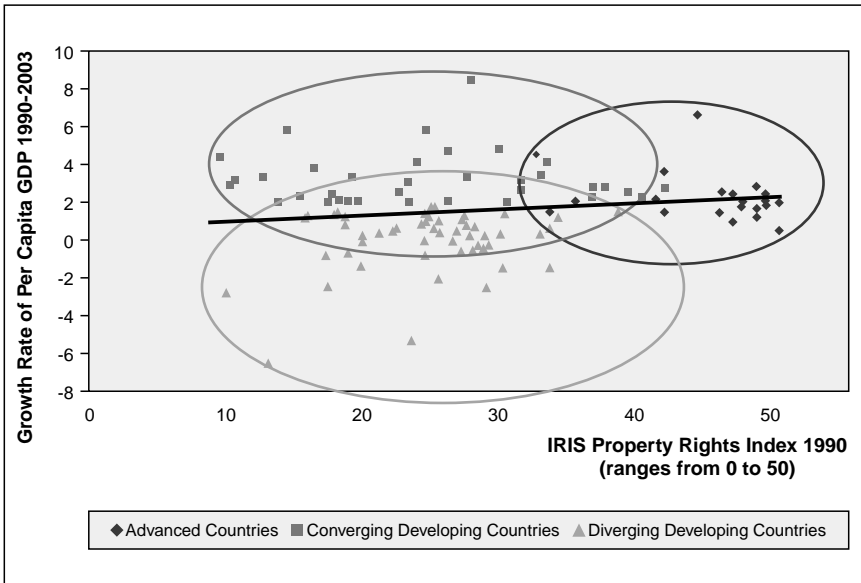


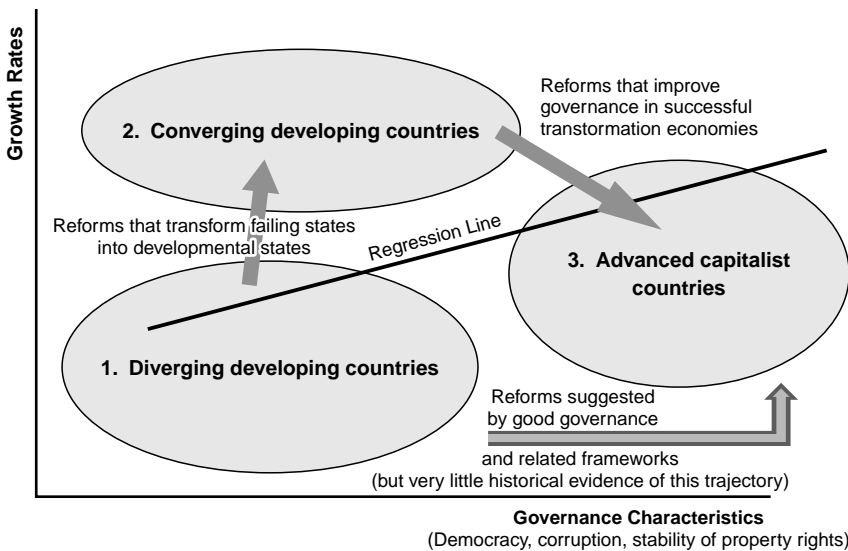
Figure 5-4: Aggregate Property Rights and Growth 1990-2003



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 that are consistent with the case study and other empirical evidence.

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 5-5, but there may be significant growth-enhancing governance differences that we should be looking for.

Figure 5-5: Stylized Relationship Between Governance and Growth



Source: Khan (2004).

## 4. 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. Countries differ widely in the capabilities of their governments to manage these weak property rights in ways that enable the emergence of a productive capitalism.

Secondly, emerging capitalists in developing countries face a structural problem with acquiring the tacit knowledge and learning that is essential for 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.

Thirdly, developing countries suffer from structural political corruption due to the difficulty of managing political stabilization using 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 move beyond patron-client politics. But this ignores the fact that modern political systems require significant fiscal resources if political competition is to focus on how to spend the budget, resources that are just not available in any developing country. As a result,

even the most successful developing countries could not be characterized as Weberian states. Success in economic transformation has rather required governance capabilities in managing patron-client politics in ways that allow political stability sufficient for capitalist accumulation to continue. We now 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 across the board are weakly protected because of the *limited public resources* available for 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, 2006a).

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 some 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 or not Europeans set up settler colonies with stable property rights. Where malaria deaths were high, white settlers did not come but they set up extractive colonies 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 set-*

*tlers 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, sometimes in genocidal proportions. To describe this as the establishment of stable property rights does violence to the historical facts.

It is more accurate to say that where the transformation of property rights to capitalist ones happened very rapidly, capitalist economies emerged earlier than in other cases 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, but we hope with less violence and more justice. Of course once a viable capitalism becomes established, 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 more sophisticated econometrics and proxy variables.

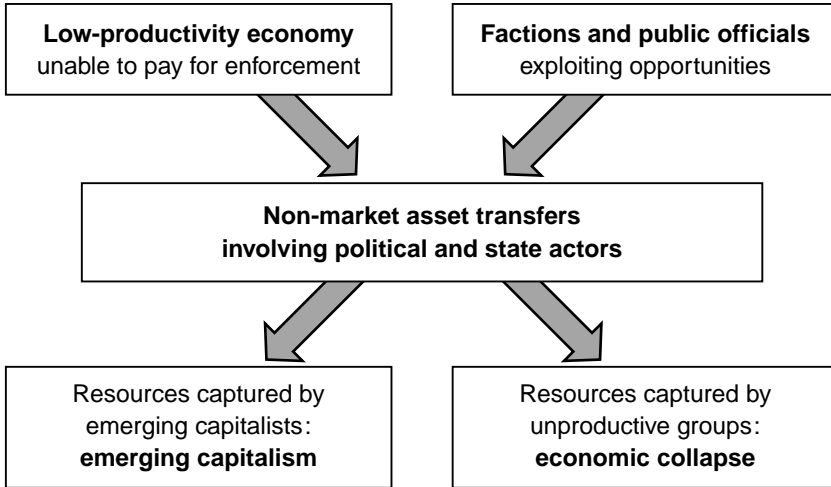
The unlikelihood of establishing stable property rights in developing countries *before* the establishment of a productive capitalism is actually well supported by New Institutional Economics. However, most researchers subscribing to this school have argued that modern economies emerged as a *result* 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 & Wallis, 1987; North, 1990).

An efficient economy has slightly lower transaction costs than others, but not zero transaction costs or anything approaching that. In an efficient market economy 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 productive (by definition) and so owners can pay 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 5-6 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 5-6 summarizes.

Figure 5-6: Drivers of Property Right Instability in Developing Countries



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 even 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 the range of asset transfers where market transaction costs would be too high is even greater because of the many property rights that are contested or otherwise difficult to transact.

Non-market asset transfers of different types can thus 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 governance capabilities that are relevant here are the institutional and political factors that ensure that non-market transfers enable 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 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.

The significant differences between successful countries suggests that there are no general institutional characteristics that all successful countries pos-

sessed 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 generally 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 their 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 due to 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 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. 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 & 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.

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. Productivity *growth* in low productivity sectors is in general slower than in higher productivity sectors. Compare, for instance, 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 by definition 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.

Overcoming the productivity gap is not just a question of setting up infant industries and letting them run, but also of setting up institutional compul-

sions 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.

These observations can help to 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.

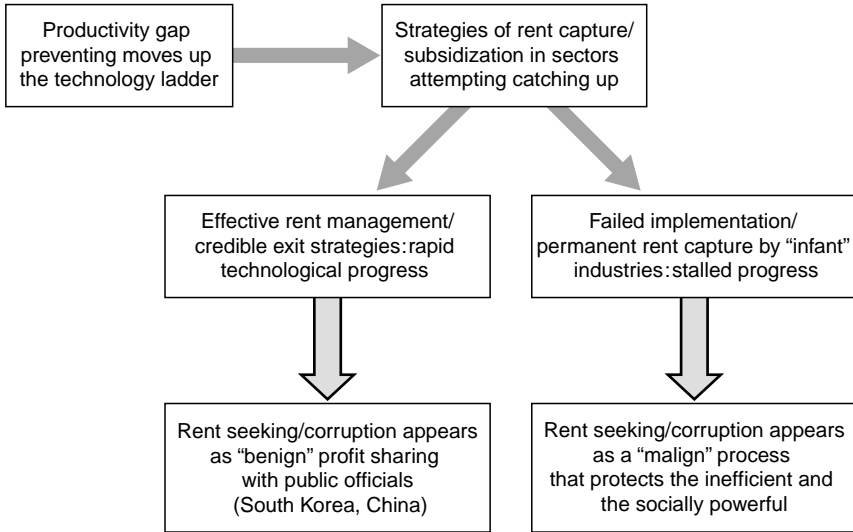
The empirical evidence that is available from relatively successful developing countries suggests that the opportunities and compulsions for learning can be created by very different types of institutions and policies. Opportunities were created using many different mechanisms including tariff protection (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 the learning processes through which productivity is raised in catch-up 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 (compared to other developing countries) 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 there is a need for careful research in these areas.

Figure 5-7 shows that in the context of productivity differentials that cannot be overcome without non-market facilitation, there are strong incentives for emerging entrepreneurs to create these possibilities for themselves through the exercise of political power through the state. As soon as this happens, rent seeking and corruption are likely to emerge. The real difference in governance with respect to the management of learning processes (between successful and less successful countries) has not been the presence of rent seeking and corruption in some cases and its absence in others (both the left and right hand forks in Figure 5-7 are associated with rent seeking and possibly corruption). The real difference is rather that only a few countries had governance capabilities that created opportunities and compulsions for technological progress. 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 that implicitly creates rents to accelerate learning may deliver worse outcomes than a market-led strategy. Badly managed rents can mean permanently poor resource allocation as well as 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. These can often be exploited in new ways if the growth strategy fails. The interactive relation-

Figure 5-7: Governance Capabilities and Catching up through Technical Progress



ship 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.
- 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 in many cases resulted in a shift towards less productive technologies in manufacturing or towards 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 (call centres in India are often manned by university graduates). 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.

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 & Weingast, 1997).

These "subsidized" inputs allow Chinese firms to set up in global production before they have necessarily achieved global competitiveness as determined

by the market. Indeed, Indian manufactures complain bitterly at the way in which Chinese manufacturing can enter markets at below the “true” 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 institutional 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 in the textbook sense has proceeded at a very slow pace. 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. India’s global presence has been exaggerated by the outward investments of a small number of Indian multinational companies, which were more interested in purchasing high technology companies abroad than developing these capacities within India. But on the whole, South Asia has relatively weak 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 part-



nerships with foreign firms. This process has resulted in limited learning in new sectors in India compared to China, and even less in Pakistan and Bangladesh.

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 performed 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 *before* it began its takeoff. 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 5-4 summarizes several historical observations to highlight some of the key characteristics of successful and less successful technology acquisition strategies. The technology acquisition strategies of the sixties and seventies 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 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 for facing international competition. 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 5-5, 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 also include 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 its growth spurt was unsustainable because its growth-enhancing governance capabilities were not adequate for ensuring the successful implementation of its technolo-*

Table 5-4: Technology Acquisition Strategies and Experiences

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

gy acquisition strategy. And today, group 2 countries include several 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. The long term sustainability of these strategies is also open to question.

By integrating into global markets and production chains using already competitive sectors, some liberalizing 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 effectively implement the strategy they are following. This is a critical research and policy question that needs to be examined further.

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 before achieving international competitiveness. It is also

important for policy to identify these processes and examine how policy can assist in deepening these trends.

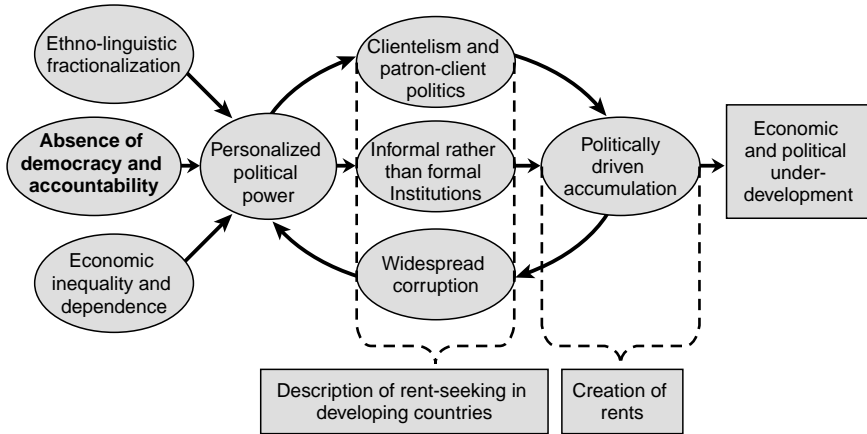
### ***Governance and the management of political stability***

One of the main reasons why developing countries as a group diverge so significantly from good governance conditions is that their political systems do not operate with formal and transparent rules for public officials that ensure their accountability to elected bodies. 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.

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 rules and widespread corruption. The result of these processes was the politically driven accumulation that produced economic and political underdevelopment in developing countries. The main links in this argument are shown in Figure 5-8. 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 & 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 politics. However, there is a growing recognition that in the presence of severe ethno-linguistic

Figure 5-8: The Neo-patrimonial Analysis of the Causes and Effects of Patron-client Politics



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 5-2.

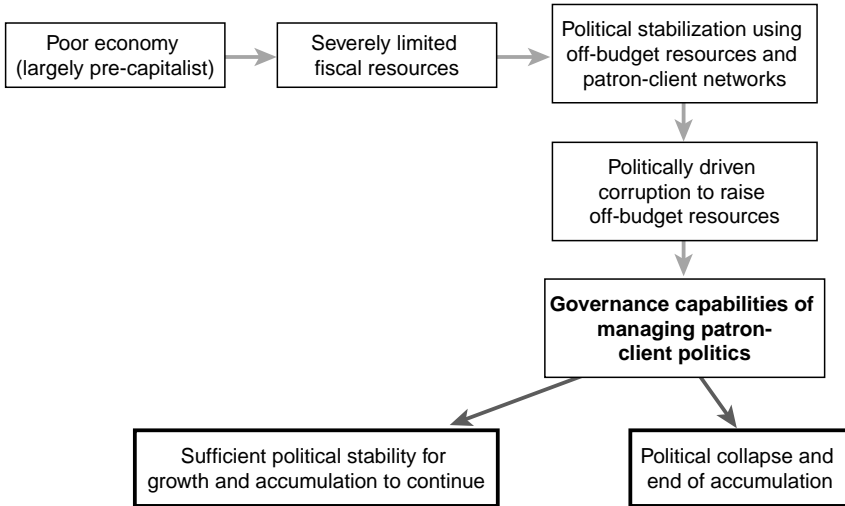
The problem is that no examples exist of such a state of politics in the developing world. Even in India, the world's most attractive model of a working and sustainable democracy in a developing country, we know that the Indian political system is riven with corruption, that patron-client politics rules, and that economic 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; Hariss-White, 2003; Khan, 2005b).

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 5-9. The critical constraint is that all developing countries suffer from limited fiscal resources (even apart from the political failures to collect tax) because 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.

Sustainable growth paths in developing countries have not been associated with Weberian states behaving in impersonal and formal ways because all developing countries suffer from patron-client politics. Rather, sustainable

Figure 5-9: Structural Drivers of Patron-client Politics



high growth strategies have been associated with governance capabilities that allowed the maintenance of political stability *through* patron-client politics (as in contemporary India), while in other countries, political stability could not be maintained and a descent into political fragmentation took 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 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.

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 are part of the political settlement. For instance, in the sixties



attempts at authoritarian limitation of patron-client demands worked in South Korea but failed in Pakistan because the organization of patron-client networks in Pakistan was much stronger and more fragmented, requiring a degree of repression that was ultimately not feasible. In turn, the feasible strategy of political stabilization that was consistent with the political settlement in Pakistan limited the possibility of success of the technology acquisition 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 in fact emerged first in Pakistan in the 1960s. Ironically, it 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 through a change in the dominant political organizations. This change in the political settlement enabled a 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 knowledge of these interdependences will allow us to deepen our analytical and policy understanding of these processes.

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