Can Aid Work in an Environment of Bad Governance?

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Abstract

Poor governance is widely recognized as an important impediment to economic growth in most developing countries. Yet, development partners have not been able to devise an effective strategy to help those countries solve it. In the meantime, traditional aid, which focuses on helping the recipient countries bridge the gaps in physical and human capital and the weaknesses in institutions, has continued on a large scale. This study argues that a different approach is called for. Using the varied experiences of East Asian economies, the study first validates the theory that identifies the character of the political economy system as the main determinant of a country's ability to achieve sustained growth. The study then elaborates that, in an environment of poor governance, the traditional way of justifying the value of individual projects is misguided; no matter how useful the projects may appear, fungibility of aid makes it inadequate to take such a "micro" view. The strategic goal of aid needs to shift from filling the resource gaps to assisting developing countries in overcoming the elite-controlled political economy system and establishing a more inclusive system. The study contends that by understanding the internal dynamics that are driving the country toward the critical transition, and by supporting such tendencies, development partners can deliver much more meaningful aid. Drawing on the author's experiences in Nepal, Ethiopia, and Myanmar, the study illustrates how this approach has been applied in practice.

Keywords: governance, corruption, political economy, inclusive system, aid strategy.

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Acknowledgement

This report is based primarily on my experience at the World Bank (1979 to 2011), in particular working in Nepal and Ethiopia as country director, as well as on my JICA-funded assignments to provide policy advice in Myanmar and Kenya more recently. The author benefited immensely from extensive interactions over four decades with a wide range of people in those countries, both within and without the governments, and with many colleagues at the World Bank, JICA, and other development partner organizations.

1. Introduction

In this report, "aid," as opposed to the broader "development cooperation," is used to emphasize the financial dimension of assistance that development partners provide to developing countries, for this is the area that is often most problematic in an environment of bad governance. "Governance" refers to "the formal and informal arrangements that determine how public decisions are made and how public actions are carried out," as defined by the Organisation for Economic Co-operation and Development (OECD).[1] The OECD further notes that the principal elements of good governance are accountability, transparency, efficiency, effectiveness, responsiveness, and rule of law.

1.1 A "micro" vs. "macro" view of aid in a poor governance situation

Most practitioners of development cooperation come to recognize, sooner or later, that "governance" is the basic problem in most developing countries. Corruption is rampant, politicians are rarely interested in the wellbeing of the nation, and many business people are ready to bribe anyone who can give them favors. The situation often feels hopeless. Yet, the need for assistance to such countries appears obvious. Many people live in abject poverty. Access to good education and healthcare, safe drinking water and sanitation, and other elements of decent life is woefully inadequate. Job opportunities are scarce. Farmers are trapped in subsistence agriculture. As a result, even where more money is unlikely to be addressing the core problem of poor governance, many development partners have tended to rationalize their programs by narrowly focusing on what a specific project is expected to achieve within the confines of that intervention, or taking a "micro view."

It is not difficult to construct a narrative that specific projects are useful regardless of the larger context that is afflicted with poor governance. If one is working on a program to train

[1] See the overview section of the OECD's policy framework for investment. http://www.oecd.org/investment/toolkit/policyareas/publicgovernance/

primary school teachers in better pedagogy, or constructing a new water system to provide safe drinking water in a village, who could question the value of such programs? However, if the whole economy continues to perform badly and fails to give everyone a fair chance and improve the overall quality of life, this justification for development aid seems unsatisfactory. Worse yet, as explained further in section 2, this approach may even be perpetuating the oppressive political status quo.

Therefore, we should not lose a "macro view" of the situation, i.e., what impact a specific project may have on the overall development process of the country. Many development partners have emphasized governance as a priority agenda. They have typically provided technical assistance to improve governance-related legislation, create new institutions (like anti-corruption agencies), and modernize institutional processes and procedures (e.g., introduction of better public financial management (PFM) system).[2] These are important building blocks of good governance. However, where the elite class has captured the political and administrative systems thoroughly, these measures are often adopted merely on paper, so as to keep aid money flowing.

The question of the political economy system is quintessentially a sovereign issue. External parties have little standing or ability to influence the situation. At one level, this seems self-evident. On the other hand, simply relying on "technical solutions" to improve governance has done little. It is similar to taking a "micro view" and continuing with specific projects that "ought to" help the poor. Are there ways for development partners to provide more effective assistance to a country whose problem is governance? This report will suggest a framework in which to think about the issue and how development partners can address it better.

[2] Some development partners have gone a step further; they recognized the importance of strengthening civil society and the media. This gets closer to addressing the real issue, but it does not seem to become the main focus of assistance.

2. Taking a broader view on development and aid

2.1 Argument for the centrality of political economy system in development

In the early days, development aid was based on a simple concept that "under-development" was a result primarily of the shortage of capital (and more advanced technologies embedded in capital goods) and skilled labor. Therefore, aid can contribute to filling these gaps. By the 1970s, it was clear that resource transfers were not improving the economic performance of many developing countries. For instance, the Pearson Commission on International Development noted in its pioneering report (Pearson 1969, 49) that "the correlation between the amounts of aid received in the past decades and the growth performance is very weak." This led to the advent of "structural adjustment programs," ostensibly to help create a sound policy environment for economic development. This too proved to be an unsatisfactory answer. Subsequently, the development community emphasized institutional reforms and capacity building, and more recently even broader systemic issues, namely the nature of the political economy system.

This section will present a theoretical framework that argues that vigorous and sustained economic development requires an "inclusive political economy system." It will also present the "fungibility" argument to underline why aid tends to fail in an environment of poor governance.

2.1.1 "Fungibility" argument

A key caution on the effectiveness of development aid in an environment of poor governance was articulated in *Assessing Aid: What Works, What Doesn't, and Why* (1998), by David Dollar and Lant Pritchett. Based on cross-country analyses as well as analyses of the same countries under different policy regimes, they demonstrate how the impact of aid varies greatly, depending on the quality of the policy environment. Their explanation of the ineffectiveness of aid in a poor governance environment is built around the concept of the "fungibility" of aid. Dollar and Pritchett point out that when a development partner provides $1 in aid for agriculture, the country's government spending on agriculture does not increase by \$1. Empirical analyses showed that it goes up on average by only about 5 cents (Dollar and Prichett 1998, 68-69). This is not because the rest of the money is stolen. It is simply a practical matter of fiscal management. Faced with competing demands from all sectors, any sensible minister of finance would reduce the government's own funding for agriculture and reallocate that money to the priority programs in other sectors. Although the development partner that provided the \$1 in aid to agriculture may have thought it was boosting the spending on agriculture by that amount, in reality it has allowed the government to finance \$1 in additional spending spread across all sectors.

This is the nub of the matter. If the quality of the government spending in general is very poor, then much of the additional \$1 will have little development impact. One might argue that, with strict oversight from the development partner over the \$1 for agriculture, "high-quality spending" will increase by \$1. This is a questionable argument. In this age of democracy, every government seeks to maintain a modicum of legitimacy by providing some public services. Without it, social and political opposition to the government could become dangerous to the regime's survival. If development partners provide valuable public services, it can reduce popular discontent, thereby in effect allowing the ruling regime to continue wasting domestic resources on its more dubious priorities.

2.1.2 "Political economy" argument

More recently, North, Wallis, and Weingast have outlined[3] a conceptual framework to describe how transition from a "limited access order" to an "open access order" has been the key to constructing a thriving economic system. They argue that in the post hunter-gatherer phase of human history (starting approximately 10,000 years ago), violence was controlled by the ruler by creating economic privileges for the elites so as to keep them contented with the existing political order. (See North, Wallis, and Weingast 2009, Chapter 2.2.1.) Naturally, most people were excluded from such benefits. This system allowed the elites to control the social and economic

[3] *Violence and Social Orders* (2009), Douglass C. North, John Joseph Wallis, and Barry R. Weingast.

order. In the last few hundred years, some societies have moved to a more open order in which all citizens had access to the political process as well as economic opportunities. Such open access order has proven to be far more dynamic economically. They explain the logic as follows (North, Wallis, and Weingast 2009, 23):

> *Individuals and organizations pursue rents as vigorously in an open access society as they do in a natural state, but impersonal economic and political competition result in the rapid erosion of rents. Joseph Schumpeter (1942) described this process of innovation and change in the economy as "creative destruction." Innovation itself is a source of rents. An important form of economic competition occurs through the development of new products and services rather than lower prices or higher quality. Organizations form to exploit new opportunities and pursue the rents associated with innovation. Open entry and access to sophisticated economic organizations are prerequisites for creative destruction and a dynamic economy.*

Except for a few oil-rich countries, all high-income countries today are open access order.

In *Why Nations Fail* (2012), Daron Acemoglu and James Robinson have developed this idea further; they explained more clearly why the transition from "extractive institutions" (similar to North's limited access order) to "inclusive institutions" (which is similar to North's open access order concept) is fundamental in determining a country's ability to sustain economic growth. They note (Acemoglu and Robinson 2012, 76):

> *Inclusive economic institutions foster economic activity, productivity growth, and economic prosperity. A businessman who expects his output to be stolen, expropriated, or entirely taxed away will have little incentive to work, let alone any incentive to undertake investments and innovations.*

They further note (——— 2012, 77) that in raising the general income levels, sustained advances in technologies are critical. In this regard,

> *This process of innovation is made possible by economic institutions that encourage private property, uphold contracts, create a level playing field, and encourage and allow the entry of new businesses that can bring new technologies to life.*

Consistent with the works of North, et. al. and Acemoglu and Robinson, this report defines the two contrasting political economy systems as follows:

An "inclusive system" consists of a set of institutions (including social norms) that assures every citizen of the country equitable opportunities to engage in any lawful economic activities and be rewarded fairly for their efforts. That would commonly include institutions to conduct economic policies transparently and effectively, regulate economic activities to check abuse of market power and violation of safety or environmental rules, and prevent acute economic inequality. There would also be legal and judicial systems to protect private properties and enforce contracts, as well as an education system to equip everyone with the abilities to engage productively in economic activities.

A "non-inclusive system," which this report often calls more descriptively an "elite-favoring and rent-centered system," consists of a set of institutions that gives the elite class privileged access to profit-making opportunities, i.e., a license to generate rent. This is typically done by giving elites a monopolistic power in the market or preference in public procurement, allowing them to abuse workers, consumers, and weaker firms, and letting them misuse or even steal public resources outright.

In economics, "rent" generally means an excess return over and above what a market equilibrium would yield. In this report, "rent," as in "rent-seeking," is used more specifically to mean excess profits from preferential arrangements, including illicit deals.

By reducing the elite group's privileged access to economic opportunities and protecting the ability of everyone to benefit from their economic efforts, countries with inclusive institutions encourage innovation and investment, thereby raising productivity, which ultimately determines the level of incomes. By contrast, where the elite group can earn large economic rents by using their monopolistic power or other ways of limiting competition, the entrepreneurial energy tends to be directed toward rent seeking. Naturally, an inclusive system requires an effective state that can enforce appropriate "rules of the game" and provide the public services to equip its citizens with abilities to participate competently in political processes and engage productively in economic activities.

The causal relationship between "governance" and economic development/growth has been long debated. A broad agreement today is that it runs in both directions, but that improvement in certain aspects of governance will likely have a large effect the country's ability to grow rapidly.[4] From that perspective, the argument here is that building an "inclusive political economy system" has a decisive impact on sustained growth.

This broad conceptual framework, which explains why some countries have succeeded in sustaining growth while others have failed to do so, is used in this report to understand the nature of the fundamental development challenges in countries that struggle with governance problems.

2.2 Applying the broader perspective

2.2.1 Evidence from East Asia

Most low-income countries are trapped in a non-inclusive political economy system. It is not easy to tell whether low income levels cause bad governance or bad governance keeps these countries poor. Comparisons of growth performance across several East Asian economies are more instructive in illuminating the central importance of building an inclusive political economy system. Many East Asian governments have pursued broadly similar economic policies, characterized by promotion of market economy and exports, investment in infrastructure and education, and macroeconomic stability.[5] However, the growth outcome has varied vastly. Figure 1 compares the growth in per capita GDP between the Philippines and Thailand. In 1960, Thailand's GDP per capita (measured in 2010 US dollars) was $570, while the Philippines enjoyed nearly twice the level of per capita income, at $1,059. By 2018, however, their positions had completely reversed. Thailand raised its per capita GDP level by 11 times to $6,361, while the Philippines raised it by less than 3 times to $3,022.

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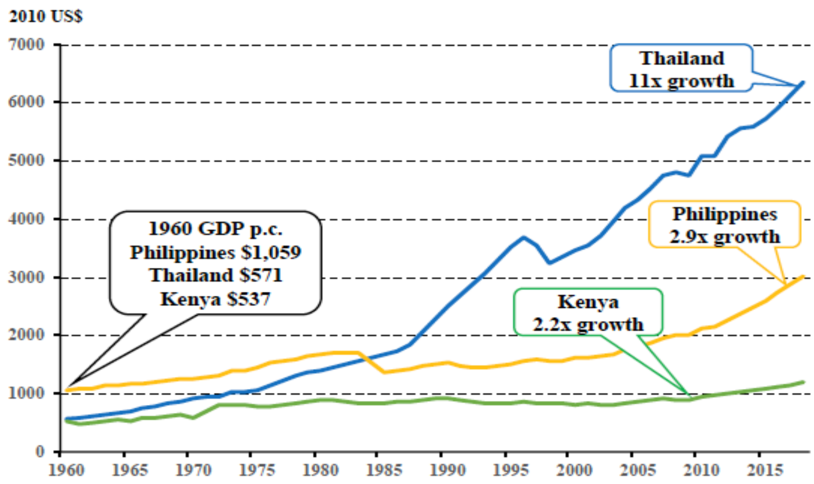
[4] See Rodrick (2008) and Grindle (2005).

[5] The so-called East Asian miracle formula is outlined in The East Asian Miracle: Economic Growth and Public Policy (1993) by the World Bank.

Figure 1: Per capita GDP growth in Thailand, the Philippines, and Kenya
(1960-2018, in constant 2010 US dollars)



Source: The World Bank

The most compelling explanation for the difference lies in the extent to which the economic system favors the elite class. The Philippines is often characterized as a country that has been dominated by 30 or so oligarchic families. Traditionally, they controlled the plantation sector and trade. Today, their strongholds are real estate, finance, and telecommunications. In each of these sectors, they were able to establish oligopolistic dominance domestically and have tended to be sheltered from international competition, thereby finding opportunities for large rents. The manufacturing sector has never become internationally competitive, as it did in many other East Asian countries. Income inequality and poverty remain high. The poverty rate using the $3.20 per day threshold (based on 2011 PPP dollars) was 26% in 2015. (This stands in a sharp contrast to 0.5% in Thailand in the same year, though at a comparable level of income, Thailand's poverty rate was similar nearly 20 years ago.) Perhaps even more damaging to the future of the country, the Philippines struggled to raise its primary enrollment rate above 90% for many years. Only in the last few years, the enrollment rate has risen to about 95%. In Thailand, primary school enrollment was virtually universal by the 1980s.

In 2011, according to an estimation by Cielito Habito, the wealth of the 40 richest families in the Philippines increased by an equivalent of 76% of the GDP increase in that year.[6] It is very much an elite-favoring economy.

The Thai economy too had been dominated by a relatively small number of family-owned business groups. They have tended to specialize in trade and agro-processing type industries (e.g., rice milling, sugar, breweries). Many have relied on monopoly rights to certain products and other means of limiting competition to generate large profits. However, the monarchy, which projects itself as representing the entire nation, has provided a countervailing political weight to the narrow interests of the economic elite class.[7] The state bureaucracy retained a measure of independence from business interests and was able to pursue economic and social policies that benefited the broader interests of the people. Access to basic education and healthcare is virtually universal, though the quality remains a concern. The government also played an instrumental role in promoting industrial development. It was particularly successful in attracting massive foreign direct investment (FDI) from Japanese automakers since the 1980s. The share of manufacturing in GDP rose from 15.9% in 1970 to over 31% by 2010, and created large numbers of jobs with decent pay. This has contributed to a sharp reduction in poverty; "abject poverty" has been largely eliminated.[8] It was a significant step in the direction of a more inclusive economic system.

However, this impressive growth record of Thailand is overshadowed by that of South Korea. In Figure 2, one sees that between 1960 and 2018, per capita GDP of South Korea rose by 28 times (as compared to 11 times for Thailand). South Korea's economy was probably just as elite captured until the 1950s as the Philippines' economy. However, under the Park Chung-Hee regime, all this changed. (See more in section 3.3.3.) Rent seeking as the main business model

[6] Habito presented this finding at the 2013 Philippines Development Forum (March 4-5, 2013). His calculations also showed that the comparable ratio was 33.7% in Thailand and 2.8% in Japan.

[7] Although the Thai monarch's role is ceremonial, the late King Bhumibol Adulyadej, during his 70-year reign (1946-2016), became so deeply revered by the Thai people that he gained considerable moral authority over the government as well as the nation as a whole. His avowed commitment to the betterment of all Thais exerted an important influence on government policies.

[8] According to the World Bank database, the poverty headcount ratio (% of total population) at $1.90 per day (2011 PPP dollars) has been virtually zero since 2011 and the ratio at $3.20 was 0.5% in 2017.

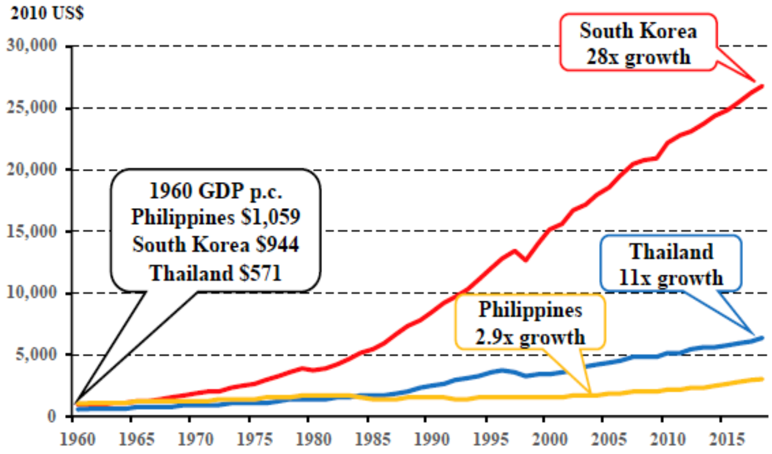
was shut down decisively. The government relentlessly pushed large business groups ("chaebols") to compete, especially in export markets (as the country was in desperate need for foreign exchange to support industrial growth). With its control of the banking sector and allocation of foreign exchange, the government would reward or punish companies depending on their export performance. Although the government's industrialization strategy initially focused on making chaebols compete, since the mid-1970s, small and medium-sized enterprises (SMEs) have grown disproportionately. The economic system was becoming more open to new entrants and more "inclusive." South Korea also implemented land reform after World War II, and created many smallholder farmers. Although government policies were not supportive of the newly-created smallholder farmers through the 1950s,[9] they became much more favorable under the Park government. This helped to create an agrarian foundation for industrialization. Widespread ownership of land immediately absorbed a large portion of underutilized labor in farming. The expanding agricultural production improved South Korea's food security and helped keep food prices stable. The rising income levels of smallholder farmers generated demand for consumer goods that stimulated industrial investment. As industries grew, rural families became the source of industrial workers. As this process continued, labor became scarce in the rural areas, which led some farmers to mechanize.[10] A robust smallholder agriculture sector and a thriving industrial sector created a mutually-reinforcing pattern of growth. In the meantime, education was improved and gave all children a chance at a decent job. Over time, Korean companies went from importing technologies to developing their own, which is evident from the rise of companies like Samsung and Hyundai. This is also confirmed by an exponential increase in the number of patents granted to South Korean nationals (see Annex Table 1). South Korea created an inclusive economic

[9] Most importantly, to cater to the needs of urban households, the government instituted a policy of forcing farmers to sell rice to the government at very low prices.

[10] The effect of land reform in South Korea was more modest than that in Japan. In part, this is probably because most farmers ended up with only about 0.5 ha of land in South Korea, as compared to about 0.75 ha in Japan.

system that was built on competition and innovation. Politically, the regime was not so open but this also began to change in the 1980s.

Figure 2: Per capita GDP growth in South Korea, Thailand, and the Philippines
(1960-2018, in constant 2010 US dollars)



Source: The World Bank

Unlike South Korea which sustained fast growth much longer and joined the ranks of industrialized countries,[11] Thailand is now struggling with the "middle-income trap." Thai companies are failing to move into higher-value manufacturing (such as precision equipment, industrial machinery, pharmaceuticals). Because rent-seeking remains an important aspect of Thai businesses, many Thai companies do not feel compelled to develop their own technologies and move up the industrial ladder. Such investments are expensive and risky. When there are lucrative rent-seeking opportunities available to influential business groups, there is little incentive for innovation. This shows the critical importance of making a full transition from an elite-favoring, rent-centered political economy system to an inclusive one. Part of the reason why Thailand has managed to grow rather successfully is its proximity to fast-growing economies and sources of FDI.

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[11] South Korea joined the OECD by 1996.

The varying development outcomes from East Asia lends strong support to the concept that inclusiveness of the political economy system is the fundamental determinant of sustained economic growth in the long run.

In *Why Nations Fail*, the key causal link between an inclusive political economy system and sustained economic growth is innovation. Acemoglu and Robinson argue that inclusive systems encourage more innovation, hence stronger growth on a sustained basis. When one observes how companies like Samsung and Hyundai in South Korea, or Sony and Honda in Japan, have contributed to economic growth of those countries, this seems intuitively right. However, the Annex offers some quantitative evidence, based on the number of patents, from East Asia to support this critical claim.

2.2.2 China exception?

Many would point out that China seems to contradict this thesis. It is evident that the political economy system is not inclusive. By all accounts, senior Communist Party members enjoy many social and economic advantages. Yet, it has staged perhaps the most spectacular economic growth in human history. It is premature to judge whether China has found a way to sustain rapid economic growth without becoming an inclusive system. The rapid growth of China in the past is in significant part a reflection of "catch-up." China started from a very low income and technology level, as well as an economic system that provided little incentive for hard work. When the people were allowed to benefit more directly from their own economic efforts (like private kitchen gardens in the early days of economic liberalization), it unleashed an enormous amount of productive energy. The country was also able to absorb more advanced technologies simply by copying what was already widely available outside China. All this, combined with the government's strong encouragement for economic growth, generated phenomenal growth.

Now that China has largely exhausted the easy opportunities of "catch-up" growth, it will have to begin developing its own technologies, if it is to continue its march toward the ranks of OECD countries. This is where the innovativeness of an inclusive system becomes critical. In fact, Acemoglu and Robinson (2012) predicted that it will not be possible for China to sustain its drive toward a high-income nation, without a major change in the political economy system. More recently, they have also argued, in *The Narrow Corridor* (Acemoglu and Robinson 2019), that the institutional capability of the Chinese government is much weaker than many people tend to think.[12] This too suggests that China may be heading for a middle-income trap. This is not inevitable, but a view that China's growth momentum is unstoppable is also simplistic. For the moment, the notion that China has found a different way to reach a status of high-income county remains an interesting but not a convincing thesis.

3. Aid in a poor governance environment

The thesis that has been outlined above has important implications for development assistance. At the core, aid should be about helping a country transform itself from a system controlled by "extractive institutions" into a system that is governed by "inclusive institutions." Tinkering at the margins will not go very far. What does this mean for development partners?

3.1 A "hard-nosed" approach

A very hard-nosed approach may be to, in essence, cut off all aid until a country is actually trying to overhaul the political economy system. There are many who believe in such an approach, in no small part because they think development partners are part of the problem; motivated by their own self-interest, they would tend to continue giving aid even in a bad governance environment. Their criticism of development partners is not without merit. However, there are several problems with this idea.

[12] *The Narrow Corridor* argues that a capable but accountable state emerges only if society also becomes stronger with the state. When the balance of power shifts too much in one or the other direction, the country will end up with either a tyrannical or a very weak state (thus the "narrow corridor" of balanced evolution). In their view, because the Chinese Communist Party has not allowed society to become strong, the Chinese state has not grown in its capabilities, either.

First, just to make the correct call on whether a genuine reform is underway, continual engagement is important. For instance, before a sudden political shift began in Myanmar in 2010, unlike most other development partners, the Japan International Cooperation Agency (JICA) had maintained at least its assistance for basic human needs on humanitarian grounds. Its continual engagement put JICA in a much better position to know what was happening in the country. It was well ahead of others in becoming aware that an opportunity to support critical economic reform was emerging and in delivering timely assistance, even while agencies like the World Bank were scrambling just to reestablish in-country presence.

Second, there is something to the notion that aid can play an important role in supporting reformers, even before they succeed. The World Bank's experience in Nepal in the early 2000s is a case in point. In 2001, the Maoist rebels escalated their armed conflict with the government, engaging the army for the first time. This led to a sudden pressure on the fiscal position, as the military spending rose and the tourist revenues declined. The government sought budget support from the World Bank to ease its fiscal problem. About the same time, a group of senior civil servants emerged who recognized the need for social and economic reforms. They saw the developing fiscal crisis as a lever by which to overcome political resistance. This was an important internal dynamic the World Bank felt it should support, though government commitment to reform at the political level remained tenuous. For instance, the Community School Support Project was approved in 2003, specifically to promote transfer of management responsibilities over public primary schools to communities, before it was clear that such a policy would be implemented. In the end, those forward-looking technocrats prevailed and some important reforms were implemented.[13] In recognition of those actions, the World Bank provided the first Poverty

[13] Key policy measures included revamping of the budget system to focus resources on priority development projects, handing over of management responsibilities of public primary schools to communities, placing under external management teams the two ailing public sector banks, setting up an independent Roads Board to improve road maintenance, strengthening the legal power of the independent anti-corruption commission, and more.

Reduction Support Credit (PRSC I) of $70 million to Nepal in 2003.[14] In this instance, continual engagement by the World Bank proved pivotal in facilitating the reforms.

Third, there are international agreements that tend to make development partners unwilling to take hardline positions. A series of joint declarations on aid effectiveness, from the Paris Declaration on Aid Effectiveness (2005) and the Accra Agenda for Action (2008) to the Busan Partnership for Effective Development Co-operation (2011), has emphasized country ownership of the reform process. It recognized that each country has to navigate through its own reality of political economy, and hence outside actors should refrain from passing judgment on whether the recipient country is "doing it right."[15]

Fourth, donor countries do face domestic political dynamics that complicate their situation. It is not easy for most aid agencies to suddenly increase aid, because the aid budget tends to be fixed in the national budget. This tends to push for maintaining some level of aid in all the target countries. In turn, this makes it difficult to take a hardline position on reform. Because of the diplomatic relations between the aid providing countries and aid receiving countries, such a pressure tends to be stronger on bilateral aid agencies. However, multilateral agencies are not free from similar pressures.

More importantly, it is rare that development partners cannot find any group of people in the country whose endeavor to reform the political economy system merits support. As this note argues in the next section, in every country afflicted by poor governance, most people actually want the situation to be different. That desire and the energy it creates for social and political

[14] First Poverty Reduction Support Credit to the Kingdom of Nepal. 2003. World Bank report No. 26556-NEP.

[15] Behind these agreements is a recognition that the structural adjustment programs that were imposed on many developing countries in the 1980s and the 1990s often ignored the severe economic and social impact of policy reforms, especially on the poor. The International Monetary Fund (IMF) and the World Bank spearheaded such programs, but many bilateral donors were also supportive, often providing co-financing for IMF or World Bank loans. This has left a deep sense of distrust of such programs in many developing countries, making them wary of any attempt by development partners to impose their ideas for reform. On their part, development partners too have become reluctant to make strong recommendations on sensitive issues like governance.

change give development partners an opening for truly useful development aid, and a real justification for continuous engagement.

3.2 Situating aid in the historical dynamics of the country

Most of today's low-income countries remain trapped, to varying degrees, in an elite-favoring and rent-centered political economy system. In today's world, however, there is likely to be a more endogenous dynamic that is pushing for transformation. People everywhere have become aware of the existence and possibility of an "inclusive political economy system."[16] In *Development as Freedom* (1999), Amartya Sen argued the desire for "freedom" is innate and realizing it is the ultimate goal of development. It seems evident that in every country, most citizens want freedom, from oppression, deprivation, and insecurity and freedom to pursue opportunities to attain one's full potential. One can expect most people want "inclusive institutions," even if specifics of what they want may vary depending on their situations. This dynamic is the fundamental force that will drive the long-term trajectory of any developing country. If this transition accelerates, it will improve the chance of the country achieving sustained and equitable economic growth sooner. More than anything else, this should be the core agenda for development.

If we accept this "macro" perspective on development, then the goal for aid should be to support the internal dynamic that is pushing for the transition to an inclusive political economy system.

3.3 How do transitions to an inclusive system happen?

[16] North, Wallis, and Weingast (2009) and Acemoglu and Robinson (2012) both suggest that transition to an inclusive system is not inevitable. Acemoglu and Robinson lays out more explicitly how the transition tends to be a result of historical accidents, though once a significant movement starts toward an inclusive system, the process tends to become self-reinforcing. This report takes the view that the process is more endogenous in many countries, though not deterministic.

To deploy aid in support of the transformational process in a particular country, it is essential to understand the specific dynamics that drive it. Nevertheless, it is useful to see how such a transformation has happened in some countries. *Why Nations Fail* presented the Industrial Revolution as a key case study. However, there are more recent examples that may be more relevant to today's developing countries.

Four countries that have achieved the most impressive economic progress in the past 100 years are Japan, Taiwan, South Korea, and Singapore. They managed to transition from an elite-favoring, rent-heavy economies to an inclusive system, and have all achieved a status of high-income country. What follows is a quick synopsis of the transitions these countries went through.

3.3.1 Japan (1945)

Japanese economic modernization goes well back into the middle of the 19th century. Up to WWII, however, the industries were dominated by the family-owned "zaibatsu" groups, which formed close alliances with the military and the military-dominated governments. They benefited from government procurement, the protected markets and exploitative labor practices in the colonies (Taiwan, Korea, and Manchuria). All this came to a crashing halt at the end of WWII.

This was the critical moment of transformation. Under the tutelage of the US occupation administration, the zaibatsu groups were dismantled, and a more transparent and open business environment was put in place. The loss of colonies also meant that to earn precious foreign exchange, Japanese companies had to compete in the export markets in the US and elsewhere. This led to the growth of a range of competitive modern companies, like Sony, Toyota, Panasonic, and many more. These companies did not depend on privileged access to markets or sweetheart deals from the government as key sources of profits. They were focused on producing competitive products. Simultaneously, a major land reform program was implemented, thereby creating a large number of smallholder farmers. Land reform in Japan was perhaps one of the most successful. Even more than in South Korea, it helped to create a mutually reinforcing growth dynamic between agriculture and manufacturing.

3.3.2 Taiwan (1949)

When the Kuomintang was defeated by the Chinese Communists on the mainland and escaped to the island in 1949, the party leadership went through a serious self-reflection process. One of the key conclusions was that allowing corruption to spread in the government was a fatal mistake. They resolved to clean up the government institutions. The Kuomintang also faced a compelling need to build a competitive economy, so that it could afford to maintain a strong enough military to ward off any threat from the Communist forces.

To promote export-oriented industrial investments, the government put in place various fiscal and other incentives. One key measure was limitations on land purchases, to discourage land speculation, which often attracts much money in developing countries. This established an environment in which corruption was contained and competitive companies, small and large, thrived. The government's industrial policy was quite scientific. Taking the concept of comparative advantage seriously, it invited prominent economists of Chinese origin from abroad to advise it on what kinds of industries to promote.[17] Over the years, Taiwan was also conscious of the need to build more advanced industries, and the government provided strong incentives for private companies to move into high-tech industries.[18]

3.3.3 South Korea (1961)

When South Korea was freed from Japanese colonial rule in 1945, the economy was dominated by the landowner class, which also held much of the political power. The business sector was controlled by the same group of people, who generated much of the profits through rent. The economy remained extremely weak, and poverty was severe. Even after the Korean War (1950-53) when the need for serious economic reforms was evident, President Rhee Syngman's

[17] T.C. Liu and S.C. Tsiang, both of Cornell University, were among those who were involved in advising the government of Taiwan on its industrial policy.
[18] For instance, the government established the very successful Hsingchu Science Park in 1980, to promote high-tech industries.

government allowed the old ways of business to continue. The turning point came when Park Chung-hee took power through a military coup in 1961.

He was keenly aware of the need to revamp the whole economic system. An astute observer of the Japanese industrialization strategy, he refined it in a critical way. On the basic approach of infant industry protection, he overlaid ambitious export targets as a performance measure. He famously chaired monthly meetings with the heads of main "chaebols" to review their progress. The exacting performance standards led many chaebols to fail and disappear, but those that met them were given strong government support (especially in terms of credit and foreign exchange), and turned into the likes of Samsung and Hyundai. These companies, in turn, created a highly meritocratic employment system, a hallmark of an inclusive economic system which gives fair opportunities to everyone.

3.3.4 Singapore (1965)

When Singapore separated from Malaysia in 1965, its economic and fiscal foundations were so weak that many wondered whether it could survive as an independent nation. Armed forces were practically nonexistent, and the government feared a possible take-over by communist sympathizers, with support from their allies in Indonesia. Under these circumstances, Prime Minister Lee Kwang Yew knew that he must build a strong economy rapidly, to generate enough jobs for the working-age population and quell social discontent, and to equip the state with basic capacity to defend the country and support economic growth.

Lacking in any natural resources to exploit, he believed that Singapore needed to become an "oasis" of good governance (in a region that was known for a corrupt investment environment) where investors, especially multinational firms, felt comfortable investing. From day one, he adopted a "zero tolerance" policy on corruption, creating an anti-corruption agency directly under the prime minister's office. The main investment promotion agency (Economic Development Board) was also placed under his direct oversight. The single-minded effort, in essence, to create an inclusive economic system paid off, with spectacular growth in investment and income.

In all these countries, corruption did not disappear entirely. Still, the main focus of the business community shifted from rent seeking to value creation, a key trait of the inclusive political economy system. In these cases, foreign aid as such did not play a key role in causing the transformation itself. The transformation was largely internally driven (though in the case of Japan, the basic driver was the US-led occupation administration). Nevertheless, aid was well aligned with what each of these countries was doing to build an inclusive system.

3.3.5 The role of national crisis and autocratic government

What is common across the four episodes is the role of national crisis. Once established, an elite-favoring and rent-centered political economy system is quite durable.[19] Since the elite group has both the incentive to maintain the status quo and the political and economic influence to do so, the general public is hard pressed to upend the control by the elite. When there is a crisis that forces the national leadership class to rethink the basic structure of political economy, a real change seems to become possible. Furthermore, all these transitions happened under autocratic political regimes. It is clearly easier for such regimes to stifle resistance from vested interests.

What has transpired in Rwanda after the genocide (1994) seems to offer another example. Under President Kagame, the country has been building a transparent business environment. In fact, Rwanda explicitly views Singapore as its economic model. It is still a work in progress, but it does seem that a new business culture is taking hold. Again, it took a catastrophic crisis to bring about a reorientation of the country.

Elite-captured as they may be, many developing countries operate in electoral democracies of one kind or another. People would often ask whether any democratic country has made such a transition, especially without falling into an existential crisis of the kind all these countries faced. And, can aid play any useful role?

[19] North, Wallis, and Weingast (2009, 2) argue that the first social order to be established in history is an elite-centered structure ("limited-access order"). For that reason, they also refer to it as the "natural state." It is only in the last two hundred years or so that some countries started to transition into the open-access order.

3.3.6 Break in history

There is an instructive example in Myanmar. Myanmar had been under military rule since 1962. In international isolation, much of the economy was dominated by "crony capitalists" who formed strong alliances with the Army. In return for huge payments they made to the Army leadership group, these businesses were given the rights to exploit mineral resources (especially gem stones) and teak forests and the licenses to deal in highly-valued goods (e.g., imported used cars). This was a quintessentially rent-centered economy. When the reclusive military regime launched a process of political and economic opening in 2010, most were caught off-guard. It appears that the military leadership at the time had quietly concluded that its strategy of isolation and repression had put the country on a dead-end path. It handed over the responsibility to implement limited democratization and economic liberalization to the Thein Sein Administration. His administration started to move with rapidity that surprised everyone. People began to feel the old rules had been jettisoned. There was a "break in history." In this environment, the government had the opportunity to rewrite the economic rule book and put in place a set of key institutions to support an inclusive economic system. As I describe further in Section 4.1.3 below, the Thein Sein government did move the country significantly in the direction of an inclusive system. Unfortunately, the military coup d'état of February 2021 shows that the current military leadership group did not appreciate the rare opportunity for systemic transformation that Myanmar had in its grasp. Nonetheless, the events of the last decade do illustrate how a break in history can play a catalytic role in moving a country toward an inclusive system.[20]

4. Putting the new perspective into practice

4.1 Identifying opportunities for supporting the internal dynamics for transformation—three country examples

[20] Such a moment can be thought of as a "critical juncture" in the language of *Why Nations Fail* (2012).

Even if the common people's desire for a more inclusive (or fundamentally more democratic) system is universal, how such energy manifests itself in the historical evolution of a country varies. Development partners need to understand the nature of the change dynamic in any specific country and identify the right entry points to help the internal process. It is not an easy undertaking. However, seeing how such analyses have been done in a few cases may offer useful hints on how to begin the process. The three country examples below are based on my own experiences, and illustrate a range of approaches that may emerge from such an exercise.

4.1.1 Nepal

A multi-party democracy was restored in 1990 through the "People's Movement" (Jana Andolan). For a time, the democratically-elected government pursued important economic reform programs and showed an interest in the wellbeing of the general public. Soon, politics became corrupted and political power seemed to be sought mostly as a source of private gains. The old caste-based social structure proved resilient and the lower social groups continued to suffer from limited access to educational, economic, social, and political opportunities, much as they had under the previous "Panchayat" regime (a 'partyless' political system under monarchical rule). It was in such a context that I served as the World Bank's Country Director for Nepal, based in Kathmandu from 2001 to 2007.

In late 2001, the Maoist rebels escalated their armed conflict with the government, engaging the army for the first time. As described in section 3.1 above, this led to a fiscal crisis, which in turn gave a group of reform-minded senior civil servants an opportunity to push through important economic and social reform measures. While supporting them wholeheartedly, the World Bank team also knew that this could well be a short-term situation, created by a coincidence of a fiscal situation and a fortuitous presence of several competent and reform-minded civil servants in influential positions. Nevertheless, there was no organic connection through which the popular will gave the reformers political power. They had to capitalize on tactical openings to push forward reforms.[21] By 2005, it was becoming difficult to sustain the momentum of reform.

The end of the civil war in 2006 was an “open moment”[22] created by a national crisis and break in history. People were ready even to countenance abolition of monarchy. However, the ruling class of Nepal failed to seize that moment. The Maoists came into the political mainstream, in a peace agreement with the “democratic parties.” The history since then abundantly shows that most of the Maoist leaders were no different from the other politicians. What started as a cause for social and political reform ended up being a captive of the old values and norms. It was not the real driver of the long-term transformation that Nepal desperately needed.[23]

Even before these political developments, the World Bank team focused on communities as the source of the real impetus for social transformation. Because of its geography which isolates many small communities, especially in the hills and mountains, and a harsh climate which exposed even wealthier families to periodic economic difficulties, community bonds tended to be strong. As a matter of fact, since the 1970s or so, some of the most successful development programs in Nepal were community-based. Perhaps the most spectacular case of success is community management of forests. In the 1970s, there was a concern that Nepal was becoming denuded of forest cover. By allowing communities to manage forest resources, Nepal has reversed this trend. Forest cover has increased from 36% in 1984 to 45% by 2015.[24] The World Bank’s own experiences with “community-driven development” (CDD) projects has been encouraging.

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[21] For instance, the initiative to hand over the oversight responsibility over public primary schools to the parents (through elected school management committees) was vehemently opposed by the teachers’ unions and mid-level bureaucrats in the Ministry of Education (MOE) as well as many politicians. Many teachers were actually party activists who were given their positions because they mobilized votes. MOE bureaucrats had the power to transfer teachers to popular locations in return for bribes. Politicians counted on teachers’ abilities to mobilize votes and protected them in return.

[22] This was the terminology Ashraf Ghani (then with the Institute for State Effectiveness, later President of Afghanistan) used to describe the situation, while he visited Nepal in 2006 to advise the government and development partners on how to capitalize on the situation.

[23] See Upadhya 2020 for an insightful account of the political evolution since 1990.

[24] Chapagain and Aase (2020) report that, based on various surveys from different years, the forest cover is estimated to have been 45.5% in 1963/64, 35.9% in 1984, and 44.74% in 2015.

They seem to empower common citizens, and deliver public services far more effectively than government-run projects.

There was a concern that CDD did not address the real issue, i.e., the dysfunction of government institutions. By bypassing the government, CDD programs could perpetuate the weaknesses of the state apparatus. In the context of Nepal, however, the World Bank team believed that CDD approaches to deliver meaningful development results and the need to build up the capacity of government institutions were not contradictory.[25]

Guided by this strategy, the World Bank focused much of its financial support on CDD projects, in water, rural electrification, rural roads, the Poverty Alleviation Fund, and even education. As noted in section 3.1 (footnote 13), one of the key reform measures supported by PRSC I was the transfer of school management responsibilities from the Ministry of Education to communities. The reformers in the government (and the World Bank team) felt this was a particularly important reform, in part because they believed that once the reform happened, communities would fight to keep their oversight power and make the advance irreversible. Indeed, communities quickly became staunch supporters of the new approach and the reform has not been reversed since it was launched in 2002, in a testament to the strength of communities.

There were two additional elements in the World Bank's strategy that complemented the main focus on communities. The first was to support young journalists with training opportunities and research funds. Although the nature of politics failed to become liberal under the multi-party

[25] A CDD project actually operates like a micro-size local government. In a typical CDD project, some beneficiary group is formed, with elected leaders. The members agree on a shared project that delivers some local service (such as water supply or rural roads). The government or a development partner provides a grant to finance part of the project cost, but the community members also contribute to the project, often in the form of labor. Conceptually, this is very similar to what a local government does, albeit on a limited scale. A local government typically receives some funding from the national government, but also raises local taxes. The only difference is whereas people often do not have much faith in the local government in Nepal, they tend to trust CDD projects (and willingly "pay tax" in the form of community contributions). They feel that the leaders of the CDD projects are accountable to the members. The World Bank team came to believe that when Nepali citizens experience successful CDD projects, they will develop an instinctive understanding on what a well-functioning local government should look like. In that sense, CDD projects were laying the foundation for strong local government. Since there was little prospect of new local government elections being held in the near term (because of the insecurity situation), it was a perfect time to be supporting CDD projects in Nepal.

democracy since 1990, media freedom did expand impressively. High-quality reporting by those young journalists raised public awareness of the problems of the financial sector and education in particular and helped build public pressure for reform.[26]

The second complementary element was to identify and support "institutions that worked." In a context in which most institutions operated without much transparency or accountability, the World Bank team felt it would be important to help Nepal establish visible examples of institutions that operated with proper governance. Demonstrating that such institutions can be built in Nepal would help convince people that they should expect the same from all institutions. With that idea in mind, the World Bank supported, for instance, Kathmandu University, which had established a reputation as a transparent and merit-based institution.[27] However, since the World Bank must work with the government to allocate its funds, it was not easy to expand this initiative. Besides, organizations that are truly excellent and can protect themselves from the elite influences are quite rare in Nepal. Nevertheless, this remains a relevant strategy in Nepal.[28]

In Nepal, the critical transition to an inclusive political economy system has been a slow process. In several moments of national crisis, including most recently when the country was hit by a major earthquake in 2015, the elite class utterly failed to respond to the popular hope for a drastic reform. It is clear that the transformation will have to be bottom-up. The increasing social and political awareness and the energies at the community level will play a decisive role in creating a tipping point eventually.[29] Development partners should consciously support community-led development efforts and programs that empower communities further. If

[26] These journalists formed the Society of Economic Journalist of Nepal (SEJON), which has become one of the most respected professional bodies with significant influence.

[27] Kathmandu University was established in 1991 in the city of Dhulikhel as a "community-owned" university, a collaborative venture between a visionary mayor of Dhulikhel and a group of academic leaders who were dissatisfied with the poor quality of the government university system.

[28] A recent initiative to establish Madan Bhandari University of Science and Technology, as a government-funded but completely independent institution, aims to create a strong academic institution, focusing on applied research to support Nepal's economic development. It is another idea that deserves development partners' attention and support.

[29] In his book "Cabals and Cartels" (2020), Rajib Upadhya notes that communities in Nepal have even become rare examples of reversing "the tragedy of the commons." He too believes that transformative shift in Nepal will be led by resilience of its communities.

development partners can also help Nepal continue to strengthen the professionalism of the media and build up a few institutions that can serve as the models for well-managed public institutions, that can contribute to bringing forward the time for real change.

4.1.2 Ethiopia

Ethiopia emerged from a long civil war in 1991, when the Ethiopian People's Revolutionary Democratic Front (EPRDF) defeated the ruling military-communist regime ('Derg'). Since then, under the leadership of Prime Minister Meles Zenawi, EPRDF tried to accelerate social and economic development of Ethiopia through a highly centralized approach. PM Meles believed that basic social services needed to be upgraded massively and swiftly. He also fervently advocated the idea of 'developmental state.'[30] He argued that the private sector in Ethiopia was "immature;" left to their own devices, Ethiopian business people would not be investing in the industries that are strategically important for the country in the long term. The state had to "guide" the investment efforts.

This approach achieved significant success in improving the access to basic services, upgrading basic infrastructure, and expanding some business activities. As a matter of priority, EPRDF had poured large amounts of resources into the rural areas, and by most objective measures, life was much better by 2005, especially in the rural areas, than in the 1980s (when Ethiopia had suffered the "Great Famine" in 1984-85). This apparently gave EPRDF confidence that it would win the 2005 national election easily, and in part to improve the international image of the country, it allowed open electoral campaigns. In the event, the opposition proved far more successful. Although the election results were much disputed, EPRDF declared its victory. This led to widespread protests by the opposition supporters, and the ruling regime responded with a violent suppression of the protests. Thereafter, EPRDF took a harsh attitude toward any group

[30] He presents his views in *African Development: Dead Ends and New Beginnings*, an unfinished and undated draft of what was understood to be his dissertation in progress. It started to circulate in public around 2006.

unsympathetic to the government. By the 2010 national election, it achieved a virtual dictatorship, with the opposition winning just two out of the 536 parliamentary seats.

It was in the aftermath of the 2005 political incident that I served as the Country Director of the World Bank in Ethiopia, from 2007 to 2011. While recognizing the massive efforts EPRDF had made to improve rural livelihood and create the infrastructural foundation for industrialization, the World Bank team nonetheless believed that the highly top-down and command-and-control tendency of the development approach was a serious source of risk in the long run, in terms of both political stability and effectiveness of development efforts. Certain policies were implemented at a blinding speed (e.g., distribution of insecticide-infused bed-nets was done so fast that the main manufacturer could hardly keep up with the demand). However, the system did not allow for bottom-up feedback of concerns or new ideas. Thus, when the government policies were misguided, no one dared to voice a concern. Negative feedback was met with hostility or even suspicion of disloyalty. It was not just the tendency of the EPRDF government. It had deep cultural and social roots,[31] which made it more intractable and problematic.

A stunning illustration of this problem emerged in 2010 when the United States Agency for International Development (USAID), the Ministry of Education, and RIT International jointly conducted an Early Grade Reading Test (EGRA).[32] It tested about 13,000 students at the end of grades 2 and 3, in 338 public primary schools. The results of the Connected Text Reading Fluency Test shocked the government. In this test, each child was given an age-appropriate text of around 60 words, which is about what they were expected to be able to read in 1 minute. About 85% of these children were studying in their mother tongue, and the text given was in it. Thus, for the most part, understanding the language itself was not a problem. After grade 2, the percentage of students who were reading at or above standard was 10% or far less, except in Addis Ababa where it was 14.5%. At the other end of the spectrum, the percentage of children who could not read a

[31] *Wax and Gold* (1965), a seminal anthropological work by Donald N. Levine, offers an insightful account of this.
[32] USAID/Ethiopia 2010.

single word correctly in 1 minute was about 34% nationwide. This figure does decline after grade 3, but it was still 20%.[33] One cannot learn much in school without being able to read.

The researchers identified many factors that correlate with the reading results, including availability of textbooks, literacy of parents, and more. But, one observation by a key researcher seemed most insightful. In the old days, when only small numbers of children went to school, most of them came from literate families and they had typically attended some form of pre-primary class where they were taught basic reading skills. Starting in grade 1, the textbooks and teaching methods were geared toward such children, and focused on the content. Times have changed. The net primary enrolment rate has gone up from around 25% in 1990 to over 80% by 2010. Yet the textbooks and pedagogy had not adapted to the different demographics of the pupils. Those children who are new to reading were not being taught the skills to decode written language.

Some teachers must have recognized there was a serious disconnect. Yet, the system did not allow that feedback to reach policymakers. As a result, despite the enormous amounts of financial and human resources that have been invested in primary education since the 1990s, a large percentage of children had received little benefit. This had gone on for 20 years.

The 2010 Country Assistance Strategy (CAS) of the World Bank emphasized the importance of continuing its support for the government's effort to improve basic services that are delivered at the local government levels. The World Bank team felt that citizen engagement in local government affairs was also building their capabilities to be effective participants in democratic processes. However, the CAS also pointed out the deep-rooted top-down tendency as a major concern.[34] Internally, the World Bank team agreed that it should play an active role in helping Ethiopia overcome this rigidity in the social system. The team identified two areas of action, though any likely impact would not be felt immediately. One was for the World Bank to

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[33] A significant part of the decline may be due to the dropping out of those children who could not read at all after grade 2.
[34] Country Assistance Strategy for the Federal Democratic Republic of Ethiopia (2008), para. iv and para. 40.

provide analysis of the economic policy issues in such a way that it is understandable to a large segment of the citizens. Ethiopians were often without adequate information to engage in meaningful discussions about government policies. The other was for the World Bank to "model" a different behavior and demonstrate that someone could disagree with the government without being oppositional to it politically. Indeed, it wanted to demonstrate that constructive criticism is an essential element of public policy discourse. Based on this thinking, I as Country Director published a number of opinion pieces in local newspapers, sometimes agreeing with and other times critiquing government policies.[35] Other donor agencies welcomed this approach; the United Kingdom (UK)'s Department for International Development (DFID), for instance, launched its own IDEAS public lecture series to expose Ethiopians to different ways of thinking about public policy issues.[36]

It is hard to know what impact these efforts have had. However, soon after Abiy Ahmed became Prime Minister in 2018, a good 7 years or so after I had published my last op-ed, which pointed out the need for Ethiopia to create a more open society in which upward feedback is welcomed, several Ethiopian acquaintances stopped me while I was visiting Nairobi. They told me with some excitement that they remembered what I had written and that under the new prime minister, they believed that such a change was finally happening in their country. It seems that the World Bank's message resonated with some Ethiopians. Sadly, the civil war that broke out in the Tigray region in late 2020 and spread elsewhere since seems to indicate that the possible move toward a more open social and political environment under Prime Minister Abiy Ahmed may be another false start.

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[35] The last of the author's opinion pieces in Ethiopia dealt with this very issue, based on the EGRA results noted above. See Ohashi 2011.

[36] In the first lecture at Addis Ababa University in March 2010, Augustine ("Gus") O'Donnell, Cabinet Secretary and Head of Public Service at the time, spoke about the importance of professional independence of the UK Civil Service.

4.1.3 Myanmar

In 2010, the military government of Myanmar surprised the world by suddenly initiating political and economic liberalization. The senior leaders of the military had concluded that the long-standing isolationist approach and domestic political suppression were no longer viable. Following the election in 2010, the military installed a new administration headed by President Thein Sein (though the National League for Democracy, led by Aung San Suu Kyi, claimed it had won). His government was given unexpected latitude in implementing economic liberalization measures.

Under the military regime, much of the non-agricultural economy was operated by very small firms. The only large private firms were "crony capitalists" who were for the most part "rent seekers." In part because international economic sanctions limited opportunities for legitimate business, they colluded with the military leadership to conduct business. They would provide both public and private goods to the military government in return for mineral extraction rights or monopoly rights of one kind or another. For instance, a significant portion of the construction of the new capital Naypyidaw was done by large business groups at their own expense, and these groups, in turn, were given opportunities to extract large rents elsewhere. It is widely believed that senior generals also received large gifts personally. It is no wonder that Myanmar's economy was not growing much.

When the ruling military elites decided to bring about far-reaching reforms quite suddenly, it created a "break in history," as described in Section 3.3.6. People accepted and anticipated that things were going to be different. Even crony capitalists did not seem to be prepared to resist the change. If anything, some "progressive" groups actually welcomed the reform, as they wanted to build more legitimate businesses for their long-term survival.

It was in this context that I worked with JICA in Myanmar from 2012 to 2017. Initially, my work focused on advising JICA on its assistance strategy in Myanmar in a new environment, but later it shifted toward helping the Ministry of National Planning and Economic Development with management of development aid and relationships with development partners.

I came to believe that what defined the historical context of development in Myanmar was the break in history it had created for itself. Many donors, especially European donors and the US, tended to see it more as an opportunity to advance democracy. In particular, they considered a constitutional amendment to make Aung San Suu Kyi eligible for the presidency a key test of democratization.[37] On several occasions, I expressed my view to such development partners that they were overlooking the importance of the moment as a chance to shut down the rent-centered economic system. If Myanmar failed to revamp the economic system during this critical period to establish an "inclusive system," a rent-based business culture would return quickly, and it would become nearly impossible to reform it for decades to come. If Myanmar succeeded in making the critical transition to an inclusive economic system, on the other hand, it would not only put the country on a path of sustained economic growth, but also strengthen the economic and social foundation for democracy.[38]

Specifically, I advocated for establishing a new set of business rules and norms as quickly as possible. This would include transparency in corporate accounting, reporting, and taxation, transparency and fairness in public procurement and granting of the rights to exploit natural resources, protection of intellectual property rights, fair labor practices, compliance with environmental regulations, and so on. To promote economic equity and a sense of shared interest in the future of the country, I also advocated for strengthening social protection programs (including pension schemes) and inheritance and/or wealth taxes.

The Thein Sein government did introduce a range of new legislation to create a legal and regulatory environment that was more compatible with international practice. The real challenge,

[37] Under Myanmar's constitution, any Myanmar citizen who has a parent, spouse, or child with a foreign citizenship is ineligible to be President. It is widely believed that the provision targeted Aung San Suu Kyi.
[38] The head of a major European aid agency in Myanmar privately agreed with my view, but he noted that domestic politics made it impossible to advocate such a position.

however, was to overhaul the business culture. In this regard, the Directorate of Investment and Company Administration (DICA) emerged as a spearhead of the reform efforts. It was headed by a former Army officer with a reputation for integrity and professional competence; it was supported by experienced JICA advisors. DICA quickly established credibility among foreign investors as a transparent, clean, and professional office to facilitate investments in Myanmar. It was clearly a beginning of a sea change that the country needed to modernize the business culture.

Unfortunately, the political developments since then have slowed the initial momentum of reform, and the recent military take-over has all but dashed the hope that Myanmar may be moving steadily toward an inclusive political economy system.

The three country cases are presented to illustrate how a development partner might describe the country situation in a long-term context and identify possible ways to align its assistance program with the internal forces that are moving the country toward an inclusive system. In Nepal and Ethiopia, the strategy was focused on the long-term and gradual shift in the country. By contrast, in Myanmar, the focus was on helping the government recognize the historic opportunity and seize it with alacrity. The jury is out on whether the approach in each case was right. Nevertheless, more recent developments in each country seem to indicate that the strategies were not misguided. In Nepal, it is even more evident today that the impetus for the transformation will have to come from the community level. In Myanmar, despite the recent reversals, the "window of opportunity" for far-reaching reform in the last decade did help the country lay a stronger foundation of an inclusive economic system. One hopes that when the broader environment becomes conducive to progress, Myanmar will be better positioned to take up its movement toward an inclusive system. And, in Ethiopia, I found that the message on the importance of overcoming the legacy of strong top-down tendency had been resonating with Ethiopians, if only at the subterranean level at the time.

5. Conclusions

"Poor governance" is a pervasive problem in most developing countries. It is usually what keeps countries trapped in poverty. It reflects the elite-favoring political economy system that is deeply entrenched. There are no obvious or easy solutions to this problem. Yet, historical evidence is clear that countries will not achieve a high-income status without addressing it, unless it happens to be a small country with an enormous reserve of oil or other natural resources. Development partners have recognized the governance problem but their efforts to help improve governance have largely focused on "technical solutions," such as PFM reforms or transparency measures, and at best small-scale support for civil society or the media. In the meantime, "traditional aid" has continued on a large scale in most countries. Arguably this has facilitated the elite-captured governments to keep wasting resources for the benefit of the rich and even entrench further the elite-favoring system.

This is not a satisfactory state of affairs. Aid practitioners have learned enough about the problem by now. The time has come to rethink the old approach. This note has argued that there is a better way.

It starts with the notion that in most developing countries, there are social and economic forces that are pushing the country toward a transformation from an elite-favoring system to an inclusive system. It reflects the innate desire of the people to be "free." It is a strong force, not just a vague hope for some change, because people in developing countries today can see other people enjoying the freedoms they lack. By better understanding the internally-generated impetus for change in each county, development partners can design a cooperation strategy that places a central focus on supporting such internal dynamics and make profound contribution to the wellbeing of its people.

The note does not argue that "traditional aid" should stop. What development partners have done all along, such as investments in infrastructure, agriculture, education, and healthcare, is necessary to make an inclusive economy function well. It is important, however, to recognize that unless the overall political economy system is transformed, such investments alone will not make a fundamental difference. Therefore, aid programs need to be anchored by an overarching strategy to help the county move toward that transition. More “traditional interventions” can also be modified to support the transformational process in different ways. For instance, a project to expand the power generation and distribution system can include a component to expand connections to the poorer segments of the society, with a life-line tariff schedule (i.e., some basic amounts are provided at a subsidized rate that is widely affordable). One may anticipate that it will likely promote a broadly-shared expectation that the government should provide social programs to assure a minimum level of equity and protection of the most vulnerable. Such a shift in social norms is an important underpinning of an inclusive political economy system. Another example may be an industrial promotion project that includes establishment of an industrial park that caters to SMEs that struggle in an environment where the playing field is tilted in favor of big firms with political connections. By giving a small initial boost to expand the production to a point of achieving some scale economy and price competitiveness, it could advance the inclusiveness of the economic system. When all the aid-funded projects and programs are oriented in a consistent direction, their collective impact can be significant.

It is no longer satisfactory to say that the issue of governance is a domestic political matter, and hence, development partners should refrain from playing an active role in addressing it. This is the core issue of development; if development partners are unwilling to address it squarely, what is their role? In the past, development partners have tried to lend a helping hand to the people of developing countries by offering tools to make their economies more productive, such as better infrastructure, technical know-how, and education. It has worked in a handful of countries, the ones that were finding their way to an inclusive system. However, in many other countries, it has not. Actually, it may have contributed to prolonging the elite dominance. If we now accept that these countries’ real struggle is with the transformation of the political economy system, it should be development partners' role to lend a helping hand to those social and political forces that are trying to change the old ways.

Developing an effective assistance strategy for any specific country will not be an easy task. It will require careful investigation and analysis of the historical context and situation of the country. This is where serious analysis and thinking are required. However, it will make aid programs much more coherent and offer a greater chance of achieving important and lasting impact.

Annex

Are inclusive systems more innovative?

In *Why Nations Fail*, Acemoglu and Robinson's argument that inclusive systems were more innovative was based on historical and current comparisons of different systems and economic logic. However, for those who seek a more quantitative linkage, East Asia offers interesting evidence.

One measure of innovativeness is the number of patents generated by each nation. The number of patents is at best one indication of innovativeness of the country's economic system. Many process innovations are not patented, but are vital in raising the productivity of the economy, especially in the catch-up phase. The standards of what constitutes a patentable idea are not uniform across countries. Still, the aggregate numbers, as reported by the World Intellectual Property Organization (WIPO), do provide quite striking differences across countries, and lends support to the notion that inclusive political economy systems are more innovative.

Table 1: The number of patents granted by applicant's origin

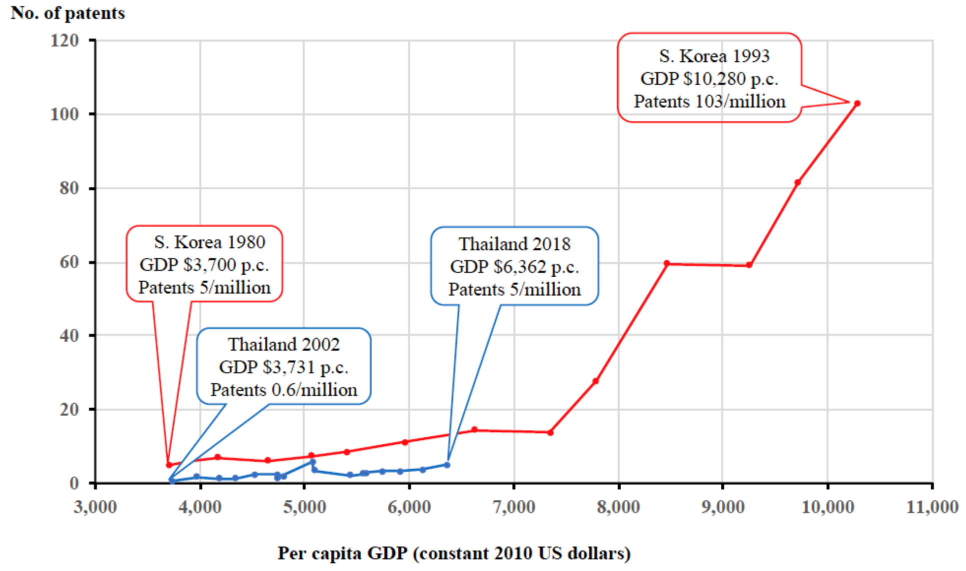
Countries	Number of patents	1980-84 (annual average)	2014-18 (annual average)
Japan	Total	35,534	285,491
	Per million persons	300	2,249
Singapore	Total	2	2,950
	Per million persons	1	529
South Korea	Total	248	124,107
	Per million persons	6	2,423
Thailand	Total	3	248
	Per million persons	0.1	3.6
The Philippines	Total	56	132
	Per million persons	1.1	1.3

Sources: The World Intellectual Property Rights Organization (WIPO) for patents, and the World Bank for population.

In Japan, Singapore, and South Korea (three countries that have all built an "inclusive political economy system"), the number of patents has been high and increased sharply between the early 1980s and the most recent period. (The WIPO data start only in 1980.) When the number of patents is compared on the basis of the number per one million persons, the advance of South Korea becomes striking. In comparison, the progress made by Thailand is quite slow, and there has been little progress in the Philippines. Other Asian countries, such as Indonesia, Malaysia, and Vietnam all fit in this same pattern. They have not shed the legacies of rent-seeking, and the innovativeness as measured by the number of patents remains lower.

One might reasonably ask whether the larger numbers of patents among the richer nations might not be merely a reflection of the higher income level itself. Richer nations are able to afford more spending on R&D, and hence more patents. To investigate this point, Figure 3 traces the trajectories of the number of patents generated by South Korea and Thailand at similar income levels. In 1980, South Korea's per capita GDP was $3,700 (in 2010 constant US dollars), while Thailand was at a similar income level in 2002. (Although Thailand's per capita GDP was almost $3,700 in 1996, it was much lower in the intervening years, because of the Asian financial crisis of 1997. To avoid the impact of that crisis, we take 2002 as the starting point of comparison.) Over the following 16 years, Thailand's income rose to $6,362, and the number of patents per million persons rose from 0.6 to 5, just catching up with the number of patents South Korea was generating in 1980. In the meantime, South Korea traversed the income range that took Thailand 16 years to cover in less than 6 years, while raising the number of patents per million persons to 11. Although the graph shows South Korea's trajectory for only up to 1993 (T+13), by 1996 (T+16), per capita GDP was $12,848 (twice that Thailand had achieved in 16 years since 2002) and the number of patents per million people had surged to 251. The number of patents granted to the citizens of South Korea was consistently higher than that for Thailand at comparable income levels. It is clear that South Korea was on a different trajectory of higher innovation and faster growth. This too is consistent with the idea that a more inclusive system tends to promote greater innovation (hence, faster economic growth).

Figure 3: Per capita GDP and number of patents per million person
South Korea (1980-96) vs. Thailand (2002-2018)



Sources: The WIPO for patent data, the World Bank for GDP data.

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Abstract (in Japanese)

要約

ガバナンス問題は、多くの開発途上国において経済成長の重要な障害であることが広く認識されている。しかし、開発パートナーは、途上国がそれを解決する支援をする有効な戦略を案出できずにいる。その間も、途上国の物的・人的資本のギャップと制度の弱点の補完を主目的とする従来の援助は大規模に続いてきた。本稿は、異なるアプローチが必要であると提唱する。第一に東アジア経済の多様な開発経験を基に、政治経済システムの特性が成長を持続する能力の決定要因だとする理論を検証する。さらに、ガバナンスが悪い環境では、個別のプロジェクトの価値を正当化する従来の手法は不適当だと指摘する。狭義にプロジェクトが有用であるように見えても、援助の「ファンジビリティ」（代替可能性）を考慮すれば、そのような「ミクロ」の見方は不十分である。援助の戦略的目標は、資源のギャップを埋めることから、開発途上国がエリート独占の政治経済体制を克服し、より包括的な体制を確立する過程を支援することへシフトする必要がある。本稿は、この不可欠な移行にむけて国を推進している内在的なダイナミクスを理解し、そのような傾向を支援することにより、開発パートナーはより有意義な支援を提供できると主張する。ネパール、エチオピア、ミャンマーでの著者の経験を基に、このアプローチが実際に適用された事例を提示している。