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Governance, Growth and Development

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Governance, Growth and Development: Background paper for UNRISD Poverty Reduction and Policy Regimes

Mushtaq H. Khan[1]

Summary: The emergence of the good governance agenda in the 1990s was a response to the failure of the structural adjustment approaches of the 1980s. It introduced an ambitious strategy of reform for poor countries to attempt the achievement of a rule of law, protection of property rights, low expropriation risk, low levels of rent seeking and corruption, and accountable and democratic governments. These goals were not just desirable in themselves, it was now argued that they were preconditions for market efficiency and therefore of sustained development. We describe this as the *market-enhancing approach* to governance. There are plausible theoretical links between these governance capabilities and the achievement of low transaction costs in markets which can result in market efficiency and therefore more rapid economic development. This paper does not engage in an examination of competing theoretical trajectories of development as these debates are available elsewhere. Rather, it looks at the possibility that even if the theory on which good governance reforms are based is plausible, it may not be possible to achieve significant improvements in market-enhancing governance in poor countries simply because these capabilities require significant fiscal and productive capacities to implement.

Supporters of good governance can point to a significant amount of empirical work based on cross-country regressions that claim to establish causality between improvements in good governance indicators and economic development. We review this data to argue that these claims deserve to be seriously challenged. The results are substantially based on governance indicators that are in turn based on subjective opinions of surveyed groups and experts. Even if we ignore the observer bias and comparative scaling problems in this type of data, the available evidence can actually be interpreted to suggest that poor countries are structurally unable to achieve significant improvements in their good governance indicators. We find that there is no significant difference in the market-enhancing government indicators of converging and diverging developing countries. Our findings are based on the same data sets that other researchers have used to argue the case for good governance. Recently, a group of researchers in the French Development Agency, the AFD, have developed an independent data set that confirms our reservations about the results derived by the supporters of good governance.

However, we do not conclude as Sachs and others have done, that governance reforms are therefore not a priority for poor countries which should instead be supported in a new Big Push to achieve development. We argue that many of the failures of the 1960s were due to Big Push experiments which were insufficiently productive because many countries lacked critical governance capabilities to implement these programmes. We argue that sustained development in East Asia was based on significant governance capabilities of their governments to overcome specific market failures, and we describe these governance capabilities as *growth-enhancing governance capabilities*.

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Our policy conclusion is that a shift is required in the reform focus from good governance to growth-enhancing governance. Many of the goals of good governance are very desirable on their own terms: goals such as the reduction of corruption, the achievement of greater accountability, improvements in the rule of law and reductions in expropriation risk. These goals should remain as long-term goals for developing countries but we need to understand that progress on these fronts is unlikely to be significant enough or quick enough to make a sufficient impact on development. The development and anti-poverty programmes of poor countries must instead identify growth-enhancing governance capabilities that their states could feasibly try and acquire to address specific market failures that are constraining growth.

The feasible strategy for identifying and enhancing these critical governance capabilities must be an incremental and pragmatic approach to governance capacity building in poor countries. Specific development problems should be identified, such as the problem of increasing investment and technology acquisition in sectors that are already performing reasonably well so that available entrepreneurial expertise can be harnessed to provide better and more extensive employment opportunities. The market failures that may be constraining the achievement of these development opportunities should then be identified, and they are usually very obvious failures in land, labour and capital markets. The interventions that could address these market failures have often been tried and failed in the past because appropriate governance capabilities to monitor and discipline these interventions did not exist, and interventions were captured or created moral hazard problems. A pragmatic way of addressing market failures would be to start with very limited goals and at the smallest scale to develop appropriate governance capabilities, perhaps with donor assistance, but certainly using public discussion and consensus building to enable specific market failures to be addressed. If appropriate governance capabilities can be developed in one or a few sectors, confidence and enthusiasm may be generated to develop growth-enhancing governance capabilities in a step by step way. This, after all, was also the incremental way in which growth-enhancing governance capabilities developed in more successful countries.

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Introduction

The adjustment model of the 1980s assumed that once economic fundamentals were set right, the state would become efficient and responsive to market and developmental requirements. This view began to change radically in the 1990s when an understanding of institutional economics and governance led to the view that efficient markets themselves required a set of underlying institutions to be effective. This view has become the dominant view particularly because many of the institutional mechanisms through which efficient markets are supposed to be achieved are themselves desirable goals for civil society in many developing countries: capacities such as a rule of law, stable property rights, institutional capacities to fight corruption, or to achieve accountable and democratic governments. While most economists now broadly agree that governance is one of the critical factors explaining the divergence in performance across developing countries, there are first, important differences of view regarding the types of state capacities that constitute the critical governance capacities necessary for the acceleration of development. Secondly, there is an emerging debate about the importance of governance relative to other factors at early stages of development.

On the first issue, there is an important empirical and theoretical controversy between liberal economists who constitute the current consensus on good governance and heterodox institutional economists who agree that governance is critical for economic development but argue that theory and evidence shows that the governance capacities required for successful development are substantially different from those identified by the good governance analysis. The economists in favour of good governance argue that the critical state capacities are those that maintain efficient markets and restrict the activities of states to the provision of necessary public goods to minimize rent seeking and government failure. The relative failure of many developing country states are explained by the attempts of their states to do too much, resulting in the unleashing of unproductive rent seeking activities and the crowding out of productive market ones. The empirical support for this argument typically comes from cross-sectional data on governance in developing countries that shows that in general, countries with better governance defined in these terms performed better. This approach to governance can be described as a focus on *market enhancing governance.*

In contrast, heterodox institutional economists base their argument on case studies of rapid growth in the last fifty years. This evidence suggests that rapid growth was associated with governance capacities quite different from those identified in the good governance model. States that did best in terms of achieving convergence with advanced countries had the capacity to achieve and sustain high rates of investment, the capacity to make resources and assets available to productive investors in a context of structurally high transaction cost markets and the capacity to implement policies that encouraged the acquisition and learning of new technologies rapidly. The institutions and strategies that achieved these goals varied from country to country, depending on their initial conditions and political constraints, but all successful states had governance capacities that could achieve these functions. This diversity in governance capacities in successful developers means that we cannot necessarily identify simple patterns in the governance capacities of successful states, but nevertheless, we can identify broad patterns in the *functions* that successful states performed, and this can provide useful insights for reform policy in the next tier of developers. We describe this approach to identifying governance priorities as *growth enhancing governance.* The empirical and theoretical issues involved clearly have critical policy implications for reform efforts in developing countries.

The second area of disagreement concerns the relative importance of governance reforms in accelerating development in countries at low levels of development. An important challenge to the mainstream good governance approach to reform in Africa has come from Sachs et al. (2004) who argue that at the levels of development seen in Africa and given the development constraints faced by that continent, the prioritization of governance reforms is misguided. They support their argument with an empirical analysis that shows that the differences in performance between African countries is not explained by differences in their quality of governance (measured according to the criteria of good governance) once differences in their levels of development have been accounted for. The important policy conclusion that they derive is that in Africa the emphasis has to be on a big push based on aid-supported investment in infrastructure and disease control. While Sachs is right to emphasize the necessity of a big push in Africa (and their arguments in favour of such a strategy should hold true for other poorly performing countries in the developing world), the downgrading of governance capacities is probably misguided even for Africa. Our review of theory and evidence will address these two major questions and debates in the contemporary literature on the role of governance in explaining differences in performance in development since 1960, with particular emphasis on the period after 1980.

Finally, the debate is also about the type and quality of the data through which these issues have been addressed. Much of this data is very questionable as institutional quality even along the vectors identified as important in the market enhancing approach is measured by subjective judgements in surveys and expert opinion. Moreover, institutional quality along other vectors has not been measured very extensively, though that is now changing with the development of a new data set by the French development agency, the AFD (Meisel and Aoudia 2008). The new data set is important as it shows that the types of institutional capabilities that the good governance agenda focuses on are not necessarily the ones that explain significant differences in country performance.

1 Three phases in the history of governance and development 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.

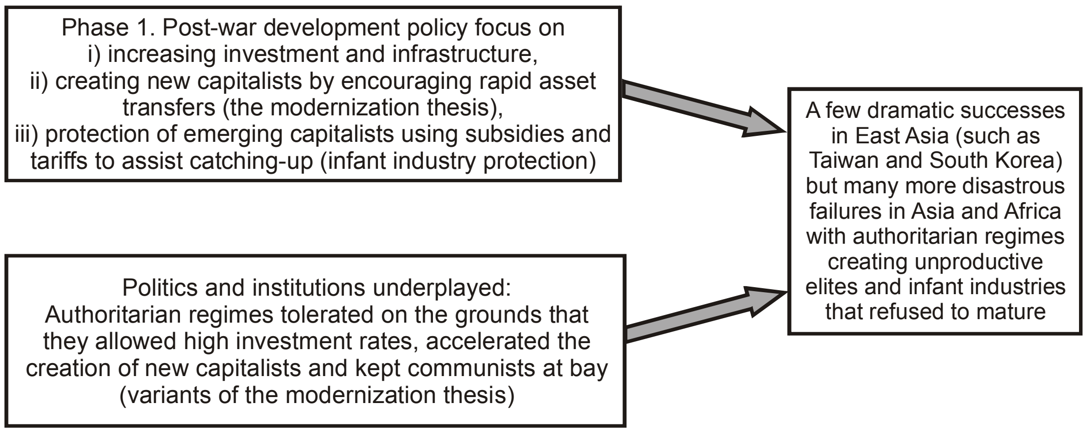

Figure 1 Post-war Growth without Governance

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

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.

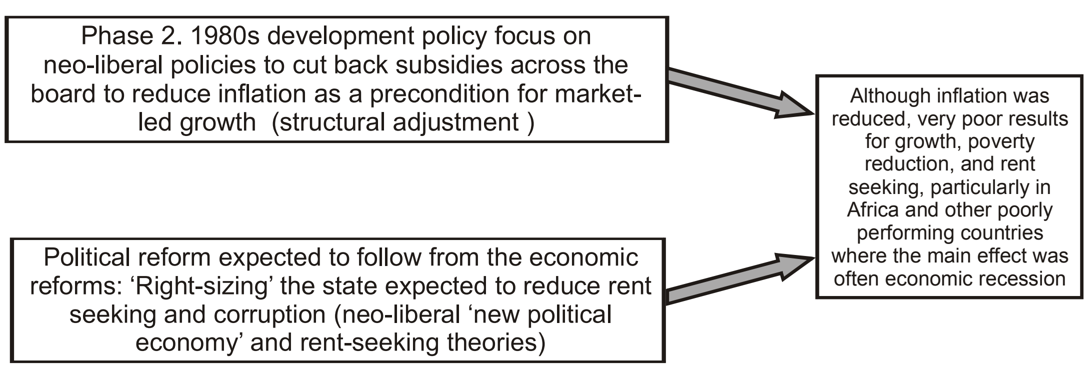

Figure 2 Structural Adjustment: Governance as Dependent Variable

As Figure 2 summarizes, in this phase of reform governance reform was not at the centre of the reform agenda but 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 and Shepsle 1990; Lal and 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 and White 1996). The realization that market-promoting governance capacities on the part of the state required specific attention led to the third, and current stage of governance approaches.

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, summarized in Figure 3 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. In Africa, the emerging commodity boom was also important for sustaining growth in a number of mineral-rich countries. However, economic performance in many of the poorest developing countries remains

poor and growth in others is based on vulnerable low technology sectors and commodities that are sensitive to terms of trade changes and are unlikely to display the growth in productivity that is necessary to achieve sustainable improvements in living standards.

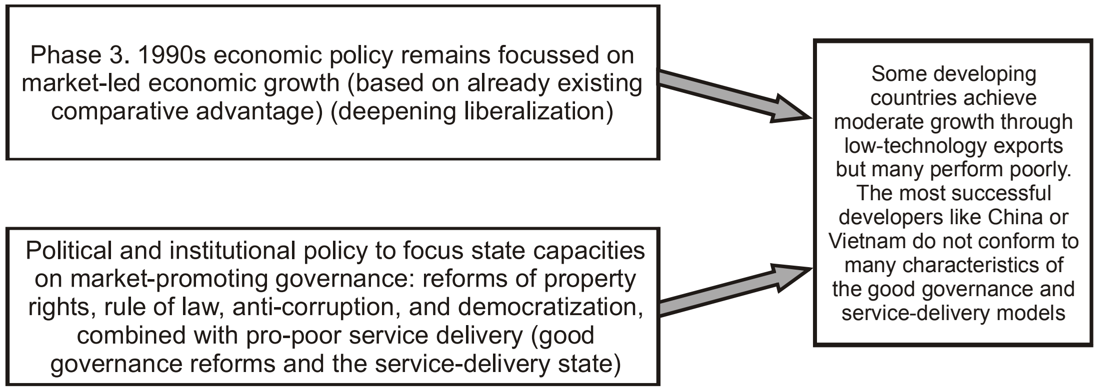

Figure 3 The Good Governance (Market-Enhancing) Agenda

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 Market-Enhancing versus Growth-Enhancing Governance

All approaches to governance reforms in developing countries begin with the implicit assumption that developing countries suffer from significant market failures and that the correction of market failures with poor governance capabilities can also result in significant government failures. The difference between the two approaches to governance can be summarized in the following way. The contemporary good governance approach, which we describe as the *market-enhancing governance approach*, argues that the attempt to correct market failures through growth-enhancing interventions in the first phase of development (summarized in Figure 1) was a failure because of significant government failures in most developing countries. It also implicitly argues that these government failures are potentially unavoidable as they are induced by the incentives created by intervention itself, such as incentives for rent seeking and corruption (Krueger 1990). From this emerged an analysis of the governance requirements for development based on the underlying assumption that efficient markets were the most important contribution that governance reform could contribute to the development process. The goal of governance should therefore be to enhance what we describe as *market-enhancing* conditions (North 1990; Kauffman, et al. 1999). The market-enhancing governance approach is to establish institutional and governance conditions that arguably make markets more efficient by reducing transaction costs in markets. If this can be achieved, interventions to correct market failure will become unnecessary. The reduction of market failures will in turn generate

growth and development as long as core public goods are delivered by an efficient and streamlined service delivery state.

In contrast, the alternative heterodox approach questions aspects of the theoretical links between market efficiency and economic development, but more significantly, it questions whether significant market efficiency can be achieved through good governance reforms in poor countries to the extent that specific interventions to reduce market failures become unnecessary (Khan 2004). It interprets the historical evidence in a very different way to argue that while government failures did indeed happen in the countries that performed poorly with intervention, no country managed to make a successful transition to prosperity without developing governance capabilities for overcoming critical market failures in land, labour and capital markets, *before* good governance can achieve significant across the board improvements in market efficiency. The policy implication here is that a focus on good governance reforms alone is mistaken in developing countries: countries accepting this policy advice will be missing the opportunity to achieve feasible governance capabilities that can actually make an impact on their rate of poverty reduction. We describe this approach as the *growth-enhancing governance approach*.

The good governance argument that is frequently referred to in the governance literature and in policy discussions is essentially a market-enhancing governance agenda. It identifies the importance of governance capacities that are necessary for ensuring the efficiency of markets. The assumption is that if states can ensure efficient markets, (in particular by enforcing property rights, a rule of law, reducing corruption and committing not to expropriate) private investors will drive economic development. This approach is one that implicitly stresses the priority of developing market-enhancing governance, and is currently the dominant paradigm supported by international development and financial agencies.

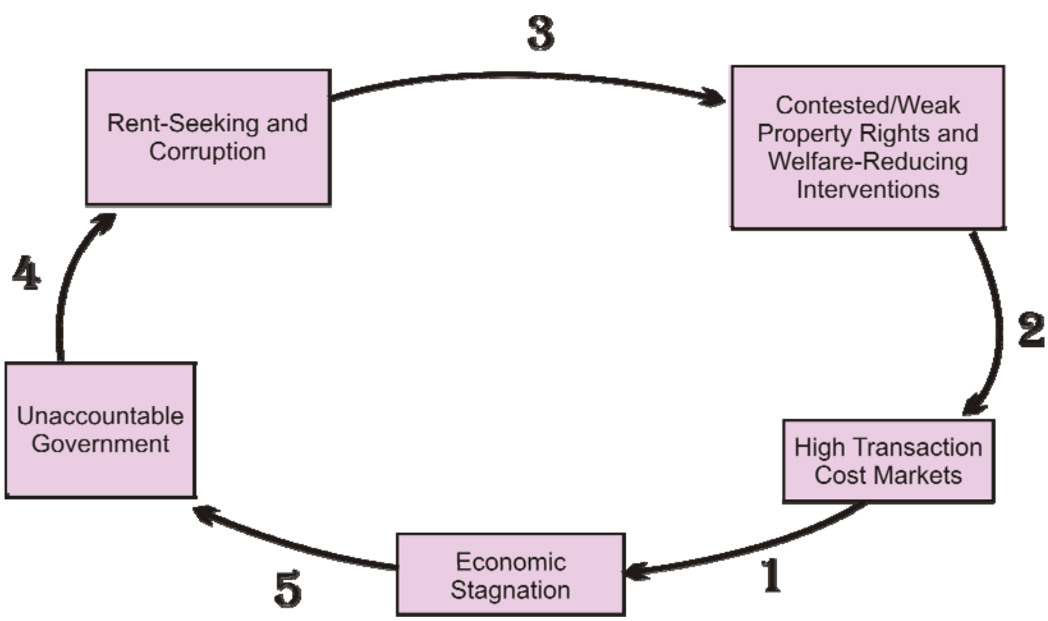

Figure 4 Theoretical Links in the Good Governance Agenda

However, in making this argument it builds on a number of links established by New Institutional Economics and the New Political Economy which are not the only links identified in these theories. The major links on which the good governance framework

is based are summarized in Figure 4. Link 1 is the claim that economic stagnation is ultimately due to high transaction cost markets, which are essentially markets subject to market failures (North 1990). This link can be a tautology, but it becomes a problematic theoretical assertion if the focus is only on a small number of relatively obvious market failures . Link 2 is the innovation that the new agenda comes up with, arguing that instead of addressing these market failures individually, the best approach is to try and make markets across the board more efficient by addressing the underlying causes of market failure, which are weak property rights, rule of law and arbitrary interventions (North 1990; Knack and Keefer 1997; Kauffman, et al. 1999; Acemoglu, et al. 2004). The theory here is that markets are essentially systems of contracts and if the absence of clear expectations and rights prevent contracting, market failure will follow by definition. Link 3 asserts that unstable property rights, poor rule of law and expropriation by states happen because small groups engage in rent seeking and corruption (Krueger 1974; Olson 1982; Mauro 1995, 1996, 1997a, 1997b). Finally, Link 4 asserts that these small groups can profit at the expense of the majority in society because government accountability is weak or non-existent (North 1990; Olson 1997, 2000). Link 5 completes the cycle because economic stagnation can in turn prevent the poor from mobilizing and enable autocracy to continue.

It is on the basis of these theoretical links that the good governance agenda argues that it is necessary to complement liberalization and other market reforms with a simultaneous set of governance reforms that include improvements in the rule of law, in defining and protecting property rights better, fighting corruption and rent seeking and embedding democracy and decentralization. As we have already argued, the power of the good governance agenda has been that many of these reforms are perceived as desirable by many civil society groups in developing countries as goals that are good in themselves. The issue of concern of for us is not whether these goals should be abandoned, but rather whether these are achievable in developing countries to an extent that they can form the basis of a poverty reduction and development agenda. The problem for the good governance agenda is that these are not the only theoretical links that can explain the persistence of patron-client politics, autocracy, corruption, weak rule of law and contested property rights in developing countries (Khan 2000b, 2000a, 2002, 2005a, 2006a). We will not review the alternative theoretical arguments explaining these phenomena in poor countries in this piece as this has already been done elsewhere. The pertinent issue for us now, is that even if the theoretical links asserted in the good governance argument are strong, there is little evidence that these are achievable governance goals for poor countries. Indeed, no poor country appears to achieve high scores in these governance capabilities regardless of their economic performance and reform strategies.

It is also important to reiterate that 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 development debate is rather about the *extent* to which markets *can* be made efficient in developing countries, and 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 approaches to governance have argued that markets are inherently inefficient in developing countries and even with the best political will, structural characteristics of the economy ensure that market efficiency will remain low till a substantial degree of development is achieved. Given the structural limitations of markets in developing countries, successful development requires critical governance capacities of states to accelerate accumulation

and ensure productivity growth. In support of these arguments, they point to the evidence of the successful East Asian developers of the last five decades, where state governance capacities typically amounted to a lot more than the capacities necessary for ensuring conditions for efficient markets. In fact, in terms of the market-enhancing conditions prioritized by the good governance approach, East Asian states often performed rather poorly. Instead, they had effective institutions that could accelerate growth in conditions of technological backwardness and high transaction costs. This approach identifies the importance of a different set of governance capabilities that can be described as growth-enhancing governance.

Thus theory and evidence points to the importance of alternative governance capabilities that can directly accelerate growth in a context of structurally weak markets and very specific 'catching-up problems' faced by developing countries. In a context of high transaction cost markets, specific governance capacities are required for assisting the allocation of assets and resources to higher productivity and higher growth sectors using both market and non-market mechanisms, and to accelerate productivity growth by assisting the absorption and learning of new technologies. While the consensus development orthodoxy of the 1950s and 1960s recognized many of these functions as important in the context of significant market failures in developing countries, it did not adequately recognize that the successful implementation of these strategies required a complementary set of governance capabilities. This is why the failure of these strategies in many countries and their dramatic success in a small number of East Asian countries could not be satisfactorily explained at the time. The governance capabilities required for ensuring the effective implementation of growth-enhancing strategies are what we describe as *growth-enhancing governance capabilities*.

Box 1 summarizes the main characteristics of governance emphasized in each. The remainder of the section discusses these characteristics in greater detail. The section after that summarizes the empirical evidence.

Box 1 Market-Enhancing versus Growth-Enhancing Governance

Market-enhancing governance focuses on the role of governance in reducing transaction costs to make markets more efficient. The key governance goals are:

- Achieving and Maintaining Stable Property Rights
- Maintaining a Good Rule of Law and Effective Contract Enforcement
- Minimizing Expropriation Risk
- Minimizing Rent Seeking and Corruption
- Achieving the Transparent and Accountable Provision of Public Goods in line with Democratically Expressed Preferences

Growth-enhancing governance focuses on the role of governance in enabling catching up by developing countries in a context of high-transaction cost developing country markets. In particular, it focuses on the effectiveness of institutions for accelerating the transfer of assets and resources to more productive sectors, and accelerating the absorption and learning of potentially high-productivity technologies. The key governance goals are:

- Managing Transfers of Assets and Resources to More Productive Sectors
- Managing Incentives and Compulsions for achieving Rapid Technology Acquisition and Productivity Enhancement
- Maintaining Political Stability in a context of rapid social transformation

The two sets of governance capabilities are not necessarily mutually exclusive, but the distinction between them is important, particularly if an exclusive focus on market-enhancing governance diminishes the capacity of states to develop growth-enhancing governance capabilities to accelerate development. There are two related theoretical problems with a focus on market-enhancing governance in the good governance reform agenda. First, the historical evidence (some of it discussed below) shows that it is extremely difficult if not impossible to achieve these governance conditions in poor countries. In terms of economic theory, this observation is not surprising. Each of these goals, such as the reduction of corruption, the achievement of stable property rights and of an effective rule of law requires significant expenditures of public resources. Poor economies do not have the required fiscal resources and requiring them to achieve these goals *before* economic development takes off faces a serious problem of sequencing (Khan 2005b). It is not surprising that developing countries do not generally satisfy the market-enhancing governance criteria at early stages of development even in the high-growth cases. Thus, critically important resource re-allocations that are required at early stages of development are unlikely to happen through the market mechanism alone.

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 16^{th} to the 18^{th} century; the creation of the chaebol in South Korea in the 1960s using public resources; the creation of the Chinese TVEs using public resources in the 1980s and their privatization in the 1990s; and the allocation and appropriation of public land and resources for development in Thailand. Successful developers have displayed a range of institutional and political capacities that enabled semi-market and non-market asset and property right re-allocations that were growth enhancing. In contrast, in less successful developers, the absence of necessary governance capabilities meant that non-market transfers descended more frequently into predatory expropriation that impeded development.

Secondly, even reasonably efficient markets face significant market failures in the process of 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. Relying only on efficient markets to attract capital and new technologies is inadequate given that efficient markets will attract capital and technology to countries where these technologies are already profitable because the requisite skills of workers and managers already exist. Developing countries have lower technological capabilities and therefore lower labour productivity in most sectors compared to advanced countries, but as against this, they also have lower wages. If markets are efficient, capital will flow to sectors and countries where the wage advantage outweighs the productivity disadvantage. However, for many mid to high-technology sectors in developing countries, the productivity gap remains larger than the wage gap.

This explains why most developing countries specialize in low technology sectors and why this specialization would not change rapidly if markets became somewhat more efficient. However, if developing countries could accelerate learning, and therefore productivity growth in mid to high-technology sectors, this would allow them to achieve more rapid wage growth, as well as attract investment and employment creation in high wage as opposed to low wage sectors. Rapid catching up therefore typically requires *some* strategy of targeted technology acquisition that allows the follower country to catch up rapidly with leader countries. However, technology-acquisition strategies have

been remarkably diverse and high-growth countries have used very different variants of growth-enhancing governance that allowed the acceleration of social productivity growth. While technical progress is possible along the trajectory set by a market-driven strategy, the climb up the technology ladder is likely to be slower through diffusion and spontaneous learning compared to an active technology acquisition and learning strategy.

But to achieve growth faster than that possible through spontaneous learning and technology diffusion, states have to possess the appropriate *governance capabilities* both to create additional incentives (rents) for investments in advanced technologies that would not otherwise have taken place but also to ensure that non-performers in these sectors do not succeed in retaining the implicit rents. The creation and management of incentives by states in developing countries has been very diverse. In many developing countries, import-substituting industrialization attempted to leapfrog technological levels by protecting domestic private or public sector enterprises. But the absence of credible commitments to withdraw support in case of failure and of adequate institutions to assist technology acquisition and learning meant that in most cases, the results were inefficient public and private sector firms that never grew up. Successful countries used many policies that appear superficially similar, including tariff protection (in virtually every case), 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). But while the mechanisms used in many less successful developers appear similar to the ones on this list, there were significant differences in the governance capacities for successfully implementing growth-enhancing strategies. In particular, they typically failed to deal with the moral hazard of inefficiency that easily emerges with such strategies (Khan 2000b).

The sharp distinction that has emerged in policy between market-enhancing and growth-enhancing governance is to some extent also due to the fact that growth-enhancing governance has some effects that appear to contradict the requirements of market-enhancing governance. For instance, growth-enhancing governance can increase the chances of corruption and other forms of rent seeking as it creates rents for the beneficiaries of these policies. In countries where the enforcement of growth strategies is effective and productivity growth is high, the inevitable rent-seeking costs have to be set against the gains. But in countries where enforcement fails and productivity growth is low, the costs of rent seeking involved in any strategy of growth-enhancement appear to be the main problem. Indeed, in most developing countries where strategies of growth-enhancement was attempted, the results were poor, resulting in a growing consensus that such strategies had inbuilt adverse incentives that doomed them to failure.

The problem is that these governance capabilities can vary from country to country depending on the type of growth-enhancing strategy attempted. When states intervene in markets to accelerate resource allocation in particular directions or assist technology acquisition, they create new incentives and opportunities, and the market on its own is not likely to suffice as a disciplining mechanism for the resources now allocated through non-market or part-market mechanisms. As a result, the effective implementation of growth-enhancing strategies typically also requires effective growth-enhancing governance systems of compulsion and discipline to supplement the discipline imposed by the market. But the precise nature of the governance capabilities required depends on the specific mechanisms through which the state attempts to accelerate technology acquisition and investment. The diversity of the experience of

successful catching up in Asia tells us the importance of the *compatibility* of the governance capabilities that states have and growth-enhancement strategies they are attempting to implement.

The learning strategy that is most likely to be effectively implemented in a country can depend amongst other things on the internal power structure that can determine if a particular strategy is likely to be effectively enforced. If a strategy requires disciplining powerful individuals or groups who can by-pass disciplining given the internal organization of power, effective implementation is very unlikely. Reform should then focus on developing a different strategy that requires incentives and compulsion for groups who might be easier to discipline, or an improvement in the governance capabilities of the state to monitor and discipline the current beneficiaries. Doing neither and simply sticking with the existing strategy *may* deliver worse outcomes than depending on the market to allocate resources according to existing productive capabilities. This explains why abandoning growth-enhancement strategies in some developing countries can result for a time in better growth performance. The growth performance with liberalization is likely to be particularly strong (as in the Indian subcontinent), if growth-enhancing strategies had built up technological capacities that could not be profitably used given the failure of effective growth-enhancing governance, but which could be redeployed in a market regime to provide a spurt of growth.

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 convergence with advanced countries. When we conduct such a test we find that the evidence supporting the market-enhancing view of governance is weak. While poorly performing developing countries failed to meet the governance conditions identified in the market-enhancing view of governance, so did high-growth developing countries. This observation suggests that it is 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.

Testing the relevance of the growth-enhancing view of governance is more complicated because we expect the relevant governance requirements will vary with the asset allocation and learning strategies followed by the country. Nevertheless, we suggest a typology of factors that can explain relative success and failure in a sample of countries that suggests that an alternative set of governance characteristics may have played a role in explaining differences in performance across countries. This approach can explain why there have been many *different* strategies of growth-enhancement in the successful countries of East Asia, each with different governance capabilities, and why some countries like India have apparently done better by abandoning strategies of growth-enhancement. There is some evidence of a similar experience in Latin America, with some countries achieving growth in new sectors following liberalization, sometimes using technological capabilities developed in the past.

Market-Enhancing Governance and Economic Growth.

An extensive academic literature has tested the relationship between what we have described as market-enhancing governance conditions and economic performance. 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. This literature uses a number of indices of market-enhancing governance. In particular, it uses data provided by Stephen Knack and the IRIS centre at Maryland University, as well as more recent data provided by Kaufmann's team and available on the World Bank's website. If market-enhancing governance were relevant for explaining economic growth, we would expect the quality of market-enhancing governance at the beginning of a period (of say ten years) to have an effect on the economic growth achieved during that period. However, the Knack-IRIS data set is only available for most countries from 1984 and the Kaufmann-World Bank data set only from 1996 onwards. We have to be careful to test the role of market-enhancing governance by using the governance index at the *beginning* of a period of economic performance to see if differences in market-enhancing governance explain the subsequent difference in performance between countries. This is important, as a correlation between governance indicators at the *end* of a period and economic performance during that period could be picking up the reverse direction of causality, where rising per capita incomes result in an improvement in market-enhancing governance conditions. There are good theoretical reasons to expect market-enhancing governance to improve as per capita incomes increase (as more resources become available in the budget for securing property rights, running democratic systems, policing human rights and so on). This reverses the direction of causality between growth and governance. Thus, for the Knack-IRIS data, the earliest decade of growth that we can examine would be 1980–90, and even here we have to be careful to remember that the governance data that we have is for a year almost halfway through the growth period. We do, however, have the Knack-IRIS indices 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 relevant indices in this data set are for 'corruption in government', 'rule of law', 'bureaucratic quality', 'repudiation of government contracts', and '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 for the index are available from 1984 for most countries.

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

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

We have divided the countries for which data are available into three groups. "Advanced countries" are high-income countries using the World Bank's classification with the exception of two small oil economies (Kuwait and the UAE), which we classify as developing countries. This is because although they have high levels of per capita income from oil sales, they have achieved lower levels of industrial and agricultural development than other high-income countries. We also divide the group of developing countries into a group of "diverging developing countries" whose per capita GDP growth is lower than the median growth rate of the advanced country group, and a group of "converging developing countries" whose per capita GDP growth rate is higher than the median advanced country rate.

Table 1 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 2 shows the composite data for the 1990s using an aggregation of the indices available in the Kaufmann-World Bank series. Table 3–Table 8 show the Kaufmann-World Bank data for the 1990s using the six indices from the Kaufmann-World Bank data set. Figure 5–Figure 12 show the same data in graphical form. The tables and plots demonstrate that the role of market-enhancing governance conditions in explaining differences in growth rates in developing countries is at best very weak.

First, there is virtually no difference between the median property rights index between converging and diverging developing countries (particularly given the relative coarseness of this index and that for most of our data the governance indicators are for a year halfway through the growth period). Secondly, the range of variation of this index for converging and diverging countries almost entirely overlaps. The absence of any clear separation between converging and diverging developing countries in terms of market-enhancing governance conditions casts doubt on the robustness of the econometric results of a large number of studies that find market-enhancing governance conditions have a significant effect on economic growth (Knack and Keefer 1995, 1997; Hall and Jones 1999; Kauffman, et al. 1999).

Third, for all the indices of governance we have available, the data suggest a *very weak* positive relationship between the quality of governance and economic growth. The sign of the relationship is as the market-enhancing governance view requires but the weakness of the relationship demands a closer look at the underlying data. This

demonstrates that the positive relationship depends to a great extent on a large number of advanced countries having high scores on market-enhancing governance (the countries in blue in Figure 5–Figure 12) and the bulk of developing countries being low-growth and low scoring on market-enhancing governance (the countries in red in the same figures). However, if we only look at these countries, we are unable to say anything about the direction of causality as we have good theoretical reasons to expect market-enhancing governance to improve in countries with high per capita incomes. The critical countries for establishing the direction of causality are the converging developing countries (the countries in green in these figures). By and large, these countries do not have significantly better market-enhancing governance scores than diverging developing countries. In the 1980s data set, there are relatively very few converging countries, and so the relationship between market-enhancing governance and growth *appears* to be relatively strong using the Knack-IRIS data set. However, in the 1990s data set, the number of converging countries in terms of our arithmetic definition is now greater and it is very significant that the strength of the relationship becomes much weaker both visually and using measures of goodness of fit despite the bias created by the governance indicators only being available from around 1994 for the Kaufmann-World Bank data set. This examination of the data therefore suggests to us that even the weak positive relationship between market-enhancing governance and growth could be largely based on the reverse direction of causality, with richer countries having better scores in terms of market-enhancing governance.

Finally, the policy implications of these observations are rather important. Given the large degree of overlap in the market-enhancing governance scores achieved by converging and diverging developing countries, we need to significantly qualify the claim made in much of the governance literature that an improvement in market-enhancing governance quality in diverging countries will lead to a significant improvement in their growth performance. Nevertheless, the significant differences in their growth rates suggest significant differences in the efficiency of resource allocation and use between these countries, and these differences are very likely to be related to significant differences in governance. The data suggests that since differences in market-enhancing governance capabilities are not significant between converging and diverging countries, we need to examine other dimensions of governance capabilities that could explain differences in growth performance.

Table 1 Market-Enhancing Governance: Composite Property Rights Index and Economic Growth 1980-90

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

The IRIS Property Rights Index can range from a low of 0 for the worst governance conditions to a high of 50 for the best conditions.
Sources: IRIS-3 (2000), World Bank (2005b).

Table 2 Market-Enhancing Governance: Composite Property Rights Index and Economic Growth 1990-2003

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

The property right index here is an aggregate of the corruption, rule of law, bureaucratic quality indices on a 10 point scale together with the index of repudiation of government contracts and expropriation risk.
Sources: World Bank (2005a), World Bank (2005b).

Table 3 Market-Enhancing Governance: Voice and Accountability and Economic Growth 1990-2003

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

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

Table 4 Market-Enhancing Governance: Political Instability and Violence and Economic Growth 1990-2003

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

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

Table 5 Market-Enhancing Governance: Government Effectiveness and Economic Growth 1990-2003

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

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

Table 6 Market-Enhancing Governance: Regulatory Quality and Economic Growth 1990-2003

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

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

Table 7 Market-Enhancing Governance: Rule of Law and Economic Growth 1990-2003

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

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

Table 8 Market-Enhancing Governance: Control of Corruption and Economic Growth 1990-2003

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

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

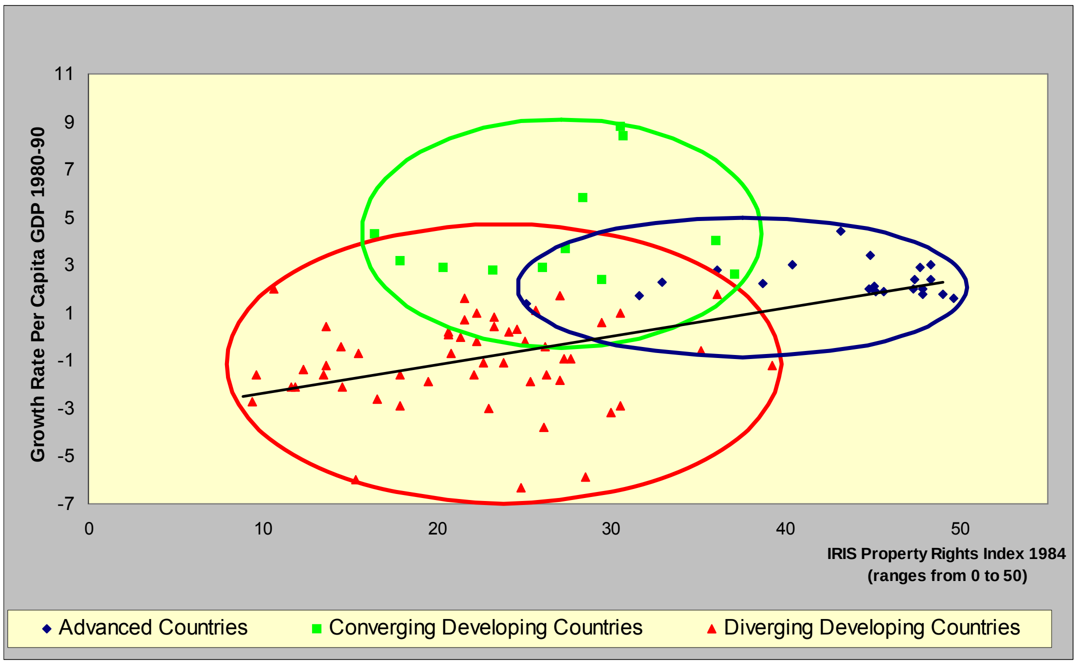

Figure 5 Market-Enhancing Governance and Growth 1980-90

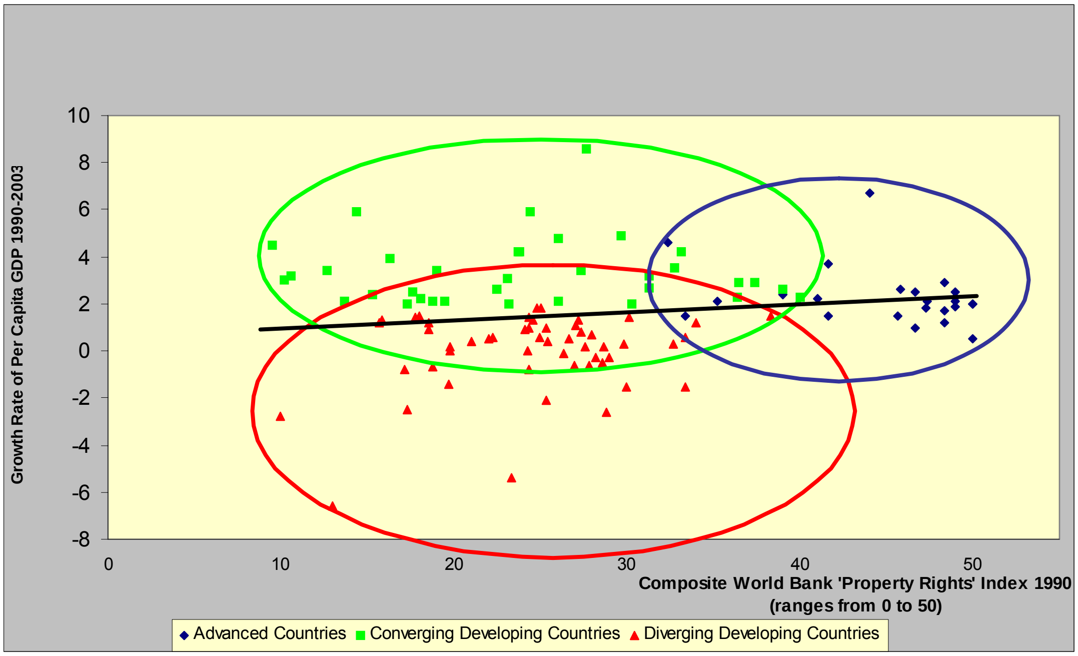

Figure 6 Market-Enhancing Governance and Growth 1990-2003

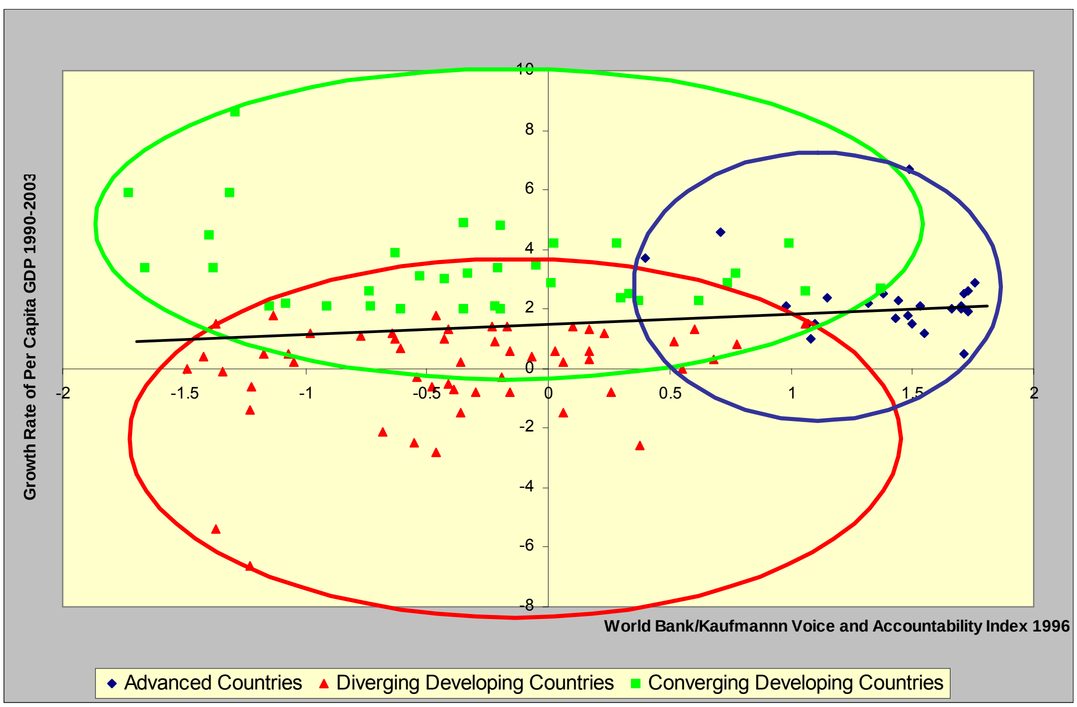

Figure 7 Political Accountability and Growth 1990-2003

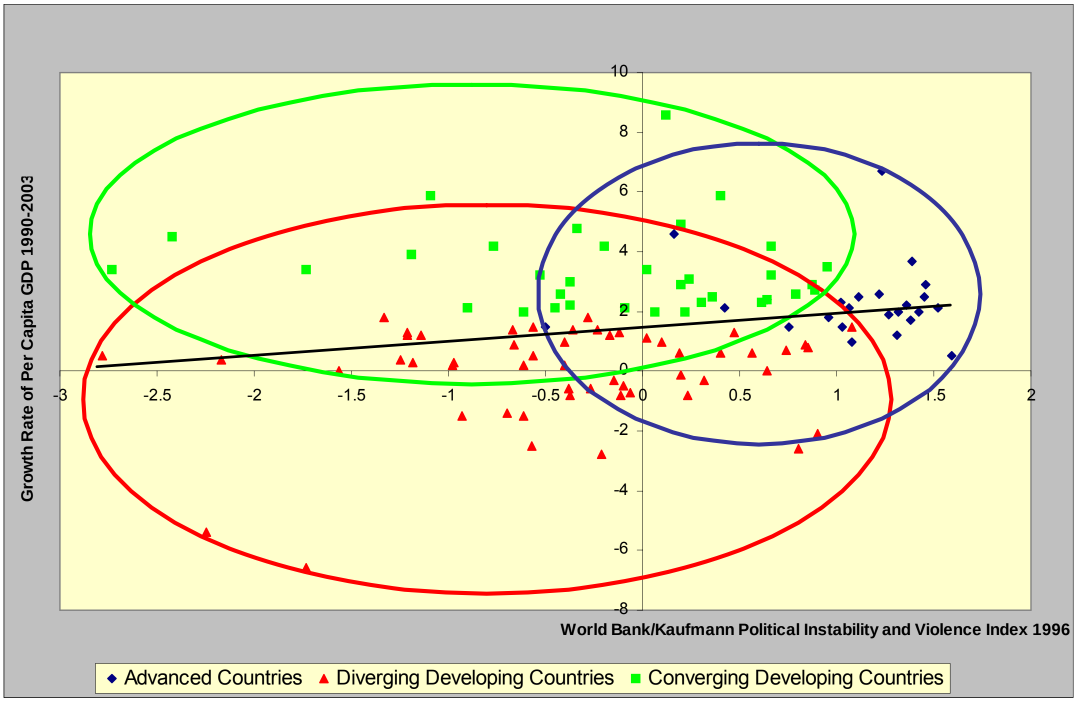

Figure 8 Political Instability and Growth 1990-2003

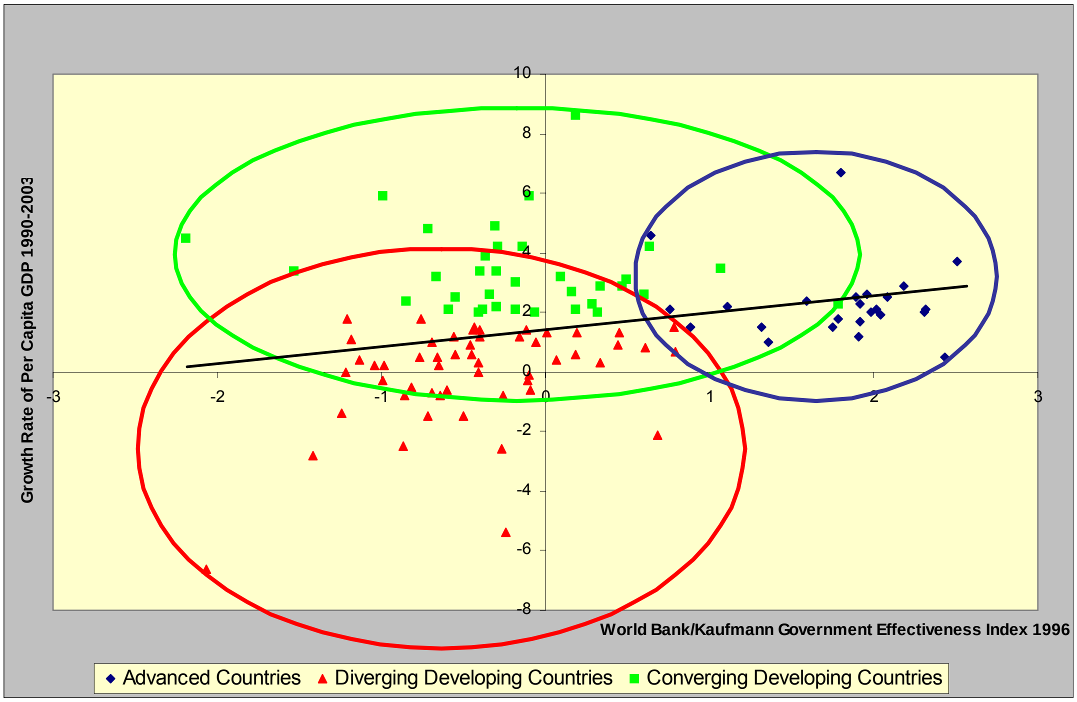

Figure 9 Government Effectiveness and Growth 1990-2003

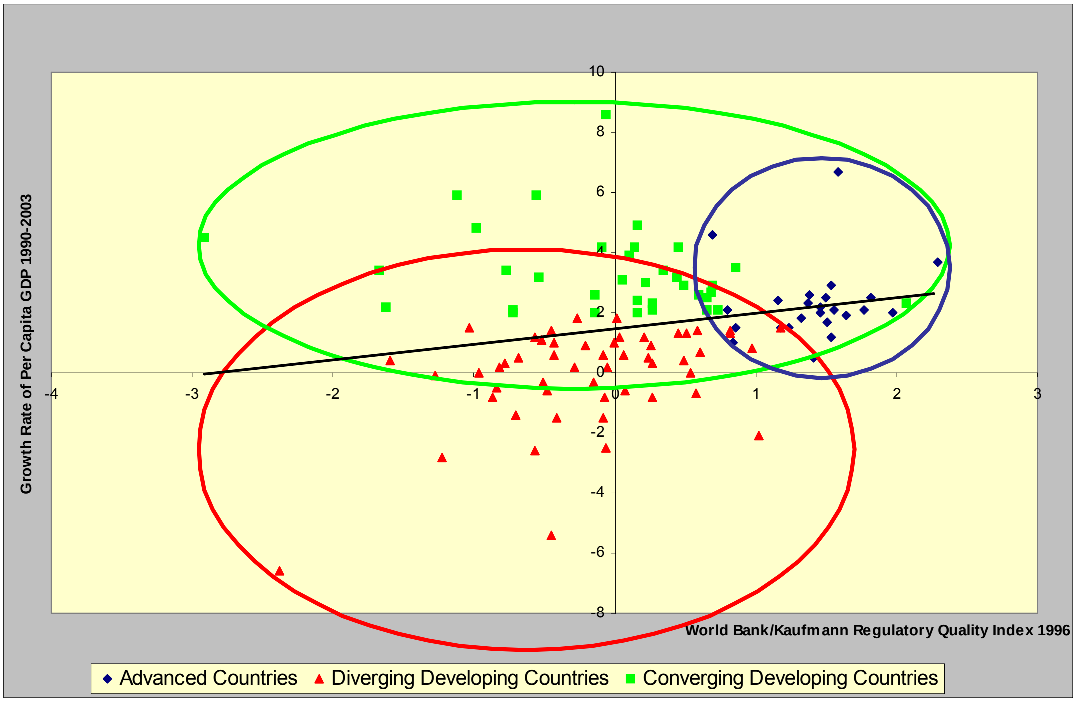

Figure 10 Regulatory Quality and Growth 1990-2003

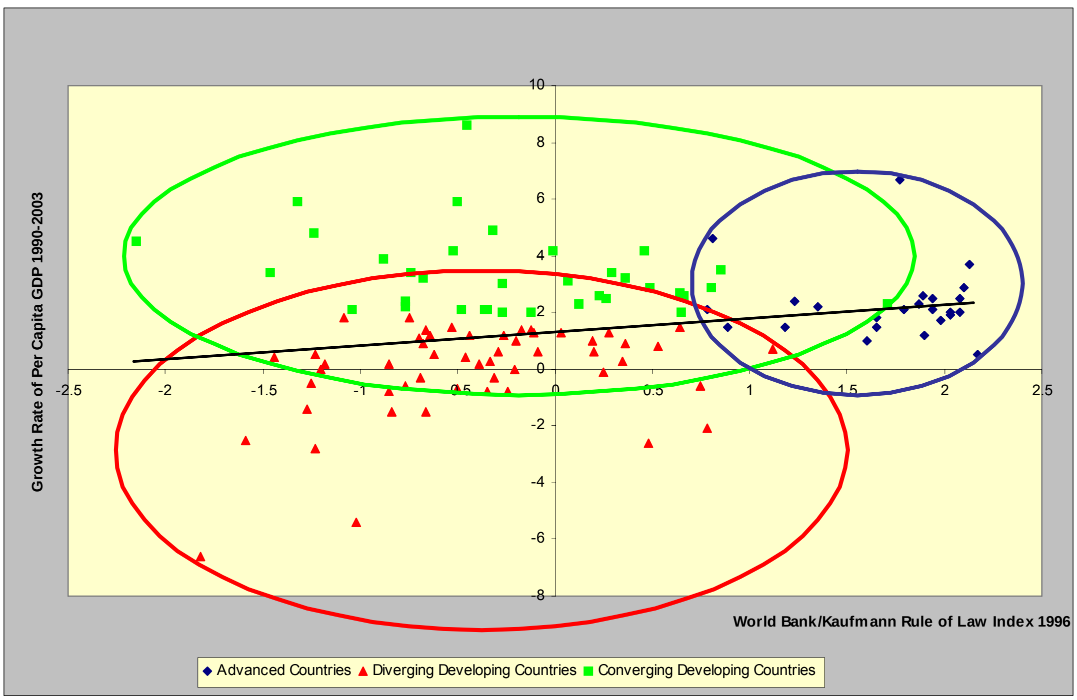

Figure 11 Rule of Law and Growth 1990-2003

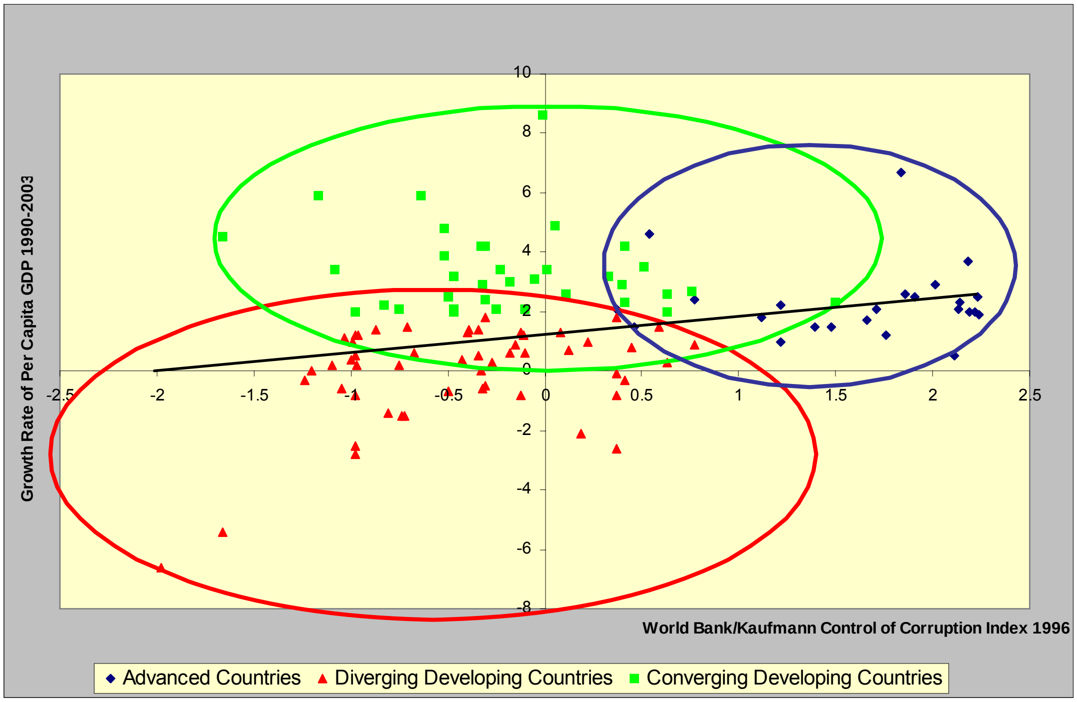

Figure 12 Control of Corruption and Growth 1990-2003

Studies that find a significant positive relationship between market-enhancing governance and growth usually do so by pooling advanced and developing countries together. Our examination of the data suggests that these studies can be misleading because we expect advanced countries to have better market governance capabilities. Pooling can thus confuse cause and effect. When developing countries are looked at separately the relationship is much weaker if it exists at all, and even in this case, we need to be aware of sample selection problems if we pool relatively advanced and poor developing countries.

Our analysis is supported by the analysis of growth in African countries by Sachs and his collaborators (Sachs, et al. 2004). In their study of African countries, they address the problem that countries with higher per capita incomes are expected to have better market-enhancing governance quality and so their better governance indicators should not be used to explain their higher incomes. They do this by not using market-enhancing governance indicators directly as explanatory variables, but instead using the deviation of the governance indicator (in this case the Kaufmann-World Bank index) from the predicted value of the indicator given the country's per capita income at the beginning of the period. This approach is a more sophisticated way of dealing with the two-way causation between governance and growth. If market-enhancing governance matters for growth, we would expect countries that had better governance than would be expected for their per capita incomes to do better in subsequent periods compared to countries that only achieved average or below average governance for their per capita incomes. By making this correction, the Sachs study finds that when adjusted in this way, market-enhancing governance has no effect on the growth performance of African countries. This result is entirely consistent with our observations of the global growth data recorded above.

However, we do not entirely agree with Sachs when they conclude that these results show that governance reforms are not an immediate priority for African countries. They

argue that to trigger growth in Africa what is required instead is a big push in the form of a massive injection of investment in infrastructure and disease control. While the case for a big push in Africa is strong, this does not mean that African countries have the minimum necessary governance conditions to ensure that a viable economic and social transformation will be unleashed by such an investment push. This is because the evidence of big push experiments in many countries has demonstrated that growth is only sustainable if resources are used to enhance productive capacity and new producers are able to achieve rapid productivity growth. These outcomes are not likely in the absence of institutional support and regulation from state structures possessing the appropriate governance capabilities given the reasons discussed earlier. The powerful econometric results reported by Sachs et al. (2004) do not actually show that all types of governance are irrelevant for growth, only that the market-enhancing governance that is measured by available governance indicators clearly has less significance in explaining differences in performance between developing countries than is widely believed. Other forms of governance may be very important, but indices measuring these governance capacities are not readily available. In our next section we look at the evidence suggesting the importance of growth-enhancing governance capabilities.

Our interpretation of the evidence appears to be contradicted by the influential paper by Acemoglu et al. (2001) who 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 instrumental variables 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, underlying historical process that the instrumental variables are capturing do not actually support the interpretation of the authors. *The countries where settlers went and settled in 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 colonial settlers. In some cases the expropriation was so severe and rapid that indigenous populations collapsed entirely, sometimes in genocidal proportions. To describe the growth that happened as being due to the prior 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 subsequently 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.

Our empirical interpretation is strongly supported by recent work being done at the French development agency, the AFD, by Nicolas Meisel and Jacques Aoudia (2008), whose work replicates our findings using their own data set. They borrow our classification of developing countries into converging and diverging groups and find exactly the same pattern that we have described. The replication of our findings using an independent data set suggests that our argument is robust.

The task of further research is to distinguish between different types of developing countries within the converging and diverging groups. We know that these groups include countries of quite different prospects and of course levels of development. For instance, converging countries include some countries that are growing rapidly because of fortunate mineral resources, other countries that are growing because of low technology manufacturing exports, and yet others that are on sustainable growth paths with strong technology acquisition strategies and productivity growth. Clearly, the last subset is the most interesting one that others within the converging set should attempt to emulate. Similarly, within the diverging group there are various types of countries, including middle-income countries that have run into serious problems of sustaining productivity growth as well as very poor countries that have not yet achieved a takeoff. Further research into these different subsets will enhance our understanding of the governance challenges that different types of countries face in attempting to either trigger or sustain growth and development. In each case, the answer may be to develop specific governance capabilities to enhance growth that are quite different from the general good governance reforms suggested by the market-enhancing governance approach.

Growth-Enhancing Governance and Economic Growth

The case for growth-enhancing governance argues that the most efficient markets that developing countries can construct will at best be relatively inefficient in transferring assets and resources to growth sectors. In addition, they are also likely to attract low technology and low value-added activities into the developing country, as these are the only activities that are currently profitable given the technological capabilities of the typical developing country. If technological capacity development can be accelerated, very high returns are likely in the future. But projects that aim to enhance technological capacity involve learning how to use new technologies and new methods of organizing work practices. This involves potentially long periods of losses with the promise of high profitability in the future, but only if there is very rapid and disciplined learning. For private investors in developing countries, the uncertainty involved in investing in this type of learning is typically too high to be worth the risk given that alternative investment opportunities are less risky and immediately profitable. Rapid catching up therefore requires complementary growth-enhancing interventions by states and the governance capabilities to ensure that they are effectively implemented (Aoki, et al. 1997; Khan and Jomo 2000).

The problem for growth-enhancing strategies is that while there is a credible theoretical case for intervention in late developers to assist them to move rapidly up the technology ladder, the effective implementation of such strategies typically also requires very effective governance capabilities to supplement the discipline imposed by the market. When states create incentives and opportunities to assist resource allocation or technology acquisition, the market on its own may well not suffice as a disciplining

mechanism. Governance capacities are now required to ensure that moral hazard problems do not subvert the growth-enhancing strategy. The precise governance requirements depend on the specific mechanisms through which the state attempts to accelerate technology acquisition and investment. The diversity of the policy mechanisms through which Asian countries accelerated catching up demonstrate that while there is clearly no single set of governance requirements to ensure that interventions for catching up are effective, the governance capabilities have to be *appropriate* for ensuring that the growth-enhancing interventions are effectively implemented and enforced.

If the requisite governance capacities are missing, a growth-enhancing strategy may deliver worse outcomes than a market-led strategy, as poorly implemented interventions may worsen resource allocation as well as inducing high rent-seeking costs. But even a failed growth strategy can sometimes have unintended consequences that are potentially useful if it develops human capital even though it fails to profitably employ these resources. If human resources are developed, these can often be exploited in new ways even if the growth strategy fails. The interactive relationship between growth strategies, governance capabilities and technological capabilities of producers can help to explain a) why many *different* strategies of industrial catching up were successful in East Asia, b) why at the same time apparently *similar* growth-enhancing strategies have worked in some countries and failed dismally in others, and 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.

While a full treatment of this diversity can only be done through a series of case studies,

Table 9 summarizes these experiences for a selection of countries showing the type of growth-enhancing strategies that they followed and the associated governance capabilities that either supported of obstructed the implementation of these strategies. During the 1960s, 1970s and part of the 1980s, most developing countries followed growth-enhancing strategies that had many common elements even though they often differed quite significantly in their detail. In all countries, two primary goals of developmental interventions were a) to accelerate resource allocation to growth sectors and b) to accelerate technology acquisition in these sectors through a combination of incentives and compulsions. To achieve the first, a variety of policy mechanisms were used including bureaucratic allocation of land (including land reform), the licensing of land use, the licensing of foreign exchange use, and the licensing or bureaucratic allocation of bank credit. In some cases, price controls and fiscal transfers were also used to accelerate the transfer of resources to particular sectors.

To achieve the second, incentives for technology acquisition included targeted tax breaks or subsidies, protection of particular sectors for domestic producers engaged in setting up infant industries, licensing of foreign technologies and subcontracting these to domestic producers, setting up investment zones for high technology industries and subsidizing infrastructure for them and so on. For both types of policies, growth-enhancing governance required monitoring resource use and withdrawing resources or support from sectors or firms that proved to be making inadequate progress.

Table 9 Growth-Enhancing Governance in Selected Countries 1960-2000

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

Monitoring progress is less complex than it may appear, particularly in countries that are well inside the technology frontier as export performance or the rate of import substitution (in the presence of competition between domestic producers) can provide very good indirect information about the rate of productivity growth and quality improvement achieved by individual producers. The difficult part of growth-enhancing

governance is to implement and enforce difficult decisions about resource withdrawal when performance is poor.

These and other available case-study evidence suggest that success in growth-enhancing governance depends on a number of institutional and political factors that enable the effective implementation of the underlying growth-enhancing strategies. Table 9 also summarizes how the internal power structures of these countries played an important role in explaining why particular strategies of governance could or could not be effectively implemented.

Growth-enhancing governance is helped if political factions are too weak to protect non-performing industries and sectors (Leftwich 2007). If political factions are strong and there are many of them, it becomes relatively easy for failing firms to buy themselves protection by offering a share of their rents to political factions that offer to protect them. The South Korean experience with industrial policy during the 1960s and 1970s demonstrates how the absence of strong political factions can have very beneficial effects for a particular strategy of growth-enhancing governance. In contrast, the South Asian experience during the same decades (like that of many other parts of the developing world) shows how fragmented political factions can prevent effective growth-enhancing governance. But growth-enhancing governance can be moderately effective even in the presence of strong political factions, provided there is a political settlement that allows the political demands of factions to be satisfied through centralized transfers that can be separated from the rents created to induce growth and technological progress. Centralized transfers to political factions can reduce the incentive of factions to capture rents by protecting any rent-recipients who are willing to share rents with them. The Malaysian growth strategy of the 1980s and 1990s provides some support for this hypothesis.

These possibilities can explain why successful countries appear to have very different growth-enhancing strategies when we look at the details of the instruments and mechanisms through which they set out to achieve rapid development. Strategies that can be effectively implemented in one context may be much more difficult to implement somewhere else. Different policy instruments may be more effective in other contexts if governance capabilities are more appropriate for enforcing these alternative strategies. This can explain why we can observe different combinations of policies and growth-enhancing governance capabilities delivering good, if not equally good results in different countries. So, for instance, a strategy of subsidizing credit for large conglomerates as in South Korea may have provided very poor results in a country like Malaysia where the enforcement capacities for such a strategy would have been much weaker.

In contrast, the Malaysian strategy of creating incentives for multinational companies to bring in high technology industries and subcontract to local companies proved much more successful because this strategy was more consistent with Malaysian governance capabilities. Thus, while Malaysian economic performance was a little poorer than that of South Korea, given Malaysia's internal institutional and political structure and growth-enhancing governance capabilities, Malaysia's growth was probably higher than if Malaysia had tried to follow South Korean economic strategies precisely. An analysis of the types of growth-enhancing strategies that can be effectively implemented in particular developing countries could therefore identify somewhat different growth strategies in different countries, even though they address similar problems (of

accelerating resource allocation to growth sectors and accelerating technology acquisition).

As our analysis suggests that growth outcomes depend on the *compatibility* of a growth strategy with growth-enhancing governance capabilities, it is possible to explain why many developing countries performed so poorly with growth strategies that appear similar to the ones followed by successful countries. A growth strategy that cannot be implemented could well provide worse results than if there were no growth strategy at all because any growth strategy overrides some allocations that would otherwise have happened through the existing market system, thereby creating rents and rent seeking opportunities. If these rents fail to accelerate learning and instead result in large rent seeking costs, the economy would be worse off trying to implement these strategies. However, this is not necessarily a failure of the growth strategy as such, but rather an indication of its inappropriateness in a particular country given its failure or inability to address the necessary governance requirements required for implementing this strategy.

Finally, in some countries such as in South Asia, growth strategies created technological capabilities and entrepreneurs even though governance capabilities were absent for fully utilizing these opportunities or for pushing emerging entrepreneurs up the value chain and productivity ladder in the way that the policy had envisaged. As a result, there were significant under-utilized resources and capabilities that liberalization could harness to generate significant growth accelerations in the 1980s and beyond. The challenge for these countries is to sustain these growth rates now that the industrial policies that created technological capabilities and allowed accumulation by new classes of emerging entrepreneurs have been significantly reduced in scope.

Policy Conclusions

The distinction between market-enhancing and growth-enhancing governance can allow us to make sense of the complex comparative economic performance of developing countries since 1960. It also allows us to reassert the importance of governance even though the types of governance that we should be focusing on may be different from the ones identified in the good governance agenda. The danger of an exclusive focus on market-enhancing governance is that we may lose opportunities for carrying out critical reforms that are more likely to produce results. We may also create disillusionment with governance reforms leading to the emergence of a false perception that governance does not matter that much for economic development.

For many poorly performing developing countries, looking at the dramatic success stories in East Asia does not provide much guidance for economic policy or governance priorities as these countries are very different from each other, and their level of institutional and governance capabilities is so far advanced from that of poorly performing countries that it is not really obvious where poor countries should start their growth-enhancing governance reforms. The feasible strategy in most developing countries must be to start with relatively small and incremental growth-enhancing governance reforms, by identifying a few sectors that already work reasonably well and asking what types of market failures may be constraining productivity growth and movements up the global value chain in these sectors. Such an approach is likely to identify relatively obvious market failures in technology acquisition, skill acquisition and land and resource acquisition in these sectors. By focusing on very discrete problems, policies can be designed to address these market failures, and this in turn should identify specific and narrowly defined governance requirements that would be required to ensure that the interventions do not fail due to moral hazard problems or rent

capture of different sorts. By deliberately starting at a small scale, governance capabilities can be built up which if they succeed in assisting productivity growth, wage growth or employment growth in a single or a few sectors can then create enthusiasm for upscaling these capabilities for application to other sectors. I have elsewhere described this as a 'Hirschmanian' approach to pursuing growth-enhancing governance reforms (Khan 2006b, 2008).

It is important to reassert the importance of governance reforms at a time when the failure of much of the good governance agenda in delivering strong results is resulting in reform fatigue and the perception that perhaps governance is not after all very important in poor countries. This would be an unfortunate conclusion given the historical evidence that the absence of governance capabilities have severely constrained poor countries from solving the market failures that have constrained their growth and development. Rather, the conclusion must be that while the good governance goals are in many cases desirable long-term goals for all countries, many of these goals are not achievable to any significant degree in poor countries. They are certainly not achievable to the extent that market efficiency will improve to the extent that other governance reform goals are irrelevant. On the contrary, the immediate governance capabilities that are required for triggering or sustaining growth in poor countries are variants of the growth-enhancing capabilities that we find in successful and sustained growth experiences in the developing world.

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