# Beyond Good Governance: An Agenda for Developmental Governance

Mushtaq H. Khan

The limitations of the good governance agenda are well reviewed in the rest of this book. The empirical relationship between improvements in the governance capabilities identified in the good governance agenda and the achievement of accelerated economic growth has not been established. There is a weak relationship identified in some regression exercises, but the strength of the relationship is weak at best. The arithmetic results suggest that the additional growth achievable through feasible improvements in good governance is limited. Deriving important policy conclusions from the results of weak multi-country regression results is also problematic for other reasons. For one thing, given the two-way causality that exists between good governance capabilities and economic growth, econometric tests are imperfect in identifying the strength of the relationship in one direction. More significantly, supporters of the good governance reform agenda have failed to identify convincing case studies of countries that actually made a significant economic transformation (from poverty to high standards of living), primarily by following the agenda that they propose. Even if we accept that achievable improvements in good governance capabilities in developing countries could result in *some* improvements in growth and development, this does not establish that these improvements will be sufficient for achieving a developmental transformation. The case study and statistical evidence actually supports the importance of governance, but suggests that a different set of governance capabilities were important. Countries that achieved significant developmental transitions in the last fifty years had strong governance capabilities, but none of them would have scored highly in terms of 'good governance' when their takeoffs began, or for a considerable period thereafter. Rather, they had governance capabilities for addressing specific problems, such as overcoming constraints limiting technology acquisition, solving problems in allocating valuable resources such as land and maintaining political stability within tolerable limits. We describe these capabilities as developmental or growth-enhancing governance capabilities.

The exclusive emphasis in policy and analysis on 'good governance' capabilities is symptomatic of a deeper bias in contemporary economic policy and research. Economists agree that there are many reasons why private contracting cannot solve many important economic problems. These reasons explain a range of market failures constraining growth and development. It would be inappropriate to suggest that institutional and policy interventions could achieve *all* the beneficial outcomes that private contracting failed to achieve. But the opposing position, which dominates in contemporary research and policy, is also inappropriate. This position is that the role of policy should be to focus solely on improving market efficiency so that private contracting could solve these problems. Governance reforms of the 'good governance' variety are essentially attempts to build state capabilities for enforcing the rule of law and property rights so that private contracting can take over and market failures will then disappear by definition. One danger of this approach is that it assumes that significant improvements in contracting efficiency are possible in developing countries. All the evidence suggests that such significant improvements are not achievable for structural reasons. This is why successful development has depended on critical public agencies with capabilities to assist in the solution of a small number of critical market failures. The contemporary approach to governance

ignores the importance of these developmental governance capabilities that have been critical for triggering and sustaining growth in developing countries.

The types of market failures that may constrain growth can be identified by looking at the policies that have been important for sustaining growth in developing countries. The Growth Report of the Commission on Growth and Development (2008) summarizes the state of knowledge in this area. The Growth Report takes care to point out that growth is a complex process involving experimentation and the ability to respond to evolving problems. It rightly points out that there is no blueprint of necessary and sufficient conditions that can be identified, and responses that are appropriate at one stage of development may become a problem if continued for too long. Nevertheless, the report identifies five broad areas where *policy* appears to have been important for achieving sustained high growth in the post-war period. These policies were both about enabling markets to address particular problems, but also correcting market failures when private contracting on its own was insufficient.

A first broad group of policies were important for supporting high levels of accumulation. A second group of policies promoted innovation and imitation, and accelerated or sustained the technological catching up that development involves. A third group of policies achieved macroeconomic stabilization. A fourth set of policies ensured the effective allocation of land, labour and capital. And finally, there were policies that ensured social inclusion and were important, not only for achieving developmental goals, but also for maintaining the political sustainability of the growth regime (Commission on Growth and Development 2008: 34). The report makes clear that countries used different policies and instruments to achieve these goals, and all countries did not perform equally strongly on all these fronts all the time. Nevertheless, sustained growth over long periods of time required policies that achieved a significant level of success on all these fronts.

These interconnected areas are broadly defined and cover the main issues relevant for understanding the growth process in developing countries. The debates over macroeconomic management have a separate literature and will not be examined further here. However, aspects of investment, technology acquisition, factor allocation and political stabilization are strongly interconnected with one another, and with the institutional and political governance capabilities that are our focus. We argue that governance capabilities that support appropriate policies in these areas are critical for sustaining growth in developing countries. But as the Growth Commission report also sets out, there is considerable debate and empirical variation observed in the policies that achieved the outcomes that contributed to sustainable growth across countries. Successful countries addressed these problems in different ways, using different institutions and policies, but success required addressing a common set of problems.

Economic policy has been important for addressing a range of serious and sustained market failures that constrained performance in each of these areas. The market failures are broadly recognized, but the best way to respond to them seriously divides economists and policy-makers. In recent years, the response to these market failures has been to focus on a narrow set of governance reforms that are aimed at enhancing the efficiency of markets and thereby reducing their extent and severity. These ‘good governance’ reforms are now well known, focusing on improving the enforcement of property rights, the rule of law, reducing corruption and improving the accountability of public officials. These governance reforms aim to achieve *market-enhancing* changes in the institutional environment rather than to directly tackle the market failures that constrain accumulation, technology acquisition and other constraints on growth in developing countries (Khan 2007b, 2008a). If a market-enhancing

governance strategy could actually make markets more efficient, private contracting would achieve all these goals and further policy attention would not be required.

While progress on market-enhancing governance capabilities is certainly desirable, the historical evidence suggests that progress along these directions is unlikely to be rapid or extensive in most developing countries for a number of structural reasons (Khan 2008a). As a result, sustaining growth in poor countries also requires governance capabilities and policies that directly address specific market failures. If particular solutions cannot be found to raise accumulation, accelerate technology acquisition and address other constraints in ways that are effective for that country, it is unlikely that growth will be sustained. These specific governance capabilities may be described as *growth-enhancing* or *'developmental'* governance capabilities to distinguish them from general market-enhancing governance capabilities. Our hypothesis is that by accident or design, successful countries had a number of governance characteristics that enabled them to implement policies to overcome critical market failures constraining growth given their specific initial conditions.

The developmental governance capabilities that drove growth in the high-growth East Asian countries have been known for some time. But it is perhaps unfortunate that the discussion of developmental governance has been dominated by the experience of these industrial policy regimes in North East Asia (for instance, Amsden 1989; Wade 1990). While these regimes were indeed developmental, the problem paradoxically was that their developmental governance capabilities were very strong, making it less likely that they could serve as credible role models for other countries whose internal political organization and initial conditions made it less likely that they would be able to follow these strategies. The more recent growth experiences in South and South East Asia and in Africa appear to be driven to a much greater extent by 'market forces'. In fact, the North East Asian countries were also market economies which grew by taking advantage of global market opportunities. The greater role of 'market forces' in the growth experiences of South and South East Asian countries in the 1980s and beyond imply that there appear to have been less significant government interventions in these countries.

In reality, the picture is, of course, more complex. The role of the state has been less direct in South and South East Asia, and technological progress in the 1980s and beyond has indeed been driven by private sector firms relying on market contracts to a greater extent. But their existing capabilities were themselves very often the result of past capability-building programmes where governments were closely involved. Also, the strategies of private sector firms in driving capability development in critical growth sectors depended on business-government relationships that enabled the leading firms to address particular market failures. The emergence of the automobile and pharmaceutical sectors in India or the garments industry in Bangladesh are examples (Khan 2009b). It is important not to misread this history as one of purely market-driven growth. The critical sectors that drove growth in these countries would not have developed if important market failures had not been addressed through very specific solutions. It is important for developing countries to continue to ask themselves where further capabilities and globally competitive firms may be coming from to spread growth to new sectors and regions.

Fortuitous global conditions and business-government relationships may have allowed the development of critical new technological capabilities in a few sectors in a few countries. Behind the scenes, their growth strategies worked because the appropriate developmental governance capabilities effectively existed. But to drive growth into new sectors and to sustain growth, an analysis of the governance capabilities that were responsible for driving growth in these sectors is necessary so that these examples of success can be replicated across other sectors and regions within

these countries. The challenge of developing growth-enhancing governance capabilities is therefore not about attempting to replicate the institutional and policy experience of North-East Asian countries, but rather to better understand the drivers of growth in particular developing countries so that their own developmental governance capabilities can be identified, built up and strengthened to sustain growth. In particular, where accidental business-government relationships drove growth, it is particularly important to identify how particular government failures were addressed, so that more formal and directed policies and capabilities can be developed for other sectors.

The next section examines the roots of the 'market-enhancing' good governance agenda. The following section summarizes the evidence that casts doubt on the relevance of this policy agenda for developing countries. The next section looks at the alternative developmental or 'growth-enhancing' governance agenda, and explains the importance of understanding the experience of growth in particular countries through this lens. The example of the Bangladeshi garment industry is used as an illustration to show how an alternative reading of history can suggest a different set of governance challenges for developing countries.

## The Emergence of the Market-Enhancing Governance Agenda

Developing countries have long known about market failures and why opening up to markets is desirable but does not guarantee the achievement of competitiveness. The distinction between competition and competitiveness lies at the heart of many of the policy challenges facing developing countries. The ability to compete in global markets is an essential condition for sustaining growth. And for this, access to global markets and eventually, openness to market competition is also essential. However, while competitiveness is indeed critical, opening up domestic markets and exposing domestic producers to the discipline of global markets will not necessarily achieve competitiveness unless domestic producers are already close to the global competitiveness frontier. Nor will access to markets necessarily allow domestic producers to make the relevant contracts to ensure that their productivity is improved to globally competitive levels. This is because markets in developing countries are likely to suffer from significant transaction costs which, in turn, are observed as market failures. The adoption of free markets *in the presence of market failures* will not ensure that currently backward domestic producers can contract to achieve competitiveness in global markets. Under these conditions, low wages are no guarantee of inward capital flows or investments by domestic investors in ways that achieve competitiveness in critical sectors that can lift up average standards of living in the country. Indeed, the historical experience has been that the adoption of free market strategies in the presence of market failures can lead to a collapse of domestic productive capacity rather than its rapid improvement, particularly when domestic producers are far from the global technology frontier.

Far from achieving convergence with more advanced countries, the colonial history of most developing countries was one of growing divergence between themselves and advanced countries after colonial trade policies were imposed on them. For instance, from 1873 to 1947, Indian per capita income declined from around 25% to under 10% of the US level (Clark and Wolcott 2002). This happened during a period of virtual free trade as average tariffs were under five per cent of trade values during most of this period. This was also a period of relatively strong protection of the rights of foreign (British) investors and virtually no restrictions on the repatriation of capital and profit. The proximate cause of this relative decline was simply that it was not profitable to invest in modern manufacturing or agriculture in India. The productivity of Indian workers was so low that low wages

did not give India a competitive advantage in almost any industry. This problem remains today for most sectors in most developing countries.

The persistence of low productivity is a puzzle because this problem should be solved by long-term private investments in up-skilling and training of workers and managers. Given the wage differentials, the promise of significant future profits should induce private investors to invest in capability development in developing countries. But the puzzle disappears when we look at the significant market failures in capital, land and labour markets that prevent productivity-raising contracts being credible (Khan 2009b). Without any corrective strategies to overcome these market failures, the only areas that are likely to grow in poor free-market economies are sectors that have already achieved international competitiveness. These are typically low technology sectors where the productivity gap with more advanced competitors is likely to be low and the wage differential can more than compensate for this. But these sectors are also typically only capable of adding limited value to the domestic economy. Moreover, the pathways up the value chain from these low technology sectors may also be blocked if the market failures constraining capability development are not addressed.

The challenge of development is that in most developing countries, there are very few sectors that have already achieved or are close to levels of international competitiveness. The rapid growth that some developing countries have experienced in recent years can be traced to their achievement of global competitiveness in a few sectors like garments and textiles, cut flowers, toy and shoe manufacturing or food processing and packaging. A few other developing countries like India have achieved global competitiveness in a small number of high technology sectors like software, pharmaceuticals, iron and steel and automobiles. When we look at these success stories, we find that in each case, global capabilities were built up through very specific processes that overcame critical market failures. In many cases, initial capabilities were developed under earlier policies that may not have been very successful across the board, but did develop capabilities in pockets. Many of these high capability sectors then led growth during the 1980s and beyond. As a result, the challenge of replication and spread remains for most of the economy, even in relatively successful developing countries.

The market-enhancing approach in addressing market failures has to be understood in the historical context of previous attempts to address these issues in developing countries. At the end of colonial rule, the initial response in many developing countries was to address market failures constraining technology acquisition using a variety of direct interventions that sought to build capabilities by protecting infant industries. These policies included import protection, the promotion of public sector industries in new technologically advanced sectors, licensing the use of foreign exchange to reduce the cost of investments in new sectors and so on. In general, these policies provided subsidies to investors in new sectors to compensate for temporary backwardness and the high costs of organizing investments, given market failures in capital, land and other markets. Such interventions were common in the 1950s and 1960s as developing countries attempted to reverse their performance under colonialism by developing infant industries in new higher technology sectors.

Early strategies of promoting infant industries were disappointing in many developing countries. One problem was that given their capabilities, the scope of policy was too broadly defined. Even to effectively address a narrower range of issues, governance capabilities would have to be developed in many cases to manage these interventions and prevent policy-induced rents being captured by unproductive firms and entrepreneurs. In most developing countries, these capabilities were not remotely sufficient to enforce the requirements for success. While there were some attempts to

improve these governance capabilities, their importance was not sufficiently recognized at the time. In their absence, interventions to correct market failures often resulted in poor outcomes. Infant industries refused to grow up, subsidies were captured by powerful groups, and public sector enterprises underperformed with rents dissipated in over-employment and other forms of inefficiency. Clearly, providing implicit subsidies was not enough without incentives and compulsions based on appropriate institutional design and governance capabilities to enforce rules to ensure that interventions to correct market failures had a positive net effect.

The response to this experience should have been to conclude that perhaps the range of interventions needed to be scaled back to only target critical market failures, and that appropriate governance capabilities needed to be developed to ensure the success of these interventions. Instead, the response from the late 1970s onwards was to abandon corrective strategies in their entirety. The perception was that the 'government failures' that had resulted from these interventions were worse than the market failures they had set out to correct (Krueger 1990). Liberalization to get rid of these failing interventions began to gain currency, particularly because in many developing countries, state interventions were indeed very inefficient and often resulted in net reductions of welfare. But it soon became clear that liberalization itself required governance capabilities. Markets required not an absence of government, but actually required very strong and effective governance to enforce property rights, maintain a rule of law and create other regulatory conditions that would allow private contracting to work effectively. And so, governance entered mainstream policy discussions as part of a strategy of promoting markets and creating the 'level playing field' for private contracting based on comparative advantage.

In theory, if the state could enforce these institutional rules, market transaction costs across the board would be low enough for market failures to disappear. This was the genesis of the theoretical economic case for good governance. All of the key capabilities within the good governance agenda were essentially about enforcing property rights and the rule of law effectively to make markets more efficient (Khan 2004, 2005a, 2008a). Other parts of the agenda, such as reducing corruption and making governments more accountable directly, fed into the goal of ensuring a rule of law and stable property rights. But in addition to the theoretical economic arguments, the good governance agenda became politically robust because obviously, citizens in developing countries wanted these conditions as *ends in themselves*. After all, who wants to live in a society with high levels of corruption or poor rule of law? But for international agencies and analytical economists, the good governance capabilities were *means to an end*: the achievement of efficient markets in developing countries. The convergence of civil society demands and the analytical policy support of mainstream economists and policy-makers contributed to make the good governance agenda unassailable for a long time.

The problem from the perspective of economic development was that the new strategy was, if anything, even more ambitious than the old one. For a developing country to do significantly better on good governance capabilities than its per capita income warrants appears to be quite difficult. There are obviously differences in good governance capabilities between developing countries, even at the same level of per capita incomes, but these differences are relatively small, particularly when we consider the standard errors inherent in numerical measures of governance capabilities. But governments can only ignore market failure and focus on good governance capabilities if they are assured of making significant progress on these capabilities. Indeed, they would have to make very significant progress in enforcing property rights and the rule of law if market failures are to effectively disappear. This is not only an ambitious expectation in developing countries, it goes

against all the historical evidence of what is possible and ignores important structural conditions that are likely to make these goals unachievable in any realistic timescale (Khan 2007a).

The most obvious structural constraint in the path of transforming poor countries in line with good governance expectations is that the protection and enforcement of property rights are expensive. When the majority of assets in a country are of low productivity, they are unlikely to have the collective capacity to pay for effective enforcement of property rights as a public good. The same goes for the enforcement of the rule of law. The historical evidence is that the enforcement of property rights and the rule of law are closely correlated with the average productivity of assets since it is the income generated by assets that ultimately has to pay for the enforcement of formal institutions. Clearly, differences among countries, for instance, in terms of how political groups are organized and how intensely the ownership of assets is contested, may affect the enforceability of rights and rule of law. Clearly too, the causality between the enforcement of rights and the productivity of assets goes in both directions, so slightly better enforcement of formal institutions can give a developing country an advantage. But it is unlikely for a poor country to achieve enforcement of the rule of law or of property rights that is significantly out of line with its ability to pay for these public goods. Therefore, it is unlikely that a feasible improvement in the enforcement of property rights and the rule of law in a developing country will make it unnecessary to identify and respond to particular market failures.

For similar reasons, it is also unlikely for a developing country to achieve a significant reduction in corruption on a sustainable basis that is out of line with its per capita income, adjusting for specific country level differences in the organization of politics and criminality (Khan 2001, 2002, 2006a, 2006b). It is not surprising that after much effort on anti-corruption campaigns, there has been little reduction in corruption on a sustained basis in developing countries. There are a number of reasons for this dismal performance which should make us not more tolerant of corruption, but certainly more careful in identifying priorities in anti-corruption strategies. The term corruption describes a wide range of processes where public officials transgress formal rules of conduct for personal benefit. Like property rights and the rule of law, a large part of corruption is due to limited resource availability for enforcement. In addition, it is structurally difficult to legalize many rents in developing countries because the emerging capitalists who are the beneficiaries of these rents still lack legitimacy. In contrast, advanced countries also have significant rents, but these rents are largely legal and take the form of subsidies and transfers. As a result, the rent seeking around these rents can also be legalized and regulated. If many rents cannot be legalized, the associated rent-seeking will remain grey or illegal, making a significant part of rent seeking structurally corrupt in developing countries. Over time, as the capitalist sector becomes established and legitimate, some corruption will disappear automatically as a greater proportion of rents become legitimate and legalized.

Most significantly, political corruption plays a structural role in developing countries and it is important to understand the nature of and variations in these processes. Political stability in any country requires significant redistributive strategies. In advanced countries a large part of national income is taxed and redistributed legally through formal fiscal processes as part of the political process of stabilization. As much as forty per cent of national income is typically taxed and redistributed in these countries. The creation and allocation of these significant rents clearly results in significant amounts of rent seeking, but this rent seeking is legal and regulated, and part of the formal political process. In developing countries, political stability is not and cannot be achieved through formal redistribution in this way, largely for structural reasons. The number of taxpayers is too small, the tax take is therefore a much smaller percentage of national income, the demands for redistribution from different quarters is significantly in excess of the resources available and

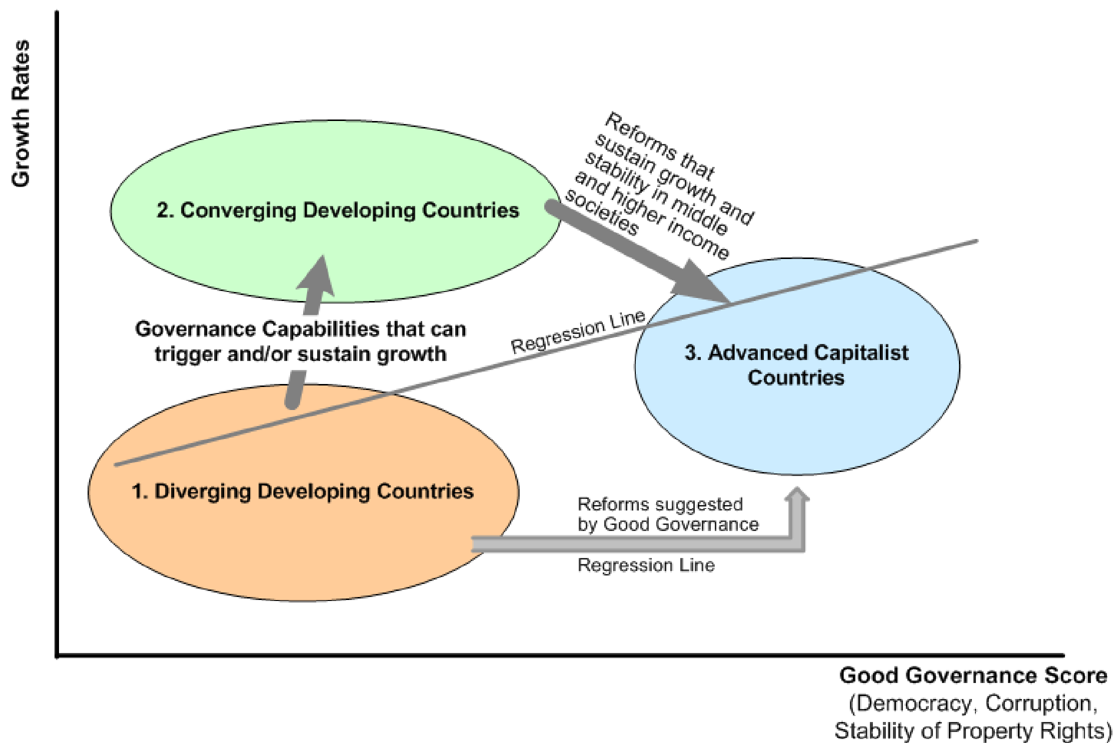
powerful groups are organized by elites who want redistribution to themselves and their groups. The general result is that politics in the typical developing country is personalized, based on constructing coalitions of the powerful who are given access to rents on a privileged basis to achieve a more or less sustainable ruling coalition (Khan 2005b, 2010). While there are significant differences among developing countries, and successful developing countries are gradually becoming rule-following democracies, the typical developing country violates rule-following norms in the very processes through which its ruling coalition is constructed. A significant improvement in capabilities to fight corruption is therefore unlikely until a social order can be constructed in rule-following ways; the development of a broad-based productive society is a necessary precondition for this.

These observations suggest that while progress in the direction of good governance is highly desirable, it is unlikely that developing countries can address their developmental problems solely by focusing on good governance. Indeed, the historical evidence does *not* support the argument that poor countries grew fast by first achieving significant improvements in their good governance capabilities (Khan 2007a, 2007b, 2008a). This is the basis of our distinction between two broadly defined governance reform strategies: the 'market-enhancing governance' (good governance) strategy that focuses on improving general market efficiency and contract enforcement and the '*growth-enhancing*' or *developmental governance* capabilities that allow specific market failures to be addressed (Khan 2007b). In one sense, the latter is less demanding because it requires a more limited set of capabilities in developing countries. But in another sense, building developmental governance capabilities is more demanding because there are no blueprints that are likely to be appropriate for every country. The market failures that are most important are different across developing countries depending on their initial conditions. But moreover, strategies that will work in some countries may not work in others because their initial political and institutional conditions are different and this matters for understanding the type of institutional solutions that are more likely to be effectively enforced. This is why we observe that successful countries used many different strategies of correcting market failures, and strategies that worked in one country often failed in another (Khan 2008a). This makes it particularly important for developing countries to understand these challenges and design programmes that can experiment with different solutions to identify approaches to critical market failures that are more likely to work in their specific conditions.

## The Evidence

It is clear that developing country economies score poorly on every aspect of good governance. Some of these countries do well and others do not and the challenge is to test whether these very significant differences in performance can be attributed to the relatively small differences in their good governance scores. One problem of testing good governance strategies is that the data available is weak and only available from the 1990s (Arndt and Oman 2006).

Figure 1. Good Governance versus Growth-Enhancing Governance




Source: Khan 2007a

However, on the basis of this weak data (based largely on aggregating subjective perceptions indicators) and the limited time over which the data are available, supporters of the good governance agenda have attempted to derive hard support for the good governance strategy using econometric approaches. The econometrics occasionally shows a weak positive relationship between good governance capabilities and growth. But these results are problematic on a number of grounds (Khan 2007b, 2008c). In particular, as Figure 1 shows, when we look at the data in a disaggregated way, high growth (converging) developing countries appear to have the same mean governance scores and the same dispersion in these scores as slower growing (diverging) developing countries. This is consistent with extensive case study evidence of institutional and political conditions in East Asia and elsewhere which suggests that high-growth countries did not *first* achieve improvements in good governance as a precondition for beginning their growth takeoffs.

The positively sloped regression line ignores these significant patterns hidden in the data. Looking solely at the regression result appears to suggest that slow-growing developing countries should focus on good governance reforms to improve their growth rate. But even a snapshot look at the data suggests that the big differences among developing countries are not in their performance along good governance capabilities. They are likely to have significant differences in their governance capabilities, but these are clearly not along the dimensions measured by good governance capabilities. In any case, even if we accept (as we do) that other things being equal, a higher score on good governance is likely to have a positive effect on growth, the strength of the relationship is weak overall. Most regression analysis shows that the additional growth that *feasible* improvements in

good governance can offer is limited (Kurtz and Schrank 2007). An additional one or two percentage points on the growth rate that feasible improvements in good governance could *theoretically* achieve do not promise a slow-growing country a developmental future. And this is ignoring the fact that there is very likely a two-way causality between good governance scores and economic growth, and it is difficult to identify the true strength of the relationship in one direction using available econometric techniques. Deriving important policy conclusions from the results of this methodologically and empirically weak multi-country regression analysis is therefore problematic.

Given the limited support that cross-section data can provide, supporters of good governance policies (for instance, Kaufmann, *et al.* 2007) have sought support in long-term econometric exercises using instrumental variables, e.g. Acemoglu, Johnson and Robinson (2001, 2002). In their approach, instrumental variables correlated with settler colonialism are found to correlate with contemporary per capita incomes. The argument is that settler colonialism established stable property rights and this explains the subsequent prosperity of these regions. But it is by no means clear that the instrumental variable approach proves that stable property rights were important for growth. Other factors were also correlated with the onset of settler colonialism, such as the higher levels of human capital that settlers had, compared to indigenous populations in non-settler societies (Glaeser, *et al*. 2004). But far more significantly, a reading of history suggests that the period of economic transformation in settler colonies was one of significant and violent property rights disruptions (Khan 2009a). The economic transformation of settler colonies involved very significant transfers of assets from indigenous populations to new settlers. History tells us that settler colonialism did not *first* establish stable property rights that allowed efficient markets to achieve significant asset transfers from indigenous populations to more efficient users of their assets. Rather, settler colonialisms followed particularly violent paths of resolving property rights issues and, paradoxically, this allowed them to achieve property right transformations rapidly, though at very high human cost. Far from the examples that Acemoglu, Johnson and Robinson rely on to establish the importance of stable property rights, their examples are actually of countries that used significant violence to achieve transformations rapidly.

The econometrics of instrumental variables diverts attention from this far less attractive historical evidence that tells us that settler colonialism achieved very rapid success in transforming traditional societies because resistance from losers was violently and rapidly overcome (Khan 2009a). Successful productive transformations subsequently allowed the stabilization and protection of the new property rights of settlers over time. No-one disputes the long-run relationship between productivity and property rights because once assets become more productive, they can begin to pay for their effective protection and property rights are likely to be better protected. Nor can it be disputed that everything else being the same, if property rights can be better defined, there will be positive effects on time horizons, investments and contracts. The question is really about governance priorities during this difficult period of *transformation* that developing countries are going through when asset use and social organization are changing dramatically from traditional economies to modern productive ones.

We are concerned about the governance conditions that ensure a rapid and successful *process* of transformation, not the governance that emerges as an *outcome* at the end of the process. Acemoglu, Johnson and Robinson were attempting to demonstrate the governance conditions during or prior to this transition, not the property rights that emerge as a result of a successful transformation. But the historical facts show that they too confuse process with outcomes by relying on econometrics without asking historical questions. History tells us that settler colonial countries did not use efficient markets and contracts (and therefore good governance) to achieve this transformation. Rather, they

used extreme force and violence and a disregard of the rights of indigenous populations to achieve rapid changes in resource allocation towards more productive uses. As models for contemporary developing countries, these are exactly the wrong models for politically acceptable developmental transformations. Thus, neither the cross-section econometrics using contemporary governance indicators nor the instrumental variable regressions provide convincing evidence that countries actually made a significant transition from poverty to prosperity by *first* achieving good governance capabilities as a precondition for the effective developmental transformations of their societies.

The contemporary data summarized in Figure 1 as well as case study data suggest that converging developing countries did not achieve their high rates of growth by first achieving good governance capabilities (Khan 2007a, 2008a). However, we know that group 2 countries in the figure include many different types of growth stories, some more sustainable than others. Some converging economies had significant growth-enhancing governance capabilities that allowed them to address important market failures across the economy. This allowed them not only to grow fast for a while, but also to sustain this growth and spread it across the economy and make a sustained transition to prosperity. The North East Asian countries were examples of countries with such governance capabilities. But other countries in the converging group are there because they have some sectors or regions or minerals which produce globally competitive products and where business-government relationships have either consciously or accidentally developed to solve particular problems constraining growth.

This means that in many group 2 countries, the governance capabilities that triggered and sustained growth were often based on very specific political and institutional arrangements that varied across countries, but nevertheless deliberately or accidentally addressed specific market failures. Despite differences across countries, institutional arrangements and governance capabilities worked only if they successfully addressed important market failures. In particular, there were broad types of problems that needed to be addressed, even if the solutions differed somewhat across countries. The viability of the growth process for converging developing countries depended on the effectiveness of these solutions and their sustainability given the political settlements within their societies. These countries face significant challenges in sustaining their growth by replicating their success across new sectors. A starting point is to analyse the factors that allowed growth in some sectors to be able to replicate and extend this growth across the economy. For the diverging countries, there is an even more difficult challenge of experimentation and effort in devising effective responses to the most important market failures constraining their growth.

## Developmental Governance: An Analytical Framework

Markets provide access to trading opportunities, and therefore a growing economy must have reasonably well-working markets. But history as well as economic theory tells us that market access may not be of much use for a developing country if it does not have the competence and capability to produce goods and services of the right quality and price for the global marketplace or domestic markets. At the heart of development therefore is the challenge of developing broad-based productive capabilities in a society. The inputs required for enhancing productive capability, namely machines and equipment and a workforce with the appropriate formal qualifications, have often been the focus of economic theory and policy. But history is replete with examples of investments that fail and workers with formal education who remain unemployed. And in fact, the fear that investments will fail to become productive is usually what constrains investment, not the absolute scarcity of productive factors. Indeed, many developing countries suffer from capital flight and the outmigration

of skilled workers, suggesting that what is missing is the knowledge about how to put together productive factors to produce competitive products.

At the heart of this missing knowledge is a set of missing technological and entrepreneurial capabilities to use machines and workforces effectively to produce competitive products. Hirschman (1958) had pointed out the critical absence of entrepreneurial capabilities in developing countries a long time ago. Hirschman's entrepreneurial capabilities were a shorthand description of capabilities that involve a type of knowledge that has subsequently been described as *tacit knowledge* that owners, managers and workers can only achieve through learning-by-doing and by putting in high levels of effort over time (Nelson and Winter 1982; Stiglitz 1987; Lall 1992; Lall and Teubal 1998; Lall 2000a, 2000b). The obverse of tacit knowledge is the codified knowledge that can be learnt in classrooms, textbooks and instruction manuals. In contrast, tacit knowledge can only be acquired by learning-by-doing, though of course, depending on the technology, some initial level of formal codified knowledge is necessary. The point is that developing countries are often unable to even produce things for which they *have* the formal codified knowledge, because what is missing is the relevant tacit knowledge. Consequently, an increase in investment in new productive capacity and in formal education is necessary, but not sufficient for achieving growth or sustaining it. It is also necessary and even more important to acquire the technological and entrepreneurial capabilities so that the country can make profitable use of new investments and keep acquiring new technologies that are appropriate for using the formal skills that they already have. A further problem in many developing countries is that new enterprises find it difficult to acquire land that is contiguous given the weak definition of property rights and the fragmentation of landholdings. This can also significantly raise the transaction costs of setting up new enterprises. Sustaining growth requires institutional solutions that can address these and other problems.

Most developing countries make relatively slow progress in 'learning to learn' these critical capabilities on an ongoing basis (Stiglitz 1987). This is often a critical problem slowing down their growth and can easily result in a spurt of growth driven by high levels of investment, eventually becoming unsustainable in a competitive global economy. Indeed, in the absence of rapid development of these capabilities, the rate of investment will also slow down since new production facilities will not be profitable. *In other words, the rate of investment is dependent on the success of a country in acquiring new entrepreneurial and technological capabilities.* While investment can assist in developing the capabilities to learn and to create the institutions and governance capabilities for sustaining learning, high levels of aggregate investment are not, in themselves, sufficient to ensure this. Since attaining these capabilities is hugely beneficial for society collectively, and should potentially be profitable for the firms investing in learning-by-doing, it is useful to ask why many developing countries find it so difficult to make sustained progress here.

In general, when economies fail to achieve socially beneficial outcomes, we can classify the possible reasons for the failure in terms of different types of 'market failures'. We use the notion of market failure as an organizational tool to classify different types of problems, and not to imply that markets are potentially self-regulating if the causes of failures are removed. There are broadly two types of approaches to market failures. The first, and less useful approach, is to compare actual market outcomes with a theoretical benchmark of a perfectly competitive market. Deviations from that benchmark are identified as market failures. This approach is typically not useful because it is now well known that a perfectly competitive market is not a realistically achievable benchmark and does not help us to identify feasible missed opportunities in a context of social transformation (Stiglitz 1996). However, the approach continues to be influential because the dominant good governance approach of developing market-enhancing governance capabilities is implicitly derived from this

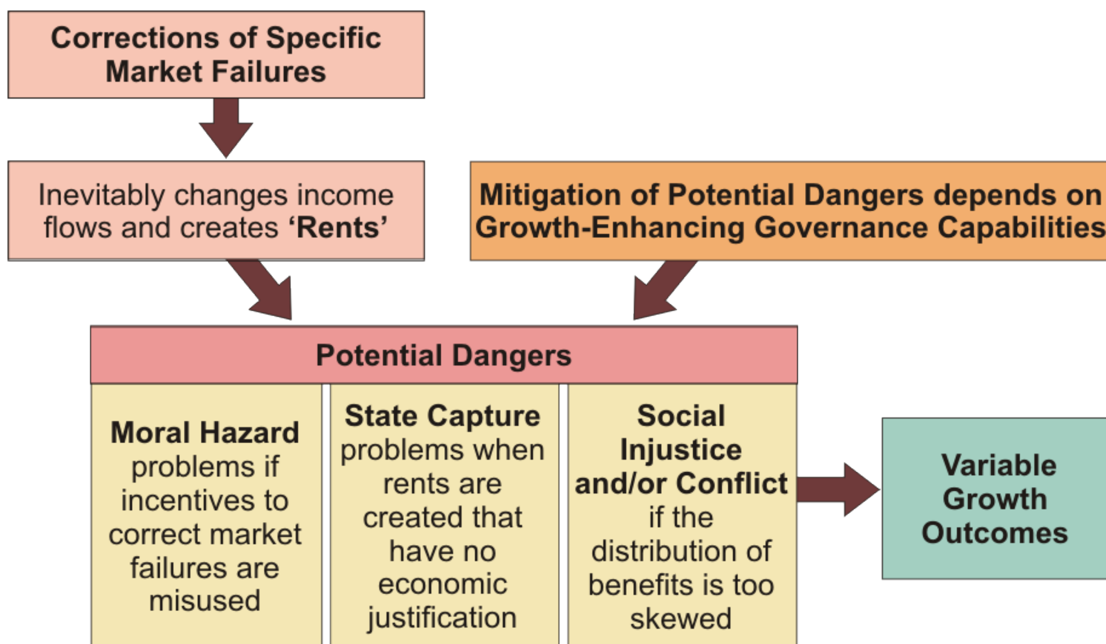
perspective. The strategy of making markets more efficient across the board by reducing transaction costs assumes that significant progress towards the theoretical optimal market outcome can be achieved in this way.

The second and more pragmatic approach to the analysis of market failure is to identify *incremental* changes in institutional arrangements that can *improve* economic outcomes. The incremental or partial equilibrium approach does not make any presumption that a theoretical perfect market exists that would maximize global welfare. Indeed, it argues that such a benchmark is based on implausible assumptions that hinder, rather than help, the construction of policy. Instead, this approach is to ask whether it is possible to solve particular problems that can raise value added or welfare in the economy. The *growth-enhancing approach to governance* is in this tradition, and argues that the primary task of governance reform is to enhance the governance capabilities of states so that they are better able to address specific problems in developing countries that private contracting is failing to solve.

The incremental approach asks if there are economic activities which would enhance social output or welfare, and if there are, why individual contracting is not resulting in these activities being implemented. If an activity (like investment in a new sector) can potentially raise net social output, in theory, it should be possible for investors, workers and others to privately contract to set up the production and collectively benefit. If they do not, then it is likely that there are specific transaction costs (including information costs and the costs of enforcing contracts) that are preventing private contracting and these are the sources of the specific contracting failures that we identify as the relevant market failures in this context. If specific institutional changes and policies can be identified that could allow some or all of these activities to take place then the market failure can be addressed. But the success of these strategies is likely to require the simultaneous development of specific governance capabilities to ensure that policies and institutions are adequately enforced. These are the relevant growth-enhancing or developmental governance capabilities in this context.

Indeed, even in very rich societies that can spend significant amounts on market-enhancing governance, specific market failures always need to be addressed. Given the greater inefficiency of markets in developing countries, it is puzzling why the importance of developing these specific capabilities is underplayed in developing countries. The work of Stiglitz (1996) and others has shown that market failures can be widespread due to information asymmetries and other reasons. These asymmetric information problems alone mean that market societies require extensive rents to operate reasonably efficiently. Rents create incentives to improve on market outcomes in the presence of asymmetric information and other market failures. Some of these rents, such as reputation rents or efficiency wages, can appear spontaneously through private institutional arrangements in advanced economies. However, many significant market failures are not addressed spontaneously, particularly in developing countries, and here, government action is required. At the same time, the correction of specific market failures does indeed face problems of rent seeking and moral hazard that the liberal critique identifies. The major problems are summarized in Figure 2.

Figure 2 Governance Capabilities for Addressing Market Failures




Policy and institutional responses that address specific market failures will inevitably change income flows and, by definition, create 'rents' defined as income flows that would not otherwise have existed in the absence of these policies or institutional responses (Khan 2000b, 2000a). The emergence of rents does not always imply the reduction of welfare or growth prospects. Indeed, some rents are associated with the implementation of growth and welfare-enhancing policies addressing market failures. The problem is that there are strong incentives to engage in rent seeking activities of different types to influence the type and allocation of rents in society. The management of rents is therefore important because rents are likely to induce rent seeking. Rent seeking is the expenditure of resources by potential beneficiaries to influence state policies in particular ways. State policies, even potentially beneficial ones, can create rents, and thus induce rent seeking. Sometimes, the rent seeking is damaging because it influences or distorts state policies in damaging ways, allows powerful groups to capture rents or otherwise subverts policy. At other times, the rent seeking may have a cost, but does not prevent the implementation of policy. In the most benign case, rent seeking is simply the mechanism through which conflicting interests formulate socially beneficial policies (Khan 2000a). Thus, like rents, rent seeking as such is not necessarily a problem, and in any case, it cannot be eliminated entirely. The important point, from the perspective of governance reform, is that while the creation of some rents (like monopoly rents) lowers social welfare, other rents (like some government expenditures) may be a response to existing market failures, and if properly managed, can raise social welfare. The critical determinant of outcomes is therefore the governance capabilities of the agencies implementing the relevant policies.

As Figure 2 summarizes, policies to correct specific market failures can result in a number of problems. First, there is a problem of moral hazard where policy creates benefits for some market participants, but fails to achieve the desired policy goal. For instance, subsidies to assist training or making credit lines available to new start-up companies to overcome capital market failures, may be

wasted without achieving the desired result. For this not to happen, governance capabilities of oversight and withdrawal are required so that the rents are not permanent and may be withdrawn if results are not achieved. The more narrowly defined the policy is, the more plausible it may be to develop the governance capability to administer the policy reasonably effectively. A second problem is that policy-making agencies of government may get captured by rent seekers who may engineer solutions to market failures that do not really exist, simply to benefit from the rents created as a result. Limiting these possibilities require governance capabilities and oversight by stakeholders to ensure that state capture cannot reach damaging proportions.

Finally, policy responses to market failures may be politically controversial because solutions to market failures may benefit particular constituencies or groups. The same market failure can be addressed by many different policy approaches with different distributions of benefits. For instance, a negative externality can be addressed by taxing the emitter of the externality, by subsidizing the emitter not to emit, by regulatory limits on emission, or by creating property rights on the externality-generating activity. Each solution has different transaction costs and therefore chances of success, but more significantly, each also has different distributions of benefits, even if the net social benefit is the same in all solutions. What this suggests is that if the distribution of net benefits is excessively adverse for powerful or significant groups in society, or if they have significantly adverse welfare implications on marginal groups, then even if the policy enhances growth overall, there may be resistance and opposition that, in turn, will have social costs in the form of conflict. We describe the distribution of power among organized groups in society as its 'political settlement' (Khan 2010). Success in solving specific market failures therefore also requires governance capabilities to ensure that policies do not have excessively damaging political consequences.

To develop reform strategies that are likely to be both implementable and effective, policy-makers would be helped by an understanding of the governance arrangements that have worked in their own countries in the past. In developing new institutional arrangements that can address important market failures, governance capabilities need to develop in parallel so that policy does not fail because of a failure of management and implementation. An examination of the ways in which responses to market failures worked in second tier countries is therefore a useful way for policy-makers to understand and learn from their own success. An important caveat should, however, be kept in mind. Because countries have very different political settlements, their capacity to enforce and manage different types of corrections to market failures is also likely to be very different. Therefore, we would expect feasible and effective strategies of incremental reform to be different across countries, depending on their political settlements and other initial conditions. For particular countries, an incremental approach to reform could build on strategies and institutional arrangements that worked in the past. This should be the foundation for developing a consensus on national development strategies (Khan 2008b). For more general lessons across developing countries, we can identify patterns and types of responses across broad types of political settlements which may simplify research into subsequent groups of countries.

**Learning and Technology Acquisition**

An important set of market failures constraining development affects the acquisition of tacit knowledge and technological capabilities. If learning-by-doing is required to acquire tacit knowledge, production will involve initial periods of loss-making that need to be financed. The private contracting problem is that financiers and those putting in learning effort within firms are

unable to write enforceable contracts that are acceptable to all sides. Learning-by-doing can fail if key stakeholders within the firm fail to put in high levels of effort in experimentation and learning, and the problem for financiers is to ensure that there are enforceable contracts that allow them to withdraw financing, change management or take other steps if progress is unsatisfactory. These are obviously contracts that are difficult to effectively enforce in a developing country. Not surprisingly, financing learning is limited to investments that can be financed by the owners of firms themselves, using their own resources in situations where they have significant control over the effort put into learning. This clearly limits the pace of learning. This important area of contracting failures can be addressed by financing loss-making periods in start-up companies, provided governance capabilities exist to ensure that finance is not wasted as a result of moral hazard problems (Khan 2000b, 2009b).

In the literature on technology acquisition, it is recognized that responding to this market failure involves the management of what have variously been referred to as *learning rents* (Khan 2000b), *contingent rents* (Aoki, *et al.* 1997: 14-18) or *performance-indexed rewards* (World Bank 1993). The financing of learning inevitably creates new income flows for enterprises, managers and workers. These are, by definition, rents, and the creation of rents induces further activity in the form of rent seeking that can subvert the potential correction of market failure. We define rents in this context as policy-induced income flows that would not exist in the absence of that policy. In general, these and many other types of policy-induced rents can be potentially value and welfare-enhancing for society (if they are associated with policies targeting market failures) or the reverse (if they are captured by powerful groups without generating the desired results) (Khan 2000b, 2007a). Whether the potentially beneficial effects of some rents can be realized depends therefore on how the rents are managed by the agencies charged with managing them.

When we look at how developing countries achieved international competitiveness in important sectors that drove their growth, we see a variety of institutional methods of financing the learning-by-doing and a variety of agencies and institutional conditions that had sufficient enforcement capability to ensure high levels of effort. These experiences have important implications for the design of institutions and agencies to promote technology acquisition in developing countries and they indicate the governance capabilities that have to be present to make success more likely. The problem is that the enforcement of institutional rules to ensure that financing is not wasted, in turn, depends on the 'political settlement' in the developing country which defines the relative power of different groups affected by the institution. The enforcement of similar institutions can therefore vary significantly across developing countries. Financing strategies that work in one may fail to have the same effect in another. Nevertheless, strategies that worked in particular countries not only tell us something about their political settlements; it also tells us the likely design of financial instruments for assisting learning that are most likely to work in these contexts (Khan 2009b).

A classic example of capability building is provided by the garments industry in Bangladesh. Low wages and a hard-working, largely female, workforce were important for the success of this industry, but were certainly not sufficient to ensure the emergence of the sector as a globally competitive industry driving exports and employment growth in Bangladesh since the mid-1980s. The acquisition of competitiveness in the sector required the financing of learning-by-doing, and this was based on a number of institutional and political arrangements that sufficed to ensure high levels of effort (Khan 2009b). One component of this financing was provided by the Multi-Fibre Arrangement (MFA) introduced in 1974 to protect the US garments and textile industry. It gave a number of least developed countries like Bangladesh quota-free access to US markets, but these countries had no garments industry that could take advantage of this access, and most of these countries failed to acquire these capabilities. Bangladesh was lucky, because while the MFA gave the country 'quota

rents', the ability to sell at a higher cost of production than the most competitive exporting countries which had become quota constrained, this was not sufficient to ensure that a competitive industry would emerge. That required the investment of further resources in learning-by-doing, and this emerged through a very specific financing arrangement between a start-up Bangladeshi company called Desh Garments and the South Korean Daewoo which had an interest in transferring garments know-how to Bangladesh, given that they also had a textile business that needed to sell fabrics to a competitive garment producing company.

The financing arrangement involved Desh sending around 150 critical personnel to Daewoo's garment production plant in Pusan in 1979, with Daewoo meeting the cost of hosting and providing production-line training. All other costs were borne by Desh. Daewoo would be repaid for its training by a three per cent royalty on eventual sales by Desh and another five per cent for marketing, given its knowledge of global marketing chains. In addition, credibility for the project was provided by high-level support from the political leader of Bangladesh at that time, Ziaur Rahman, who wanted the new sector to emerge. This support made credible the promise that critical institutional innovations required for the project, like back-to-back LCs and bonded warehouses that reduced the cost of financing imports of fabric required as inputs, would be forthcoming. Thus, a combination of targeted institutional arrangements, backed by sufficient enforcement capabilities to ensure high levels of effort in the learning effort, was essential for the eventual success of the project. The way in which the training and learning-by-doing was financed ensured that Daewoo had strong incentives for ensuring that tacit knowledge was rapidly transferred. After all, Daewoo would not be paid till Desh technicians returned home and started exporting. The Desh technicians also knew that an easy life in Pusan was not assured for long, and they too had every incentive to acquire the knowledge and return. Both Desh and Daewoo were confident that assistance would also be provided by the political leadership in Bangladesh to implement a limited number of specific institutional arrangements required for the new sector. Given a full description of the mechanisms of financing and the institutional and governance capabilities backing these conditions, it is not at all surprising why high levels of effort were in fact forthcoming.

In fact, the learning happened at an explosive rate. The initial understanding between Desh and Daewoo was for the collaboration to continue for five years, but so successful was the learning effort that Desh cancelled the collaboration after one and a half years. Indeed, the dramatic growth of garments exports from Bangladesh, first from Desh and then from a growing number of imitators, led the USA to impose quotas on Bangladesh in 1985. So, in the end, the learning opportunities created by the MFA and the additional financing arrangements that allowed the learning-by-doing to happen, only needed to last for a very short time. This is partly because of the relatively simple nature of the technology, but also because the mechanisms and governance capabilities were appropriate for ensuring high levels of effort in learning. In a different way, very specific financing instruments, governance arrangements and an appropriate political settlement were behind other success stories, like the Indian automobile industry and its pharmaceutical industry takeoffs in the 1980s. In each case, market failures that were otherwise constraining learning were overcome by specific financing arrangements backed by institutional and governance structures that ensured high levels of effort in acquiring the relevant tacit knowledge required for global competitiveness (Khan 2009b).

There are lessons to be learnt from these experiences. First, success, even in relatively low technology sectors like garments, was not based simply on opening up markets and waiting for

comparative advantage to do the rest. There were significant missing capabilities, and acquiring them was more difficult than acquiring the machines or organizing the workforce. Secondly, the complex 'contracting' that was required to achieve success in learning-by-doing did not have to await the achievement of generalized good governance conditions that would allow purely private initiatives to solve these problems. The generally high levels of transaction costs in these markets would have prevented private contracting in the absence of any additional assistance. But relatively limited assistance was often sufficient. For instance, in the case of the garments industry in Bangladesh, the limited support coming from the MFA, and a very specific set of institutional promises from the political executive in Bangladesh were sufficient to create both the incentives for private players to invest in learning as well as compulsions for all sides to put in high levels of effort. Thirdly, the solution of these problems did not require national level industrial policy as in the North East Asian countries. Indeed, many of the developing countries that succeeded in accelerating their growth rates after the 1980s did not have the governance capabilities to have attempted learning strategies on that scale. At the same time, these were not simply successes driven by already existing comparative advantage that did not require learning strategies: even relatively simple technologies like garments production required learning strategies to become competitive.

Fourth, in each case of success, the design of the financing instrument was critical. The critical financing 'instruments' (like the Desh-Daewoo agreement) had to be credible in terms of protecting the interests of the different parties, while creating strong incentives for high levels of effort. As the overall governance environment was typically far away from the benchmark of 'good governance', what was required was that the enforcement of critical elements of these agreements was credible, given the overall political settlement in the country. Thus, it is by placing specific arrangements within the broader context of institutions and the political settlement within a country that we can understand why particular financing arrangements worked effectively when others did not. In cases of success such as the Bangladeshi garment industry, the enforcement capabilities and interests of the political leadership were appropriate for the enforcement of particular arrangements and the provision of specific institutional support that was limited in scope and not opposed by powerful interests within the political settlement. It follows, finally, that the replication of success into new sectors and regions within these countries requires an appropriate set of strategies for financing learning while making sure that the institutional and governance conditions are appropriate for ensuring high levels of effort. This can be based on replicating the design of particular financial instruments that worked in successful sectors in that country in the past. But different sectors and technologies have somewhat different requirements and more complex technologies may require longer periods of support. In the general case, it may also be necessary to strengthen governance capabilities around a limited number of agencies and institutions in ways that are feasible given the overall political settlement so that successively more complex financing arrangements become credibly enforceable. The *developmental governance* agenda for promoting technology acquisition can be structured around such a set of insights.

### Market Failures in Land Markets

Another serious constraint in many developing countries is that investors can find it almost impossible to buy contiguous plots of land close to infrastructural amenities. This is ultimately because of structurally high transaction costs in land markets, traceable to poorly defined land rights, multiple claims on land, poor contracting institutions and often very fragmented land ownership. These are common problems faced by many developing countries though the specific problems can

depend on particular historical circumstances. Transaction costs in land markets can frequently preclude the setting up of new economic activities or the expansion of existing ones except at very high cost. This, in turn, slows down economic transitions by making it difficult to set up firms producing new products and services and constraining the rapid expansion of successful activities to capture changing market opportunities.

Transaction costs in land markets should not be confused with the price of land, though for the purchasers, the difference may not be very obvious. The net effect is that the price of buying a piece of land effectively becomes so high that potential investors are put off. Potential investors find that to acquire a substantial piece of contiguous land through the market, they have to deal with perhaps dozens of potential sellers, many of them with competing or overlapping claims, and it takes a long time to settle these conflicting claims. The presence of many smallholders also raises transaction costs because some can hold out for better prices when the deal is almost done. In some cases, there may be no formal rights at all; the land may formally belong to the state or to a community with no clearly defined rules for its use or transfer (Khan 2009a).

The cost of establishing well-defined property rights over land, in the good governance sense, is typically unrealistic in the short to medium term in most developing countries. In reality, investors in developing countries have to fall back on a variety of non-market processes to acquire land, and these can be interpreted as more or less successful responses to the underlying market failure. These strategies can range from state regulation in the form of compulsory purchase orders to acquire land for industrial development, the involvement of political actors or even mafias who acquire land using their political power for onwards selling to actual investors, to business-government relationships that are used to deploy political power to acquire land for particular investors. The particular mechanisms and their efficacy can vary significantly across countries, as well as the implications for social justice, sustainability and economic growth.

The importance of government responses to market failures in land markets is not limited to developing countries. Even in advanced countries, where land has well-defined property rights, transaction costs can sometimes be large enough to justify some form of public purchasing policy for land. This would be the case, for instance, if many contiguous plots of land have to be acquired, for instance for making a highway. In these cases, transaction costs can become very high if prices have to be negotiated and agreed with each owner separately. In addition, subsequent owners can hold out for higher and higher prices, knowing that the purchaser has already pre-committed to purchase plots in this area. As a result, we typically see compulsory purchase orders of different types as a way of addressing this problem. The acquisition of land for major infrastructure projects like roads begins with a public enquiry where alternative routes and fair compensation rates are discussed, followed by compulsory purchase orders to acquire land for the project.

In developing countries, the much higher transaction costs in land markets mean that a wider range of projects may require public land use legislation and assisted purchases if projects are to go forward (Khan 2009a). These public interventions are often necessary policy responses to high transaction costs that cannot be significantly reduced over the short to medium term by market-enhancing governance reforms like stabilizing property rights or improving the rule of law. At the same time, the absence of governance capabilities for managing these processes can result in significant social injustice and eventually, political confrontations. High growth developing countries have managed to solve the land problem, at least in pockets using a variety of agencies and arrangements. Implementing any particular strategy of solving land access problems requires governance capabilities, such as the ability to identify critical land use requirements, carrying out

land acquisition fairly, given the constraints set by the political settlement and with acceptable levels of compensation for existing users while ensuring that land becomes available at the lowest transaction costs for growth sectors. In the absence of these growth-enhancing governance capabilities, non-market land allocations are subject to serious risks. The possibility of political capture of agencies by powerful groups, or direct land grabbing by unproductive speculative interests, can not only inflict social injustice on vulnerable groups; these activities may significantly slow down growth and direct investible resources into unproductive speculative activities. The institutional and political capacity to overcome these market failures is an important growth-enhancing governance capability for developing countries.

## Conclusions

For most developing countries, the East Asian developmental states with their significant developmental capabilities, have not been very useful for identifying or setting immediate reform priorities. The post-colonial political settlements in these East Asian countries were very unusual and allowed their states to effectively intervene in solving market failures on a scale that is unfeasible in most developing countries. But the agenda set by the good governance approach is also unfeasible for the typical developing country since it is even less likely that they will be able to make enough progress on these capabilities to make a significant impact on their development prospects. The only feasible governance agenda may be to incrementally improve developmental governance capabilities on a smaller scale and taking account of the political and institutional initial conditions in each country. A good starting point for particular countries would be to look at the sectors and firms that actually drove spurts of growth in particular sectors. How did they solve or overcome the market failures that affect learning, technology acquisition and land purchases? What other significant market failures did they have to overcome? A closer examination of these questions is likely to reveal country and sector-specific solutions that worked, and this is an important starting point for identifying strategies that may work in similar sectors or for achieving further technology upgrading in existing sectors.

This incremental 'Hirschmanian' approach to capability development has to be based on experimentation and trials, not on the adoption of blueprints from other contexts. If development and capacity building is seen as a process of trials, which it is, developing countries are more likely to incrementally and pragmatically develop specific governance capabilities that allow them to address the most significant market failures constraining growth sectors. This would be a radical departure from the comforting certainties of the good governance approach to governance reform. It would mean experimenting with strategies of financing technology acquisition and identifying the agencies and financing instruments that would need to be governed effectively for high levels of effort to be forthcoming. It would mean experimenting with strategies of land acquisition that were politically feasible in that country and building the governance capabilities for operating critical agencies that were required for making these strategies effective. It would mean identifying other critical market failures that are specific to the country and its stage of development and identifying agencies and governance capabilities that could address these problems. International agencies do not like to admit that this type of country-specific experimentation drives development because this does not allow a consistent and general set of policy advice to be provided to all countries. But the historical evidence suggests that it is the incremental development of growth-enhancing governance capabilities that is critical for triggering and sustaining development.

## References


Acemoglu, Daron, Simon Johnson and James A. Robinson (2001). The Colonial Origins of Comparative Development: An Empirical Investigation. *American Economic Review* 91 (5): 1369-1401.

Acemoglu, Daron, Simon Johnson and James A. Robinson (2002). Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution, *The Quarterly Journal of Economics* 117 (4): 1231-1294.

Amsden, Alice (1989). *Asia's Next Giant: South Korea and Late Industrialization*. New York: Oxford University Press.

Aoki, Masahiko, Hyung-Ki Kim and Masahiro Okuno-Fujiwara (eds) (1997). *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Oxford: Clarendon Press.

Arndt, Christiane, and Charles Oman (2006). *Uses and Abuses of Governance Indicators*. Paris: Development Centre of the Organisation for Economic Co-Operation and Development (OECD).

Clark, Gregory, and Susan Wolcott (2002). One Polity, Many Countries: Economic Growth in India, 1873-2000. In Dani Rodrik (ed.). *Institutions, Integration, and Geography: In Search of the Deep Determinants of Economic Growth*. Princeton NJ: Princeton University Press. Available: <http://ksghome.harvard.edu/~.drodrik.academic.ksg/Growth%20volume/Clark-India.pdf>

Commission on Growth and Development (2008). *The Growth Report: Strategies for Sustained Growth and Inclusive Development*. Conference Edition. Washington, DC: World Bank.

Glaeser, Edward L., Rafael La Porta, Florenico Lopez-de-Silanes and Andrei Shleifer (2004). Do Institutions Cause Growth? *Journal of Economic Growth* 9 (3): 271-303.

Hirschman, Albert O. (1958). *The Strategy of Economic Development*. New Haven: Yale University Press.

Kaufmann, Daniel, Aart Kraay and Massimo Mastruzzi (2007). Growth and Governance: A Reply. *The Journal of Politics* 69 (2): 555-562.

Khan, Mushtaq Husain (2000a). Rent-seeking as Process. In Mushtaq H. Khan and K.S. Jomo (eds). *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press.

Khan, Mushtaq Husain (2000b). Rents, Efficiency and Growth. In Mushtaq H. Khan and K.S. Jomo (eds). *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press.

Khan, Mushtaq Husain (2001). The New Political Economy of Corruption. In Ben Fine, Costas Lapavitsas and Jonathan Pincus (eds). *Development Policy in the Twenty-First Century: Beyond the Post Washington Consensus*. London: Routledge.

Khan, Mushtaq Husain (2002). Corruption and Governance in Early Capitalism: World Bank Strategies and their Limitations. In Jonathan Pincus and Jeffrey Winters (eds). *Reinventing the World Bank*. Ithaca: Cornell University Press.

Khan, Mushtaq Husain (2004). State Failure in Developing Countries and Strategies of Institutional Reform. In Bertil Tungodden, Nicholas Stern and Ivar Kolstad (eds). *Annual World Bank Conference on Development Economics Europe (2003): Toward Pro-Poor Policies: Aid Institutions and Globalization*. Proceedings of Annual World Bank Conference on Development Economics. Oxford: Oxford University Press and World Bank. Available: <http://www-wds.worldbank.org/servlet/WDS_IBank_Servlet?pcont=details&eid=000160016_20040518162841>

Khan, Mushtaq Husain (2005a). The Capitalist Transformation. In Jomo, K.S. and Erik S. Reinert (eds). *Development Economics: How Schools of Economic Thought Have Addressed Development*. London and New Delhi: Zed Press and Tulika.

Khan, Mushtaq Husain (2005b). Markets, States and Democracy: Patron-Client Networks and the Case for Democracy in Developing Countries. *Democratization* 12 (5): 705-725.

Khan, Mushtaq Husain (2006a). Corruption and Governance. In Jomo, K.S. and Ben Fine (eds). *The New Development Economics*. London/New Delhi: Zed Press/Tulika.

Khan, Mushtaq Husain (2006b). Determinants of Corruption in Developing Countries: the Limits of Conventional Economic Analysis. In Susan Rose-Ackerman (ed.). *International Handbook on the Economics of Corruption*. Cheltenham: Edward Elgar.

Khan, Mushtaq Husain (2007a). Governance and Growth: A Preliminary Report. Research Paper supported by DFID grant. SOAS: London. Available: <http://mercury.soas.ac.uk/users/mk17/Docs/Preliminary%20Report.pdf>

Khan, Mushtaq Husain (2007b). Governance, Economic Growth and Development since the 1960s. In José Antonio Ocampo, K.S. Jomo and Rob Vos (eds). *Growth Divergences: Explaining Differences in Economic Performance*. Hyderabad, London and Penang: Orient Longman, Zed Books and Third World Network. Available HTTP: <http://www.un.org/esa/desa/papers/2007/wp54_2007.pdf>

Khan, Mushtaq Husain (2008a). Governance and Development: The Perspective of Growth-Enhancing Governance. In GRIPS Development Forum (ed.). *Diversity and Complementarity in Development Aid: East Asian Lessons for African Growth*. Tokyo: National Graduate Institute for Policy Studies. Available HTTP: <http://mercury.soas.ac.uk/users/mk17/Docs/GRIPS.pdf>

Khan, Mushtaq Husain (2008b). Investment and Technology Policies. In Department of Economic and Social Affairs (DESA) (ed.). *National Development Strategies: Policy Notes*. New York: United

Nations. Available HTTP: <http://esa.un.org/techcoop/documents/PN_InvestmentTechnologyPolicyNote.pdf>

Khan, Mushtaq Husain (2008c). *Vulnerabilities in Market-Led Growth Strategies and Challenges for Governance*. Research Paper Series on Governance for Growth. School of Oriental and African Studies, University of London: London. Available HTTP: <http://mercury.soas.ac.uk/users/mk17/Docs/Vulnerabilities%20in%20Market%20Led%20Growth%20Strategies%202.doc>

Khan, Mushtaq Husain (2009a). *Governance Capabilities and the Property Rights Transition in Developing Countries*. Research Paper Series on Governance for Growth. School of Oriental and African Studies, University of London, London. Available HTTP: <http://mercury.soas.ac.uk/users/mk17/Docs/Property%20Transitions%20internet.pdf>

Khan, Mushtaq Husain (2009b). *Learning, Technology Acquisition and Governance Challenges in Developing Countries*. Research Paper Series on Governance for Growth. School of Oriental and African Studies, University of London, London. Available: <http://mercury.soas.ac.uk/users/mk17/Docs/Learning%20and%20Technology%20Acquisition%20internet.pdf>

Khan, Mushtaq Husain (2010). Political Settlements and the Governance of Growth-Enhancing Institutions. Research Paper Series on Governance for Growth. School of Oriental and African Studies, University of London, London. Available HTTP: <http://mercury.soas.ac.uk/users/mk17/Docs/Political%20Settlements%20internet.pdf>

Krueger, Anne O. (1990). Government Failures in Development. *Journal of Economic Perspectives* 4 (3): 9-23.

Kurtz, Marcus J., and Andrew Schrank (2007). Growth and Governance: Models, Measures and Mechanisms, *The Journal of Politics* 69 (2): 538-554.

Lall, Sanjaya (1992). Technological Capabilities and Industrialization. *World Development* 20 (2): 165-186.

Lall, Sanjaya (2000a). Selective Industrial and Trade Policies in Developing Countries: Theoretical and Empirical Issues. Working Paper Series No. 48, Queen Elizabeth House, Oxford.

Lall, Sanjaya (2000b). Skills, Competitiveness and Policy in Developing Countries. Working Paper Series No. 46. Queen Elizabeth House, Oxford.

Lall, Sanjaya and Morris Teubal (1998). 'Market-Stimulating' Technology Policies in Developing Countries: a Framework with Examples from East Asia. *World Development* 26 (8): 1369-1385.

Nelson, Richard R. and Sidney G. Winter (1982). *An Evolutionary Theory of Economic Change*. Cambridge, MA: Belknap Press of Harvard University Press.

Stiglitz, Joseph E. (1987). Learning to Learn, Localized Learning and Technological Progress. In Partha Dasgupta and Paul Stoneman (eds). *Economic Policy and Technological Development*. Cambridge: Cambridge University Press.

Stiglitz, Joseph E. (1996). *Whither Socialism?* Cambridge, MA: MIT Press.

Wade, Robert (1990). *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*. Princeton: Princeton University Press.

World Bank (1993). *The East Asian Miracle: Economic Growth and Public Policy*. Oxford University Press: Oxford.