Governance, Economic Growth and Development since the 1960s: Background paper for World Economic and Social Survey 2006

Mushtaq H. Khan

Economists agree that governance is one of the critical factors explaining the divergence in performance across developing countries. The differences of view between economists regarding governance are to do first, with the types of state capacities that constitute the critical governance capacities necessary for the acceleration of development and secondly, with 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 mainstream consensus on good governance and statist 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.

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 and to implement policies that encouraged the acquisition and learning of new technologies rapidly. The institutions and strategies that achieved these 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. The empirical and theoretical issues involved here 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, a focus on 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.

1. Market-Enhancing versus Growth-Enhancing Governance

To highlight the differences between the different economic approaches to governance, we will make a distinction between what we will call 'market-enhancing' and 'growth-enhancing' governance. The good governance argument that is frequently referred to in the governance literature and in policy discussions essentially 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.

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 has rather been 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 (in both the private and public sectors) and ensure productivity growth (again in both sectors). 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.

While a sharp distinction between these two approaches need not exist, it has been unfortunate for policy-making in poor countries that a somewhat artificial chasm emerged between these positions with the growing dominance of the liberal economic

consensus of the 1980s. The new consensus was responding to the failure of many state-led industrialization policies in developing countries that had resulted in large non-performing industrial sectors in many of these countries by the 1970s. Instead of examining what was different about these cases compared to the successful developers, the new consensus argued that economic problems in these countries were mainly due to their attempt to correct market failures through state interventions. It concluded that the costs of state failure were significantly greater than the costs of market failure and so government policy should only focus on making markets more efficient (Krueger 1990). The contribution of the New Institutional Economics that emerged at about the same time was to point out that efficient markets in turn require elaborate *governance* structures. 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 states could make 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).

In contrast to this view, an alternative body of economic theory and considerable historical evidence supports a different view of the governance capabilities required for accelerating economic development in poor countries. This theory and evidence identifies the importance of governance capabilities that can directly accelerate growth in a context of structurally weak markets and very specific 'catching-up problems' faced by developing countries. 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 that can 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. These governance capabilities required for ensuring the effective implementation of growth-enhancing strategies are what we describe as *growth-enhancing governance capabilities*.

According to this view, the role of governance reform is to achieve these critical growth-enhancing governance capabilities. These governance capabilities are substantially different from those identified in the market-enhancing view. 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 accelerate development. 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:
● Achieving Market *and* Non-Market 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

In the market-enhancing view, the governance capabilities that are critical include the state's capability to maintain stable property rights, since contested or unclear property rights raise the transaction costs of buyers and sellers and prevent potential market transactions and investments taking place. For property rights to be stable, the state in particular has to constrain itself from expropriating the fruits of private investment, so another critical governance condition in this analysis is the credibility of government in assuring investors of low expropriation risk. Efficient markets also require governance capabilities to ensure efficient and low-cost contracting and dispute resolution. This requires in turn a good legal system. The same economic theory tells us that markets require low corruption as corruption increases transaction costs as well as allowing the disruption of contracts and property rights. Corruption as a form of rent seeking can also result in the creation and maintenance of damaging rents. Finally, efficient markets require that the state will deliver public goods that the private sector cannot provide, and theory says that this requires an accountable and transparent government to convert a collective willingness to pay into efficient delivery of public goods and services. In theory, these governance capabilities should together ensure the efficiency of markets and from this stems much of the 'good governance' analysis of the role of governance in economic development. Efficient markets in turn will ensure the maximization of investments and the attraction of advanced technologies to the developing country, thereby maximizing growth and development. Thus, by enhancing the efficiency of markets, good governance drives economic development. The prediction of the theory is that differences in the quality of governance measured by these characteristics will correlate with performance in economic development. We will see that the evidence provides at best very weak support for this prediction.

There are at two related theoretical problems with this view of market-led development that are stressed in the growth-enhancing view. 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 2005). 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 16th to the 18th 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 requirement 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 amount to an acceleration of the pace of development.

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. Thus, not only are markets unlikely to become very efficient in developing countries, even relatively efficient markets would not necessarily help overcome some of the critical problems constraining rapid catching up in developing countries.

To the extent that productivity growth depends on better resource allocation, improving market efficiency is clearly desirable. But sustained productivity growth depends on the creation of new technologies or (in the case of developing countries), learning to use existing technologies effectively. Markets by themselves are not sufficient to ensure that productivity growth will be rapid unless appropriate incentives and compulsions exist to

induce the creation of new technologies or the learning of old ones. While technical progress is possible along the trajectory set by a market-driven strategy, the climb up the technology ladder is likely to be slower through diffusion and spontaneous learning compared to an active technology acquisition and learning strategy.

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. Box 2 summarizes the shift in consensus opinion away from a position that was very sympathetic to the growth-enhancing goals of intervention to a new consensus that stresses only market-enhancement.

Box 2 The Switch from Growth-Enhancement to Market-Enhancement

From roughly 1950 to 1980, the dominant view within development institutions was broadly sympathetic to a *growth-enhancement* approach to development. The consensus was that market failures were serious and state intervention was required to improve resource and asset allocation through non-market mechanisms. State intervention was also required to accelerate technology acquisition. This led to a broad degree of support for strategies of import-substituting industrialization, indicative

planning and licensing the use and allocation of scarce resources like land and foreign exchange.

However, there was little attention given to the *governance capabilities* that states needed to have to implement these strategies and overcome the moral hazard problems of assisting some sectors and firms. Because of this, in most developing countries, the results of these strategies were poor. By the 1970s, a few developing countries had done spectacularly well but in most, the large protected sectors were performing poorly, many suffered from unsustainable fiscal deficits and debt, and the countries achieved low growth. A broad coalition of forces, including civil society groups and NGOs, the World Bank and IMF, international economists and even some bureaucrats and politicians within these states began to criticize these strategies and demand reform.

At this juncture, growing support for *market-enhancing* policies and the market-enhancing approach to governance emerged. The emerging consensus explained the poor performance of these countries in terms of their states trying to do what was unachievable and ignoring what was essential. The new consensus eventually accepted that the successful East Asian states did not fit this model, but it argued that their success was due to pre-existing state capacities that did not exist elsewhere (World Bank 1993). But instead of focusing governance reforms to attain at least some of these capacities, reform focused on achieving market-enhancing governance. The problem remains that while growth-enhancing governance capacities may be difficult to achieve, market-enhancing capacities are not necessarily any easier to attain in poor countries. And even if markets became somewhat more efficient, it is not clear this would be sufficient to spur development in poor countries (see text).

As Box 2 suggests, the abandonment of growth-enhancing strategies by the 1980s had a lot to do with the lack of attention given to the *governance capabilities* that states needed to have to implement these strategies effectively. 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.

2. 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 data from the same source for the 1990s. Tables 3–8 summarize the data for the 1990s using the six governance indices from the Kaufmann-World Bank data set. Figures 1–8 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 Figures 1-8) and the bulk of developing countries being low-growth and low scoring on market-enhancing governance (the countries in red in Figures 1-8). However, if we only look at these countries, we are unable to say anything about the direction of causality as we have good theoretical reasons to expect market-enhancing governance to improve in countries with high per capita incomes. The critical countries for establishing the direction of causality are the converging developing countries (the countries in green in

Figures 1-8). 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 (Knack-IRIS dataset) and Economic Growth 1980-90

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	21	52	12
Median Property Rights Inde 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 Grow 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 (Knack-IRIS dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Property Rights Inde 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 Grow Rate 1990-2003	2.1	0.4	3.0

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

Table 3. Market-Enhancing Governance: Voice and Accountability (Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Voice and Accountability Index 1996	1.5	-0.4	-0.3
Observed range of Voice anc Accountability Index	0.4 – 1.8	-1.5 – 1.1	-1.7 – 1.4
Median Per Capita GDP Grow 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 (Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Political Instability ar 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 Grow 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
(Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Government Effectiveness Index 1996	1.9	-0.5	-0.2
Observed range of Govt Effectiveness Index	0.6 – 2.5	-2.1 – 0.8	-2.2 – 1.8
Median Per Capita GDP Grow 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
(Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Regulatory Quality Index 1996	1.5	-0.1	0.2
Observed range of Regulator Quality Index	0.8 – 2.3	-2.4 – 1.2	-2.9 – 2.1
Median Per Capita GDP Grow 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
(Kaufmann-World Bank dataset) and Economic Growth 1990-2003

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Rule of Law Index 19	1.9	-0.4	-0.3
Observed range of Rule of La Index	0.8 – 2.2	-1.8 – 1.1	-2.2 – 1.7
Median Per Capita GDP Grow 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).

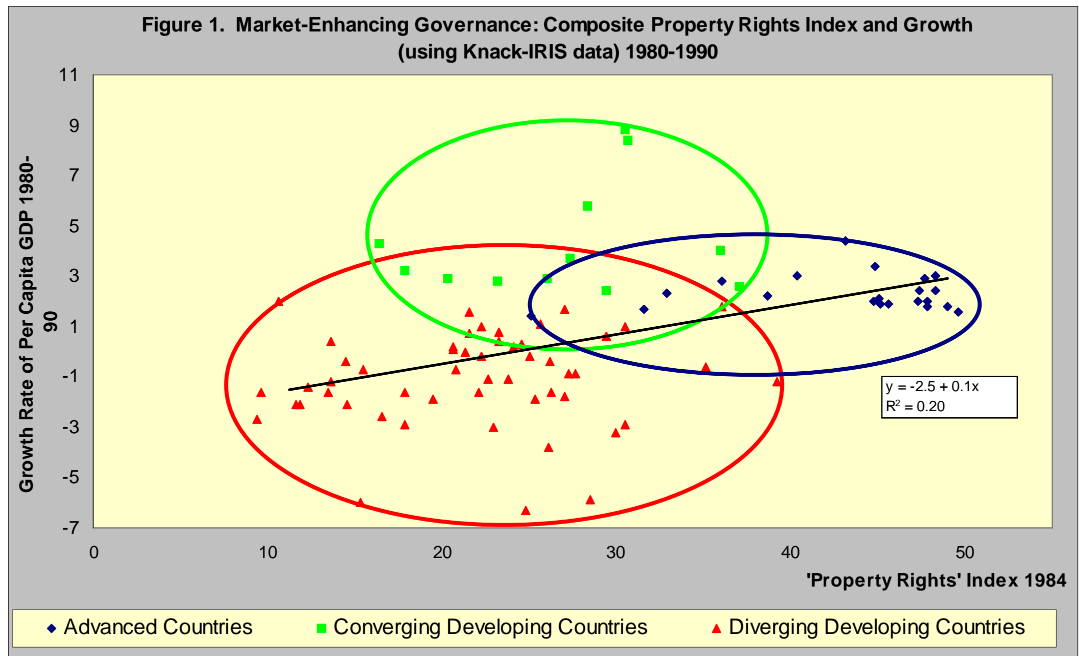
Figure 1. Market-Enhancing Governance: Composite Property Rights Index and Growth (using Knack-IRIS data) 1980-1990
Growth Rate of Per Capita GDP 1980-90
'Property Rights' Index 1984
y = -2.5 + 0.1x
R² = 0.20
Advanced Countries
Converging Developing Countries
Diverging Developing Countries

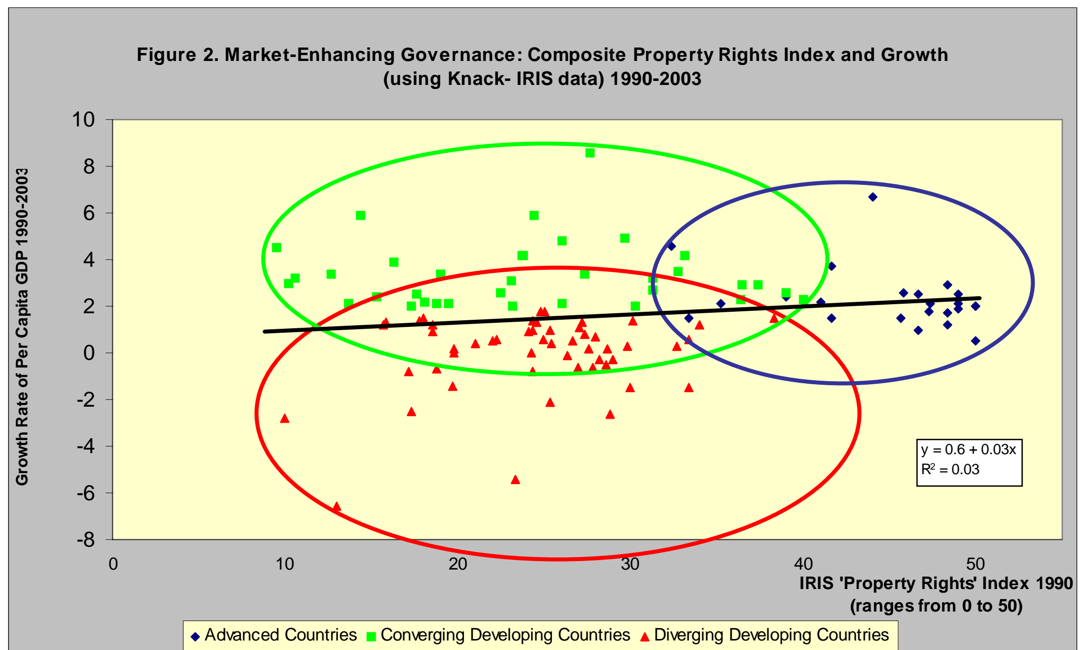
Figure 2. Market-Enhancing Governance: Composite Property Rights Index and Growth (using Knack- IRIS data) 1990-2003
Growth Rate of Per Capita GDP 1990-2003
IRIS 'Property Rights' Index 1990 (ranges from 0 to 50)
y = 0.6 + 0.03x
R² = 0.03
Advanced Countries
Converging Developing Countries
Diverging Developing Countries

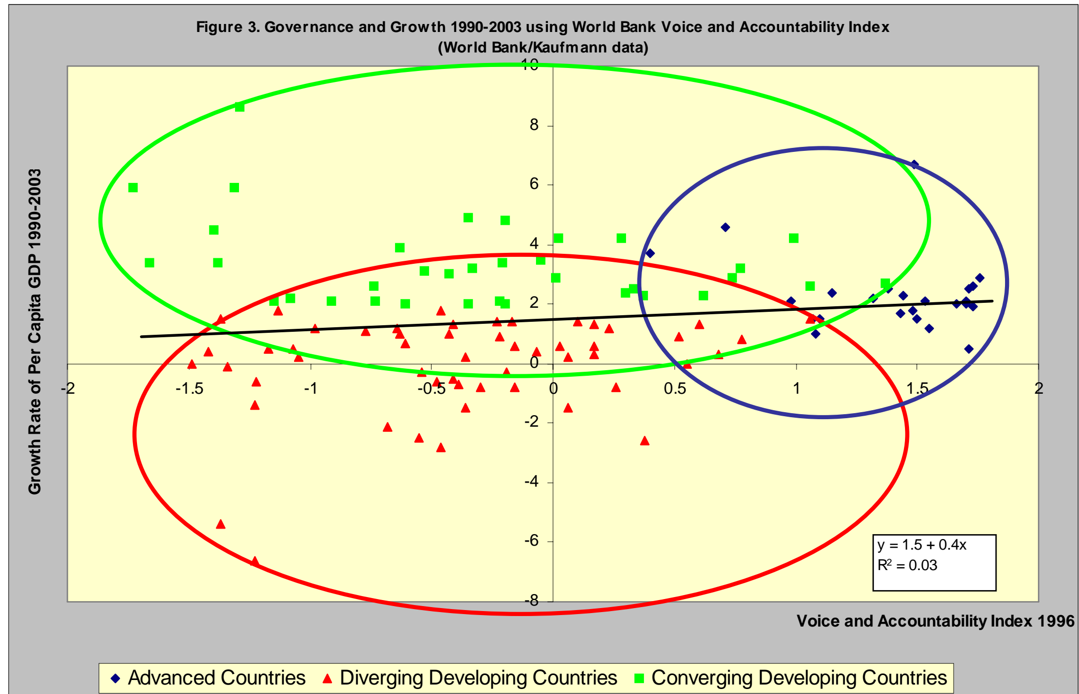
Figure 3. Governance and Growth 1990-2003 using World Bank Voice and Accountability Index
(World Bank/Kaufmann data)
Growth Rate of Per Capita GDP 1990-2003
Voice and Accountability Index 1996
y = 1.5 + 0.4x
R² = 0.03
Advanced Countries
Diverging Developing Countries
Converging Developing Countries

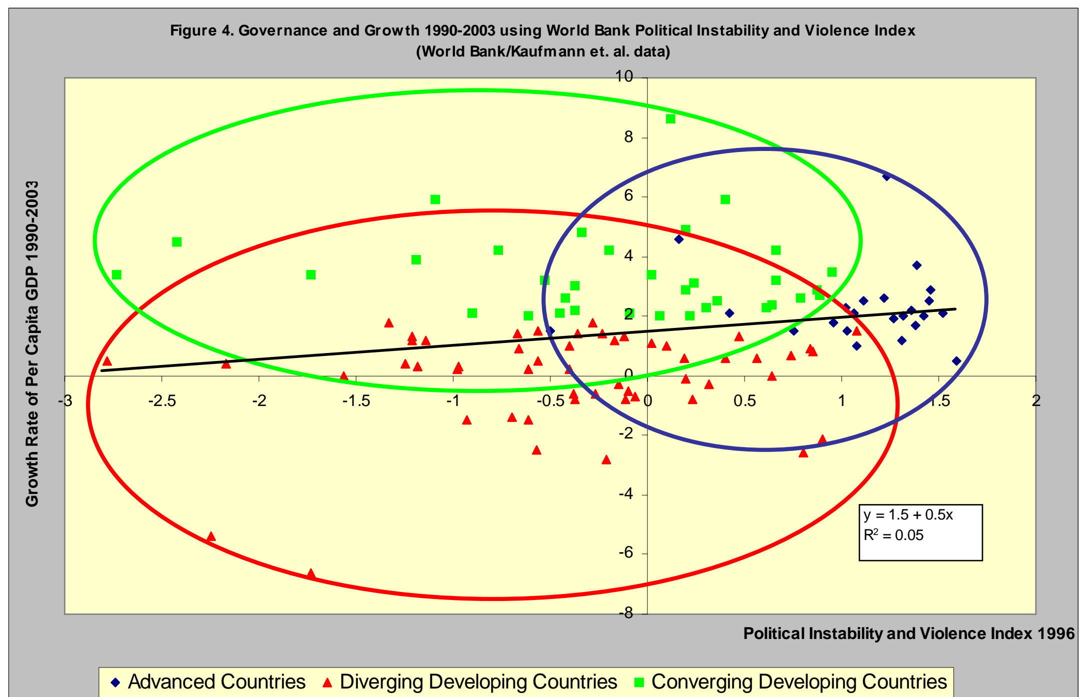
Figure 4. Governance and Growth 1990-2003 using World Bank Political Instability and Violence Index
(World Bank/Kaufmann et. al. data)
Growth Rate of Per Capita GDP 1990-2003
Political Instability and Violence Index 1996
y = 1.5 + 0.5x
R² = 0.05
Advanced Countries
Diverging Developing Countries
Converging Developing Countries

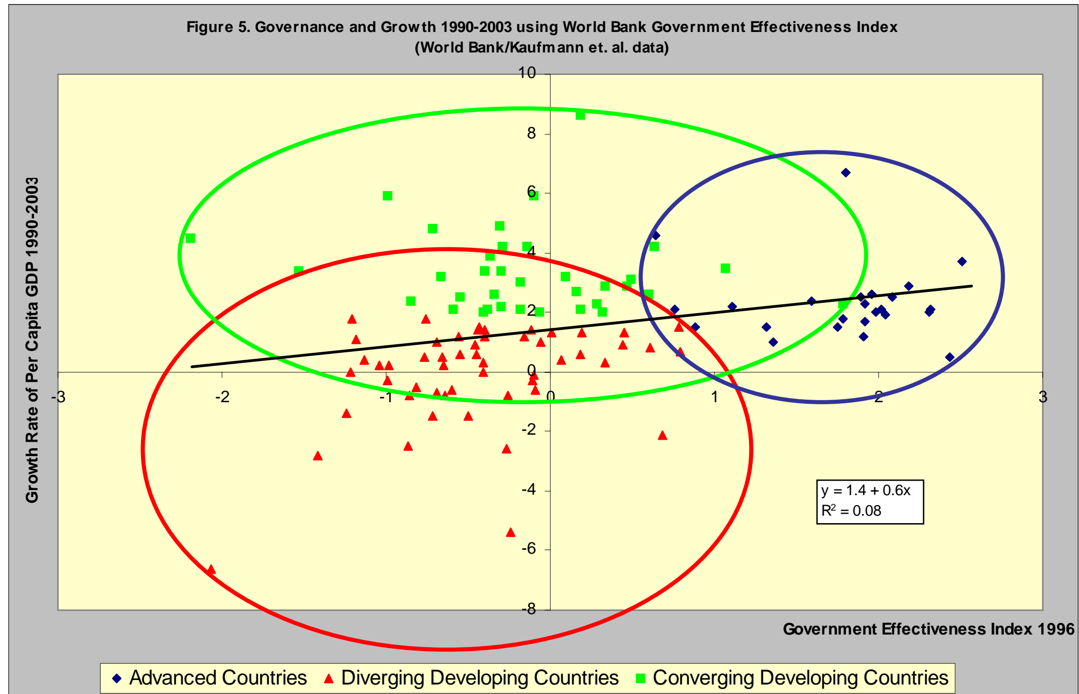
Figure 5. Governance and Growth 1990-2003 using World Bank Government Effectiveness Index
(World Bank/Kaufmann et. al. data)
Growth Rate of Per Capita GDP 1990-2003
Government Effectiveness Index 1996
y = 1.4 + 0.6x
R^2 = 0.08
Advanced Countries
Diverging Developing Countries
Converging Developing Countries

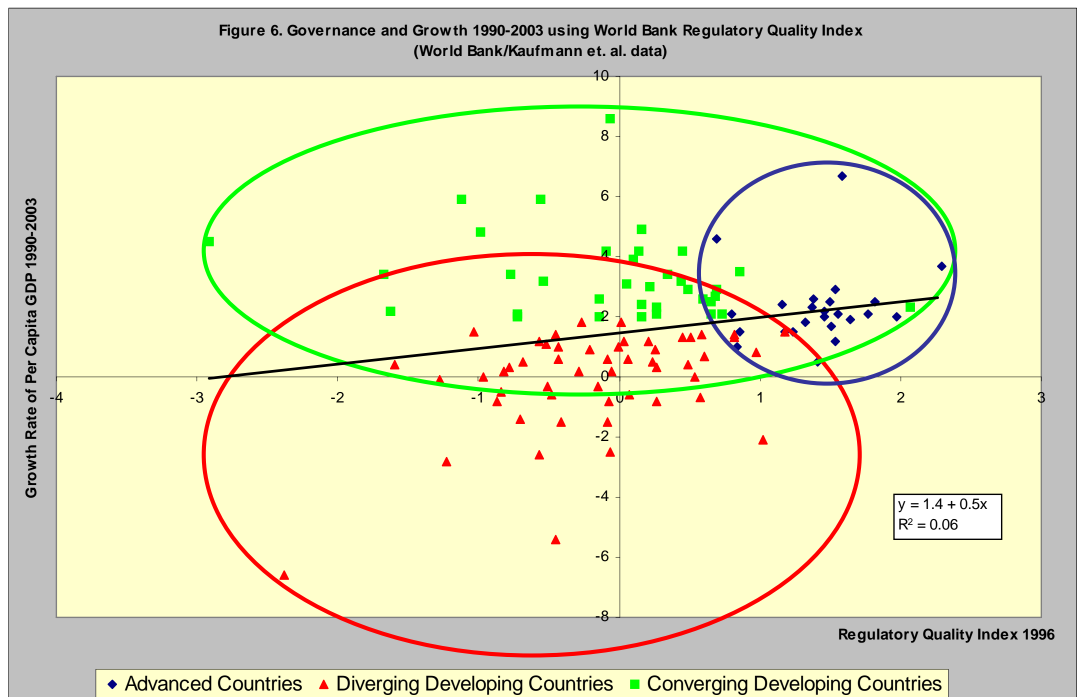
Figure 6. Governance and Growth 1990-2003 using World Bank Regulatory Quality Index
(World Bank/Kaufmann et. al. data)
Growth Rate of Per Capita GDP 1990-2003
Regulatory Quality Index 1996
y = 1.4 + 0.5x
R^2 = 0.06
Advanced Countries
Diverging Developing Countries
Converging Developing Countries

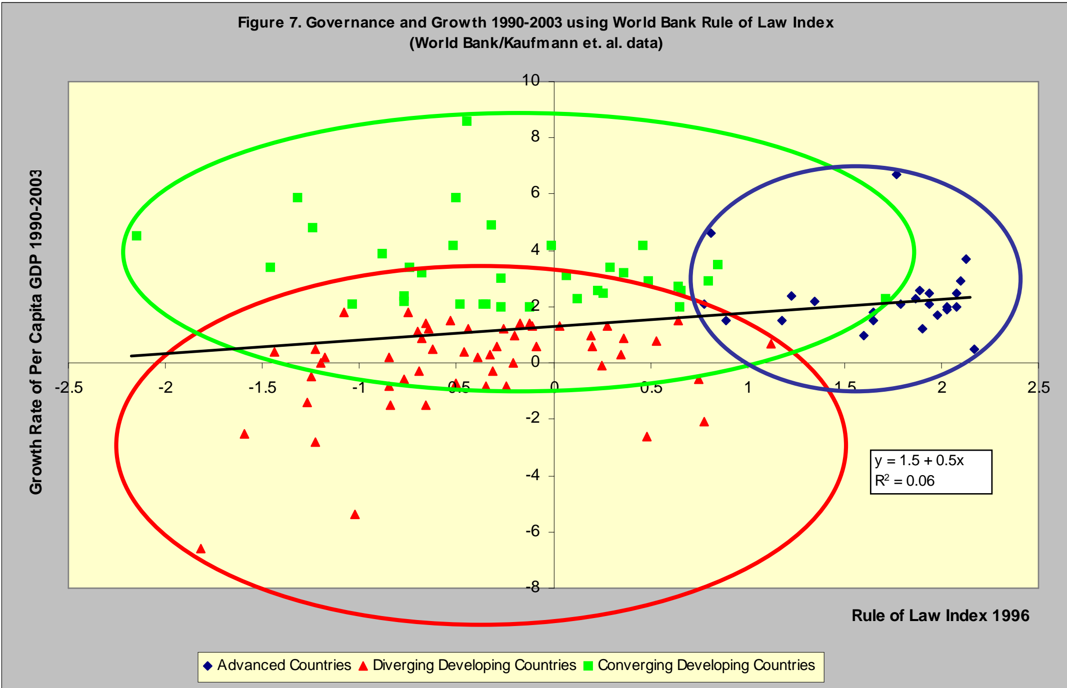
Figure 7. Governance and Growth 1990-2003 using World Bank Rule of Law Index
(World Bank/Kaufmann et. al. data)
Growth Rate of Per Capita GDP 1990-2003
Rule of Law Index 1996
y = 1.5 + 0.5x
R² = 0.06
Advanced Countries
Diverging Developing Countries
Converging Developing Countries

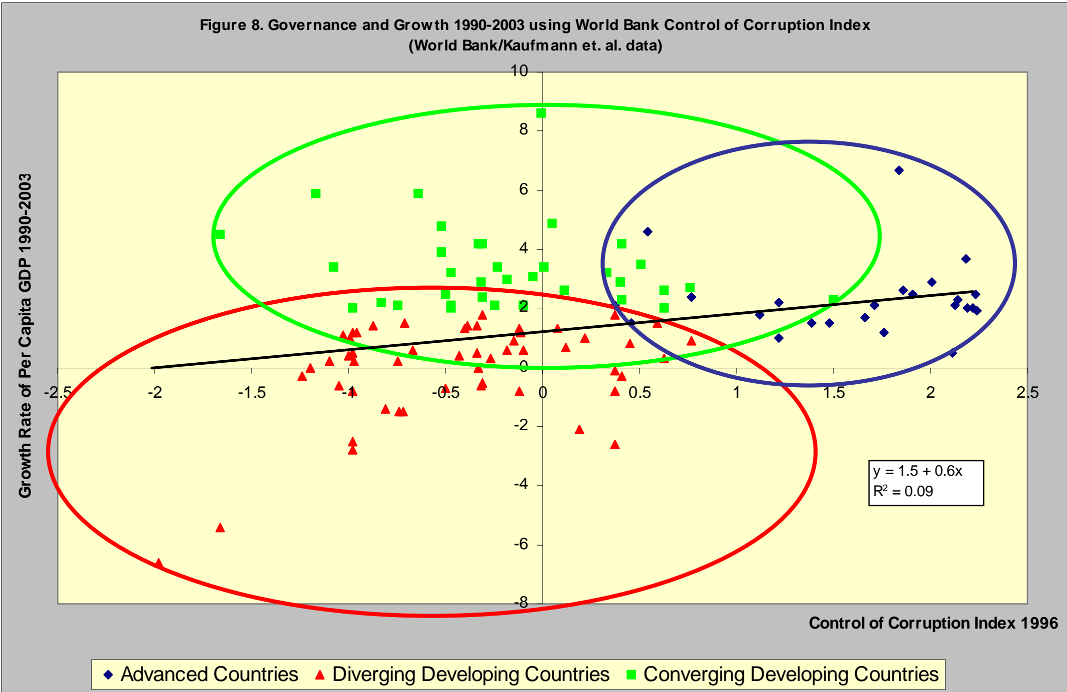
Figure 8. Governance and Growth 1990-2003 using World Bank Control of Corruption Index
(World Bank/Kaufmann et. al. data)
Growth Rate of Per Capita GDP 1990-2003
Control of Corruption Index 1996
y = 1.5 + 0.6x
R² = 0.09
Advanced Countries
Diverging Developing Countries
Converging Developing Countries

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

	Advanced Countries	Diverging Developing Countries	Converging Developing Countries
Number of Countries	24	53	35
Median Control of Corruption Index 1996	1.8	-0.4	-0.3
Observed range of Control of Corruption Index	0.4 – 2.2	-2.0 – 0.8	-1.7 – 1.5
Median Per Capita GDP Grow 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).

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.

Growth-Enhancing Governance and Economic Growth

The argument for market-enhancing governance that we have examined so far is that if efficient markets can be constructed, they will attract the most profitable technologies to a developing country. In contrast, 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, c) why some countries like India have done reasonably *well* with liberalization by using some of the capacities developed by previous growth strategies in new ways and d) why some countries in Latin America have fared rather *less well* in terms of growth after liberalization when they allowed markets to significantly guide resource allocation to areas of current comparative advantage. In Latin America countries liberalization has often resulted in a shift towards lower technology manufacturing and commodity production (Palma's data in his paper demonstrates this very clearly).

While a full treatment of this diversity can only be done through a series of case studies, Table 1 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. 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.

Table 1 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.

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. The institutional requirements include the requirement that the agencies involved in monitoring and

enforcement are sufficiently centralized to be able to internalize all the costs and benefits of implementing the strategy (Shleifer and Vishny 1993; Khan 2000a). This is to ensure that failing industries or sectors are not able to offer inducements to monitoring agencies to allow them to continue to receive their rents without delivering performance. Just as important if not more is the political requirement that the governance agencies are able to enforce difficult decisions about rent and resource withdrawal from non-performing sectors and firms when required. This in turn requires a compatibility of the required governance tasks with the internal power structures of the country. Table 1 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. If political factions are strong and there are many of them, it becomes relatively easy for failing firms to buy themselves protection by offering to share a part of their rents with factions that offer to protect them. The South Korean experience with industrial policy during the 1960s and 1970s demonstrates how the absence of strong political factions can have very beneficial effects for a particular strategy of growth-enhancing governance. In contrast, the South Asian experience during the same decades (like that of many other parts of the developing world) shows how fragmented political factions can prevent effective growth-enhancing governance. But growth-enhancing governance can be moderately effective even in the presence of strong political factions, provided there is a political settlement that allows the political demands of factions to be satisfied through centralized transfers. This can reduce the incentive of factions to capture rents by protecting rent-recipients who are willing to pay. The Malaysian growth strategy of the 1980s and 1990s provides 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). The importance of such an

analysis is not only to identify the growth strategies appropriate for the country given its growth-enhancing governance capabilities. In many countries, growth-enhancing governance capabilities may be so poor that no growth strategy can be implemented. In these cases, the policy response should not necessarily be to abandon growth strategies and shift to market-enhancing strategies. It should rather be to examine the type of growth-enhancing governance capabilities that can feasibly be achieved in that country through a process of governance reform.

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

Another feature of the growth experience of the 1960s and 1970s was that many developing countries performed very well with growth-enhancing strategies that required minimal enforcement at the early stages when new resources were being made available to emerging infant industries. But their performance declined when the new industries demonstrated inadequate effort at learning and productivity growth and it turned out that states lacked the governance capacities to impose discipline or re-allocate resources. While the institutional and political feature that led to this result were different in different countries, the overall story is common to very many countries in Asia, Africa and Latin America that began to perform very poorly in the latter half of the 1970s and beyond.

The liberalization that began in many developing countries in the late 1980s and 1990s in many developing countries has also produced very different results. This diversity of experience can also be addressed by an analytical approach that looks at the interdependence of growth strategies, growth-enhancing governance capabilities and technological capabilities. In countries where technological capabilities were already strong or were being continuously developed, partial liberalization produced strong results. At one end, China has emerged as the fastest growing economy in recorded economic history in a context of gradual and measured liberalization because previous growth-enhancing strategies had produced widespread technological capabilities within China to move into mid-technology manufacturing. Many aspects of the successful growth-enhancing strategies of the past continue to be effectively implemented and appropriate growth-enhancing governance capabilities exist to implement them effectively. These strategies include the strategies of local and central government in China to make land and infrastructure available on a priority basis to investors in critical sectors, and to offer fiscal incentives and attractive terms to both foreign and overseas Chinese investors engaging in investments critical for economic progress (Qian and

Weingast 1997). Thus, while compared to the earlier generation of East Asian developers, the Chinese state appears to be doing less in terms of actively supporting technology upgrading, it still has very strong governance capacities to ensure the allocation of land, resources and infrastructure to critical investors. With its vast internal market and the broad-based technological capabilities it has already achieved, Chinese manufacturing has been able to acquire scale economies that enable it to compete in price almost without challenge in the low to mid-technology manufacturing industries.

In contrast, the countries of the Indian subcontinent have had a different experience with liberalization. Here, previous growth-enhancing strategies had succeeded in creating technological capabilities that were less broad based than in China. Political fragmentation was much greater and the governance capabilities of states to direct resources to investors were significantly lower than in China. As in China, liberalization proceeded at a very slow pace, opening up opportunities without precipitately destroying too much of existing capacity by exposing inefficient industries to excessive competition in the local market. Growth has been led by sectors that had already achieved the minimum technological capability for international competition taking the opportunity to start producing aggressively for domestic and international markets. The results were higher growth rates than in the past, led by a small number of sectors that had acquired enough technological capability to enjoy comparative advantage in international markets. These sectors differed across South Asia, ranging from the garment industry and shrimps in Bangladesh, low-end textiles in Pakistan to diamond polishing, call centres and software in India. The growth of internal demand has also sparked off investment in a range of industries that still have not acquired international competitiveness. While South Asia does not have the broad-based manufacturing growth we see in China, and has a much bigger and faster growing service sector, it too has been a beneficiary of very gradual liberalization of this type. However, while attempts at improving market-enhancing governance have not occupied too much time in China, the greater exposure of South Asian countries to the development discourse in multilateral agencies has resulted in a much greater interest in and concern with improving performance in market-enhancing governance.

Our analysis suggests that while it is desirable over time to improve market-enhancing governance, the comparison of liberalization in China and India suggests that market-enhancing governance cannot explain their relative performance. Case studies of China and India do not suggest that China performs much better than India (if at all) along critical dimensions of market-enhancing governance such as the stability of property rights, corruption or the rule of law. Where it does do better is in having governance capacities for accelerating resource allocation to growth sectors, prioritizing infrastructure for these sectors, and in making credible and attractive terms available to investors bringing in advanced technologies, capabilities that we have described as growth-enhancing governance capabilities.

Latin America provides even more compelling evidence that a focus on market-enhancing governance alone cannot provide adequate policy levers for governments interested in accelerating growth and development. Compared to China and the Indian subcontinent, liberalization in Latin America has been more thoroughgoing and has extended in many cases to the liberalization of the capital account and much freer entry conditions for imports into the domestic market. In terms of market-enhancing governance, Latin America on average scores highly compared to other areas of the

developing world. This is not surprising given its higher initial per capita incomes, much longer history of development, and relatively old institutions of political democracy (even though in many cases these institutions were for a while subverted by military governments). Yet the combination of more developed market-enhancing governance capabilities and a more thoroughgoing liberalization did not help Latin America beat Asia in terms of economic development in the 1990s and beyond. In fact, its relative performance was exactly the opposite of what we would expect from the relative depth of its liberalization strategy and its relative governance indicators. But in fact, the rapid liberalization of Latin America and its greater reliance on market-enhancing governance achieved results that should not be entirely surprising given our analysis. Latin American countries shifted even more rapidly to producing according to their comparative advantage, and in most Latin American countries this meant a shift to lower technology industries and to commodity production. This has produced respectable output growth in some countries, but productivity growth has been low and living standards have yet to fully recover from the collapse suffered in the 1990s (see data in Palma's paper for this important experience).

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

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