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Governance, Growth and Development

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

Mushtaq H. Khan[1]

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

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

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

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

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

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Introduction

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

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

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

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

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

1 Three phases in the history of governance and development policies

It is useful to recall that the consensus on economic policy and appropriate governance capacities for developing countries has gone through radical changes over the last fifty years. The first phase of growth and governance policies describes the economic strategies adopted by most developing countries from their decolonization at different stages of the last fifty years to sometime in the early 1980s. The concern of most developing countries and international agencies during this period was to accelerate the creation of growth-enhancing sectors in developing countries. However, they failed to give much attention to the development of governance capabilities appropriate for the