Growth-Promoting Governance in Africa

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Abstract: Improving and sustaining growth in poor countries is a challenge not only because economic policies to promote and sustain growth are difficult, but also because these need to be supported by governance capabilities, which in poor countries are correspondingly weak. The role of the state is critical in economic development. Therefore, the governance capabilities which describe the areas in which a particular state can intervene and its effectiveness clearly matter for development outcomes. A wide variety of governance requirements have been identified in economic theory that could in principle assist the promotion of growth. The policy problem for poor countries is to identify particular areas of governance reform and capability improvements that are most likely to make a difference to the growth challenges they face. Here, much of the governance advice that Africa receives is often too general to be of immediate use, and sometimes they indicate areas of priority that are hard to justify on the basis of the historical evidence of governance capabilities and strategies of successful rapid developers. To take account of the limited reform capabilities in real contexts, a targeted approach to developing governance capabilities makes sense. The experience of successful developers suggests that growth-promoting governance was important, but many of the political and institutional initial conditions enjoyed by the successful countries of East Asia are very different from those in Africa. Any simplistic attempt to learn the lessons of East Asia is therefore likely to be misleading. However, the good governance agenda is of equally limited use in many of these countries as a guide to identifying reform priorities. This is because important structural constraints prevent the implementation of the good governance agenda to an extent that will make a significant difference to market efficiency. A more relevant approach for Africa is to learn from the experience of successful developers but aim for sequential "Hirschmanian" strategies of addressing critical constraints in particular areas where it is likely that the development of specific governance capabilities will deliver results. The experience of successful developers suggests some broad areas where attention should be focused. In particular we focus on three areas. First, on governance capabilities for addressing capital market failures that slow down investments in new technologies, secondly on capabilities for addressing critical labour market failures that prevent skill development and training, and finally on capabilities appropriate for addressing land market failures that constrain land acquisition for startups and even more so for capacity expansion and upgrading. This approach does not provide a blueprint because the priorities will be different in each country, but it provides a template for thinking through governance options in particular countries.

Background

Economic development requires an appropriate framework of institutional rules to accelerate and sustain growth and achieve other social objectives. This is because the framework of rules creates the incentives and opportunities for behaviour that promotes growth and social objectives as well as the sanctions for behaviour that is counterproductive. This much is widely recognized today by policy-makers in both developing and advanced countries. The question for poor developing countries is a more specific one. These countries uniformly suffer from weak governance capabilities, so in principle improvements along a wide variety of fronts could be called for. The specific problem is therefore of identifying the most important rules that need to be enforced and developing the appropriate governance capabilities for enforcing the rules that need to be developed.

A distinction needs to be immediately drawn between institutional rules that may be optimal in terms of economic theory or in terms of observations of how more advanced and successful countries operate, and rules that can actually be enforced given the historical and political conditions of particular countries. When Douglass North (1990) defined institutions as rules, he was careful to point out that the existence of a formal rule meant little if it could not be enforced. The significance of this observation is often missed. Most countries have many rules that are very good rules on paper. In practice the reality is often very different. The discussion about governance priorities is therefore both about the particular *rules* that a developing country needs to enforce to accelerate growth and development, and also about the *governance capabilities* that need to be developed to enforce particular rules.

These two issues are clearly closely related because if a particular set of rules cannot be enforced, their appropriateness as a policy priority can be questioned. The desirability of many rules that would work to make markets more efficient or particular contracts easier to enforce is often not in question. We may even find strong empirical support 'proving' the importance of some of these institutions when we look at more advanced countries. We may find that the rules under discussion not only exist in more advanced countries, they do also work to make markets more efficient in the way theory had suggested. But if it is implausible to enforce some of these rules in any effective way in a particular country, or to make sufficient improvements in governance capabilities that would improve the enforcement of these rules over a reasonable time frame, these rules may be inappropriate as the priorities for policy in a practical sense.

This obvious observation is frequently ignored in policy discussions. Developing countries have often been criticized for attempting excessively ambitious interventionist programmes in the past. Often the very same countries are now regularly urged to embark on massively ambitious programmes of improving the rule of law, reducing corruption across the board, improving the accountability of government and other equally ambitious measures. These may all be desirable in their own right but they are unlikely to be achieved in the medium or even long term to an extent that is likely to make a significant impact on the economic performance of the country. This does not mean that these reforms should not be pursued by poor countries. Precisely because most of these reforms are desirable in their own right, they should indeed be pursued. But they cannot be the core of a growth-promoting strategy with immediate and intermediate objectives. Accelerating growth even in the medium term does require policies and institutions and these in turn require specific governance requirements if they are to be successfully implemented. These narrowly defined governance requirements in turn require critical governance capabilities, and these are the growth-promoting capabilities that we need to prioritize for immediate attention. The long-term goals of broad, across the board governance reforms are precisely that, long-term goals.

From this practical perspective, the design of a growth promoting governance strategy must begin with a discussion of an economic strategy of growth and a discussion of the political economy of the country which may make particular governance capability improvements more or less likely. This suggests that the identification of the governance priorities for growth is likely to be an iterative process where the most promising growth strategies are simultaneously identified. Other things being equal, a growth strategy that is most likely to promote growth is one where the growth strategy has governance requirements that are likely to be delivered. As a practical question, we need to identify the critical governance requirements for particular growth strategies and make the achievement of these governance capabilities the priorities for governance reform.

Governance and Growth

The ability to compete in global markets has rightly been identified as an essential condition for sustaining growth. However, it is often wrongly concluded that since competitiveness is critical, it is sufficient to introduce free markets and expose domestic producers to the discipline of global markets. If free markets mean the adoption of policies that prevent domestic producers getting assistance to achieve competitiveness in global markets, free markets may have very different effects on growth depending on the already pre-existing productive capabilities of the country. If domestic producers are far away from the global frontier of productivity, product quality and price, free markets could lead to a collapse of domestic productive capacity rather than a rapid improvement in productivity. The possibility that free markets could lead to divergence rather than convergence was most powerfully experienced by many developing countries during their colonial history when virtual free trade was accompanied in most cases by a growing divergence between themselves and the advanced countries.

For instance, from 1873 to 1947 Indian per capita income declined from around 25% of US per capita income to under 10% of the US level (Clark and Wolcott 2002). This happened during a period of virtual free trade as India was only allowed minimal tariff protection, a period when there was 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 higher productivity manufacturing industries in India because of the low productivity of Indian workers, which was so low that even its low wages compared to the home country did not give India a competitive advantage for prospective British investors in most industries. This problem remains today for most sectors in most developing countries. Without any corrective assistance and strategies, the only areas that are likely to growth in a free-market economy are sectors which have already achieved international competitiveness. These are typically low technology and low value added sectors where the productivity gap with more advanced countries is likely to be low and the wage differential can more than compensate for this, giving the developing country a competitive advantage in these sectors. These are sectors like garment stitching, cut flowers, simple toy and shoe manufacturing or simple food processing and packaging.

In theory, there are two broad types of policy responses to this problem, with different governance requirements. Both are responses to a common underlying problem which we need to first understand. Low productivity levels in a country may explain why investments in many areas are not *immediately* profitable but do not necessarily explain why investment to raise productivity in these sectors does not take place. If productivity can be raised through investment, and if wages are low, high profits are assured over time and this should typically pay for the additional time and risk involved in raising productivity. If this is not happening, we need to look at the market failures that may be preventing investors from raising the underlying productivity at an acceptable level of risk. A number of different market failures can prevent optimal levels of investment in late developers (Arrow 1962; Murphy, et al. 1989; J. Stiglitz 1989). A market failure that has recently received attention is that involved in financing 'discovery' in developing countries (Hausmann and Rodrik 2003). The products in which a country may have competitive advantage are not known *ex ante* and require an investor to make investments to discover the underlying capabilities of the country. In many cases the investor will lose money, but investment can still be sustained if there are high profits for investors who strike it lucky. But if new entrants can easily enter the sectors that have been 'discovered' they can bid up wages and raw material costs and wipe out the profits of the pioneers. The market failure is that it is not possible to protect the profits of the Schumpeterian investors in this case and the answer may be to provide carefully designed subsidies for startup firms in such contexts. This market failure assumes that there are innate competitive advantages that some countries have because they are better at producing some low technology products rather than others. Such innate advantages are not necessarily convincing for too many types of products and processes.

Other market failures may be more serious in preventing investment in new sectors in developing countries. We know that if new technologies take time to learn, even if a country has a *potential* comparative advantage in a product it will not be immediately profitable (Khan 2000b). As a result, investors (whether private or public) will have to act as principals providing finance to firms, with managers and workers within these firms acting as agents undertaking the learning. Initially, the principals will be making a loss, but they expect to make a substantial profit eventually. However, the cost of the investment, and indeed their ability to make eventual profits, will depend on the effort the agents put in. In a world where contracts were perfectly enforced, investors could ensure that managers and workers will put in the optimal effort or they will be able to exit, and this will in many cases enable investments to take place by making the risk involved acceptable. In reality, if contracts are difficult to enforce, it may be very difficult to enforce compulsions on firm-level agents, or even to withdraw the investment. In these circumstances, investors external to the firm may not be willing to take the risk of investing for productivity improvement. This is an example of a market failure that may condemn the developing country to low levels of investment in productivity-enhancing industries.

This brings us to the two types of responses to these problems of market failure constraining growth in developing countries. The first response is to respond to specific market failures with narrowly defined interventions that create incentives or compulsions to move the outcome closer to what a more efficient market may have achieved. For instance, subsidies to investors may help to compensate for the costs of discovery or the higher uncertainty they face as a result of unenforceable contracts. Indeed, this was the type of intervention that was very common in the 1950s and 1960s as developing countries attempted to reverse their performance under colonialism. This strategy was in the end disappointing in many developing countries because the range of market failures which policy-makers tried to address were too broadly defined, and in most cases existing governance capabilities were not remotely sufficient to enforce the requirements for success with such a range of interventions. While there were some attempts to improve the governance capabilities required to effectively manage these interventions, these governance requirements were not sufficiently recognized at the time. In the absence of a sufficient effort to develop these governance capabilities, interventions to correct market failures often resulted in poor outcomes. In particular, many infant industries refused to grow up. Clearly, providing a subsidy was not enough without incentives and compulsions created by institutional design and governance capabilities that ensured that the subsidy had the desired effect.

Instead of responding to this experience with the conclusion that perhaps the range of interventions needed to be scaled back to target critical market failures, and that critical governance capabilities needed to be developed, the response from the late 1970s onwards was to abandon this strategy in its entirety. The new strategy was to address market failures by making markets more efficient across the board. This began with liberalization as developing country states were persuaded to withdraw from activities that they were not doing very successfully anyway. However, it was soon recognized that liberalization does not work too well in the context of the rather inefficient markets in developing countries, and reforms were needed to make these markets more efficient. And so paradoxically mainstream policy-makers began to incorporate the importance of the state and of governance capabilities into the reform agenda. But it was explicitly understood that the governance capabilities to be developed or strengthened were the ones necessary for the creation of efficient markets, not the capacities required to address market failures.

The governance reform strategy that emerged in response was the ambitious ‘good governance’ strategy where a number of core governance capabilities are addressed which should in theory reduce market transaction costs and allow private contracting to proceed more efficiently. *If* these good governance reforms could be implemented to a *sufficient* degree in the typical less developed country and market transaction costs do come down significantly, then the types of market failures that prevent adequate levels of investment and technology upgrading will indeed have been addressed. Our contention is that while the good governance reforms on which so much attention is being focused in developing countries are desirable in themselves, they are unlikely to be implemented to a significant degree in the near future for *structural* reasons that primarily have to do with underdevelopment rather than with the political will of the ruling coalitions in these countries. If so, a different set of governance capabilities should also be pursued that may enable these countries to effectively implement specific strategies of investment and upgrading. The appropriate response for developing countries must therefore be to identify and tackle critical market failures directly and develop the governance capabilities to do this effectively. The governance requirements here are likely to be very specific to strategies of correcting important market failures in that country, and these reform priorities will almost certainly be different from the ones identified in the good governance approach.

There are therefore two broadly different governance reform strategies, which we have elsewhere distinguished as one of promoting '*market-enhancing governance*' that focus on general market efficiency and contract enforcement (also known as the good governance agenda) and the alternative of focusing on '*growth-enhancing governance*' capabilities that allow the resolution of specific market failures (Khan 2007). In the first, the aim is to strengthen governance capabilities that allow the enforcement of rules that would in theory allow markets to operate more efficiently. *If* market efficiency can be significantly increased, the market failures that concern us will have been indirectly addressed, and private contracting will now be able to bring together the resources and investments to move the economy forward. In the next section we will briefly summarize the persuasive logic behind this approach. We will also discuss the *structural constraints* that limit the effective implementation of this strategy in most poor countries.

In contrast, the *growth-enhancing governance* strategy is a strategy developing governance capabilities that will enable the implementation of strategies of correcting market failures. These strategies may be more or less ambitious depending on the initial conditions of the country, in particular its initial governance capabilities and characteristics of its politics. Our argument is that the interventionist strategies of the 1960s and 1970s were disappointing in many developing countries because the market failures were not carefully identified, and the interventions were over-ambitious and not tailored to the feasible governance capabilities of particular countries. Yet these strategies did succeed dramatically in a few countries, but these were countries which for historic accidents had the appropriate governance capabilities to enforce the strategies they had embarked on. The lesson we wish to learn from the history of our experiences with both the interventionist strategies of the 1960s and the more recent history of good governance reforms of the 1990s is that neither address the pressing problems of triggering and sustaining growth and development in poor countries. An alternative growth-promoting governance strategy is to promote sequential and specific governance improvements tailored to effectively implement limited strategies that aim to overcome specific growth constraints in LDCs. This will be further elaborated in the context of poor countries in subsequent sections. We believe that such an incremental growth-promoting governance strategy is important for the least developed countries given their limited capacities for making significant progress in the medium term on ambitious generalized governance improvement strategies. This does not at all suggest that good governance reforms should be abandoned, but that the acceleration and sustaining of growth requires serious attention to an alternative set of governance goals.

Market-enhancing governance (the good governance) reforms

The relative failure of some catching-up strategies in developing countries in the 1960s and 1970s, particularly in promoting technological upgrading through infant industry subsidies and protection was primarily due to the absence of governance capabilities that would have been required to manage and monitor such strategies. Effectively, the problem was that attempts to address market failures worked through the creation of rents. These rents could either create incentives and opportunities to overcome the market failure, and this was obviously the intention. But the rents could also simply create opportunities for easy living that would last as long as the government could be persuaded through different types of rent seeking to keep the programme going. Success therefore depended on whether the country had the governance capabilities for effectively establishing credible withdrawal strategies for the subsidy or protection if performance was poor over time. It turned out that very few countries had these governance capabilities and as a result many of these programmes turned out to be unviable.

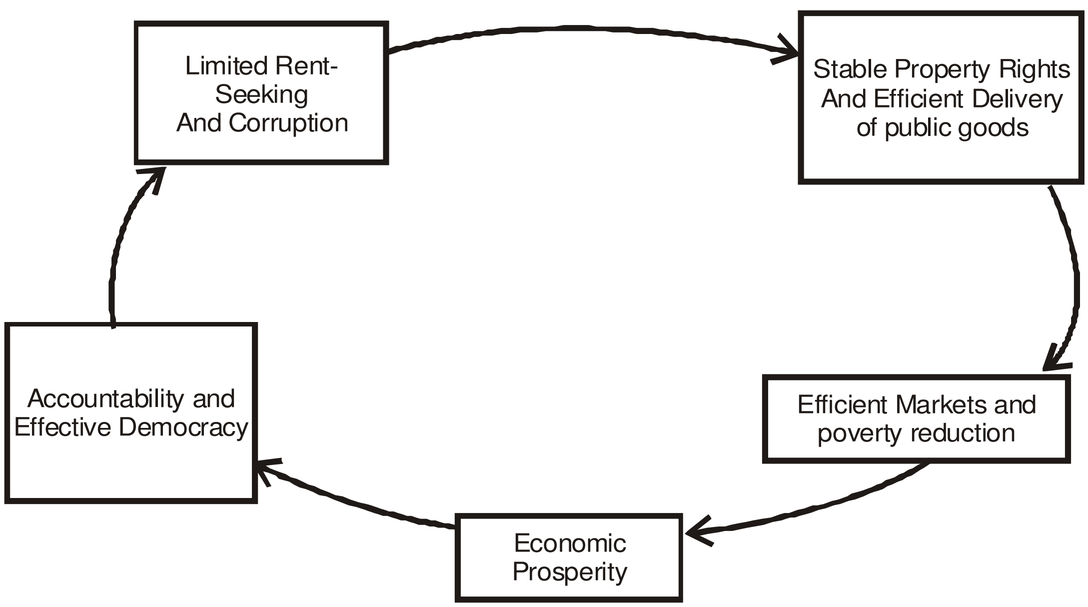
Interestingly, a few countries did of course succeed in their strategies of catching up through intervention to promote new sectors and technologies. These tiger economies possessed the critical governance capabilities that enabled them to manage and enforce the requirements for the successful implementation of learning strategies. Their success was to a limited extent later acknowledged by international agencies including the World Bank, which recognized the success of these strategies in a few countries (World Bank 1993). However, this qualified recognition was attended by the observation that the appropriate state capacities were missing in most other developing countries. In these countries, attempts to replicate East Asian strategies would not only fail, but would make things worse due to static efficiency losses and rent-seeking costs.

At one level, the World Bank's argument against growth-promoting strategies of the East Asian type in most developing countries is absolutely accurate. Not only are the appropriate governance capabilities absent, an attempt to acquire these capabilities on a scale that would enable the typical developing country to attempt the types of interventionist economic programmes typical of East Asian countries in the 1960s and 1970s would probably also be beyond the feasible capacity of reform for most developing countries. It was indeed a failure of growth-promoting economists that they did not clearly recognize the importance of the missing growth-promoting governance capabilities in the countries that did less well. As a result, there was no concerted attempt to develop the appropriate capacities in poor countries.

However, while we recognize the obvious truth in the World Bank’s analysis of the problem, their policy conclusion does not necessarily follow. It is not necessary to conclude that because the substantial growth-promoting governance capabilities of the tiger economies did not exist in most other developing countries (and indeed could not be feasibly replicated in most countries given their very different initial conditions) the optimal strategy for the others is to abandon *all* growth-promoting strategies entirely and resort to the alternative of seeking to promote market efficiency through the development of market-enhancing governance.

This is because a market-enhancing governance strategy may be equally over-ambitious and may not deliver any significant returns. Ironically, the reasons for this are very similar to the reasons which led to the poor performance of post-colonial catching-up strategies in most developing countries. The governance capabilities required to enable markets to work efficiently are also impossibly demanding for most developing countries. To attempt to make markets in general work so efficiently that market failures are no longer a problem may be just as daunting if not even more so for many developing countries as the attempt to correct vast swathes of market failures as in the early catching-up strategies. Here we will briefly summarize some of the problems that market-enhancing governance strategies are facing in developing countries. In the next section we will argue that while an attempt to develop governance capabilities for very ambitious growth-promoting strategies may indeed be infeasible in very poor economies, there may be intermediate strategies that are potentially attractive.

To see why intermediate strategies are so critical for developing countries we need to quickly summarize why the experience with market-enhancing governance strategies have so far produced very limited results (see Khan 2004a, 2004b; 2007 for a more extensive discussion). The good governance agenda is about implementing governance reforms to achieve multiple social goals (including growth) primarily by improving the efficiency of markets. The components of the argument include the following. The work of New Institutional Economics and in particular of Douglass North (1990) established that efficient markets are markets that have low transaction costs. Achieving low transaction costs has a number of conditions but a necessary one is the achievement of well-defined property rights and a rule of law. To the extent that unstable property rights are due to government predation and corruption, efficient markets also require anti-corruption strategies (which may also help service delivery and the provision of effective public goods). Finally, since the majority is always hurt by corruption and poor service delivery, anti-corruption strategies can be embedded and made permanent by institutionalizing effective democracy and accountability.



Source: (Khan 2006c: Figure 1)

Figure 1 Policy links in the good governance (market-enhancing) governance approach

This set of interlinked propositions lead to the good governance agenda with its emphasis on a simultaneous campaign across multiple fronts: it is not sufficient to liberalize and remove restrictions on markets, it is also necessary to adopt strategies of stabilizing property rights through reforms of courts and the rule of law, supporting these with strategies of fighting corruption and rent seeking, and in turn supporting these with strategies of improving the accountability and effectiveness of democracy. The great strength of the good governance agenda is that it is supported by many different constituencies for different reasons. Surveys of business opinion in developing countries confirm that many of these areas of weak governance are of concern to business as important constraints to their own investment and technology upgrading strategies. Clearly, if the rule of law and contract enforcement is weak, investors both domestic and foreign will hesitate to make long-run commitments in their investment. And these are precisely the investments that are most likely to raise productivity and enable moves up the value chain. No businessman will approve of corruption, even when they occasionally benefit from it, and the lack of government accountability is a frequent complaint.

At the same time, civil society groups in developing countries often support the enforcement of these rules on the grounds that many are highly desirable goals regardless of their economic efficacy. And finally, the fiduciary responsibility of donor agencies to protect taxpayer funded aid programmes has driven donor concerns about corruption and the diversion of resources in developing countries. This too has provided support for anti-corruption strategies and for accountability reforms. The convergence of support from multiple constituencies who are at loggerheads on most other issues explains why support for this particular reform agenda is so deep-rooted and pervasive. Suggesting an alternative or even complementary governance agenda requires the construction of a new constituency that may be quite difficult to achieve compared to the broad constituency backing the good governance agenda.

Nevertheless, building support for an alternative governance agenda is important because the problem is that there are structural reasons why the good governance capabilities are not likely to be rapidly achievable in poor countries to an extent that is likely to have a significant effect on the overall efficiency of markets. Three sets of structural problems are briefly described below. They explain why a strategy of market-enhancing governance has achieved very limited success in making a dent on the variables that could in theory have significantly improved market efficiency. For a more extensive discussion see Khan (2006b; 2007).

Stable property rights are expensive and take a long time to achieve. The achievement of property right stability in poor countries faces extensive structural constraints. North's analysis of property rights and transaction costs has implications that are often ignored: reducing transaction costs is itself very costly. In rich countries, almost all assets are productive and their owners pay very significant taxes and these pay for the protection of all property rights as a *public good.* In developing countries the tax base for protecting property rights as a public good simply does not exist in most cases, particularly in the poorest developing countries. Most assets are by definition in non-capitalist and low productivity sectors such as peasant agriculture or the informal sector, and they generate an insignificant surplus that is insufficient to pay for their protection either through taxation or the purchase of private security. If stable property rights across the board cannot be achieved as a public good, informal institutional arrangements that protect critical investors are much more important. Growth-promoting governance capabilities for managing investor property rights in developing countries can therefore often look very different from the good governance capabilities of establishing and protecting property rights as a public good (Qian 2003). What can look like a set of informal and ad hoc arrangements for protecting specific investments may well be the most effective institutional arrangement in a poor country to promote investments in critical areas. Similarly, if property rights are not well-defined and transaction costs are high, investors may often be unable to purchase the assets they need, in particular land. The strategy of improving market efficiency in these cases may take too long and specific governance capabilities need to be developed to deal with the growth constraints emanating from high transaction cost asset markets.

The fight against corruption is a long-term one. Corruption has multiple drivers and many of these are very difficult to attack in the short term in developing countries (Khan 2006b). A governance strategy that focuses on achieving significant improvements on this front is likely to disappoint in many developing countries. This does not mean that anti-corruption strategies are not desirable. It simply means we should not expect significant growth dividends from anti-corruption strategies delivering significant and *sustained* reductions in corruption. The sustainability of corruption reduction is particularly important. In many developing countries, sharp shocks from new anti-corruption agencies sometimes have a temporary effect on corruption, but over time, the tendency is for corruption to creep back. We will not discuss the reasons for this here, but we have discussed these extensively elsewhere (Khan 2006a, 2006b). What is relevant here is that if corruption cannot be significantly reduced in the medium term, we cannot expect a significant growth dividend from anti-corruption strategies.

A related problem with the good governance agenda is the assumption that *all* rents and rent seeking are damaging. Stiglitz and others have shown that a vast range of rents are essential for the proper functioning of market economies, even advanced ones (J. E. Stiglitz 1996; Khan 2000b). Rents are no less critical in developing countries, an indeed, many of the catching up and technology acquisition problems that developing countries face require significant rent-management capabilities on the part of governments if the entrenched market failures facing developing countries are to be overcome. This is because assistance for technology acquisition is by definition a rent, the only question is whether this rent is well-managed, resulting in growth accelerations or poorly managed, resulting in a waste of national resources. Clearly, while many rents are indeed damaging, others are second-best responses to market failures that would have worse effects without the rents. In such a context, to target general problems of rent seeking without a strategy of distinguishing between rents and identifying potentially growth-enhancing rents can be misleading. In the case of the latter, the strategy must be to develop the governance capabilities to manage some of these essential rents. These capabilities are part of the critical growth-promoting governance capabilities that developing countries need to focus on.

Thus, strategies of technology upgrading will generally create rents for firms engaging in technology upgrading. These rents are not a problem; they are the mechanism through which some market failures may potentially be overcome. Indeed, successful developing countries had governance capabilities for managing these rents (mostly due to accidents of internal politics rather than clever design) and less successful countries did not. We will turn in the next section to the governance lessons poor countries can draw from this differential experience.

Democracy in developing countries is fragile and often works through patron-client networks. Clearly democracy is an end in itself and should be supported on these grounds alone. If we support democracy *because* we believe it is a mechanism that reduces rent seeking and corruption, we are likely to be frequently disappointed. Moreover, democracy in the least developed countries remains fragile because conflicts over resources are intense, particularly between competing political factions. Fiscal constraints in developing countries often mean that democracies find it difficult to deliver public goods for everyone and political stability is often dependent on the ability of the political system to deliver to powerful factions. In these contexts, programmes to increase democratic accountability may or may not directly assist the management of growth and productivity enhancement strategies. Sometimes, the powerful patron-client factions who are the primary players in the democratic process in these countries are the very organizations that impede the efficient allocation of public resources, while at other times their competition may enable the introduction of reforms and the efficient allocation of resources (Jenkins 2000; Khan 2005). The only general conclusion that we can draw is that support for democracy in developing countries should not be justified by the assertion that democracy will always improve market efficiency. Rather, democracy deserves support as an end in itself, and should not be confused with the more difficult task of creating governance capabilities for supporting growth.

These structural reasons do not mean either that the developing countries should abandon their reform attempts in the direction of 'good governance', or that corruption or poor accountability are acceptable evils in poor countries. Rather, we are pointing out that *progress along the good governance reform path is likely to be very slow and gradual*. When occasionally quick successes are achieved, if the underlying structural factors sustaining these reforms are missing, we should also be prepared for occasional reverses. In the meantime, *economic development may require specific governance improvements in agencies and regulatory bodies that are critical for addressing specific market failures.* Identifying these in the context of particular countries is a very different approach to governance reform, one we will describe as incremental growth-promoting governance. If a feasible set of specific growth-promoting governance reforms is identified, this stands a much better chance of implementation than the ambitious good governance agenda. If a reasonable effectiveness in some critical but limited governance areas can be achieved this is likely to make some impact on the capacity of developing country to trigger or sustain growth. In contrast, if the governance reforms focus only or mainly on the illusory achievement of good governance as an immediate objective, the impact on growth is likely to be negligible.

Specific problems attributed to Africa. While the market enhancing good governance agenda is claimed to be applicable for all developing countries, it has become particularly relevant for Africa in a context where many reformers both within Africa and in the African development industry feel that Africa is particularly in need of these reforms for a number of specific reasons. These are mainly to do with the perception that Africa is more obviously suffering from an absence of good governance and that some culture, ethnic and other features of Africa that could be addressed by the successful implementation of good governance reforms are responsible for the continents poor comparative performance. These specific features of African political economy include the following:

a) Neo-patrimonialism. The argument here is that African states are distinctively pre-modern. This analysis goes back to Médard who has written a number of pieces, with the main arguments summarized in Médard (2002). The neo-patrimonial state contrasts with a modern Weberian state that is supposed to be impersonal, formal, accountable and non-corrupt. The neo-patrimonial state is the precise opposite, with personalized and informal relationships between the boss or patron and his clients. The patron is accountable and hugely corrupt, treating the public domain as a private fief, and dispensing benefits to clients to stay in power. *While all these characteristics are clearly visible in Africa, a comparative historical analysis shows that these features are common to all developing countries going through the developmental transformation.*

Médard argues that the problem in Africa is the absence of accountability that allows leaders to treat the public domain as their private fief. The policy suggested is the support of democratization and accountability as a way of weakening the hold of the personal power of the 'big men', thereby helping to make the state become more modern and Weberian. In this respect, the argument is close to the one summarized in Figure 1. However, this theoretical argument is not supported by any historical observation from anywhere in the world that shows that democratization has driven (rather than having followed or co-evolved with) the emergence of a modern capitalist economy and the Weberian state that is associated with it (Khan 2005).

b) African Culture. A variant of the neo-patrimonial argument is that the personalized politics observed in Africa is supported by a specific African peasant culture. The 'economy of affection' that describes this culture in turn emerges in the fragmented economy of African agriculture where exchange has to be based on personalized relationships. Patrimonial politics results from this economy and the culture that it generates (Hyden and Williams 1994). But again, a comparison with the Asian experience suggests there is nothing unique about the African peasant economy. James Scott made exactly the same observations about the Asian peasantry in his account of the *moral economy* of the Vietnamese peasantry (Scott 1977). These accounts are consistent with our explanation that formal property rights and institutions cannot be sustained in poor economies since the underlying assets do not yet generate enough of a surplus to pay for their protection and the maintenance of a set of institutions that would allow impersonal private contracting at low transaction cost. However, none of this precluded *transitions* to productive capitalist economies in Asia. It is not clear why peasant culture alone should be playing this negative role in Africa.

c) Ethnic fragmentation. A third common response about Africa refers to the *ethnic fragmentation* in Africa, and the fact that many African states have not resolved fundamental questions about their territorial limits and ethnic compositions. The argument here is that this prevents any dominant group in an African polity being able to enforce rights or even decisions about the allocation of social resources. There is an element of truth in this argument but ethnic fragmentation should not be overstated as an explanation of state weakness. The extent of fragmentation varies across African countries. Often conflicts over resources can take an ethnic form, but these conflicts would probably have been just as intense in ethnically homogenous societies where cleavages would have been organized along other lines. It is also worth remembering that many African countries are relatively new, having just emerged from colonial occupation as in Mozambique and Angola. The Asian experience of post-independence development shows periods of considerable turmoil can follow independence even in ethnically homogenous societies (Bangladesh in the 1970s).

It is equally important to remember that national identities even in states that now appear to be ethnically homogenous have always been the product of social engineering. Successful states in Asia and Europe created national identities with differing degrees of success. Asian states like Thailand that appear to be ethnically homogenous today, achieved this through very specific state policies of nation-building that were often not very pleasant for minorities (such as the Chinese in the case of Thailand). Examples of states working to create homogenous or at least cohesive national identities are not absent in Africa: the case of Tanzania is particularly interesting because the creation of a composite national identity was one of the primary goals of the Nyerere years, and by all accounts, the results were quite remarkable in the African context. The Tanzanian experience shows that nation building is a long process where outsiders can contribute little but could potentially do much damage by suggesting easy options that may not exist.

Africa is a relative newcomer to the long centuries of ethnic conflict that have marked state building in Europe and Asia. The lesson from the European and Asian experience should not be that Africa has a problem because it is too ethnically fragmented, but rather it should be that Africa has been relatively civilized so far compared to Europe and Asia, and how can it learn the lessons of state building so that this can be achieved in less bloody and socially costly ways. While it is clear that a minimal national consensus is required for a society to embark on any development strategy, the challenge is to identify what needs to be done in terms of institutional reform priorities once a minimal national consensus emerges in countries like Tanzania.

d) Africa's Resource Curse. It is often also argued that Africa's problems with weak states and the descent into predation stems from the easy availability of *natural resource rents*, while Asia was helped by the absence of these natural resource rents. The argument is that warring factions in Africa can sustain conflict by financing themselves using natural resources. Conversely, the leadership of resource-poor Asian countries had to concentrate on how to produce wealth through industrialization. But while the easy availability of resources can sustain conflict, it does not explain why fragmentation exists in the first place since the discovery of windfall incomes in a country with a strong state could be a spur to development. Industrialization requires resources for investment, and where states with some enforcement capacity exist, natural resources can be very helpful in generating resources for high rates of investment in industry. This strategy was very successfully followed, for instance, by Malaysia.

In themselves, natural resource rents do not have to be damaging (see for instance Khan 2000b). Indeed, these are necessary rents from an economic perspective, as they help to achieve a rate of extraction of natural resources that is closer to the sustainable or optimal level. As with all rents, the existence of natural resource rents will induce rent seeking and in some cases where easy rents are available, this rent seeking can divert economic and political entrepreneurs into unproductive activities to an excessive extent. While this is theoretically possible, there is no reason to believe that it is inevitable. Even in Africa, there are already plenty of counter-examples. Botswana's success has been based on natural resource rents but it has not succumbed to civil war. Ghana exports large amounts of gold but is relatively peaceful, and even Angola is moving into a more peaceful era as well as being Africa's largest diamond exporter.

We can accept the argument that natural resources can sustain conflicts that would otherwise have to be fought using more primitive weapons, but this does not mean that in the absence of these rents the fragmented states would have become cohesive. Fragmented states without natural resources can always discover new ways of generating income to sustain conflict, ranging from drugs to intervening in conflicts in neighbouring countries. It is quite plausible for instance to argue that Saudi Arabia without the oil may have been more like Afghanistan than South Korea. Thus, without denying the complications (both positive and negative) created by the presence of natural resource rents, we need to ask why states remain institutionally fragmented and politically weak in some contexts but manage to reform themselves and become developmental in others. The Asian experience suggests that developmental states emerged in both resource poor countries (South Korea, Taiwan) as well as in resource rich countries (Malaysia). Equally, weak states have persisted in many Asian countries that are resource poor (Nepal, Bangladesh). These observations are particularly relevant for Africa where large natural resource endowments should be seen as an opportunity rather than a curse. Institutional and governance capacities should be developed that allows resource rich African countries to manage these rents for economic development.

However, some of the proposals coming from the good governance approach are likely to be impossible to implement and have problematic implications for the development of growth-oriented states. For instance, there is a frequent suggestion that hydrocarbon and mineral rents should be in ring-fenced development accounts that are pre-committed to service delivery expenditures in specific areas such as health and education. These suggestions may appear to be a huge improvement on the corruption and capital flight that is often associated with mineral rents in many African countries, but it is hard to imagine how the expenditure of such large chunks of national income can be effectively de-linked from internal power structures for too long. This is likely to be another example of a good idea that on closer inspection turns out to be implausible as an implementable strategy. Nor is it clear given the market failures affecting investment in new technologies and sectors in these countries that ring-fencing all these potential investment resources from traditional investment options within the country is necessarily a good idea. It may be a better long-term bet in many of these countries to develop effective governance capabilities for managing growth-enhancing strategies. If mineral and hydrocarbon rents are even moderately efficiently used in such strategies the long-run outcome for the country is likely to be satisfactory.

Growth-Promoting Governance Strategies

By the 1990s, most developing countries had adopted variants of market-promoting strategies. The initial result of liberalization was often a dramatic acceleration of growth in many developing countries as they already had achieved pockets of productive capabilities in some sectors where their wage advantage gave them international competitiveness. Allowing these sectors access to international markets and opening up their access to internal resources to sustain their growth led to a rapid growth spurt in a number of countries. In Africa countries like Uganda and Kenya as well as a number of others began to enjoy this type of growth led by labour-intensive sectors. The challenge for these countries is to sustain this growth, open up new sectors and to push existing competitive sectors higher up the value chain, and raise their productivity in response to growth competition from other low wage countries, and internal wage push. Other African countries have benefited over the last decade from the commodity price boom and these countries face the challenge of converting their mineral and hydrocarbon rents into productive investments that can exploit these windfalls to raise social productivity and employment. And finally there are other developing countries in Africa and elsewhere where the growth takeoff with liberalization has been far less dramatic because even a few sectors with global competitiveness have not emerged. In all these countries, good governance reforms are widely believed to be a strategy for growth, either to allow a deepening of growth to new sectors, to enable the use of mineral and hydrocarbon rents in socially desirable ways or to trigger off a growth spurt in poorly performing countries.

The challenge for all these countries is that there is very limited evidence that good governance reforms are yielding the necessary gains in market efficiency that could sustain technology upgrading and new investments to the requisite degree. There is also limited evidence that good governance reforms are improving accountability to the extent that mineral and hydrocarbon rents will be more effectively used. This is not primarily because the political will is lacking to push through these reforms, though that may be problem in some cases. The real problem is that these reforms often come up against the structural constraints to achieving significant improvements in each of the aspects of market-enhancing governance in poor countries that we discussed in the last section. We will focus on the challenges facing developing countries in pushing for growth in the context of structurally high transaction cost markets and the structural presence of patron-client politics in the political sphere.

What we do know is that successful countries in the last fifty years did manage to achieve high rates of growth and development despite suffering from poor governance as defined by the good governance criteria. We know that they did this by focusing on overcoming specific market failures by developing targeted governance capabilities. But we also know that many developing countries did rather poorly in the 1960s and 1970s when they tried to do the same. In this contemporary global context we need to reconsider the reasons for the failure of past growth-promoting strategies and the appropriate lessons to learn from these failures. A striking feature of the first round of growth strategies followed by developing countries in the 1960s to the 1980s was that little attention was given to the governance capabilities that were required to enable them to implement the strategies they were following. We know that developing these governance capabilities is not a simple matter and that the initial endowment of institutional and political capabilities of developing countries greatly differs.

Ambitious Growth-Promoting Strategies. Supporters of growth-promoting governance interventions often refer to the examples of the Asian countries, particularly in East Asia, which used extensive interventions including industrial policy to accelerate technology acquisition and move up the value chain at a more rapid pace than would have been likely without these interventions. These countries, which include South Korea, Taiwan, Malaysia and others demonstrate the possibility that extensive interventions across a range of sectors can succeed in creating both incentives and compulsions for enhanced investment in growth sectors, accelerated productivity growth and learning, and sequential moves up the value chain. Moreover, they managed to achieve these results without attempting or succeeding in achieving good governance as defined in the good governance consensus. However, their success was based on a different set of state capabilities and the very scale of their successful interventions suggests that it may not be possible to develop a growth-promoting governance strategy for poorly performing developing countries simply by looking at and attempting to imitate the governance capabilities of more successful developers. This is so for at least two different sets of reasons.

First, the more successful developers enjoyed more favourable historical endowments of institutions and political conditions to begin with, which amounted to significant governance capabilities in some areas. They also had some pockets of capitalist development, such that entrepreneurs and technological capabilities were present to a somewhat greater extent than in many of the poorest countries in contemporary Africa. These political, institutional and technological endowments allowed some of these Asian countries to successfully implement ambitious industrial policies in the 1960s and beyond with considerable success. The initial conditions in many developing countries today are less favourable and so an exact imitation of any of these industrial policy strategies is very likely to prove infeasible. In particular, it is important to remember that the institutional capabilities and political conditions in these high-growth Asian countries allowed a range of interventions that could be *effectively policed* in the sense that it was difficult for inefficient rent seekers to capture state created rents if they failed to produce results in terms of investments in new sectors followed by accelerated learning.

We now know that very extensive governance capabilities are required for exerting discipline over the range of rents that successful industrial policy countries deployed during their catching up phase (the relevant literature is reviewed in Khan 2004a). These governance capabilities are clearly lacking in many developing countries, and this was particularly apparent in many countries which tried different variants of industrial policy using tariff protection, public sector investments and so on to accelerate industrial growth in the 1960s and 1970s with very poor results. In many of these countries, the rents created by industrial policy interventions were captured by powerful social groups and their states found it impossible to withdraw or re-allocate these rents long after the failure of the supported industries and sectors had become very clear (Khan 2000a).

But secondly, successful developers also had many different strategies of overcoming market failures, each backed by quite different mixes of governance capabilities that were more or less appropriate for the strategies they actually ended up following. For instance, South Korea used a strategy based largely on conditional subsidies to its big chaebol, while Taiwan and Malaysia used the public sector much more extensively for technology acquisition but with effective capabilities to discipline managers within the public sector. Both types of strategy were successful because success depended on the capacity to enforce discipline within the sectors receiving explicit or implicit subsidies. Malaysia also used incentives to attract high quality foreign direct investment to bring in new technologies and establish backward linkages with domestic firms. But this strategy also required governance capabilities, in particular the capacity to discriminate between different types of foreign direct investments and offer incentives to those that were most likely to help the national strategy of technology acquisition. Success in each case depended on the country selecting economic instruments to correct market failures involved in technology upgrading and investment that it could actually enforce given its internal political settlement and institutional capabilities (Khan 2000a, 2006b).

The second set of observations suggests that even in countries with relatively high governance capabilities, it was important that the interventions were compatible with the political and institutional capabilities of the countries. The strategies used by South Korea may not have been implementable in Taiwan or Malaysia, or vice versa because disciplining and setting implicit conditions for different types of firms requires specific political and institutional capacities to enforce. This is an important observation for many poorly performing countries, where overall governance capabilities are poorer and where it is therefore much more important to design interventions and governance reforms very carefully to achieve the maximum effect and to avoid failures that can easily happen if limited capacities are overstretched.

These observations suggest two different routes for developing growth-enhancing governance capabilities in poor countries. The first, which we can describe as the *ambitious strategy* is to begin with the experience of one or other of the successful developers as a model, and attempt to replicate the interventions through which these countries rapidly moved up the productivity ladder. This would clearly be an ambitious strategy because it would require the creation of governance capabilities that would allow the implementation of such strategies on a similar scale. This approach is not likely to be very plausible in most developing countries that have not already demonstrated success in managing interventionist strategies in the past. The scale of governance capabilities that would need to be developed to enable growth-enhancing interventions on the scale of the East Asian NICs is not likely to be feasible in most of these countries.

Paradoxically, the ambitious growth-enhancing reform agenda is not likely to yield significant results in poor developing countries for the same reasons that the good governance agenda is likely to fail. The problem is that governance capabilities that make sense in theory may be totally unimplementable in the context of real developing countries that are far removed from the initial conditions required for their implementation. There are relevant institutional and political capabilities that East Asia possessed that are important to understand, particularly since these capabilities are often missing in other developing countries today. In particular, the East Asian states were able to achieve institutional control over the different arms of the state involved in industrial policy and this in turn implied a degree of political coordination and cohesiveness both within the political elites and in their relationships with the business sector.

However, a second, less ambitious strategy could be followed that addresses some of the market failures that the good governance strategy is implicitly trying to address but without attempting the ambitious implementation strategies of either the good governance agenda or the East Asian developmental states. This second, less ambitious strategy can be described as an *incremental strategy*, where the goal is to address critical market failures, but to focus on a few of them at a time, and in a limited number of sectors, so that there can be a focus on developing sufficient governance capabilities for tackling these market failures. The importance of developing appropriate governance capabilities needs to be a significantly important part of the reform agenda, particularly in countries that have in the past had poor results with interventionist strategies. Poor results with intervention could have a number of possible explanations, but they do suggest that the governance capabilities for effectively implementing the interventions were missing in the past. The distinctive part of the alternative approach that is outlined here is that interventions to overcome market failures and governance capabilities appropriate for implementing them effectively should be simultaneously identified and developed so that the feasibility of the strategy as a whole is clearly addressed.

Incremental/Hirschmanian Approaches to Governance Reform. It has been widely observed that institutional capacities to implement policies are in general weaker in African countries compared to the more successful Asian ones. It is also widely recognized that poor institutional capacity to implement can result in predatory behaviour because different parts of the state behaving in uncoordinated ways may try to raise revenue in ways that are value destroying. In contrast, if the political leadership of a developing country was coordinated enough to agree on the rights that needed to be enforced, a moderately intelligent leadership would soon realize that even their selfish interests would be best served by economic development. This is a variant of the argument put forward by Olson when he contrasted stationary bandits (a cohesive and stable state) with roving bandits (a fragmented and unstable state) (Olson 2000). A very similar point is made by Shleifer and Vishny in their analysis of the effects of corruption in fragmented and centralized states. They argue that corruption has worse effects if the state is institutionally fragmented (Shleifer and Vishny 1993; Khan 1996a).

One difference between Asia and Africa was that colonial powers had been in Asia longer and had fashioned more developed colonial states from the already more established pre-colonial states that existed in most Asian countries. Weak institutional capacity and the fragmentation of states are clearly very important in explaining the somewhat more frequent observations of predatory behaviour in Africa. But in the very successful Asian countries, it was not just that states were more institutionally developed when the colonial powers left, but in addition, they were able to engage in institutional development that took them further towards even more capable states. Our problem is to understand better why if weak and fragmented state institutions are so damaging, they also appear to be so persistent in some countries while others manage to create coherent institutional structures that can protect critical rights and enforce critical interventions.

If the problems were purely institutional ones, developing countries and their leaders would themselves have strong incentives to put this right, without much advice from outsiders. But institutional fragmentation is rarely a purely institutional problem that can be resolved by changing the structure of ministries or departments. Underlying the institutional fragmentation of the state is usually a political problem whereby different parts of the state have been captured by different factions or interests and establishing a cohesive state requires a resolution of underlying conflicts of interests. The persistence of institutional fragmentation and weak state capabilities may have a lot to do with the *political fragmentation* of the polity, particularly taking the form of multiple well-organized factions that each seek to gain maximum power and rents for themselves.

Just as in the case of institutional fragmentation, political fragmentation can result in different factions attempting to appropriate rents for themselves. But if no faction is sure that their gains are secure, winning factions will not invest in production and the slow transition to productive capitalism will not begin. The metaphor of roving and stationary bandits can be used here too, but the problem here is political fragmentation rather than simply a fragmentation of the institutional structure. While institutional fragmentation can be addressed by institutional reforms, political fragmentation can only be addressed by political reorganizations, for instance through the construction of new parties and more inclusive political movements. It is important to at least understand the limitations of what can be done in the absence of political measures to address political problems.

The political fragmentation of polities in Africa has been frequently commented on. For instance, Chabal and Daloz (1999) in an influential argument observed that in African states *disorder was institutionalized*. What they refer to is precisely the disorder that allows the transfer of resources down patron-client networks. The weakness of their argument is that what they refer to as a specifically African problem is actually at a general level a characteristic of all developing countries. Or to put it differently, the institutionalization of order (stable property rights, entrenched democracy, low or negligible corruption, the accountability of leaders and so on) requires a significant level of development in order to be effectively implemented.

So what is distinctive about Africa? Chabal and Daloz, and most commentators on Africa appear to be saying that African leaderships do not have the political will to make the difficult transition of imposing order and then trying to capture significant productive surpluses by enhancing production instead of the easy surpluses that can be captured through unproductive means. We are suggesting that the focus of attention should be on the institutional and political fragmentation of African states, and not just or even primarily on the political will, integrity or other characteristics of the leadership, important though these may also be in some contexts. The importance of political fragmentation in Asia in explaining the differential performance of Asian countries has been explored in Khan (1996b; Khan 1999, 2000a). Some of these ideas have been developed in the African context in the recent work of Lockwood (2005). The Asian experience suggests that the same political leaderships (and therefore the same political will) achieved very different things when political organizations changed. This is because the capacity to enforce and therefore the strategy of accumulation that political elites opt for will depend on the capacity of the political organizations to enforce particular interventions. Of course, building the political organizations and enforcement institutions that may eventually allow African societies to make more rapid transitions to productive economies is also a matter of conscious political activity, but this is the collective political activity, not the political will of a specific leadership.

An important starting point of institutional reform in Africa is to recognize that the fragmentation within political organizations and the fragmentation of power within the aspiring elites are relatively high to begin with. Enforcement capacities are therefore more limited as subsidies and other resources are more likely to be captured by individual factions and the maximization of social benefit is likely to be more difficult. In these contexts it is clear that strategies of technology upgrading and increasing investments are more likely to succeed if they are narrowly defined and supported by *pragmatic and limited instruments* (Khan 2006d). These may make a big potential impact, provided some very *specific and limited governance capabilities* are developed to support these instruments.

If the question is put in such a pragmatic way, it is unlikely that we should conclude that in general there are no intermediate steps that a developing country could take to counter the types of market failure that slow down technology upgrading, learning, sectoral diversification and so on. But even here, the optimal strategy will be different in different countries because of differences in their initial conditions and in particular their governance and enforcement capabilities. As a result, we expect that countries will have to go through a process of experimentation to identify the mix of instruments and strategies that are most likely to deliver results given their initial conditions and in particular their political settlements.

The link with Hirschman's ideas on entrepreneurial development in poor countries is very instructive (Hirschman 1958, 1967). The critical conditions for making progress in governance in countries with poor governance capacities has many parallels with the equivalent problem of developing entrepreneurship in countries where the initial endowments of entrepreneurship are very limited. In a series of pioneering works Albert Hirschman pointed out that progress is most likely to be made in an incremental and often disequilibrium fashion and the aim of development strategy is to identify areas of critical bottlenecks where entrepreneurial development is likely to have the biggest spillover effects through backward and forward linkages. To a great extent, this approach to thinking about the problems of entrepreneurship is just as relevant for thinking about the problems of governance. The pool of competent and committed personnel and resources that are available to make a dent on the problems of governance is if anything even more limited than the pool of potential entrepreneurs in many developing countries.

If we are to work within these constraints, it is imperative that strategies of governance reform to support growth are selected in a very pragmatic way, based as closely as possible on a good understanding of the initial conditions of the country, and in particular the productive capacities the country has already achieved and asking what can governments do to accelerate this growth given *existing* governance capabilities and the capabilities that could be feasibly developed in line with programme requirements. We will describe this incremental, experimental and pragmatic approach to growth-promotion as a Hirschmanian approach, though Hirschman was obviously not exactly addressing our problem of governance reform and capacity building.

Such an approach is not an exact science, as Hirschman had pointed out in his early discussion of project design and project choice (Hirschman 1967). Very often projects that he observed up close were chosen because their problems had been underestimated, but so had the capacity of entrepreneurs to resolve these problems. Their success in resolving these problems had multiplier benefits for society because the *development* of these entrepreneurial capacities was precisely one of the preconditions for development. But the critical condition for success here was that mistakes must not be allowed to continue for too long, and *if the entrepreneurial capacities to solve problems did not emerge in particular projects, there had to be some process of exit* otherwise the likely social costs were obvious. Exactly such an approach can be used to think through some of the problems of developing appropriate governance capabilities for making growth-promoting strategies work in poor countries.

Therefore a Hirschmanian incremental approach to governance would have a number of components: We should not stretch existing governance and productive capabilities too much by trying to do everything at once. Rather we should focus on a few areas that appear to be relatively obvious areas where growth could be further promoted (we will discuss what obvious means in this context later). The essential Hirschmanian insight is that we should not expect a scientific and conclusive *ex ante* identification of critical bottlenecks or constraints a society faces because success depends on the *ex post* effort put in by stakeholders into the process of discovery and experimentation and so results cannot be 'pre-planned'. What appears to be a good bet may turn out to be otherwise, and what appears to be an unlikely area *may* provide a challenge that results in the unexpected development of new productive and governance capabilities. Most importantly, therefore, *we need to have good exit strategies for the few things that we do try, and not try to do things where vested interests are likely to be so strong that exit may be precluded*. If we keep in mind these pragmatic pointers, we should be able, through a process that must involve both prior analysis but also some experimentation, to identify a pragmatic set of strategies for developing countries that recognize both the reality of pervasive market failure and the limited capacities for overcoming them.

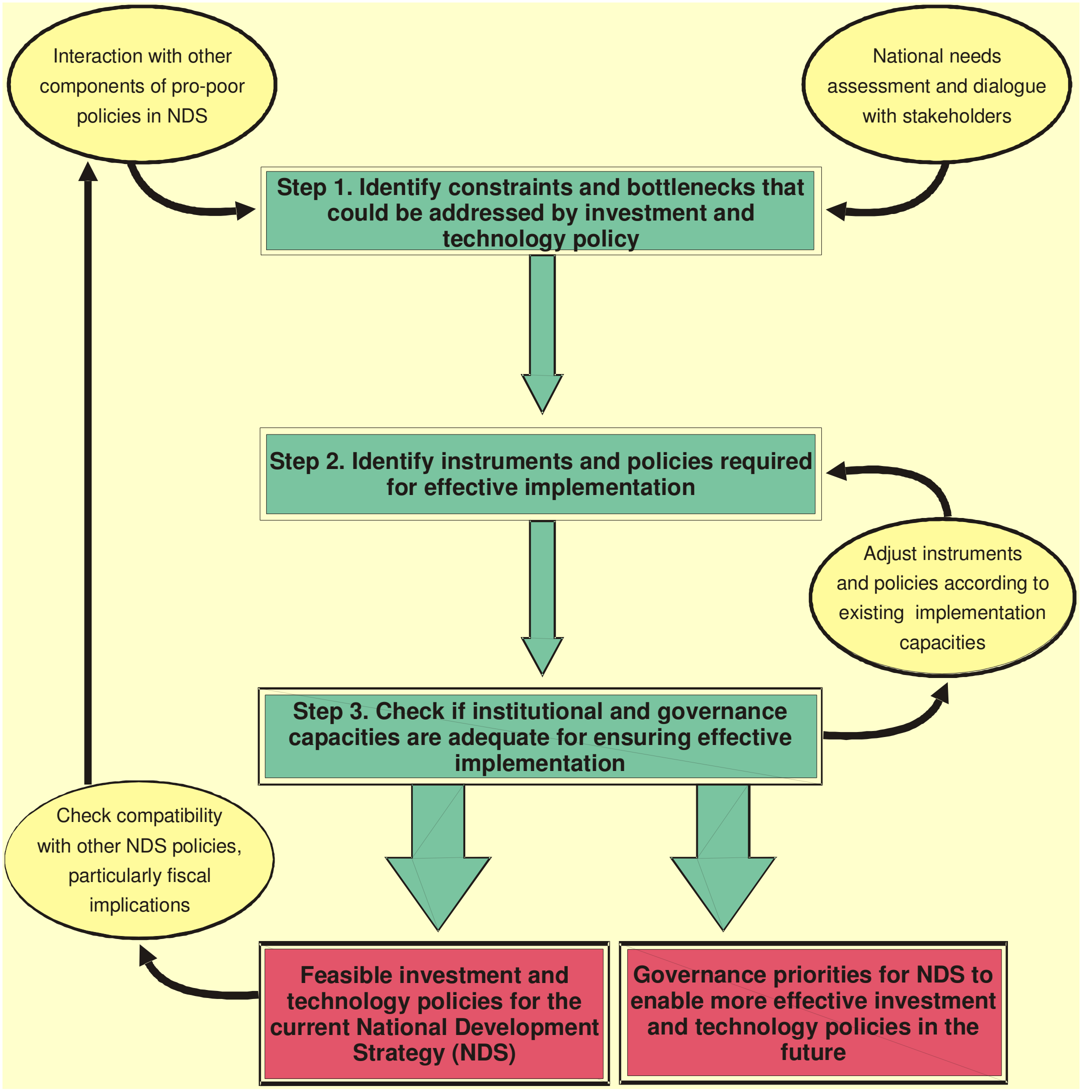
The argument that governance priorities for developing countries should be modest and should focus on the most important constraints has already been powerfully made by a number of observers, including Rodrik and his team (Hausmann, et al. 2005). They have also pointed out that the detailed governance capabilities that have been found to work in different countries can vary widely (Qian 2003). However, Hirschman's perceptive observations made 50 years ago on the indeterminate nature of the feasibility studies that preceded the adoption of projects in developing countries are just as applicable today to the sophisticated 'growth diagnostics' methods that are often suggested for identifying binding constraints in developing countries (Hausmann, et al. 2005). When the binding constraint approach is actually used in different countries, different economists can come up with very different conclusions about what the binding constraint is. A lot depends on the methodologies different economists may use, their own methodological assumptions and their degree of knowledge about the country (Leipziger and Zagha 2006). The conclusion that the assessment of binding constraint is a 'disciplined art' rather than a 'science' would not have surprised Hirschman at all.

Apart from the problem of the many different methodologies that different observers can use to assess binding constraints, the real difficulty, as Hirschman pointed out, is the uncertainty that comes from not being able to foresee *future* problems and opportunities that will open up with *any* strategy chosen. The importance of *exit strategies*, and therefore the importance of choosing areas of intervention where exit is more likely to be feasible if future problems appear can thus emerge as the critical issue. The issues of uncertainty, experimentation and therefore the necessity of exit strategies are critical issues that the binding constraints approach ignores.

Hirschman's approach suggests a different focus for attention. The focus here is not on how to identify and select in a scientific way the binding constraints that first need to be tackled to support growth. Rather the focus suggested by a Hirschmanian reading of development history is on how to develop *new capabilities* in a pragmatic experimental way *through a process of experimentation and problem-solving that could not have been foreseen from the beginning. From this perspective, it makes sense to select a number of reasonably obvious starting points for capacity building that make sense in terms of challenges currently being faced by growth sectors in the country. The critical condition is rather that the priorities for capacity building should be selected in such a way that the political capacity for exit is assured if the results are not satisfactory*.

It is here that we should focus, because we believe that in the poorest countries, reform can begin at various points and that typically it will not be possible to find or agree on a single binding constraint. The actual point at which reform begins to build growth-enhancing governance capabilities is likely to depend on specific political possibilities and capabilities, and there are likely to be a number of obvious places where we could begin (Khan 2006d). If success is achieved in one sector, the capabilities and lessons learnt can then be transferred to strategies for other sectors. These possibilities have to be discussed in the context of concrete country discussions. The simplest strategy for a country is to begin with sectors which have already achieved some global market presence or were close to doing so. This is a pragmatic way to begin because to identify market failures in abstract may be beyond the technical and planning capabilities of many least developed countries. However, every country has some sectors where growth has been higher than in others, and where exports are actually making some progress even if more could be achieved. If we begin with these sectors and ask if and how capacity expansion, technology upgrading and increases in value addition could be accelerated here, government agencies and governance capabilities could be developed (in a Hirschmanian incremental way) that have broader application to other sectors.

The steps involved in such a strategy are summarized in Figure 2, based on Khan (2006d). Once a number of initial sectors and bottlenecks have been identified in Step 1, the critical decisions are about Steps 2 and 3 in Figure 2, which are the stages at which a discussion of the requisite governance capabilities for the growth strategy comes into focus.



Source: (Khan 2006d: Figure 1)

Figure 2 Steps in Developing a National Growth Strategy

Step 1 in Figure 2 is to identify a few sectors where growth policy (the investment and technology policy) should focus in terms of addressing constraints on further productivity enhancement and moving up the value chain. The difference with the good governance type reforms is that here we recognize that very general, across the board governance improvements that would in theory make an impact on *all* sectors should not be the *sole* focus of governance or growth policies in poor countries. The structural impediments that make these reforms unlikely to deliver in developing countries have already been outlined. In contrast, a pragmatic approach would be to identify one or two sectors where growth is already present but could be accelerated, or where the challenge is to move into higher value adding products or move higher up the value chain, or simply raise productivity and competitiveness using machinery that has already been installed but is not yet optimally used.

As developing countries have different initial conditions, there is no common blueprint that all of them can follow. Rather, countries need to follow a simple methodology to identify at each stage a small number of things that they will attempt to do to enhance growth. In most developing countries, there are a number of sectors where some growth has been achieved and a pragmatic approach would be to start with these sectors and ask what needs to be done to improve productivity, move up the value chain and enhance growth generally in these sectors. If public policy and the appropriate governance capabilities can be developed to assist these sectors, generic growth-promoting governance capabilities will indirectly have been constructed.

The identification of these obvious sectors could be managed through a transparent process of evaluation and dialogue that involves the key business organizations in the country. But while there may be debates at the margin about which sectors should be selected as the initial few for policy attention, the sectors that must be included will be less controversial. For instance, in Ethiopia, the leather sector, cotton textiles and cut flowers immediately attract attention as sectors that have already achieved some success. Or in Tanzania, cotton textiles, tourism and mining are obvious candidates for initiating the policy investigation. This is not to suggest that identifying the sectors that policy-makers should initially focus on is always going to be uncontroversial. There are likely to be intense conflicts in some countries where growing sectors that are not included feel that they have been discriminated against. For the policy process to be inclusive and transparent it is therefore important for as many as possible of there important sectors to be included, without diluting the efficacy of the policy dialogue excessively by including the whole economy (see also Khan 2006d).

In some countries there may be an obvious dominant sector like the ready-made garments sector in Bangladesh. In this country, garment exports account for around 75% of export earnings but nevertheless, other sectors may have more significant long-term prospects. But these other sectors may be initially difficult to identify because there may be several candidates that may graduate to that position eventually. Nevertheless, the ready-made garments in Bangladesh may still be an obvious sector to focus on initially, simply because it accounts for well over half of the country's foreign exchange earnings, entrepreneurs in the sector have a very good idea of international market conditions and the competition they face, and there are obvious forward and backward linkages that can be accelerated, and substantial value addition that is possible. Focusing on this sector does not mean that diversification is not desirable or that other sectors may not eventually have a higher payoff. It simply means that this is a pragmatic place to start because we are building on existing expertise and any governance capabilities for promoting growth in value addition and productivity that we can develop here can then be used for other sectors. Indeed, if success can be achieved here, important governance capabilities will have been developed that might assist other sectors like the ailing jute manufacturing sector. It is nevertheless easier to develop growth-promoting governance capabilities with reference to a sector that is growing and dynamic than in a sector that has been forced to cut back. However, in some countries, the dominant and important sector may well be a sector that has potential but is currently not doing too well (Khan 2006d).

By focusing on a few sectors and looking for the constraints that are preventing growth, it is more likely that market failures will be discovered in a pragmatic way that could be the target for specific policy interventions to correct these failures. The focus in this paper is on Steps 2 and 3, which describe a process of iteration through which a small number of narrowly defined instruments or policies are selected *such that agencies charged with their implementation have the necessary governance capabilities to implement them effectively or where these growth-enhancing governance capabilities can be feasibly developed.*

Technology Upgrading and Growth-Promoting Governance Capabilities

While many types of market failures can affect growth and technology upgrading in developing countries, it is useful to categorize a number of issues that broadly affect investment especially investment in new technologies and technology upgrading. All of these issues are implicitly of concern to the good governance reform agenda, as well as being the subject of the extensive interventions that East Asian countries carried out during their takeoff periods.

First, there are a number of market failures that directly affect the cost and risk of investing in new sectors and technologies. In a well-working market of the type that the good governance reforms hope to achieve, the risks can be shared and the cost of investment should come down. In reality, these reforms are virtually impossible to implement and so alternative measures of reducing the costs of investment and sharing the risks need to be devised together with governance capabilities to manage these instruments.

Secondly, and related to this are the market failures affecting training and skilling of labour. Again, in a well-working market economy we can imagine how the costs and risks of these activities can be efficiently shared. In reality, good governance reforms are unlikely to proceed fast enough for this to happen, and once again specific interventions and governance capabilities are required if countries are to move up the value chain and raise productivity in their industries.

Finally, as the good governance reform agenda well recognizes, one of the main problems in developing countries without well defined property rights is that asset markets, particularly in land, do not work and this has important consequences for industrial and agricultural activities. While this recognition is absolutely accurate, the solution that the good governance agenda offers is unlikely to be implemented at a pace that will be sufficient to meet the pressing needs of developing countries where acquisition of land for higher value uses is becoming a serious constraint in many countries. Once again, specific institutional capabilities and strategies are required to address these problems in the meantime while a proper rule of law and well defined rights are gradually established.

Some emerging developing countries have had considerable success in the last two decades in developing new sectors like garments, cut flowers, leather and shoe manufacturing and so on. However, in many of these developing countries, these sectors face growing ‘competition from below’ from other low wage economies aggressively entering these markets. They also face stiff ‘competition from above’ from countries that are higher up the value chain, which have achieved higher productivity and quality and have established and built strong relationships with buyers. Sustaining growth and moving up the value chain requires a continuous process of technology upgrading that can be broadly described as productivity growth. Sustaining productivity growth has proved very difficult in poor countries where growth has often happened through replication of plants. Since the original plants often relied on cheap labour rather than a productivity advantage to achieve international competitiveness, these growth sectors (garments are a good example) are often characterized by low productivity and value added in many poor countries (Ahmed and Hossain 2006: Figure 4). Attempts to move up the value chain or into backward and forward linkages in these countries almost always run into problems which include some combination of the three broad types of market failures referred to earlier.

It is often not easy to carry out an analysis of the market failures that may be constraining growth and technological upgrading in developing countries. The technical capacities in government agencies are often lacking and entrepreneurs themselves may have perceptions about what constrains their expansion that are based very closely on the consensus opinion of international financial institutions that are regularly reported in the national press. For instance, we carried out in-depth interviews of around 30 firms selected to represent different technologies and scales of operation in the garment and textile sector in Bangladesh and found that often entrepreneurs in these sectors were identifying exactly the problems of governance and investment climate that had been identified by international agencies working in the country (Khan 2008).

Some issues of concern to entrepreneurs were well-known infrastructural issues that were not at all surprising, and which affect virtually every developing country. For instance, poor road infrastructure, delays at ports, and an unpredictable power supply. But in addition, many entrepreneurs identified problems of governance and corruption in exactly the way in which the problem has been framed by the good governance consensus. Many of these problems are very real and are also well known. However, even with these constraints, output in the Bangladeshi garment industry had grown rapidly (at double digit growth rates) for a couple of decades. In our face-to-face discussions with entrepreneurs, bankers and managers, we drilled down deeper and asked why low-productivity exports have grown rapidly with these constraints but moving up the technology ladder to high value items seemed to be precluded.

One way of posing the question was to ask entrepreneurs to imagine that significant improvements in power supply, port throughput times and improvements in other infrastructural obstacles took place. Would they expect as a result to export even more of the types of things they were already exporting or would these changes be sufficient to enable them to move rapidly up the productivity chain. This was a particularly important question because growing pressure from the workforce for higher wages has also made employers aware that doing more of the same low productivity production was not a viable strategy over time. When put in that way, entrepreneurs began to give more nuanced answers. Some of their answers then veered towards good governance issues, on the grounds that better governance would enable them to raise capital more effectively, particularly from foreign investors. But here the suggestion that these reforms were likely to take a very long time to make a significant impact was immediately accepted as the most plausible conclusion. We could then move on to a more detailed discussion of very specific questions, and different sets of constraints appeared[1].

To proceed step by step, we looked for market failures in the allocation of the key resources at issue, namely investment funds, labour and land. Our strategy was to ask how these resources were being used and allocated across uses, the institutions responsible for their allocation, and what if any market failures we could detect that may be constraining their optimal allocation and use. This then directed our attention to the absent governance capabilities that prevented addressing some of the more obvious market failures through simple interventions. We could then conclude that the absence of these governance capabilities was indirectly constraining growth and in particular the growth of productivity.

Market failures affecting Investment in New Sectors and Technologies. In many developing countries, the rapid growth of sectors like the ready-made garments sector suggests that in an absolute sense, there is no scarcity of investment funds in these growth sectors. In Bangladesh, this was confirmed by the banks that we surveyed and we suspect that the finding would be similar in many African countries. If anything, at the time of our survey, banks wanted to lend more and if anything lending was constrained by the conservatism of borrowers or the absence of borrowers who could satisfy the collateral and other requirements of the banks. Borrowers in turn corroborated this. Entrepreneurs held back from borrowing typically because of concerns with the generally high levels of interest rates and the collateral requirements of commercial banks. As investments in new technologies were inherently more risky, these conditions made critical investments in new technologies even less attractive because the repayment period was more uncertain in these investments and the individual borrower with good collateral was therefore excessively exposed. A small miscalculation of the period of learning could result in rolled up interest making the project unviable, and unless the entrepreneur had very deep pockets and was willing to take relatively very high levels of risk, they were understandably unwilling to borrow for technology upgrading. In a mild form, this is the generic adverse selection problem identified as a possibility in bank-based lending systems (J. E. Stiglitz and Weiss 1981; Hellman, et al. 1997).

In the typical case, the problem of adverse selection is not so severe that only bad borrowers end up borrowing. Rather in the form that is typical of many market-based developing countries relying on bank lending, the problem is a 'milder' one. It is simply that a borrower who has to pledge good collateral and pay high interest rates will only take a risk with investment in technologies that promise an assured return over a relatively short repayment period. This means that borrowers have a strong tendency to stick to known technologies with rapid repayment periods, and prefer 'extensive' investments (replicating what they know) or very incremental backward and forward linkages (where the repayment is relatively rapid and assured).

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[1] It is important to understand that given the widespread conventional wisdom on the good governance and investment climate constraints in most developing countries, most entrepreneurs are likely to repeat the conventional wisdom they have been reading about in the newspapers. A longer discussion and step-by-step questioning based on prior analysis of the sector by the research or policy team is the only way to discover the *specific* market failures that actually constrain investment and upgrading in particular sectors and countries.

It is rational for them to stay away from 'intensive' investments in technologies where the repayment period can be moderately long and cannot be predicted precisely. By definition, new, higher productivity technologies have to be learnt by managers, workers and others, and new markets sought. The expected net present value of these investments may be high, but the risk is also high because the breakeven period cannot be predetermined accurately. If the entire risk is carried by an individual borrower (which is typically the case with family run businesses), the level of risk carried by the owner may be unacceptable given the narrow margins and limited uncommitted bank balances of most businesses in developing countries. A delay in project implementation by a small margin may add an unsustainable debt burden on the project due to the accumulation of high interest payments, and rapidly make the project unviable, leading to the possible loss of the owner's collateral.

The failure to allocate investible resources towards long-term investments that can raise productivity is a market failure. In a low transaction cost market, investors with different risk appetites would pool resources to invest in upgrading and move production towards higher productivity technologies. If these contracts were possible (share participation is one example), the firm would not suddenly face an unsustainable debt service burden if repayments were delayed for plausible reasons, but investors would expect a higher total return over time for the extra risk. These types of contracts are precluded in high transaction cost markets because contracts protecting outside investors (that is investors who are not directly in control of the firm) cannot be enforced. As a result outside investors who may have been willing to absorb risk will not do so because they cannot be sure that the firm will not default with their money, or less dramatically, that the firm will not put in suboptimal effort, or not disclose fully, such that the return to outside investors will be insufficient given the risk. As contracts to enforce management changes or other strategies to compel effort or disclosure are not enforceable in the typical developing country, potential risk-absorbing outside investors stay away from these activities.

This market failure is of course well recognized in the market-promoting agenda. However, the standard good governance reform strategy is to make markets more efficient by focusing on rule of law reforms, anti-corruption strategies and competition policies. In theory, if a broad-based rule of law could be enforced, contract-enforcement would improve, allowing the types of long-term profit-sharing investments including stock markets. However, the practical question is whether these market-enhancing governance reforms can be implemented to a sufficient extent and soon enough to have any effect on these pressing market failures. How much further would contract enforcement, rule of law, anti-corruption and disclosure reforms have to proceed to allow firms to raise money from efficient capital markets? When put in this way, all business respondents in our Bangladesh survey agreed that reliance on market-promoting reforms would take far too long for them to raise the money they needed to ensure that the emerging garment and textile industry has a secure future (Khan 2008).

An incremental growth-promoting governance approach in this context would be to work with existing financial institutions, the government and the private sector to develop feasible governance capabilities that allow *existing* financial instruments or ones similar to those used by other developing countries to be implemented to allow risk-sharing investments. The critical issue is not just to provide implicit subsidies to financing instruments, or for government to absorb some of the risks involved, but to have well-designed instruments so that the desired results are achieved. In particular, poor countries would be right to start with relatively small experiments with specific financial instruments and scale up if the governance capabilities for these instruments can be developed.

A number of variants of financing instruments to deal with these market failures exist but each has to be carefully tailored to local needs and governance capabilities if they are to have positive effects. The possibilities range from subsidies on the capital cost of borrowing to equity participation by government in new projects. Since many examples of such interventions exist in developing countries where they have often not produced good results, it is important to start from first principles and work out the conditions under which that particular instrument can succeed and ask whether governance capabilities to make it work can be feasibly developed. Most importantly, exit options have to exist for government in case a strategy turns out after a few years of trial to generate unsatisfactory results.

A subsidy on the cost of capital for startup industries and for firms making investments in new technologies makes sense for the reasons discussed earlier, but for the programme not to be captured for unintended uses requires governance capabilities in the central bank or the ministries disbursing the funds to monitor the allocations and their subsequent uses. Without such minimal capabilities, the subsidy is likely to become a free gift for investments that would have happened anyway. Many examples of such failed attempts can be found in the developing world. The incremental way to develop growth-promoting capabilities in developing countries with poor governance capabilities would be to set up a limited fund for specific technology upgrading subsidies and set up a relatively small dedicated agency within government with high quality personnel charged with monitoring a narrowly defined subsidy scheme. The programme would test if minimal governance capabilities could be developed in the agency charged with its monitoring, and only scale up if the results were promising after the first few years. But given the challenges LDCs face from next tier developing countries like India and China, which have many explicit and implicit subsidy strategies for developing manufacturing and high value adding services, it is imperative that LDCs begin the task of improving their capacities to deal with critical market failures in technology upgrading.

Similarly, government equity partnerships are also often found but the financing instruments are usually badly designed and with limited governance capabilities, these financing instruments also become a source of free capital injection into projects which would have happened anyway. As an example, we found a scheme run by the government of Bangladesh since 2001 called the Equity and Entrepreneurship Fund, which had been set up precisely to address the types of market failures that we identified in our discussions with entrepreneurs. This fund was limited to a number of sectors identified as thrust sectors by the government (IT and agro-industries), but our observation was that it suffered from internal design problems and the government lacked critical governance capabilities for operating this fund to achieve the desired results. If these could be addressed, this fund or a similar one could be developed to finance the critical upgrading the garment and textile sector in Bangladesh required to face international competition.

The objectives of the Equity and Entrepreneurship Fund (EEF) are exactly the right ones, and the government clearly recognized the difficulties of using bank lending to finance investment in new technologies. In the EEF instrument, the government buys up to a 49% stake in companies engaging in investments in *new* areas, relieving the entrepreneur of immediate and onerous interest payments. The entrepreneur can buy back the equity in 3 years at face value (implying a 3 year interest-free loan), or after 8 years at either face value or a vaguely defined break-up value to be determined from the balance sheet by accountants. Otherwise, the government has the option of eventually converting the equity into a loan, implying a significant long-term interest free loan till that point. However, as an internal evaluation of the Fund shows (Bangladesh Bank 2006), the projects financed were poorly chosen, there were no credible exit strategies for the external financier (the government), and given the incentives it is not surprising that performance under the fund has not been as dynamic as it could have been. However, given the recognition of market failure in an already existing instrument, it is possible to ask how we can improve its operation by changing its design and the governance capabilities of the agencies managing the fund.

The current design of the fund creates virtually no compulsions for firm management to perform or deliver a return on the equity. When the government hands over the money for its equity stake, this is effectively an interest-free loan to the startup firm with no collateral requirement. With such an attractive financial package, it is not surprising that many beneficiaries did indeed set up what appear to be viable new enterprises (though as the Bangladesh Bank evaluation points out, it was still quite early to properly evaluate success after only four years). At the same time, given the insufficient incentives and compulsions on firms, it is also not surprising that progress in implementing and learning new technologies was often slow. The types of technologies that were being successfully adopted were often fairly straightforward and many could in principle have been financed in the traditional way by bank loans and would probably still have been viable.

A reform objective would be to achieve a combination of i) a pooling of risk so that an individual owner would not face ruin if a project to upgrade technology took longer than planned or failed, with ii) the creation of sufficient compulsion on the owner/manager to put in every effort into the project because learning new technologies, finding new markets and organizing work in new ways are all difficult tasks that are unlikely to be undertaken without some pressure. There were also local initial conditions that we had to take into account. In particular, manufacturing units in the garment and textile sector in Bangladesh are still predominantly family owned enterprises and the owners are generally not prepared to share a significant part of ownership with outside investors. Secondly, monitoring capacities at the Bangladesh Bank, which was hosting the EEF scheme, were limited and the Bangladesh Bank preferred to work through the commercial banks for monitoring firms. Representatives of commercial banks who were giving complementary loans to these firms were charged with making firm visits and liaising with the boards of the beneficiary companies. However, while this was a good idea in principle, and saved on overall monitoring costs, the commercial banks were not particularly interested in whether new technologies or productivity improvements were being acquired. They were, however, clearly interested in the standard financial viability of the companies, and this was good enough to ensure that a minimum early warning system existed for any emerging problems.

A number of adaptations to the existing scheme were easy to identify which could make it more appropriate for overcoming the relevant market failure. The interest free period implicit in the equity holding is very desirable but it needs to be combined with a claim on subsequent profits that provides some compulsion on the entrepreneur to increase productivity and profitability. However, firms have little incentive to truthfully disclose profits and book profits are difficult to determine in a developing country. One possibility would be to link the return that the entrepreneur has to provide the external investor (whether private or public) to the export earnings of the firm. Export earnings are relatively easy to observe and banks in Bangladesh already have arrangements that deduct bank returns from export earnings.

A second weakness in the existing Equity Entrepreneurship Fund is the buyback option for the firm. This is essential to ensure that firms do not feel they will permanently lose control of their firm, but is based on a vague book value which is in reality virtually impossible to calculate. An alternative has to be worked out that is easy to observe and which could potentially be enforceable. One possibility is a buy-back option for the firm which is based on the loan value plus the accumulated interest at an interest rate determined in advance less the payments already made. Such a hybrid arrangement would give the firm an option to pay back the loan if it had enough accumulated surplus to give a predetermined return to the external funders, or to continue its learning process with the technology on an export earning sharing formula. To reduce the risk for the firm, the loan for technology upgrading could be backed by collateral less than the value of the loan, with the government absorbing some of the risk. Provided the collateral pledged was committed in the same way as it was to commercial banks, with real risk of loss in case of failure, this would provide strong incentives for performance for the firm without raising the risk level to the point where a small entrepreneur would not borrow for these purposes.

Clearly these improvements in the design of the fund, or other variations around this theme would require very clearly defined governance capabilities on the part of the state to make it work. The critical governance capability would be the development of a high-powered agency that could provide the assurance that it would monitor and enforce the terms of the specific funding arrangements under its remit. As investments would be limited to specific technology upgrading projects in the way we are suggesting, the agency would initially be responsible for monitoring relatively small amounts of funds in absolute terms. We could therefore begin with a governance capacity building project in a relatively narrowly defined government department. But it would be vital to ensure that it was a relatively well-funded agency able to buy in skilled personnel to carry out these regulatory tasks, that it had political backing and clear terms defining exit conditions for the government. A small and dedicated agency may be able to achieve these conditions even in difficult developing country environments, and its significance would be disproportionate to its size because its success could be the trigger for replication or expansion.

Labour Skills and Training. Despite poor countries being labour surplus economies, when it comes to manufacturing employment, even in relatively low technology sectors, they appear to suffer from perennial labour shortages. Some of the shortages are due to shortages of specific skills, but there is also a shortage of 'unskilled' labour. The reason for the latter is that while labour is abundant, workers exposed to factory discipline and conditions of work in a high pressure export sector are difficult to find. The skills provided by formal school education are socially important but do not necessarily fill this gap. Firms in these countries therefore have to engage in on-the-job training which suffers from market failures for well known reasons. At the same time, many private sector training institutes have been set up in some more advanced developing countries with large manufacturing sectors. For instance, in our survey of the garment industry in Bangladesh we found that many training institutes have been set up specifically aimed at skills gaps in the garment sector. But the private training sector faces serious problems because of low uptake and the unwillingness of the garment employers to pay very much for training their workforce. This too is a clear example of a market failure. Training is available and required, but is not taken up despite employers facing serious shortages of skills. The problem is that the employer financing the training faces a market failure (externality) problem because the worker could leave the firm with the training and bargain for a higher wage elsewhere.

Once again, a number of simple solutions could address the market failures affecting labour skills and training. However, each solution requires specific governance capabilities on the part of the government to deal with that market failure. The possibility of long-term employment contracts with the personnel receiving training is one solution that is ruled out by the implausibility of enforcing such contracts in a developing country environment. This leaves the possibility of subsidizing the provision of training. The training at issue could range from orientation programmes for new entrants into the industrial workforce to very specific programmes of skill development required for specific technologies. This is not as simple as it sounds if resources are not to be wasted in subsidizing programmes that add little to productivity. Even a relatively small subsidy could provide resources for critical orientation programmes for new entrants. Similarly relatively small subsidies for employers sending critical personnel to accredited private training institutes could provide a sufficient incentive for taking up some of the available training. In countries like Bangladesh, overcoming labour shortages in key bottlenecks would likely have a strong effect on growth. If worker skills could also be improved in critical areas, this would provide an important boost for productivity growth.

However, for a training scheme not to waste public funds, it would need to be carefully designed and managed, bringing us back to the issue of developing specific growth-promoting capabilities in selected government agencies. The programmes would have to be developed in close consultation with industry associations without allowing training priorities to be defined exclusively by the interests of specific sub-sectors. This would only work if governance capabilities could be developed to provide accreditation to programmes in association with employers' associations. Even more important would be to charge well-resourced agencies within government to monitor the operation of the subsidy programme. This requires governance capabilities for the agencies managing the subsidies to monitor the results and exit from the support of programmes that failed to meet standards.

Remarkably little attention is given in most developing countries to the importance of accredited training for key parts of the workforce. Paradoxically, in many developing countries orientation training for workers coming largely from non-industrial backgrounds to acquire employability in manufacturing jobs would overcome a critical constraint. Even in countries like Bangladesh where manufacturing employment is relatively advanced, this remains a constraint, together with sharp shortages in more skilled categories. Given a poor experience with training programmes in the past, the constraint is clearly not just the capacity of the budget to support subsidies, but much more the absence of governance capabilities that can deliver the maintenance of quality and ensure exit from programmes that fail to deliver. The subsidization of poor training programmes can obviously be more socially costly than not doing anything. Here too is an example of a relatively modest strategy of improving governance capabilities in narrowly defined agencies, which if successful can be replicated to deliver to other sectors facing skills shortages.

Land Allocation and the Achievement of Scale Economies. The problems of acquiring land can be a serious constraint for new projects and for expansions in developing countries, particularly in relatively densely populated ones. Land typically does not have clearly established property rights in most developing countries. It is often difficult to establish clear ownership, there are often multiple claimants for most plots of land and the plot sizes are typically small. There are structural reasons for this, to do with the limited productivity of most land, and the high cost of establishing clear property rights on assets like land (Khan 2006c). A potential investor faces a long and complex process to acquire a large piece of uncontested land. Interestingly we found that one reason why the garment industry in Bangladesh was slow to achieve scale economies was simply because of the difficulty of setting up contiguous production on single production sites. The same owner therefore typically has multiple plants rather than a single one, losing many potential scale economy benefits.

Many developing countries attempting sustained manufacturing growth face a potentially serious crisis due to poor governance capabilities to address land market constraints. The Nandigram crisis in West Bengal in 2007 is an example of how the absence of good strategies and governance capabilities for handling conflicts over land acquisition can rapidly lead to a serious political crisis. Here an attempt by the state government to acquire land through compulsory purchase orders for an industrial project resulted in organized political opposition leading to police shooting in which a number of people were killed. In many developing countries industrial zones and land allocation for industrial development that states can offer is often far away from the infrastructural amenities available near urban centres. This prevents the development of clustering advantages and often land allocated for industrial development is not taken up because of these disadvantages. At the same time, the absence of industrial development land close to good infrastructural amenities often leads to unplanned and illegal developments within urban centres.

In the conventional governance approach the solution to these problems is to improve the land market as a whole by improving land records, the operation of the court system and fighting corruption, so that land market transactions can take place smoothly. The importance of land use regulation is obviously also recognized but by itself this will not solve the problem faced by industry if overall land market efficiency does not also improve. These good governance or market-enhancing governance strategies are clearly only likely to deliver in the very long-run. In contrast, an incremental growth-promoting governance approach would be to identify specific land bottlenecks and develop moderately efficient agencies to address land use problems on a case-by-case basis.

The incremental growth-promoting approach suggests that we should focus on a single or small number of specific problems facing an actual growth sector. This would allow us to focus available governance resources and capabilities (which are very limited in most developing countries) on clearly defined objectives. For instance, if the expansion of specific industries is being constrained by land acquisition problems, land availability for expansion would be critical for the success of the strategy. To address this, appropriate governance capabilities would have to be rapidly developed in agencies targeted to resolve land acquisition problems faced by the sector. This could take the form of prioritizing the acquisition of land for industrial zones with adequate infrastructural amenities.

The precise configuration of tasks and capabilities for the suggested land agency would obviously vary from country to country, depending on the types of problems and the political and institutional initial conditions. The essential point is simply that the growth-promoting approach is about focusing on limited things that can be done, and then ensuring that the highest quality personnel with clear political support are made available for these agencies. As with the other types of interventions discussed, the ability to change the policy and indeed to exit from strategies that are not working is critical for improving the chances of success.

Concluding Points

The incremental growth-promoting governance approach that we are advocating is not necessarily limited in relevance to these countries alone. We believe it has general relevance, but it is particularly relevant in poor countries where the general weakness of governance capabilities often leads them to accept a market-enhancing strategy whose governance requirements for success are actually paradoxically even more demanding if only they are properly spelt out.

In summing up, we summarize the steps that would need to be followed to think through the points for action in specific cases. The important point is to remember that the strength of this approach is that it describes a realistic strategy of experimentation and discovery where the importance of exit strategies is paramount. It is more important to develop high quality growth-promoting governance capabilities in a few areas that can link with existing growth sectors and opportunities, rather than to worry excessively about where to start and which are the truly binding constraints. If the strategy begins to pay dividends in a few areas, these capabilities can then be replicated for other sectors. If not, exit is likely to be easier if the agency was initially small and targeting a small number of problems.

We have argued that a good place to start is to begin with sectors where the country already has some experience in international competitiveness and where some productive capacities have already been developed. These are the types of sectors where relatively small improvements in technology upgrading strategies, investment expansion strategies, strategies to address labour and land market imperfections are more likely to deliver quick dividends. Once strategies to overcome specific market failures can be shown to work because the requisite governance capabilities have been developed, it will be politically much easier to scale up these agencies, replicate them in other sectors, and apply these tools for resolving problems faced by ailing sectors.

Our survey in Bangladesh is also interesting in pointing out that the initial responses of entrepreneurs and others to questions about constraints facing them is likely to replicate the conventional wisdom to which they have been exposed. In other words, policy-makers should not be surprised if the initial response of market players in developing countries is to identify the importance of market-enhancing (good) governance reforms. This is because of the dominance of the good governance programme in contemporary developing countries and the diverse constituencies which support it. It requires some amount of probing to identify the market failures that really affect them, and spelling out the mechanisms through which good governance could resolve these problems quickly convinces most entrepreneurs that more immediate solutions have to be sought.

Finally, a good practical strategy is to think through for the sector(s) chosen the market failures that could affect the operation of capital, labour and land markets in ways that constrain technological upgrading, labour upskilling or land acquisition for value-enhancing uses. The specific market failures that may be relevant are likely to be variants on the theme of the types of market failures that affect the Bangladeshi garment industry, but their specific form may be different. In particular, the initial conditions defining likely responses to these market failures are likely to be different because existing financial instruments, training schemes, land acquisition and land use regulations and agencies are all likely to be different. But by beginning with what exists and investigating feasible incremental improvements that are most likely to make a big impact on the constraints facing the potential growth sector, we will be making progress in identifying and developing growth-promoting governance capabilities.

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