

Chapter V

Governance, institutions and growth divergence

The present chapter will examine how institutional and governance factors can help account for the divergence in economic growth among countries. As shown in chapter I, a fairly small group of countries—those in Western Europe and its offshoots—had increased their growth rates in the period after 1820 and enjoyed sustained growth and they have remained the richest countries in the world. This was a unique achievement in historical terms because formerly growth spurts had inevitably been associated with reversals. Moreover, the example of Japan appeared to indicate that other countries would “catch up” by enjoying faster rates of growth than those of the first industrialized countries, would join the growth club and would achieve comparable standards of living. Yet, as chapter I also showed, this has not happened because most other countries failed to achieve faster rates of growth than those of the developed countries. After 1980, there was a dual divergence, involving lower growth rates of developing countries as a group vis-à-vis the industrialized countries and strikingly different growth experiences among the developing countries themselves.

This chapter argues that the quality of institutions and governance structure matter for the growth of a country and for growth divergence among countries. Ideally, governance promotes the public interest by, inter alia, promoting social cohesion, making the society more fair and stable, guaranteeing an adequate provision of public goods, ensuring the functioning of markets, and encouraging calculated risk-taking behaviour by individuals and businesses. Building towards a higher quality of institutions in specific areas where constraints on growth are most stringent (but without overhauling the entire governance structure) lifts the economy to a higher growth path. Furthermore, the experiences of some countries in East Asia and sub-Saharan Africa show that ways of removing such constraints were based on country-specific practices and organizations and thus that there is no unique way to achieve the goal. These countries also demonstrated the effectiveness of adopting a gradualist or, in a sense, experimental approach (as opposed to a big-bang approach) to lifting the constraints. When reform in a single area is undertaken, this approach helps policymakers understand and implement necessary changes in other parts of the governance structure so as to complement the original reform and make it more effective. Furthermore, this approach supports the argument that successful economic transformation depends on creating institutions that guarantee not just the better functioning of markets, but also social cohesion.

The chapter begins with a consideration of the relationship between institutions and economic divergence. It then examines two dominant theories concerning the importance of governance structures in economic growth/development and their relevance to policymaking in the developing world. The third section analyses several country cases in which transformation of the governance structure successfully lifted binding constraints on growth and led to sustained economic growth thereafter, while the following section examines growth failures and some institutional and governance aspects of countries affected by conflicts. The chapter concludes with a few policy recommendations.

Institutional and governance factors help account for the divergence in economic growth

Successful growth depends on institutions that can make markets function better and that can guarantee social cohesion

Institutions, governance and economic growth

Suitable forms of institutional “quality” and good governance to support sustained growth are inherently country-specific

A build-up towards better institutions in specific areas can be sufficient to lift binding constraints on growth

Market functioning can be improved by lower transaction costs, public goods provision, industry regulation and strategies for long-term growth

It is difficult to pin down exactly what institutional “quality” and what forms of good governance should be pursued in order to support sustained growth processes. Such features appear to be inherently country- and context-specific. For policymakers, it is relevant to know whether new economic opportunities can be unlocked in a significant manner even when more modest and focused changes are being made in the existing institutions and governance structure. Policymakers are thereby informed of the possible impacts on economic performance during the transition from the existing to the new system, and of how they can best create a high-quality governance structure without imposing large costs on society.

Looking at economic history and institutional change, it appears that a build-up towards better institutional frameworks in specific areas can be sufficient to lift binding constraints on growth and initiate a sustained growth process. In the seventeenth century, protecting a broad group of trade merchants in the Netherlands and Great Britain from arbitrary interference in the exercise of their property rights and building an effective and extensive legal system to safeguard those rights constituted one of the undertakings that laid the foundation for the sustained growth process of these countries (see box V.1). More recently, China’s reform of rural and agricultural institutions that had begun in the late 1970s laid the groundwork for its current economic success (see below).

Successful economic performance within the context of a market system depends on creating institutions that guarantee not just the better functioning of markets but also social cohesion. For the purpose of this chapter, governance, or public institutions, are understood to promote the public interest by dealing with these two broad areas—the functioning of markets and social cohesion.¹ Growth that is achieved at the expense of the latter is not likely to be sustainable over the long term, while improvements in the functioning of markets and greater social cohesion should be mutually reinforcing.

No rigid distinction can be drawn between “governance” and “institutional” factors. Institutions correspond generally to a somewhat broader concept, as they encompass formal and informal “constraints”, including rules and regulations, that not only dictate the functions of the State, but also govern those of private entities (see United Nations, 2000, chap. VIII).

While there is some overlap between the two sets of governance factors—those creating a market, and those strengthening social cohesion—they can be usefully subdivided along the lines suggested by Ocampo (2006). Governance factors that create and improve markets can be classified as those that: (a) help create markets, by reducing transaction costs and granting and protecting property rights; (b) provide for public goods (measuring, in the classical sense, non-rival and non-excludable goods), as well as those that generate positive externalities, and reduce the supply of the ones that generate negative externalities; (c) help in regulation at the industry level, particularly in relation to non-competitive market practices; and (d) provide for regulation that avoids short-run macroeconomic imbalances, and design structural strategies and policies that create conditions for long-term growth by extending adequate incentives and helping finance innovation, human capital accumulation and investment.

¹ The World Bank and International Monetary Fund (2006, part II) defines public sector governance in a similar fashion, but mainly emphasizes the openness and transparency of political systems and administrative machineries in creating good national governance systems.

Box V.1

The first great divergence and the importance of the Atlantic trade

The importance of the Atlantic trade to the first great divergence in economic growth can be judged from the fact that those Western European countries that engaged in that trade had faster rates of urbanization and growth in gross domestic product (GDP) than the Eastern European and Western European countries that did not (see Acemoglu, Johnson and Robinson, 2005).

The profits from the Atlantic trade, colonialism and slavery were one factor that directly accounted for their faster growth. However, the importance of this direct relationship has been felt to be relatively small and it is thought that another factor, indirect but more significant, was the shift in the balance of power within the trading countries themselves away from the narrow royal circle to a broader group of merchants, slave traders and colonial planters who profited from this trade and who demanded—and obtained—significant institutional reforms protecting their property rights. In those two countries where there were already constraints on the monarch, namely, England and the Netherlands, the members of this group were successful in securing added protection for their property rights.

In Britain, where the majority of commercial interests had been alienated as a result of the grants by James II of various monopoly privileges and had supported the invasion of William, the Dutch stadtholder, the outcome of the Glorious Revolution of 1688 was the acceptance by the new monarch of the principles of constitutional monarchy and the supremacy of Parliament, as affirmed in the Bill of Rights of 1689. The Glorious Revolution was a revolution in the sense not of having overturned existing institutions, but rather of having restored those “laws and liberties” that were thought to have been endangered by the absolutist tendencies of the Stuart monarchy.

Similarly, the merchants in the Netherlands constituted a major group pressing for independence from Hapsburg rule and for greater protection for their property rights. With their newly acquired property rights, “English and Dutch merchant nations invested more, traded more and spurred economic growth” (Acemoglu, Johnson and Robinson, 2005, p. 572). In the case of the Netherlands, the following conclusion has been drawn:

Dutch institutions favoured economic growth. Religious tolerance encouraged skilled immigration. Property rights were clear and transfers encouraged by cadastral registers. An efficient legal system and sound banking favoured economic enterprise. Taxes were high but levied on expenditure rather than income. This encouraged savings, frugality and hard work. Thus the Dutch were a model of economic efficiency with obvious lessons for British policy (Maddison, 2001, p. 80).

Political institutions in Spain and Portugal, in contrast with the Netherlands and Britain, were more absolutist. As groups allied to the crown were granted monopolies over the Atlantic trade and were the main beneficiaries of transoceanic trade and plunder, they did not press for institutional changes. With institutional atrophy came considerably slower economic growth: by 1700, incomes per head in the Netherlands and Britain had reached \$2,110 and \$1,405 respectively, as against \$854 and \$900 in Portugal and Spain (Maddison, 2001, p. 90, table 2-22a).

The other set of governance factors that make the workings of the market consonant with social cohesion are those that: (a) guarantee adequate provision of the goods and services that a particular society considers to be those that should be provided to all its members; (b) through redistributive policies, change the structure of wealth ownership and income distribution so as to achieve levels of redistribution considered desirable or at least tolerable by society; (c) manage conflicts that can be generated by the functioning of markets; and (d) determine participation in decision-making processes, relating not only to distributive outcomes, but also to the very functioning of markets, as it is not possible to achieve the desired distributive results without influencing how markets function.

Adequate provision of the goods and services, wealth redistributions and participatory decision-making processes strengthen social cohesion

These institutions very much reflect the views within society at a particular time as to what is just and fair with regard to the appropriate level of redistribution of wealth and income within society, the appropriate role of the Government in the provision of public goods, and the goods and services that should be guaranteed to citizens. Even among the developed countries, there is considerable difference of opinion as to what the institutions should achieve, with the Scandinavian countries, for instance, using the taxation system to achieve a redistribution of income and benefits greater than that in the United States. Moreover, historical experience has shown that successful societies have made progress on both fronts, namely, in perfecting the workings of the market economy and in achieving social cohesion, and have not just single-mindedly pursued one particular abstract notion such as “the defence of property rights” or the “unfettered workings of the market”. As was pointed out by Karl Polanyi in 1944, the pursuit of a pure self-regulating market without any government or societal involvement reflects a dangerous illusion (Polanyi, 1944). Success has generally come from extending the scope for participation and by making continuous changes so that the changing relationships within society are managed in a stable manner.

A widespread sharing of the benefits of growth creates a sense of justice and fairness among the population

The resulting institutional arrangements affect the incentives of people to invest, work, learn and conduct research and development. The effectiveness of the system is determined, to a large extent, by its ability to promote growth and rising levels of income and overall well-being and to achieve social cohesion and, in general, to produce a society that is perceived by its citizens as being just and fair (Rawls, 1999). As will be argued below, the success of countries in East Asia and of African high achievers such as Botswana and Mauritius was largely based on a widespread sharing of the benefits of growth which created a sense, among the population, of justice and fairness.

The way in which this institutional system is built determines the framework for policymaking and often imposes constraints on policy discretion by introducing, for example, a balanced-budget law or a currency board to achieve macroeconomic stability (Glaeser and others, 2004). When such self-imposed constraints strike a balance with policy flexibility in other areas of economic and social management, the credibility and sustainability of the overall policy framework thereby open up available policy space to the authorities in the future. As discussed in chapter IV, the fact that balanced-budget laws in some countries in East Asia limited the need for deficit financing, a key to stable macroeconomic performance, in turn made it possible for the fiscal authorities to actively provide financing for education, health and infrastructure.

Changes in governance structure and growth

The shifts in paradigm in development policies brought vast changes to institutional frameworks

The shifts in paradigm in development policies over the past decades brought vast changes to the institutional frameworks within which those policies were to be conducted. Following the poor growth experience that started around 1980, development policies have predominantly focused on reducing government interference in the economy by freeing domestic markets of price controls, lifting trade barriers, liberalizing financial markets and privatizing State-owned enterprises. Rolling back the State, so the logic went, would lead developing countries to higher and more sustained growth. As noted above, the growth performances since the initiation of these widely implemented reforms have differed among developing countries: some (particularly in East and South Asia) have continued to outperform all others and have been rapidly catching up with the rich countries; others have had poor to very poor growth performance either on a more or less sustained basis (in many parts of sub-Saharan Africa, for example) or as a result of going through booms and busts (as in Latin America).

It would be tempting to simply focus on the features of the reform policies of the 1980s and 1990s and suggest that the diverging paths were mainly due to differences in the speed and design of the reforms. It is now recognized that differences in governance structures are part of the deeper causes explaining the diverging paths and have become a basis for questioning the pertinence of some of those reforms in contexts where changes in the governance structures had been poorly suited to facilitating the expected outcomes of the reform policies.

Two approaches to unraveling the importance of the governance structure as a determinant of growth and development have emerged in the recent literature: (a) new comparative economics, where the rights of the individual in law (including property rights), anti-corruption measures and other governance-related factors are considered to be the key factors, with the significance of these key factors often being estimated by cross-country analyses; and (b) the varieties of governance systems approach, which recognizes differences in institutions over time and across space and examines how economic agents respond in different contexts to the specific set of rules and regulations governing markets.

The cross-country analysis approach seeks to establish a positive and causal correlation between the quality of governance and growth. However, as will be argued below, attempts to measure the quality of governance face serious conceptual and empirical challenges. Recognition of to what extent governance systems can vary, on the other hand, gives rise to the possibility of explaining in part the formation of both the regional “convergence clubs” and the divergence patterns examined in chapter I. If a country has developed its own unique governance system, it will be difficult (if not impossible) to transplant the system to another country; however, a unique system may be adopted, with slight modifications, by neighbouring countries with similar socio-economic conditions.

Two approaches have emerged on the importance of the governance structure for growth and development

Attempts to measure the quality of governance face serious conceptual and empirical challenges

New comparative economics

Cross-country growth regressions have been the favourite tool among some economists for assessing the significance of the governance system in economic development. Income per capita or the growth rate is regressed on several governance quality indicators—such as the rule of law, (anti-) corruption, political stability and government effectiveness. Other non-governance-related variables, such as geographical and historical characteristics, are also used in such regressions.

Cross-country regression analyses typically use the correlation between income per capita and measures of the quality of governance, such as the rule of law, to claim that good governance exerts a positive influence on economic performance. Take, for example, the indicator for the rule of law which measures the extent to which citizens have confidence in and abide by the rules of society and includes their perceptions on the incidence of crime, the effectiveness of the judiciary and the enforceability of contracts (Kaufmann, Kraay and Mastruzzi, 2004, p. 4). It presents a strong association between the quality of governance—the fairness and predictability of rules in this case—and the income level. To capture the multifaceted aspects of the governance system, a composite index consisting of several governance indicators—such as government effectiveness, regulatory quality and anti-corruption measures—can be constructed and applied in a similar cross-country framework. Many studies have also attempted to identify factors influencing the quality of governance, and have used ecological, geographical, geologic and historic data.²

² Perhaps the most influential article in this field is Acemoglu, Johnson and Robinson (2001).

Cross-country regression analysis has shown that governance has a strong influence on incomes ...

The literature has shown that governance has a strong influence on incomes even after the non-economic reasons have been factored out. Developed countries enjoy high living standards because the rule of law prevails, contracts are enforceable, corrupt officials are likely to be caught and punished according to the law, the barriers to entry into a new business are low, monetary and fiscal policies are prudent and appropriate social safety nets are in place to mitigate unforeseeable risks. Above all, when conflicts arise over issues such as the distribution of income or wealth, and the provision of public goods, these countries have a governance system by which the State is able to arrive at a different arrangement through democratic processes. A deficient governance system, on the other hand, discourages productive activities and long-term investment, thus depressing potential growth opportunities. It also discourages investments in human capital through education and thus further reduces the chances for sustained growth. Weak governance has often failed to prevent social unrest or, once it has emerged, to mitigate its adverse impacts on the society.

... yet these findings carry a message that is both pessimistic and deterministic

However, there is a message carried by these findings that is both pessimistic and deterministic (Dixit, 2005, p. 5). The message is pessimistic because it implies that if a country does not possess the right governance system at the start of development then that country is doomed to failure. And, if it is indeed the case that geographical and geologic factors and history have a strong influence on governance or on the income level, and that there is therefore little that can be done, as these factors are predetermined, then the message is also deterministic. The thrust of the theory of the natural resource curse (discussed below)—that a country endowed with abundant natural resources is unfortunate—is a well-known expression of such pessimism and determinism.

Such studies fail to explain how better governance systems lead to higher growth

However, some developing countries, particularly in East Asia, managed to undergo major economic transformations in tandem with changes in their governance structures, thereby casting doubt upon the pessimistic and deterministic predictions of cross-countries regression studies. Because such studies look only at the outcome of economic and governance development, they are silent on the subject of how better governance systems have been built in these countries. They are thus unable to explain the reason for the success of these countries. Instead, their framework could be better employed to show how improvements in governance systems may lead to better economic performance.

Critiques of governance measures and cross-country analysis

The quality of governance is usually measured by indicators based on subjective judgement

Strictly speaking, the evidence provided by cross-country analyses identifies the correlation between growth and the quality of governance as measured by indicators whose interpretation is largely based on the subjective judgement of researchers or of those who were asked to complete survey questionnaires. Because of the subjective character of these evaluations, the difficulties in finding objective indicators of the quality of governance and the complex nature of governance itself, studies linking economic performance to the governance structure are subject to severe criticisms. Moreover, when aid allocation to developing countries is decided on the basis of such subjective, clouded measures, it may not produce the intended outcomes.

The perception of the quality of governance is strongly influenced by economic performance

The first critique is based on the fact there is a two-way relationship between economic performance and the governance system: economic performance and the quality of governance exert an influence upon each other and thus are determined jointly. This being the

case, the results of cross-country regression analyses are biased.³ Neither governance nor its quality is directly observable. People's perception of the quality of governance is strongly influenced by the economic performance of a country; when a country faces an economic or financial crisis, people are likely to perceive the quality of the country's governance as deteriorating. The rule-of-law indicator widely used in the literature can again be taken as an example. After Argentina had abandoned its currency board in January 2002, the value of this indicator assigned to the country sharply declined from the level comparable to that for a typical middle-income country, such as Egypt or Turkey in 2000, to one for a low-income country, such as Bangladesh or Guinea in 2002.⁴ Yet, it is not conceivable that a country could lose the effectiveness of its judiciary to such an extent within only two years. What was being estimated, in fact, was not the quality of the rule of law itself, but the perceived quality of the rule of law, which in turn had been largely influenced by the vicissitudes of economic performance; in the case of Argentina in 2002, an economic crisis and of the confusion surrounding the end of the currency board and of convertibility.⁵

The second critique focuses on the usefulness of the conclusions drawn from such analyses for actual policymaking. A technique called the "instrumental variable" estimation is a common method used to clarify the issue of causality with respect to governance quality (or perceived quality) and economic performance. Some of the instruments that have been found to be useful are the colonial history of countries (see, for example, Acemoglu, Johnson and Robinson, 2001), geography (see, for example, Gallup, Sachs and Mellinger, 1998) and natural resources (see Sachs and Warner, 1995). While they are technically appropriate, they do not provide insights that are very useful for policymaking.

The history-based approach, for example, argues that those parts of the world where European colonizers confronted great health hazards—and thus high settler mortality rates—were less likely to build a European-based governance system, including the protection of property rights against arbitrary interference, and more likely to put in place institutions designed to plunder the area's resources in the shortest period of time. The prime example of the kind of "extractive State" characterized by such institutions is probably the tragically misnamed Congo Free State under King Leopold II of Belgium (Ascherson, 1963; Hochschild, 1999). Thus, settlers' mortality rates centuries ago are used to identify which countries acquired "high-quality" governance and to determine to what extent the rates help predict today's income levels. Countries in Northern America, Australia and New Zealand, where the mortality rates were low, enjoyed high income per capita, while European colonizers experienced higher mortality rates in much of Africa and, to a lesser extent, Latin America and the Caribbean, and so were deterred from building high-quality governance structures which over time would have enabled the countries to achieve high incomes per capita. These studies conclude that the variation in today's per capita income levels among former colonies is, in fact, caused by the quality of governance—which, in this case, is measured by investors' perceptions with regard to the risk of expropriation by the State.

However, this result should not be interpreted as meaning that colonialism—as captured by settlers' mortality rates—was the root cause of the great divergence of economic performances. The divergence in the past two or three centuries among countries that were never colonized has been as great as among colonized countries. The former group includes Afghanistan, Ethiopia, Japan, Thailand and Turkey. The mortality rates proved to be capable of capturing

The cross-country regression analyses do not provide useful insights for policymaking

³ For technical discussions, see Brock and Durlauf (2001). Some say that if institutions (including governance) are endogenous to a particular outcome (say, economic performance), then institutions cannot matter for growth, because they are not the sort of factors that may influence the outcome (Przeworski, 2003).

⁴ For the interpretation of differences in governance indicators across countries and over time, see Kaufmann, Kraay and Mastruzzi (2005).

⁵ Rodrik (2005) argues that a similar linkage exists between growth and economic policies.

the forces underlying economic divergence, but they do not provide a convincing explanation. Finding an appropriate instrument to measure the quality of governance at the present time is thus a different matter from providing an adequate explanation for economic divergence. The geography- and natural resource-based approaches employ similar lines of analysis, using economic or geologic variables.

The relevance of governance indices can be questioned

The third criticism of cross-country regression studies is that governance or its quality as measured and considered in these studies does not correspond to what governance is thought to be. Governance is supposed to constitute one of the more durable elements of any economic system but, as argued previously, Argentina's rule-of-law indicator before and after the collapse of the currency board showed a sharp change. Glaeser and others (2004) demonstrate that this lack of stability is exhibited by most measures of institutional quality used in the literature—and that those measures that exhibit more stable features show no significant relation with economic performance. These experts, along with others, question the relevance of the governance indices, arguing instead that human capital is the basic determinant of economic development and indeed of institutional quality and that the settlers brought not so much their institutions as they themselves, with their existing educational and technical attainments and their desire to improve through further learning. In this respect, it has been noted that, of all the New World colonies, Canada and the United States of America, were the ones to put the most emphasis on education and that, by 1800, the latter had probably the most literate population in the world (Sokoloff and Engerman, 2000).

The final critique focuses on the use of the outcomes of such cross-country analysis for actual aid allocation by donor countries and international financial institutions (Herman, 2005). Because of the apparent high correlation between the quality of governance and growth, donors maintain that if aid-recipient countries “get their governance right”, they will have created an environment that is conducive for development. Recipients should be able as a result to use the aid disbursed more effectively and efficiently.

The cross-country analyses provide poor guidance for defining governance conditions in aid allocations

There is indeed considerable debate on the use of conditionality to improve governance. As examined above, the indicators currently used to measure the institutional quality or governance of the recipient country should claim to be no more than “windows into a partial and clouded picture of development” (Herman, 2005, p. 282). One should be modest when assessing the extent to which such measures and analysis can effectively capture the quality of governance and its significance in development. This is especially important if such indicators are considered comparable across countries and, in this sense, to be global measures of governance. Recent analyses by the World Bank seem to agree with this evaluation and claim only that these indicators “will do better at signalling longer-run trends” (World Bank and International Monetary Fund, 2006, p. 14).

Varieties of governance structures

Another approach to examining the linkage between governance and economic performance is to analyse the functioning of economic systems on a country-by-country basis. The distinctive nature of this approach lies in its explicit acceptance of the fact that countries have developed their own particular institutional structures within which government, firms and households achieve their individual or societal goals. Existing governance structures are the cumulative result of the interaction with one another of many agents over long periods of time during which the existing structure is continuously being reshaped (Young, 1998).

The upshot is that there is no one set of governance elements that are the “best” for all countries and for all times.⁶ Each country is required to find, by trial and error, its own governance system—the one that works best in its existing context. This approach also implies that there will be multiple governance structures that are able to tackle the problems that constitute barriers to growth (Haggard, 2004). Because the functioning of one governance element depends on other elements of the governance system or non-governance factors—such as “common sense”, social norms, intra-company labour relations and even culture—a governance system cannot be easily transplanted from one country to another.

The fact that there exists an interdependency—in the form of what are often called complementarities—among governance elements casts some doubt on the effectiveness of policy recommendations urging the improvement of only those governance capacities that are necessary for ensuring the efficiency of markets. These recommendations often assume that if a Government ensures market efficiency by enforcing property rights and the rule of law, reducing corruption and committing itself not to expropriate, private sector activities will then drive development. Market functioning, however, needs to be complemented by the governance capacities of the State in order to ensure productivity growth⁷ and to make the workings of the market consonant with social cohesion.

Significant complementarities also exist across different areas of policy reforms and they help create either a vicious or a virtuous circle. The presence of suboptimal governance makes it difficult for a Government to initiate a change without creating complementary changes in other governance elements. The lack of human and financial capacities in the Governments of many developing countries always constitutes a barrier to undertaking such multifaceted reforms or, if they do manage to be initiated, prevents relevant efforts from being sustained for the sufficiently long period of time required for those reforms to become fully effective. The mere introduction of a market-enhancing institution that should reduce transaction costs does not ignite economic activity unless there is also a functioning legal system that can be trusted with enforcement. Similarly, coordinating trade and industrial policies often becomes a challenge for developing countries (see the discussion in chap. III).

The complementarities existing among various governance elements seem to explain at least some of the dynamics of the divergence patterns and of the emergence of regional convergence clubs identified in chapter I. These can create a virtuous circle once a Government establishes its credibility with its citizens in respect of planning and implementing reforms. By the same token, the Government can gain credibility only if the promise that its citizens will share in the benefits of growth is kept over a considerable period of time. This shared growth, which fostered social cohesion, was one of the results of the policies pursued in East Asia. While not all the countries in the region offered equal access to the political system to all members of their population, the fact that leaders could build on a fair amount of social cohesion, based on shared values and relatively low economic inequality, established the legitimacy of their reform policies. The development success of Botswana can also be understood in this framework: the country created a shared-growth path through its traditional consensus-building democratic process.

⁶ Analysis is here based on United Nations (2000), chap. VIII.

⁷ Khan (2006) distinguishes between two types of governance capacities necessary to achieve sustained growth: market-enhancing governance and growth-enhancing governance. The former encompasses governance factors, such as the protection of property rights and the enforcement of rule of law, that ensure market efficiency. The latter encompasses the State’s abilities to complement market activities, including the capabilities to accelerate the transfer of assets and resources to more productive industries, and to facilitate the absorption and learning of new technologies.

There is no one set of governance elements that are the “best” for all countries at all times

There exists an interdependency among governance elements

The complementarities among governance elements can start a virtuous circle once a Government establishes its credibility with its citizens in respect of planning and implementing reforms

Countries with successful governance transformations

Some developing countries achieved sustained growth over the past three to four decades and narrowed the income gap existing between them and developed countries. Their success in governance transformation is illuminating in two respects. First, it demonstrated the importance of addressing the binding constraints on growth being faced and of creating a sense of priority in governance transformation. The success of such transformation therefore does not depend on the comprehensiveness of reforms in governance structure. Rather, a step-by-step, or gradual approach to removing such constraints can be very effective. Second, their experiences demonstrated that when a governance reform (such as a trade reform) induces large shifts of income from one group to another, it was important to make the workings of the market consonant with social cohesion. These success stories show the importance of addressing the issues of complementarity not only between economic reforms, but also between economic and social management.

Step-by-step changes to governance structures can be sufficient to trigger growth

The cases of land reform and trade and financial reforms analysed below, and the gradual reform process in China, highlight these points. They show that step-by-step changes to governance structures can be sufficient to trigger growth. At the same time, the experiences examined demonstrate that governance changes can take different forms across countries. This is particularly the case for land reforms in Asia. China's growth success is shown to have been based on gradualist governance reform and to have been achieved through a process quite different from any that might have been developed according to the policy prescriptions emanating from the Washington Consensus.

Land reforms

For countries with the majority of their population engaged in subsistence farming, increasing productivity in the agricultural sector is the key to initiating sustained long-term growth. Higher agricultural productivity not only leads to lower food prices, but also improves the nutrition of the population (thus increasing labour productivity in the economy as a whole), creates demands for manufactured goods and services and contributes to the development of non-agricultural sectors through their linkages with the agricultural sector.

Land reform can be an effective means of easing the constraint on growth productivity

In many contexts, low agricultural productivity constitutes a major binding constraint on sustained growth. Land reform is an effective means of easing this constraint by transferring ownership to farmers who operate the land or, more generally, by securing for farmers the right to share an appropriate return from their activity on the land. The Republic of Korea and Taiwan Province of China, two of the first-tier newly industrialized economies, implemented the redistribution of land from landlords to smallholders or tenants and secured the private property rights of landholding (United Nations, 2000, chap. V). Guaranteeing the private property rights connected with owning land is a means of providing farmers with economic incentives to produce crops and to maintain and invest in their land.

Outright transfers of ownership do not represent the only way to undertake land reform

Such outright transfers of ownership do not represent the only way to undertake land reform. In fact, they were possible and successful only in the context of the socio-economic conditions prevailing in these economies at that time. The Governments of both economies distributed land previously owned by Japanese persons or companies to farmers who were tenants on the land. Large inflows of migrants from the mainland to Taiwan Province of China further necessitated comprehensive land reform.

When outright transfers of landownership are not feasible for political or socio-economic reasons, higher agricultural productivity can be achieved by merely enforcing tenancy law or by guaranteeing a return to farmers' activities on the land. In fact, the reforms of China, India and Viet Nam did not involve the full-fledged transfer of ownership to farmers. Different forms of governance changes can ease one of the major constraints on the sustained growth process of many low-income developing countries—low agricultural productivity.

In 1978, China initiated one of many major reforms, the household responsibility system, under which households were provided with use rights to collectively owned land under long-term leases (initially 5 years, but later extended to 30 years). In exchange, farmers were obliged to supply a pre-fixed share of output to the collectives' production quotas, but could sell the remaining output on the free market or to the Government at negotiated prices.⁸ The reform was complemented by the relaxation of restrictions on private market transactions in rural areas and on non-agricultural activities by farmers.

In Viet Nam, collective farming was replaced with family farming during the period of *doi moi* (the policy of renovation) in the 1980s. Under the new system, farmers were allowed to sign contracts with the Government on parcels of land for up to 15 years—in effect, they leased the land—and were given the freedom to sell their products as they wished. As in the case of China, other reforms proceeded at the same time, including the introduction of market-based transactions in agricultural and non-agricultural products and liberalization of trade-related activities and foreign direct investment(FDI).

In the case of India, on the other hand, effective land reform involved only stricter enforcement of the existing tenancy law. The country had enacted a land-reform act in 1955 but did not enforce the law largely because of the lack of administrative and legal resources. During the 1970s, however, the State of West Bengal launched a new programme, called Operation Barga, which was designed to enforce tenancy laws that regulated rents and accorded security of tenure to sharecroppers (Banerjee, Gertler and Ghatak, 2002).

The Land Reforms Act of 1955 and its successive amendments have guaranteed to sharecroppers permanent and inheritable incumbency rights to land that is registered, as long as they pay the legally stipulated share. Because of loopholes in the law and little administrative support for poor and often illiterate sharecroppers, very few of them had actually registered with the State. Under the Operation Barga project, those sharecroppers were encouraged to register with the Department of Land Revenue and supported by the State in doing so. The State would entitle them, when registered, to permanent and inheritable tenure on the land they sharecropped as long as they paid the landlord at least 25 per cent of output as rent. Owing to the success of Operation Barga, 65 cent of share tenants in the State had been registered by 1993, as compared with 15 per cent before the project began.⁹

As a result, the State of West Bengal had experienced a significant jump in the growth rate of production of rice, its major food crop, from 1.8 per cent during the period 1960–1980 to 4.7 per cent during the period 1977–1994 (Raychaudhuri, 2004). This growth experience is in fact comparable with that of Taiwan Province of China whose agricultural production after the reform had grown by about 4.2 per cent per year during the 1950s and 1960s (United Nations, 2000, chap. V). Between 1973 and 1999, for which comparable data are available, the rural poverty rate—defined as the proportion of people below the poverty line of 49 rupees per capita per month in 1973–1974 prices in rural areas—fell from 73.2 to 31.7 per cent.

⁸ The share subject to quota has been reduced and the mandatory production plan was terminated in 1985.

⁹ India developed a decentralized system after its independence and thus the experience of West Bengal does not apply to the entire country (see Kochhar and others, 2006).

Transfers of land-ownership to farmers need not be full-fledged as shown by the cases of China, Viet Nam and India

Despite the limited reform of rural institutions, China, Viet Nam and West Bengal saw significant increases in agricultural output, which led to economy-wide sustained growth some years later

What was common to these reforms was a limited transfer of property rights to tenants (as opposed to a full transfer of landownership, as in the cases of the Republic of Korea and Taiwan Province of China) as a means of easing the constraint on agricultural productivity. The transfer gave the farmer the right to claim a certain share of output and long-term (or permanent) use rights. Despite the limited transfer of rights, there were significant increases in agricultural output, which led to economy-wide sustained growth some years later. The land reforms—constituting a change in the governance system—clearly influenced the incentives of farmers to work harder, to improve the soil and to invest in new equipment, new seeds and new techniques.

What was not common, though, was the design of the policies adopted by these Governments. Reform policies were based on the prevailing socio-economic systems in each economy. Several forms of governance restructuring can therefore lead to the same outcome—in this case, a rise in agricultural productivity.¹⁰

Trade-policy reforms

Difficulties in undertaking a trade policy reform lie in the fact that it constitutes only a small part of an economy-wide reform package. As argued in chapter III, trade reform can be complemented by production sector policies to promote the emergence of new activities through encouraging the participation of the private sector. By the same token, a shrinking tax base, as a result of lower tariffs, should be complemented either by increasing the existing taxes rates, or by creating new tax bases (Aizenman and Jinjark, 2006). Furthermore, conflict management institutions, including a social insurance or safety net, should be in place to shelter at least temporarily those who are affected adversely by the new trade regime. At the same time, new institutions or rules for macroeconomic stability have to be established to stave off external shocks once the economy becomes more exposed to developments in the global economy.

Countries that successfully integrated trade policy reforms into their overall development strategies avoided incurring an excessive administrative burden by adopting gradual or dual-track approaches and by moulding imported institutions to fit into the domestic frameworks. While the scope for undertaking such production sector policies has increasingly been limited (chap. III), the well-known successes of China, Mauritius and East Asian countries point to the necessity of allotting some policy space to developing countries for finding new activities through which to take advantage of a more liberalized trade regime.

The trade reform in Mauritius had been launched in 1970 with the creation of free trade in an export processing zone (EPZ). Until the mid-1980s, the domestic sector outside the EPZ was highly protected in order to maintain social cohesion because of the fragile social and ethnic fabric of the country. The EPZ provided a means to expand opportunities for external trade and employment creation, especially for women, without the country's running the risk of igniting social unrest (United Nations, 2000, chap. VIII). The country thus established a system for maintaining social cohesion and a shared growth pattern. The Government of Mauritius took advantage of the fact that it had a large number of civil society associations by encouraging the participation of civil society in policymaking; as a result, the EPZ-based export promotion strategy was born.

Mauritius used export promotion to mainstream social cohesion

¹⁰ Not all land reforms have been successful, in particular when land redistribution involves resettlement of farmers. In Africa and Latin America and the Caribbean, resettlement is common and the selection of farmers often becomes an obstacle to implementation (see United Nations, 2000, chap. V).

The success of Mauritius was not repeated in sub-Saharan African countries. Although the reasons for this appear to be numerous (Subramanian and Roy, 2001), two governance-related factors are especially relevant in this context. First, macroeconomic adjustment and stabilization were pursued consistently in Mauritius under three different democratically elected Governments with divergent political ideologies; and within the context of the democratic political system, the transparent decision-making process enabled economic problems to emerge and be tackled early. Second, the competent and (equally important) well-paid civil service managed to minimize rent-seeking.¹¹ Export processing zones have failed in many other countries in the region because their governance systems were not able to combat rent-seeking and the other types of inefficiencies that need to be controlled by selective interventions.¹²

Economies in East Asia, on the other hand, employed the network of interactions between the bureaucracy and segments of the public sector to achieve export-led growth. As in the case of Japan, which provided the “model” of export-led growth to neighbouring countries, the interaction was a means to overcome the lack of information flows about market conditions—prices, quantities produced and sold, bottlenecks in production and shortages of input materials—and to manage the large differences in income being generated by the various industries. This interaction greatly reduced the chances of “coordination failure” and contributed to these economies’ setting appropriate national priorities in their development strategies. The underdevelopment of the domestic financial market also necessitated direct involvement of the Government in channelling finance to the priority industries.

Coordination efforts at the central government level on the allocation of goods, services and finance ensured that the benefits of the success were shared among the population, further strengthening social cohesion and involving the broad public in the success of the development strategy. Such efforts also contributed to building up a consistent set of trade and industrial policies in East Asia. Heavy market interventions by the Governments may have distorted resource allocation and thus created “static” inefficiency in markets, but there is little dispute that those interventions accelerated the pace of development. In other words, they turned out to be efficient in a dynamic sense. As the shared-growth path was seen to be successful, this reinforced the credibility of the Governments’ policies.

At a more practical level, what is common among these examples are the proper recognition by the economies concerned of the constraints that they faced and the creativity they employed to remove or soften them (Hausmann, Rodrik and Velasco, 2005). The success of these countries lies in the fact that they practised the step-by-step approach to undertaking complementary policies, according to constantly evolving domestic and external situations. In fact, they were among the first developing countries, between the mid-1960s and the early 1970s, to reorient their policies towards exports and away from import substitution in order to deal with the lack of domestic demand and to force companies to be competitive in global markets. As noted in chapter III, the rules of the General Agreement on Tariffs and Trade (GATT) prevailing at that time allowed countries more freedom than would have been available under the current World Trade Organization rules to combine orthodox trade reforms with heterodox and protective policies to allocate resources among various industries.

¹¹ Reflecting another important aspect of policy was the fact that the country had supported the development of the sugar industry, instead of taxing it, and that trading partners gave the country preferential access in sugar to their markets.

¹² Export processing zones in other parts of the developing world faced similar governance-related constraints (see, for example, Willmore, 1994).

Yet export processing zones have failed in many other countries

Economies in East Asia employed the network of interactions between the bureaucracy and segments of the public sector to achieve export-led growth

The gradualist approach: China

China's growth success has been based on a gradual and pragmatic approach to institutional reforms

China can be taken as an example of successful ongoing institutional change. The Chinese economy has been growing at a rapid pace since the initiation of its reform policies in the late 1970s. Despite some social and economic volatility, its economic achievement has lifted tens of millions of people out of abject poverty in the last two decades. The sustained growth of the Chinese economy has confounded the pessimists and disproved much conventional wisdom, particularly that the major institutions of the market economy must be in place before any major reforms can be expected to lead to positive results. Instead, the gradualist approach China adopted in its reforms presents a sharp contrast with what occurred in many transition economies. The gradual reform process endowed the economy with great resilience which it needed in order to confront an unfavourable world economic environment or the constraints arising from a rigid bureaucracy and the absence of a sound market infrastructure.

As described by Deng Xiaoping, Chinese economic reform has been a process of "crossing the river by groping for the stepping stones" and one where no stereotypic reform package was adopted in advance. Designed with a pragmatic vision, institutional reform has been immune to ideological considerations and economic development has been laid down as the ultimate goal (Qian and Wu, 2000; Qian, 2003).

Economic reforms have taken place in three stages

The institutional reform process has been guided in the general direction of improving overall economic efficiency by providing individuals with incentives, by fostering competition among different categories of market players and by ensuring that the resulting economic affluence is shared by a growing number of recipients. This in turn has elicited broader support for the reform process. The reform experiments have ranged from providing incentives to the agricultural sector and encouraging the formation of township-village enterprises to reforming the fiscal sector and, more recently, State-owned enterprises and the banking sector. In general, China's transition to a market economy has been a gradual process of economic reform which can be characterized as having taken place in three stages.

In the first stage, which spanned the period from 1978 to 1993, reform had been carried out incrementally to improve incentives and to expand the scope of the market for resource allocation. The second stage began in 1994 at which time the Chinese Government decided to set the eventual establishment of a modern market system as the goal of reform. The most recent stage has put a stronger emphasis on the need to deal with the growing regional and income disparities generated by the accelerated growth process.

The first stage was characterized by successful agricultural reform and a dual-track price-setting scheme

The first stage had been characterized by successful agricultural reform and the dual-track price-setting scheme described above. Implementing the reform was relatively easy, as most peasants, benefiting greatly, embraced the scheme. Some enterprises and bureaucrats also enjoyed its benefits. Nevertheless, the dual-track price-setting scheme, like any scheme involving two prices for the same product, nurtured a degree of corruption, especially in relation to the allocation of key productive materials, and created much resentment among the general public.

In the second stage, the dual-track price-setting scheme was phased out

In the second stage, the task of reform had been more challenging, as it would impinge upon the fundamentals of the central planning system. The dual-track price-setting scheme was phased out, with market forces coming into full play with respect to allocation of resources, and the administrative power of various key sectoral departments was dismantled. From 1994 to 2000, several radical reforms were implemented, namely, the unification of official and swap exchange rates, the reform of taxation and fiscal systems, the full recognition of the functions of the central bank in maintaining price stability and promoting economic growth, the experimental privatization of small-scale State-owned enterprises and the establishment of a social safety net.

The third stage has put a stronger emphasis on the need to spread the benefits of economic growth more equitably among all social groups and all regions of the country. The country's Gini coefficient—a measure of income equality with zero signifying greatest equity and 1 greatest inequality—has been on the rise in recent decades and is currently expected to increase further in the next decade and a half (World Bank, 2003). Regional income disparities, particularly between urban and rural areas, are a major cause of this rising inequality. Owing to the success of the first-stage reform, rural incomes had increased to 55 per cent of those of urban areas by 1984, but declined to a level of about 40 per cent in the 1990s. To address these inequalities, the Government announced in 2006 its plans for implementing four types of reforms that should raise rural incomes: a reform of rural taxes and administrative fees; water conservation projects and technological support to enhance agricultural productivity; increases in public investments in education and other social infrastructure for the rural population; and political reforms providing self-governance to villagers.

In addition to the question how to distribute benefits from economic growth, other challenges remain, in particular continuing reforms of the agricultural sector and of large State-owned enterprises. Currently, the greatest success in the reform process has been limited to the privatization of small State-owned enterprises in the mid-1990s which resulted in the layoff of redundant employees. The large-scale State-owned enterprises still pose a major problem, particularly as they threaten the proper functioning of large State-owned commercial banks and impose a potentially large fiscal burden on the State. The future of large State-owned enterprises will ultimately depend on the improvement of corporate governance, which will first entail the severance of the government-business relationship and the establishment of a free and competitive enterprise system. Furthermore, China's entry into the World Trade Organization commits it to fully observing the rules of a market economy, including the protection of intellectual property rights, which will entail the need to undertake further reforms.

China's experience has shown that it is not indispensable to set up the institutions regarded by some analysts as "best practice" in order to initiate a process of reform. Even with institutions that these same analysts might consider "imperfect", a reform package that conforms to the existing economic and political realities can still achieve a favourable outcome. China's experience underlines the importance of viewing institutional reform as a process, rather than as a one-off event, and of ensuring progress both in the reform effort and in economic development.

China's experiences illustrate the broader lesson for all countries that there are different types of obstacles to growth faced by countries and equally many ways to remove (or minimize) such obstacles. Countries that achieved success had been likely to initiate their reform processes with a careful evaluation of the existing obstacles and then remove them step by step. As the above analysis of the varieties of governance systems suggest, a country's success cannot be directly exported to other countries. Policymakers can combine their knowledge of their own countries with the lessons learned from other countries that had successful institutional reforms in order to start their own reform processes. This approach differs significantly from the application of the across-the-board reform packages that was recommended in the past.¹³

The cases examined should provide a message of some optimism, as their experiences make clear that it is not necessary to have all the required elements of good governance in place before sustained growth can be initiated. Countries need not first go through a long process of institutional reform before growth results may become visible. The reforms need not even be comprehensive, but they do need to be able to unlock economic potential previously blocked by inadequate rules and regulations.

The third stage of the reform process is to put a stronger emphasis on the need to spread the benefits of economic growth more equitably among all social groups and all regions of the country

Challenges still remain for China's reform process, in particular continuing reforms of the agricultural sector and of large State-owned enterprises

China's experience underlines the importance of viewing institutional reform as a process, rather than as a one-off event

It is not necessary to have all the required elements of good governance in place before sustained growth can be initiated

¹³ World Bank (2005b) emphasized the need for policy diversity and for selective and modest reforms.

Sources of growth failures

Growth failures in the past 50 years: overview

While other chapters in this publication have analysed some of the macroeconomic and structural characteristics of economies that can account for their slow growth, the emphasis in the present section will be on the role of governance and institutions in explaining growth failures. To illustrate the extent of the failure of societies to grow, table V.1 gives data for those countries that saw a long-term slide in living standards, as measured by a fall in real income per head over seven consecutive years or more.

The table shows that countries that suffered from such growth failures were at all levels of development, some of them being oil producers with relatively high levels of income. Many fuel- and mineral-rich countries had failed to turn this wealth into assets, including human capital, that would have provided a supplementary or alternative long-term source of growth. However, on the whole, countries that faced growth failures tended to be poor, to be located in certain regions of the world (in particular sub-Saharan Africa and Latin America), to be conflict-ridden and/or to be dependent on primary commodity exports, as analysed in chapter I.¹⁴ Growth collapses also occurred elsewhere, but those with more diversified economies did not usually end up having become full-fledged growth failures (see the discussion in chaps. I and III). It should be noted in this respect that several economies with a heavy dependence on commodities can still be highly diversified and less liable to a growth collapse. Examples are Brazil, Chile, Indonesia and Malaysia which have important mineral as well as agricultural sectors.

The growth collapses in many countries that are highly dependent on commodities have given rise to a belief in the “natural resource curse”, according to which countries that are heavily reliant on resources are likely to grow more slowly than other countries. Several reasons have been advanced for this phenomenon—the deterioration in the terms of trade of commodities as against manufactures; the volatility of commodity prices which makes investment planning difficult and discourages investment because of the risk and sunk costs; the Dutch disease, whereby a boom in a resource sector renders other industries unprofitable; and rent-seeking, whereby economic agents pursue short-term objectives to extract monopoly profits, rather than attempt to invest in the long-term future of the industry. Such rent-seeking is made easier in cases where the commodity is a “point resource”, that is to say, one (like a mine or oil well) located in a specific area, rather than a “diffuse resource” (like wheat), which is one produced over a large area.

As the recent surge in demand for commodities, in particular to fuel China’s economic expansion, could have major benefits for commodity producers (see chap. I), it is particularly important to judge whether the natural resource curse can be avoided by appropriate policies and institutional changes, enabling natural resource-rich countries to attain fast and sustainable growth. That the curse could be avoided was the opinion of the report of the Commission for Africa (2005) which stressed the following:

Slow growth is, however, not an unavoidable outcome for developing countries with abundant natural resources. The experiences of Botswana and South Africa show that, when the right set of policies is in place, natural resources can be a source of prosperity, not necessarily a ‘curse’. Other resource-rich countries in Africa could

Countries that faced growth failures tended to be poor, to be concentrated in sub-Saharan Africa and Latin America, to be conflict-ridden and/or to be dependent on primary commodity exports

The growth collapses in many commodity-dependent countries have given rise to a belief in the “natural resource curse”

Yet, “when the right set of policies is in place, natural resources can be a source of prosperity, not necessarily a ‘curse’ ”

¹⁴ See also Reddy and Minoiu (2005) for a similar finding.

Table V.1.
Countries with at least seven consecutive years of decline in real per capita income, 1950-2001

Region and country	Period of decline	Real GDP per capita in the first year of decline	Real GDP per capita in the last year of decline	Percentage decline in period	Total number of years of negative growth between 1950 and 2001 ^a
		(1990 international Geary-khamis dollars)			
Africa					
Cameroon	1986-1994	1 695	978	42.3	11
Côte d'Ivoire	1985-1994	1 798	1 214	32.5	23
Democratic Republic of the Congo	1974-1983	842	587	30.2	32
	1986-2001	598	202	66.2	
Djibouti	1984-1998	1 802	1 092	39.4	29
Liberia	1979-1989	1 230	889	27.7	26
Libyan Arab Jamahiriya	1979-1995	7 565	2 321	69.3	25
Madagascar	1971-1978	1 246	1 007	19.2	26
	1979-1988	1 076	784	27.2	
Namibia	1981-1988	4 159	3 478	16.4	14
Sao Tome and Principe	1985-2000	1 486	1 226	17.5	25
United Republic of Tanzania	1976-1985	620	519	16.3	24
Uganda	1971-1980	871	577	33.7	21
Latin America and Caribbean					
Bolivia	1978-1986	2 715	2 074	23.6	17
Cuba	1957-1965	2 406	1 988	17.4	20
Haiti	1980-1994	1 304	753	42.3	29
Jamaica	1973-1980	4 130	3 121	24.4	17
Nicaragua	1983-1993	2 169	1 308	39.7	22
Venezuela	1977-1985	11 251	8 521	24.3	23
Western Asia					
Iraq	1979-1986	6 756	3 759	44.4	22
Qatar	1980-1991	29 552	6 467	78.1	30

Source: UN/DESA, based on Maddison (2001).

^a Meaning the total number of years in which income per head was less than in the previous year, which do not therefore represent a period of uninterrupted decline.

achieve similar success if they pursue prudent management of the resource flows from their wealth. The experiences of South Asian and Latin American countries suggest that, given the right set of policies, commodity-dependent African countries have, like them, the potential to diversify and upgrade their agriculture to achieve rapid growth. One possibility for these countries is to move towards commodity-based export-oriented industrialization (as in the case of Indonesia or Malaysia) or diversify within the primary sector itself (such as in Chile, Costa Rica or Colombia).

Furthermore, in the nineteenth century, resource-rich countries such as the United States and Australia, as well as the Scandinavian countries, had achieved sustained growth and large increases in living standards as a result of their thriving agricultural, forest and mineral industries.

Institutional aspects of the failure to grow

One of the most important ways to avert the realization of the natural resource curse is to prevent rent-seeking behaviour

One of the most important ways to avert the realization of the natural resource curse is to prevent rent-seeking behaviour, by ensuring that the resources in question are produced by efficient and reputable operators and turned into wealth that accrues both to the producers and to the Government in the form of taxes and (if the Government has a stake in the operations) of dividends. Furthermore, the revenues accruing to the Government should be monitored in a transparent fashion and used wisely in the country's long-run interest. In this connection, the Extractive Industries Transparency Initiative and the "Publish What You Pay" campaign are designed to inform debate and to lead to a better distribution of the wealth generated by the mineral industry in such a way as to foster social cohesion and avoid possible conflicts.

It is in the Government's interest to establish mutually beneficial relationships with commercially-driven enterprises that can exploit the country's resources profitably and efficiently

Under efficient producers, exploitation of a natural resource can be highly profitable, yielding a large difference between its price and the cost of production (see United Nations Conference on Trade and Development, 2005a, pp. 124-126). It is therefore in the Government's interest to establish mutually beneficial relationships with commercially-driven enterprises that can exploit the country's resources profitably and efficiently. This can be a painstaking and difficult process, often requiring considerable administrative capabilities on the part of the Government, but the results can be highly beneficial to both parties, as attested by the relationship between De Beers and the Government of Botswana.

Many countries prefer to maintain a strong presence of State-owned enterprises, sometimes associated or coexisting with private firms, in the exploitation of their mineral or oil and gas resources. These include countries that are widely believed to have highly liberalized economies, such as Chile, where CODELCO, the highly efficient State-owned copper company and a world leader, coexists with private sector copper enterprises. It is then crucial to establish institutional rules that allow these firms to operate with high technical standards and administrative independence.

Much of the failure of poor countries to grow, especially in Africa, was due to the direction of insufficient attention to the development of their agricultural resources

In other commodity industries, particularly agriculture, the need is not so much to attract new entrants as to provide sufficient incentives and support to existing producers. Much of the failure of poor countries to grow, especially in Africa, was due to the direction of insufficient attention to the development of their agricultural resources (Collier and Gunning, 1999). Often it was thought that industrialization could be facilitated by using the funds available from the agricultural marketing boards that had survived independence and whose proceeds were not ploughed back into increased earnings for farmers or the improvement of the agricultural sector, particularly through research and development. To pay insufficient attention to agriculture was to ignore the fact that the industrialization of many of the existing developed countries and of the earlier globalizers (examined above) had been possible only because of their firm agricultural base.

One irremovable feature of both mineral and agricultural commodity price markets is their extreme volatility

Even with the most efficient producers' being engaged in developing a country's natural resources and being provided with the appropriate incentives for doing so, there is one feature of mineral and agricultural commodity price markets alike that can hardly be eliminated: their extreme volatility, with price variations of over 30 per cent a year. Inasmuch as the mineral industry, especially fuel, is highly capital-intensive, relying on immovable assets for its profitability and employing relatively few people, it can provide the bulk of a nation's taxable income. Whereas in a diversified economy the mineral industry will supply only a relatively small part of government revenues, in some of the developing countries over 50 to as much as 90 per cent of government revenue can come from extractive industries (United Nations Conference on Trade and Development, 2005a, table 3.5).

With government and export revenues highly reliant on the proceeds from one industry, effective planning of government expenditures becomes a key to mitigating the consequences of fluctuations, as described in chapter IV. Moreover, stabilization funds can be used to smooth government revenue flows: funds can accumulate during the boom periods to be drawn down to support government programmes during the period of low prices. However, the pursuit of such counter-cyclical policies is difficult in poor countries with limited administrative abilities. Indeed, the success of stabilization funds requires strong governance and institutional arrangements (Davis and Tilton, 2005, p. 238). Such funds have proved successful in a country like Botswana (see chap. IV) which generally is considered to have well-functioning institutions. Such prudent counter-cyclical policies are easier to pursue in a country with strong institutions where the authorities are able to set aside funds during boom years. In countries with weak institutions, where there is a disconnect between the leaders and the citizenry, hence no common understanding of the need for prudent management of income surges, the tendency will be to spend the revenues coming in from a boom and to borrow to maintain expenditures after the boom has ended, often resulting in debts that are difficult to repay (for a fuller discussion of counter-cyclical policies, see chap. IV).

The success of stabilization funds requires strong governance and institutional arrangements

Governance, civil strife and conflict management

The failure of institutions to function properly and to resolve the many internal non-violent conflicts to which all societies are subject is most evident in those countries where conflict has erupted into civil war. In this context, the institutions that failed were more those promoting social cohesion than the ones established for the purpose of creating markets.

After 1946, the peak in the number of armed conflicts had been reached in 1991-1992, after which there was a decline, with many long-running conflicts coming to an end. However, since the end of the cold war in 1989, there have been 118 conflicts in 80 locations, and so conflict continues to exert a major influence on country and regional economic performance (Murshed, 2006, p. 11). Most wars are now internal conflicts taking place in poor countries. These conflicts, which can extend over long periods of time, have heavy immediate and long-term economic costs. For instance, during a war, the growth rate is typically reduced by about 2 per cent. Losses can continue after the war, as people may continue to move their money out of the country owing to perceived high risks of future conflict (Collier, 2006, p. 10). About half of the conflicts are renewed during the first five post-war years. During a conflict, much of the infrastructure, including roads, railways, schools, hospitals and power plants, is destroyed, either through direct military action or through lack of maintenance. The number of lives lost during a conflict is typically much greater than the number of direct military casualties and includes lives cut short because of famine or the failure to deliver medical services. Moreover, warfare destroys social capital, which is much harder to rebuild than physical capital. Warfare also diverts efforts from productive economic activity to rent-seeking, violence and illegal activity, including illicit drugs, which have been used to help finance some conflicts. Normal economic activity breaks down during a conflict, as often the situation is not even secure enough to permit planting for the next year's harvest. The educated class will leave their homeland and many children will not go to school. Indeed, the subsequent further impoverishment of the country due to conflict helps breed ready recruits, even among children, for those benefiting from the conflict, the so-called conflict entrepreneurs.

Most wars are now internal conflicts that take place in poor countries and they have heavy immediate and long-term economic costs

Warfare in one country inevitably has repercussions on other countries, causing growth rates to converge downward

In addition, warfare in one country inevitably has repercussions on other countries, through the displacement of refugees, through the destruction of infrastructure needed for domestic production and for export (for example, during the conflict in Angola, the Benguela railway which had served the mining industry of Central Africa, was closed) and through the deterring of domestic and foreign investors who judge the overall climate to be unfavourable for making commitments. These regional effects will cause growth rates to converge downward. All regions, including Europe, have witnessed conflicts, but recently the regional dimension is perhaps most apparent in Africa, which until recently has seen declining growth rates and a lack of interest by foreign investors, as attested by the continent's small share in global FDI flows and by the fact that about 40 per cent of African savings are kept outside the continent, as compared with just 6 per cent for East Asia and 3 per cent for South Asia (Commission for Africa, 2005, p. 26). For these reasons, the full economic effects of civil wars are difficult to assess, but can hardly be overestimated (Murshed, 2002, p. 388).

One measure of the results of conflict—and also of domestic human rights violations—is the number of internally displaced persons. In December 2005, it was estimated that the global total of such persons amounted to 23.7 million (Norwegian Refugee Council, 2006). Some 50 countries across Africa, the Americas, Asia, Europe and the Middle East were affected by conflict-induced internal displacement in 2005. The human suffering caused by such displacement is incalculable as are the pure economic losses (arising from the fact that the victims are not as gainfully employed as they would be if they were able to enjoy stable, secure and settled lives).

The linkage among growth failures, conflict and resource abundance can be broken by governance and institutional arrangements that help turn natural resource endowments into a source of long-term growth

In a sample of 17 countries that had been subject to internal conflict, those with a manufacturing or diffuse commodity base tended to maintain positive growth over time, while those with point source resources, such as alluvial diamonds or timber, tended to show a decline in output (Murshed, 2006, table 4). Declines in output, leading to increases in poverty, heighten the inequalities within society, breed grievances and enhance horizontal inequality. As horizontal inequalities within society have been found to constitute a fertile breeding ground for conflicts, there is a linkage among growth failures, conflict and resources. This linkage can be broken by governance and institutional arrangements that help turn natural resource endowments into a source of long-term growth.

The steady building of institutions for conflict management strengthens what may be described as the social contract, will serve to diminish the risk of conflict and will help pave the way towards more sustained growth. Violent conflict is unlikely to take hold if a country has a framework of widely agreed rules, both formal and informal, that govern the allocation of resources, including resource rents, and the peaceful settlement of grievances. Such a viable social contract can be sufficient to restrain, if not eliminate, opportunistic behaviour such as large-scale theft of resource rents, and the violent expression of grievances.

The principles that apply in a post-conflict situation are similar to those that apply in peaceful conflict resolution. There is a need to build those institutions and governance practices that will convince the population that the benefits of growth and wealth creation will be fairly shared and thus that long-term investment is viable. Reducing poverty is one of the essential tasks in any post-conflict situation; and in many poor countries, this can be most effectively accomplished by the revitalization of the agricultural sector. Selective policies of subsidies to productive sectors might have to be instituted to encourage long-term investment and thereby reignite the growth process (Murshed 2001).

Economic growth helps reduce conflict risk

Economic growth helps reduce conflict risk in several ways. By decreasing poverty and providing employment opportunities, it breeds fewer ready recruits for conflict entrepreneurs. It can lower inequality and so reduce horizontal inequality. By creating denser sets of interactions between economic agents, economic growth produces a situation where there is more

to lose from engaging in conflict, which can help improve institutional functioning, creating better chances of peaceful conflict resolution, and may even lead to the emergence of high-quality and endogenous democracy. These benefits of growth have been particularly noted in African countries that have emerged from conflict and are progressing towards sustained growth and the building of strong democratic institutions.

Growth itself is not enough, however, for there should be an active policy to promote social cohesion among all groups and, in particular, to lessen inequality, especially horizontal inequality. Investment should also be directed towards human capital and infrastructure in order to make the growth sustainable. In countries where much of government revenue comes from natural resource rents, fiscal and budgetary institutions that are open and transparent should be put in place to ensure that there is no siphoning off of revenues and windfalls by ruling elites. In sum, it is through improvements in institutions and governance that the resource curse can be averted and resources turned, instead, into a vehicle for growth, poverty reduction and conflict prevention.

Conclusion

Good governance and sound institutions can provide the environment in which decisions on long-term investment in both human and physical capital, essential for economic growth, can be made. The advanced countries have developed, over time, an intricate governance and institutional structure to assist in achieving economic growth and have used it to build strong and cohesive societies. As described in this chapter, the foundation of such a system must be rooted in a shared concept of justice: citizens must believe that they are being treated fairly, that changes would be made to the laws and regulations to remove any perceived injustices, and that the country is moving in the right direction. With such confidence, economic activity and especially investment will be encouraged.

The sense that the changes being made constitute steps in the right direction can sometimes be created by fairly minor changes in existing governance structures. This can have profound results as long as the perception exists that there will be further changes and that those changes will be steps in the same direction, as was best shown in the case of China described above. Having established the perception that they are moving in the right direction, countries can also initiate numerous changes in governance structure.

There is, therefore, no justification for the pessimistic belief that certain countries will remain mired in low growth and shackled with institutions that impede their growth. Sustained growth is indeed possible with initially imperfect institutions; what is important is that the Government itself be credible in its commitment to making the changes that will remove institutional obstacles to growth (Johnson, Ostry and Subramanian, 2006).

The description of the origins of growth failures in many poorer countries, particularly in Africa, has stressed institutional factors, thereby providing not only an explanation of what caused economic decline, but also guidelines on how to achieve sustained growth. Sustained growth is achievable through a careful reform of institutions so that what may be considered to be a just society can be created—one in which the benefits of growth are felt to be shared justly and where the incentives for legitimate economic activity are encouraged and those for rent-seeking are removed. This is a complex and difficult undertaking: although some general principles can be laid down, there is no one set of institutions that can be readily adopted to ensure this outcome. What is required is that all sectors of society be involved in the effort to build new and vigorous institutions. That an undertaking is too complicated and wide-ranging to be undertaken by one single authority is a fact that is widely appreciated at the present time.

Yet, growth itself is not enough: there should be an active policy to promote social cohesion

Good governance and sound institutions provide the enabling environment for economic growth

Sustained growth can be generated through small governance changes and with initially imperfect institutions

The challenge for many developing countries is to put in place those participatory institutions that will allow all segments of society to feel that the fruits of the nation's wealth and the industry of its citizens are being put to good use and that the benefits of this wealth are being distributed appropriately.

This challenge is doubly important for poor countries with weak institutions in which significant fuel and mineral deposits are found. The very wealth that is producible in a short period of time by their exploitation can exacerbate social conflicts, as its distribution—particularly between the central authorities and the local interests where the deposit is located—can be a source of contention. If strong institutions are not in place to resolve these issues right at the start of exploitation, separatist violence can erupt and, in general, existing differences within society can be heightened if it is felt that the wealth is not being distributed justly. One of the major research findings has been that this particular manifestation of the resource curse can be averted if countries have strong institutions.

For the international community, this finding has particular relevance to countries that are emerging from conflict or have become “failed States”. In most cases, the most important consideration is to foster the resumption of economic activity, which usually means the revival of the agricultural sector. As demonstrated throughout the chapter, a solid agriculture sector is usually essential for subsequent economic development, as it will encourage further investment in that sector and raise farmers’ incomes so that their own demand as directed towards the rest of the economy will increase. A prosperous agricultural sector can show that growth is indeed shared and so can help create a stable and just society. With economic growth comes the opportunity to adjust institutions and improve governance so that a virtuous circle is created.

The international community has also assigned a central importance to improving governance in its efforts to achieve the Millennium Development Goals. Governance issues are assuming an increasing weight in bilateral and multilateral lending programmes, and the question how to monitor progress is receiving greater attention. Efforts to improve governance are recognized as necessitating a long-term engagement between development partners. For instance, the achievement of a “good enough” administrative budget system is feasible when a country is determined to build one, but this takes between 5 and 10 years (World Bank and International Monetary Fund, 2006, p. 21).

All parties acknowledge in their steps toward greater mutual accountability that the stakes are very high, as confidence that the mutual accountability process is yielding benefits in terms of improved governance can assist the scaling up of flexible official development assistance (ODA) to achieve the Millennium Development Goals. In this scaling-up process, efforts should be made to improve governance through actions aimed at remedying specific deficiencies rather than through the attachment of conditions to aid that are based upon global measures of governance which, as analysed earlier, are highly subjective and riddled with serious conceptual problems. International support in this area should be directed towards improving specific areas of governance weaknesses, such as public budget and administrative management systems. Help should also be given in supporting or developing institutions that create and support fair markets, that enhance growth, that manage conflicts over the distribution of the benefits of growth, especially in the case of natural resources, and that in general promote social cohesion. Imposing on aid-recipient countries wide-ranging conditionality based on global governance measures should be avoided, as these measures have serious limitations.

In the case of most post-conflict countries or “failed States”, the most important consideration is to foster the resumption of economic activity

Governance issues are assuming an increasing weight in bilateral and multilateral lending programmes

International support should be directed towards improving specific areas of governance weaknesses rather than achieving comprehensive reforms