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Building Growth-Promoting Governance Capabilities

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Building Growth-Promoting Governance Capabilities

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. There is now a wide consensus that governance matters for economic development, and a wide variety of governance improvements have been identified that could 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 LDCs receive 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 are different in the least developed countries. However, the good governance agenda is also of limited use in many of these countries because the structural constraints prevent the implementation of the good governance agenda to an extent that will make a significant difference to market efficiency. Our approach is to draw on the experience of successful developers, but aim for sequential “Hirschmanian” strategies for addressing critical constraints in particular areas where it is likely that the development of critical governance capabilities will deliver results. The experience of successful developers suggests some broad areas where attention should be focused: governance capabilities for addressing capital market failures that slow down the upgrading of technology, addressing critical labour market failures that prevent skill development and training, and land market failures that constrain 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.

This paper was commissioned by UNCTAD. The opinions expressed here are exclusively those of the author.

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 regularly embark on massively ambitious programmes of improving the rule of law, reducing corruption across the board, improving the accountability of government and other governance measures that are all desirable in their own right but which are unlikely to be achieved in the medium 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 that must have intermediate objectives. However, achieving these objectives may have specific governance requirements that need to be addressed. 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 while not forgetting the long-term goals of broad, across the board governance reforms.

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. The combination of growth strategy and governance 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 ways of identifying these critical governance requirements and making them priorities for reform strategies.

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 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 can experience 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 gap in productivity with more advanced countries is likely to be low enough for the wage differential to compensate for this, giving the developing country a competitive advantage in these sectors.

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; Khan 2000; Hausmann and Rodrik 2003). For instance, if new technologies take time to learn, investors will have to act as principals who finance firms, managers and workers who act 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 and investors external to the firm may not be willing to take the risk of investing for productivity improvement in these contexts. 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 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. For instance, many infant industries refused to grow up.

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 in these areas needed to be developed, the response from the late 1970s onwards was to abandon this strategy in its entirety. The new strategy was 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 results in rather inefficient markets in developing countries, and reforms were needed to make these markets more efficient, and in

particular to ensure that these ‘market economies’ did not suffer the divergence they had experienced during the colonial period. This time the importance of governance capabilities was explicitly recognized but these governance capabilities were linked to the requirements of creating efficient markets, not the requirements of resolving 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. We argue that the appropriate response for developing countries must be to identify and tackle critical market failures directly and develop the minimal governance capabilities to do this.

There are therefore two broadly different governance reform strategies, which we have elsewhere distinguished as one of promoting ‘*market-enhancing governance*’ 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.

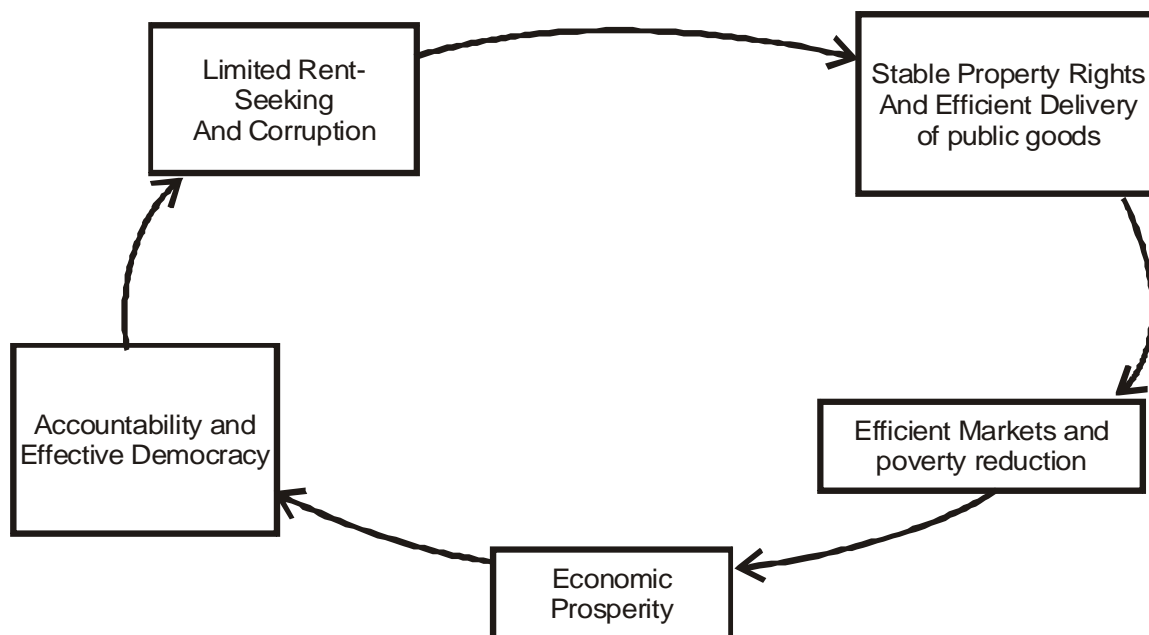
Interestingly, a few countries did of course succeed in their strategies of catching up through intervention to promote new sectors and technologies. These tiger economies possessed the critical governance capabilities that enabled them to manage and enforce the requirements for the successful implementation 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).

Property right stability. 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 to have an effect and immediate specific governance capabilities need to be developed to address these problems.

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 2000). Rents are no less critical in developing countries, and 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.

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. 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. As a result, liberalization is being supplemented today in many developing countries with vigorous good governance programmes in the hope that the process of growth is sustained. In other developing countries where the growth takeoff with liberalization was less dramatic, good governance reforms are seen as a strategy of triggering off a growth spurt.

The challenge for both sets of developing 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. 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 market-enhancing governance in poor countries that we discussed in the last section.

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. We have seen that in the first round of growth strategies followed by developing countries in the 1960s to the 1980s, little attention was given to the governance capabilities that were required to enable them to implement the strategies they were following. Moreover, 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.

It is not possible to develop a growth-promoting governance strategy for a developing country by looking at and attempting to imitate the governance capabilities of more successful developers for two different sets of reasons. First, the more successful developers enjoyed more favourable historical endowments of institutions, governance capabilities and political conditions to begin with. The initial conditions in many developing countries today are less favourable and certainly very different so that an exact imitation may not be feasible. But secondly, successful developers had many different effective 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, Taiwan and Malaysia used the public sector much more extensively for technology acquisition and here success depended on their capacity to enforce discipline within this sector, and Malaysia also used incentives to attract foreign direct investment that was technology enhancing. 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 2006b).

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 create governance capabilities that will allow the emulation of that strategy, or the construction of a variant on a similar scale. The second, less ambitious strategy would be to recognize the more limited scope for achieving significant growth-promoting governance capabilities in the medium term in many less developed countries. We can describe this as an *incremental strategy*, where the goal is to address similar market failures that the more successful developers addressed, but to focus on a few of them at a time, and focus on developing high-quality governance capabilities for tackling these market failures.

Ambitious Growth-Promoting Strategies. We will not devote much time to developing the ambitious strategy because following this agenda requires a political opportunity for significant political and institutional restructuring that is only occasionally available to countries. Such a strategy would have to look at the political factors that made particular strategies of growth-promotion in successful countries effective. A wide-ranging strategy of growth promotion along the lines of one of the rapid developers would have to achieve not only the governance institutions that it had, but also a complementary political settlement that would allow these institutions to achieve the enforcement powers in the appropriate sectors that were essential for the successful implementation of the strategy. In many cases, this would require a restructuring of political organizations or other changes that effectively changed the balance of power within that society allowing institutions to work in the requisite ways. This is clearly an ambitious strategy because its success would depend on the political mobilizations that reformers could achieve to change the political constraints that impeded the successful implementation of particular strategies. This is a task that may be appropriate at some moments of political opportunity for some countries, but cannot form the basis of an ongoing strategy of reform in most countries.

Incremental/Hirschmanian Approaches to Governance Reform. The ambitious political reform approach is not the only one that is likely to yield results in developing countries facing growth challenges. While the governance capabilities of the leading developers in East Asia and therefore the precise strategies of catching up that they pursued may well be infeasible in the least developed countries without significant changes in their political settlement and other initial conditions, less ambitious strategies of catching up and the appropriate governance capabilities to make these effective may well be feasible. These strategies would involve promoting technology upgrading and investments in promising but initially risky sectors with *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 such intermediate steps that any 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. As a result, we expect that countries will have to go through a process of discovery to identify the mix of instruments and strategies that is 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 money that is 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 *its* 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

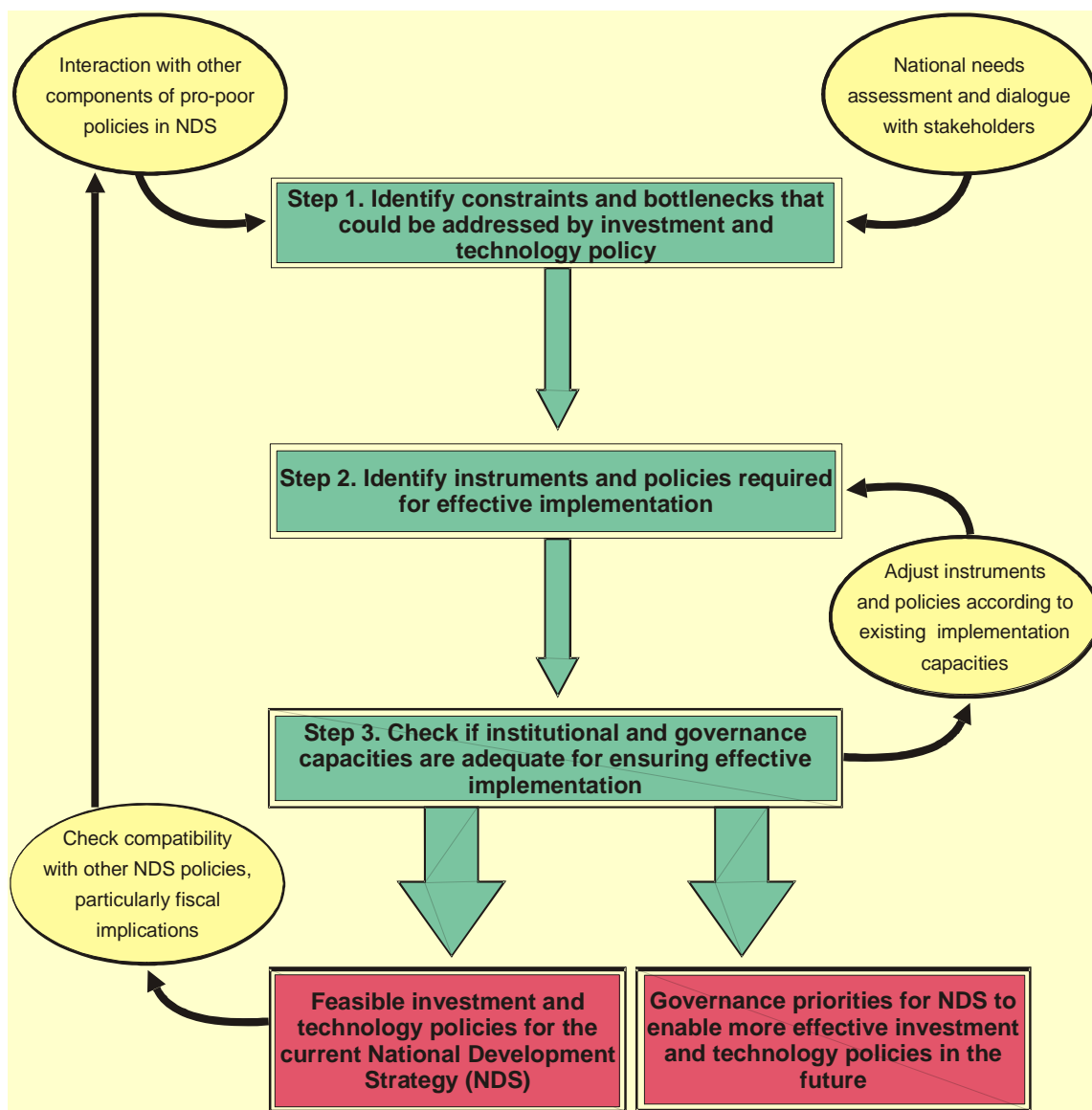
underestimated, but so had the capacity of entrepreneurs to resolve these problems. Their success in resolving these problems had multiplier benefits for society because the *development* of these entrepreneurial capacities was precisely one of the preconditions for development. But the critical condition 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 are 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 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 capacities 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 very 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 issue of exit strategies, and therefore choosing areas for attention where exit more likely to be feasible if future problems appear is one that is critical. 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. If success is achieved in one sector, the capabilities and lessons learnt can then be transferred to strategies for other sectors. We will discuss these possibilities in the context of a concrete country discussion in the next section.

The Hirschmanian approach that we are elaborating here is a development of our approach to investment and technology policy which is outlined in our Policy Guidance Notes on Investment and Technology Policy for UN DESA/UNDP (Khan 2006d). There, we identified a pragmatic strategy for identifying the sectors which could serve as the starting point for developing a growth strategy in a developing country. We argued there that the simplest strategy was for a country to begin with sectors which had 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 in such a strategy are summarized in Figure 2, from the Policy Guidance Note. In the subsequent discussion in this paper we will focus on 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 one or two sectors where growth policy (the investment and technology policy) could begin. The significant 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, the first step in our approach is 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 of machinery that have been installed but not yet optimally used.

By focusing on one or two 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*. To illustrate some of the ways in which market failures could be addressed in a growth sector in a developing country, we look at the technology upgrading and investment problems in the ready-made garments sector in Bangladesh. Our aim is to illustrate how the application of an incremental growth-promoting governance approach could assist policy-makers in identifying priorities for policy.

Technology Upgrading and Growth-Promoting Governance Capabilities: the Bangladesh Garment Industry

As least developed 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. An example of the steps in that analysis is provided by an exercise we conducted in Bangladesh to identify the market failures constraining growth and productivity improvement in an important sector driving growth in Bangladesh in recent years, namely the ready-made garments industry. The study sought to identify a number of possible interventions and instruments that could assist the reduction of market failures affecting the sector and the (growth-promoting) governance capabilities that would need to be developed to ensure the implementation of these strategies (Khan 2008 forthcoming).

The ready-made garments sector in Bangladesh has been a tremendous success story because it ended the heavy dependence of the country on the declining jute manufacturing sector which had failed to achieve sustainable product development and productivity growth. Ready-made garments in Bangladesh is an example of an obvious sector to focus on, 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 with 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).

The Bangladeshi ready-made garments sector has grown rapidly in the last 20 years (recent growth rates are shown in Table 1). There has also been a significant growth of backward linkages, particularly backwards into spinning, dyeing and textiles and

forwards into accessories and packaging (Bhattacharya, et al. 2002; World Bank 2005; Ahmed and Hossain 2006). Domestic value addition in RMG exports was estimated at around 45% of the total in 2002 and the sector is estimated to account for around 75% of current Bangladeshi export earnings. But the sector faces growing ‘competition from below’ from other low wage economies aggressively entering these markets. It also faces 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. The real underlying constraint is that productivity growth is low and the sector remains dependent on low wages (Ahmed and Hossain 2006: Figure 4).

Table 1: Bangladesh Ready-Made Garments Industry
(annual rates of growth of output and exports 2002-2006)

Year	Woven	Knitwear	Total RMG Export
2002-03	4.3	13.3	7.2
2003-04	8.6	29.9	15.8
2004-05	1.7	31.3	12.9
2005-06	13.5	35.4	23.1

Source: Bangladesh Export Promotion Bureau

Our analysis of the market failures that may be constraining growth and technological upgrading in this sector was based on in-depth interviews of around 30 firms selected to represent different technologies and scales within the garment and textile sector (Khan 2008 forthcoming). Not surprisingly, some well-known infrastructural issues came up repeatedly in our interviews: poor infrastructure, in particular delays at ports, and an unpredictable power supply. However, many of these problems are well known and even with these constraints, output in the sector had grown rapidly 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, but here the observation that these reforms were likely to take a very long time to make a significant impact was immediately accepted as the most reasonable conclusion. We could then move on to a more detailed discussion of very specific questions, and different sets of constraints appeared¹.

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

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. The absence of these governance capabilities were then indirectly constraining growth and in particular the growth of productivity.

Investment allocation. The rapid growth of the ready-made garments sector suggests that in an absolute sense, there was no scarcity of investment funds in Bangladesh, particularly for investors in growth sectors like the ready-made garments industry. This was confirmed by the banks that we surveyed. If anything, at the time of our survey, banks wanted to lend more and if anything lending was constrained by the conservatism of borrowers. Borrowers in turn corroborated this. Their concerns were to do 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 these critical investments less attractive because the repayment period was more uncertain in these investments and the individual borrower with good collateral was therefore excessively exposed. 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).

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

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.

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 in moving 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. 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 by the market-promoting agenda. However, their strategy is to make markets more efficient using the good governance approach. In theory it is true that if the rule of law can be enforced, contract-enforcement will also improve. The fight against corruption and for greater transparency in government decisions also feed into this. These strategies are expected to enable the development of stock markets and other institutions that would then enable exactly the type of risk-sharing that we are describing. However, the question is whether these market-enhancing governance reforms can have an effect fast enough to have any effect on the 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 our respondents agreed that reliance on market-promoting reforms would take far too long for them to raise the money they needed to ensure that Bangladesh's emerging garment and textile industry has a secure future.

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 strategies or ones similar to those used by other developing countries to be implemented to allow risk-sharing investments. The possibilities would vary from case to case, but in Bangladesh we identified a number of possibilities based on existing financial instruments that could be used if appropriate governance capabilities could be developed.

a) We discovered there was already a fund that the government of Bangladesh had been running 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 other 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.

b) An alternative approach to technology upgrading is through a direct subsidy for the capital cost of acquiring pre-specified technologies. This is obviously the preferred choice amongst many garments and textile factory owners in Bangladesh. The appeal of this approach also comes from the strategy of Bangladesh's big neighbour India, which also happens to be a major competitor in the textile and garment sector. Upgrading in the textile sector in India has been given a big boost with a multi-billion dollar injection of funds under the textile sector Technology Upgradation Fund Scheme, adopted by the Indian government in 1999 (Ananthakrishnan and Jain-Chandra 2005: 23). Under the scheme, investments in pre-specified machinery (deemed necessary for improving productivity in the Indian textile sector) were given a five per cent reimbursement on the interest charged on the purchase loans.

Given the scarcity of budgetary resources, it is unlikely that Bangladesh could match the equivalent Indian programme, and at best a more targeted interest rate subsidy may be possible. This too would need to be matched with governance capabilities in the government agencies monitoring the use of disbursed funds. The monitoring would have to make sure that the subsidy was only claimed for investments that were authorized for clearly defined technologies and that over time these investments were paying off in terms of value addition in the sector. Countries like India with greater budgetary resources could tolerate a higher level of wastage than LDCs like Bangladesh. This puts a double pressure on poorer countries. Not only are their budgetary resources more limited, they have to aspire to higher monitoring standards precisely because resources are limited. This underlines what we have said earlier about the importance of starting on a small scale with a focus on quality personnel, and relying on experimentation and learning to develop the capabilities required for success. The pressure on the agency to perform would also have to be ensured with clearly defined exit conditions for the programme if specified performance criteria were not met. The last is important, given the limited success of subsidy strategies in countries like Bangladesh in the past. However, that failure cannot be a permanent justification for not attempting to develop the governance capabilities required for managing subsidies given the adoption of subsidy strategies by more advanced competitors like India. One lesson that needs to be learnt from the mistakes of the past is precisely to start with very modest programmes with a small well-resourced agency charged with the monitoring and implementation of a narrowly defined programme.

The incremental way to develop growth-promoting capabilities in countries like Bangladesh would therefore 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. In Bangladesh, it would make sense to start with a much less ambitious scheme than India, 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 like Bangladesh 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.

Labour Skills and Training. Despite being a labour surplus economy, the garment sector in Bangladesh suffers 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. Like other firms in Bangladesh, the garment sector therefore has to engage in on-the-job training but it is limited. At the same time, many private sector training institutes have been set up in Bangladesh 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. Here 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. 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 the 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 achievement of scale economies in the garment industry is taken as an immediate target for policy attention in Bangladesh, 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 a large industrial zone with adequate infrastructural amenities where the highly dispersed garment sector would be given incentives to relocate. In the meantime (as this would take some time), intermediate steps may be necessary to facilitate the temporary expansion of critical facilities in firms who apply for assistance. These would have to be assessed for their importance by an agency charged with this responsibility, and the agency would have to be given powers to facilitate temporary solutions by negotiating the renting or acquisition of contiguous land.

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 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 for least developed countries 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.

Our discussion of a specific case from the Bangladeshi garments industry raises some specific issues which have general relevance. 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, practitioners 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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