

Seminar on Governance for Economic Growth in Developing Countries, 2-3 July 2007

Summary Report of Discussions and Findings

a. This two-day technical workshop was hosted by SOAS in collaboration with DFID. Its purpose was to discuss the implications for policy and practice of recent research on governance for growth.

b. Key speakers included Professor Mushtaq Khan (SOAS), Phillip Keefer (Development Research Group, World Bank), Professor Mick Moore (IDS), Steve Webb (Independent Evaluation Group, World Bank), Nicolas Meisel (AFD) and Daniel Kaufmann (World Bank Institute, World Bank).

c. Background papers, including a literature review and executive summary (link to list and key texts)

d. Participants (see list at end).

1. Background

1. The conventional good governance agenda advocates property rights stability, reducing corruption, a transparent and accountable public sector, democratic government, rule of law and competitive (rent free) markets, not only to satisfy the popular aspirations of millions living in developing countries, but also as a means to promote growth and ensure sustainable poverty reduction. Recent research has questioned the robustness of the linkages to growth. In the very long-term there seems to be a clear correlation (although causality remains in question). But policymakers are concerned with the short to medium-term (the next 5-20 years) when the correlations are weak. Some countries with weak governance have achieved good, and even spectacular, growth. And the feasibility of implementing a full reform agenda is open to doubt. Several studies, including the World Bank report on Low-Income Countries Under Stress, have called for increased selectivity and realism in the plans for reform that donors propose..

2. The workshop objectives were to review the major issues identified in the literature on links between good governance and growth, to consider different interpretations of this evidence, including what matters for growth and why, and to identify the implications for policymakers, including:

- Policy and practice: what should the World Bank, DFID and others be doing differently?
- Measurement: what do current governance indicators tell us, what do they leave out and are there other approaches to quantitative analysis?
- Research: where are the gaps in our understanding? What new research needs to be undertaken?

3. Key questions for policymakers that emerged from presentations and discussion included:

- i) What are the feasible reform priorities for countries wanting to sustain growth? or for slow-growing countries wanting to accelerate growth?
- ii) How is it possible to make some progress in the wide range of "second-best" governance environments?

II Summary of Main Findings

Areas of Convergence

4. Throughout the presentations and discussions, a degree of convergence was evident around a number of common themes. These included:

- governance does matter for growth and development; this was not what Dani Kaufmann termed a "governoskeptic" gathering. In the long-term good governance is associated with successful development, and understanding the causes of weak governance, and feasible options for strengthening it should remain a major preoccupation of policymakers. But the reform agenda needs to be prioritised and sequenced both to match the context and to achieve political traction.
- conventional approaches to governance reform are deficient, and attempts to address governance problems by transplanting institutional models from OECD countries are likely to fail because they are often in conflict with local political incentives, and operate differently in different contexts. Dani Rodrik's distinction between the form of institutions and their function was acknowledged as useful (eg you could achieve a specific governance function such as property rights through a range of different institutional arrangements, formal and informal).
- the *form* of governance in many developing countries is distant from OECD models, and this has implications for growth. Steve Webb's point that governance in developing countries reflects a distinctive social and political logic, and should not be viewed just as an aberration from OECD models, found broad acceptance.
- All developing countries are characterised by personalised, exclusive relationships between holders of political power and citizens (variously described as "hand-in-hand arrangements", "limited access orders" and "clientelism"). The good governance agenda highlights the ways in which these inhibit growth: the workshop discussion recognised the need to understand better the circumstances in which they might also support growth, and provide the basis for building better governance.
- Politics and economics are interdependent: political actors create economic rents by limiting access to resources, and then use those rents to sustain themselves in power and to buy off those capable of organising violence. So problems of growth in developing countries are inseparable from problems of state building. Political actors and potential investors stand to benefit from co-operation, but both face risks in doing so. So a critical question is what makes it worthwhile for

political elites to refrain from predation, and see their interests as lying in nurturing growth?

- The ability of governments to make credible commitments to protect property rights was recognised as crucial for investment and therefore growth, (although protection across the board is unlikely to be achievable, and not necessary for growth).
- There is a need to recognise and explore the diversity of circumstances between countries and within countries, and also the way in which different economic structures and relationships within particular economic sectors affect growth.
- The global environment is very important and potentially problematic, although the impact on governance in poor countries of access to rents from natural resource exports and aid was contested, as was the impact of multinational firms on governance.
- There is still no "big story" about how growth and better governance emerges, and a lot we don't know. There are "shreds of evidence", different interpretations of it, and an urgent need not just for more research but for more imaginative experimentation and active learning by policymakers.

III Detail, and some divergent interpretations

5. Four of the presentations, from Phil Keefer, Mick Moore, Steve Webb and Mushtaq Khan, dealt in different ways with some common issues:

- how to explain the key characteristics of governance in developing countries, and their impact on growth;
- the reasons why growth is sometimes achievable in poor governance environments;
- the processes or circumstances through which better governance emerges.

6. The presentations from Phil Keefer, Mick Moore and Steve Webb all (with differences of emphasis) focused on the political incentives and calculations of rulers in relation to potential investors. Mushtaq Khan's presentation emphasised the importance of "growth-enhancing capabilities" understood as the compatibility between institutional rules for addressing market failures and the governance capabilities for their enforcement.

7. The difference between these two broad approaches is partly reflected in different assessments of the impact on governance and growth of rents associated with failures in economic and political markets.

- While all agree that many rents can be damaging, Moore and Keefer view rents – especially from natural resource exports and aid - as an important part of the explanation for weak incentives to establish institutionalised arrangements with citizens, through which credible commitments on property right security etc can be generalised (i.e. beyond a select group of cronies).

- To Keefer, credibility is key and is a function not of capacities or fiscal constraints but of the political arrangements that help governments stay in power.
- In Webb's analysis the violence potential in developing countries requires the creation of rents to achieve stability. A strategy of reducing rent seeking (as the good governance agenda seeks to do) presents risks without a deeper understanding of the role of rents in the control of violence.
- Mushtaq Khan distinguishes between wholly illegal and damaging rents and those that are second-best responses to markets failures and, when 'managed' effectively, can be growth enhancing. This points to much more state engagement in facilitating and enforcing the institutional rules for effective rent 'management' and stronger growth outcomes including through acquisition of technology.
- Some challenges to such an approach emerged in discussion, including whether there is a definable "developmental state" model, whether it is relevant in the very different global context faced by countries in Africa today, whether the technology gap has been overstated, and how to define growth-enhancing capabilities and the practicalities of rent management.

Specific presentations

(for a fuller exposition of the presenters' research see the literature review by Hazel Gray)

(a) *Phil Keefer:*

8. The critical issue to focus on is the political calculations that rulers make about how to maintain themselves in power. In *autocracies* the question is whether regime stability is best served by growth despite the loss of rents that this implies. In *democracies* the question is whether electoral advantage is best served by broadly targeted policies for growth for service delivery, rather than narrowly targeted benefits for a few.

9. The common problem is the basis on which governments can offer *credible commitments* to potential investors to protect their property rights. In China, an institutionalised party offered credible promises to party members (60 million people, 5% of the population). It is possible to get growth in non-institutionalised autocracies, but this is not sustainable (Mexico under Diaz). More typically, growth will be slow (Egypt). Rents from external sources reduce incentives for institutionalisation.

10. In non-democracies, growth can occur when a "large enough" minority enjoys good governance. The *lessons* for policymakers in poorly performing autocracies are to focus on the damaging impact of rents; and on spreading the opportunities for cronyism as widely as possible.

11. In *democracies*, *political market imperfections* explain poor performance. Citizens cannot hold governments accountable, and politicians cannot get credit for improving welfare, if citizens do not have information about their performance. Citizens cannot hold governments accountable when promises

of their political competitors are not credible. When governments have low political credibility, they target resources to supporters, or to patrons who can make credible promises to clients. This explains clientenism.

12. Political market imperfections (no broadly credible, programmatic parties; voters uninformed) help explain the modest impact on policy of the 2000 elections in Ghana. Central government investment and public employment were as strong as before, reflecting the continuing importance of clientenism; corruption increased, and indicators for rule of law and bureaucratic quality declined. So conventional public sector reform programmes were unsustainable, because they worked against the prevailing political logic.

13. In poorly performing *democracies*, donors should focus on addressing political market imperfections, by increasing information available to citizens; prioritising reforms that are easy for citizens to monitor and that enhance the reputation of politicians (e.g. infrastructure over public financial management); and linking public sector management reforms to visible, sectoral programmes. But demand side interventions need to be tailored to specific circumstances (ie not information for the sake of information).

14. In the context of growth, the political credibility of government commitments to investors is key. It should not be assumed that addressing infrastructure needs will deliver growth if the credibility problem has not been addressed.

(b) Mick Moore and Hubert Schmitz

15. Neither the good governance "market" model, nor the "developmental state" model is helpful for developing countries looking to increase growth. A distinction needs to be made between the *costs* of doing business (the "business climate"), and perceptions of potential investors about the likely impact of government behaviour on their ability to make and retain profits (the "political investment climate"). It is useful to focus on the latter, and specifically on the relations between people with political power and people who control capital.

16. In OECD countries, institutionalised relations of trust sustain political and economic competition in ways that are mutually reinforcing. In developing countries, relations between political and economic actors are much more personalised, or "hand-in-hand", reflecting low levels of institutionalised trust. Both parties need each other and stand to benefit from co-operation that produces growth, but their relations are also potentially antagonistic. It is therefore important to understand the factors that affect that relationship, including economic structures and the organisation of different sectors; where governments get their political support and resources (from the business sector, or from external rents?); and what restraints exist on government predation. Evidence from China and from Mexico suggests that hand-in-hand relations can provide channels for realising a common interest in growth; but in many other cases hand-in-hand relations are destructive. A promising avenue for research is to look at the differences in performance between different sectors or regions of one country, to see whether hand-in-hand

relations play a role, and under what conditions they provide incentives for political actors to nurture growth rather than to predate.

17. A major focus for donors should be on ways in which the global environment adversely affects state-business relations in developing countries, including the collusion of OECD governments and businesses in corruption, money laundering and other “drivers” of bad governance.

(c) Steve Webb

18. A new framework for considering the impact of governance on growth has been proposed by a team of researchers including Douglass North, Steven Webb, John Wallis and Barry Weingast. They start from a different understanding of the state: violence potential is spread throughout society rather than concentrated and no one has a monopoly on violence. Thus, all societies structure their economies and politics in order to solve the universal problem of violence and disorder. The social dynamics of developed countries are fundamentally different from those of developing countries, and the ‘development tools based on first world experiences are ill-suited to the development goals in third world countries.’ The primary concern of political elites in developing countries is how to control violence. They therefore manipulate the economic system to create rents for the benefit of individuals and groups capable of organising violence.

19. Most rich countries are Open Access Orders (OAOs). They rely on competition, open access to organizations and the rule of law to hold the society together. These societies, use competition and institutions to make it in the interests of political officials to observe constitutional rules, including political control over a consolidated military.

20. By definition developing countries are "limited access orders" (LAOs), and historically most states have been LAOs.). The LAO creates limits on access to political and economic functions as a way to generate rents. Rents are created by limits on access to resources and functions like worship, trade, education and fighting and by limiting access to forms of social organization that the larger society will support. Rents are then redistributed in order to maintain social stability and limit violence. There are wide variations, from "fragile" LAOs (Zimbabwe) through "basic" LAOs (the USSR) to "mature" LAOs (India). LAOs operate according to a different social and political logic from "open access orders" (OAOs) in OECD countries -- they are not just "failed" OAOs. .

21. Trying to improve governance in developing countries by implanting institutions from OECD countries will therefore fail. Instead the focus should be on understanding how LAOs work, and how they could progress towards more open access societies.

22. In a world dominated by OAOs, LAOs can benefit by learning from institutional forms developed by OAOs. But the global environment also brings disadvantages:

- the international order protects state boundaries, and therefore the survival even of "unfit" states;

- the import of technology can benefit elites without improving domestic institutions;
- multinational firms could provide incentives for LAOs elites to improve domestic institutions by providing models (of good accounting, or labour standards); alternatively, the availability of imported models (banks, or financial services used by elites) could lower incentives to develop domestic institutions;
- joint ventures that rely on external enforcement of property rights may weaken the need to develop domestic solutions.

23. An important way in which LAOs create rents is through privileged access to organisations that receive state support. Whereas basic LAOs have limited or no elite organisations outside the state, mature LAOs allow a range of non-state organisations, including domestic business corporations. OAOs, by contrast, sustain open entry to political and economic organisations. It could be useful to understand more about how organisations form in different contexts, and their potential to stimulate broader institutional change - for example, by helping to hold governments to their commitments. But what tips LAOs into becoming OAOs remains far from clear.

(d) Mushtaq Khan:

24. The need for market-enhancing capabilities that underlies the good governance agenda is desirable but not achievable in the early stages of development, nor sufficient to induce/sustain growth. Instead, evidence from the transformational states of East Asia and China points to the importance of property right stability for growth-generating investors and the necessary governance capabilities for enforcing these (= *growth-enhancing governance capabilities*). Rent seeking is pervasive (given market failures) but not all rents equally damaging. Where rents are second-best responses to market failures they can be positive for growth. The ability to use rents effectively is a key part of the East Asian story. Key is the compatibility of institutional rules for addressing market failures and the governance capabilities for their enforcement.

25. The specific experience of the East Asian states is non-replicable, but there are important lessons to draw including (a) the importance of institutions to address market failures and (b) the importance of institutions (rules) that are compatible with internal political arrangements. A key part of the problem faced by poor performing economies in Africa and elsewhere is that the rules through which they are trying to solve market failures cannot be enforced due to internal political/social structures. And second best responses to pervasive market failures (the protection of property) tend not to be growth-enhancing. The critical constraints facing developing countries are limited fiscal resources and the social dislocation caused by the social and economic process of development. Within this structural context, the logic of patron client politics dominates. Khan (2006) writes 'patron-client politics makes sense because it allows the governing group to identify the most critical, the best organized, the most troublesome, or simply the most dangerous constituencies and buy them off selectively.'

26. An alternative agenda is therefore one that:

- Identifies and protects critical - *productive* - property rights (i.e. those focused on growth-generating investors) rather than *all* property rights. In so doing we need to recognise that by protecting productive property rights the obverse is the non-protection of unproductive property rights which means losers as well as winners in the reform process.
- Differentiates between types of rent and seeks to improve the institutional and governance capacities of the recipient to use rents effectively
- Accelerates technology acquisition and learning through different types of 'rent management' strategies
- Includes an analysis of political structures – patron-client networks etc – and the way in which political stability is managed in a resource constrained environment.

(e) Nicolas Meisel and Jacques Ould Aoudia:

27. In thinking about the institutional characteristics that matter for growth it is useful to consider two major ways of regulating a social system (i) through informal rules and interpersonal relationships, and (ii) through formal rules and impersonal relationships. The de-personalisation of the regulation of the social system, the effort to formalise rules and detach institutional functions from the personal is a crucial part of the 'development' agenda although history is clear that there is no mechanical transition between these two states and they frequently co-exist. In this schema the indicators frequently associated with the 'good governance agenda' represent an arrival point along a long process of rules formulation.

28. Descriptive statistical analysis based on a new 'institutional profiles' data set shows that the point at which rules are formalised in line with the good governance agenda is highly correlated with the level of national income but not with the rate of income growth. The institutional characteristics of developing countries that achieve high rates of growth are not those of 'good governance'. Instead countries doing well (converging countries) appear to have strong capabilities for coordination and strategic vision as well as the ability to provide quality public goods and security of property rights. For diverging countries (those whose long term growth is below the developed country average) there is a clear absence of coordination and strategic vision capability, weak transactions security, low administrative efficiency and low transparency. A first order reform agenda for these countries might therefore focus on building coordination and strategic vision capabilities, with a view to aligning key private capital interests with those of the state, and reducing transactions uncertainty before tackling more ambitious governance reforms more suited to those countries already doing well.

(f) Daniel Kaufmann:

29. In a riposte to the 'governoskeptics' Kaufmann focused on the evidence on 'governance matters', the measurement challenges (how and what) and what the evidence currently tells us about which governance dimensions matter for growth.

30. Those sceptical about the links between governance and growth often retreat into casual empiricism to support their claims. The challenge is to disentangle the underlying causal relationships, including the reverse causalities. This requires explicit and formalised hypotheses and rigorous empirical testing. What the evidence does confirm is that the aggregate growth effects of governance are best discerned over the very long run (not 10-20 years). Different causal models confirm the relationship although the results differ in magnitude.

31. Is it the case that what is currently being measured is wrong? Don't the fundamentals of security and property rights protection matter in all views of governance? The question of *what* to measure comes down to distinguishing between 'rules' relating to governance (presidential/parliamentary system etc) and governance 'outcomes' (independent ombudsman, rights to freedom of information etc). Measuring rules is clear – they either exist or don't – but it's not always clear which rules matter and which do not, what are enforced and why.

32. Measuring outcomes means that there is more focus on what works in practice. Outcome measures rely more heavily on perceptions data but this is problematic when it comes to linking perceptions about outcomes to specific policy reforms.

33. On *how* to measure, some basic principles apply:

- Be transparent, encourage public scrutiny and rigorous vetting
- Avoid false or misleading dichotomies
- Avoid over-promising on new indicators
- Recognise measurement error is everywhere
- Distinguish indicators for research and analysis (WGI) and those designed for decision-making/resource allocation (CPIA)

34. In terms of what governance dimensions matter for growth there is still much empirical work to be done but it is clear that 'injecting' institutions to control corruption etc is not working. Instead intervening on the important *proximate determinants of good governance* may be more productive e.g. transparency reforms, together with interventions to mitigate reversals such as the media, freedom of information acts etc and support for key institutions of accountability outside the central executive (PACs, business associations). A second best world means a better job at (a) prioritising and (b) country tailoring. – country specific governance assessments and diagnostics.

IV. Summary of points for policy, measurement and research

Policy

- There is actually a lot consensus on the proximate governance issues that matter for growth. For example, most approaches emphasise the importance, for example, of: (i) stability/peace; (ii) property rights; (iii) credible commitments / enforcement; (iv) nature of regulation /

competition; (v) the capacity of the bureaucracy / enforcement capacity. It is how you get and sustain these that is the key area of divergence.

- Solving the barrier to growth is a key contributor to maintaining the political settlement in developing countries over the medium to longer term.
- A number of findings confirm that growth is a political process. Donors need to get much smarter at incorporating into all growth work a better understanding of the political underpinnings and governance capacities needed for economic growth. This would include analysis of political incentives and disincentives for a growth strategy, identifying scope for building on what works, building capacity to formulate policy options, experiment and learn by doing, and capacity to manage the social changes that follow from or constrain growth
- This points to a fundamentally different approach for donors that moves away from the transfer of "best practice" ideas and institutions from OECD countries (injecting commissions etc. as noted by Kaufmann) towards more experimentation, more attention to local solutions and donors looking for entry points to help influence institutional incentives of key stakeholders in the growth process.
- In the face of political market imperfections donors need to think again about the traditional public sector reform agenda which emphasises rule formalisation.
- The governance for growth agenda thus extends beyond the executive and the traditional focus on public sector management, fiduciary concerns of donors and aid conditionality. But there are some contexts where donors are best advised to leave well alone. Diagnosis of binding constraints and prioritisation of reforms are key.
- There are no blueprints and hence a need to create capacity for learning and experimentation (L&E). Donors need to start with their own capacity for L&E in country. The new governance/political economy agenda makes new demands on the capacities/skills of donor-based staff and for internal organisational incentives.
- Opportunities and constraints are often found initially at least, at sub-national and sector level
- In some contexts the priority will be to increase information directly available to citizens (through direct and indirect support for information collection, dissemination and addressing policy barriers to government information, transparency laws etc).
- Credibility is key so give priority to reforms that are easy for citizens to monitor and allow faster reputation building for governments. Donors could also include much better information around donor interventions. Key message is not to let the desire for quick wins derail the long term focus on alleviating political market imperfections.
- The global environment for growth is developing very rapidly - this brings a need to keep abreast of it (eg role of China, global rents etc)

and focus donor attention on collective action to alleviate global governance 'bads' .

- Bottom-line - this is not business as usual. Promoting growth is about better understanding and responding to politics not just economics. Identifying fewer, prioritised interventions that address growth constraints requires detailed country knowledge, more political economy analysis and a willingness to work within the constraints of the "second-best".
- Many of the above points have implications for research and measurement too; in addition

On Measurement

- analysis of Governance at country level needs to address growth issues, and how better to track the governance aspects – both market-enhancing and 'growth-enhancing,' and to bring out the implications for design of donor support.. This could involve a more systematic mapping of current indicators and approaches to political assessment.
- A key principle is that the objective should drive the approach to measurement. Two of the key axes are: (i) level – from global comparisons to national policy to sectoral or regional focus; (ii) whether the measures are for research or policy purposes.
- There are particular gaps in measures regarding the political economy and international governance issues.

On Research

- The challenge is to help resolve the specific nature of 'growth-enhancing governance': such as the governance capabilities to manage rents and political stakeholders effectively for constructive sustainable growth outcomes.
- Among the research questions are: what kind of hand in hand arrangements lead to productive investment and which do not; under what conditions do good policies emerge out of clientelism/patrimonialism; how to conceptualise and operationalise 'power' and social; order' in order to move forward with research; how to extract portable lessons (eg clusters and pairs)?

30 July 2007

SOAS/DFID Workshop (at the Hotel Russell, London)

Governance for Growth

2nd and 3rd July 2007

List of Participants

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Daniel	Davis	DFID
Jonathan	Di John	SOAS
Ben	Dickinson	Development Assistance Committee, OECD (DAC)
Alison	Evans	ODI
Max	Everest Phillips	DFID
Marta	Foresti	ODI
Hazel	Gray	SOAS
Harry	Hagan	DFID
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