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# **Improving governance for economic growth: An agenda for Anglo-Japanese development collaboration**

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Max Everest-Phillips

**SPIRU Working Paper 21**

April 2008



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**Overseas Development Institute  
London**

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SPIRU was set up by the UK Department for International Development (DFID) to undertake policy research and analysis by DFID staff on key issues in international development and to make the conclusions accessible and useful to policy and programme staff working in development around the world.

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## Acronyms

DFID	United Kingdom Department for International Development
G8	Group of Eight
GDP	gross domestic product
IFI	International financial institution
JICA	Japan International Cooperation Agency
MDGs	Millennium Development Goals
MITI	Ministry of International Trade and Industry (Japan)
OECD	Organisation for Economic Co-operation and Development
PRSP	Poverty Reduction Strategy Paper
UK	United Kingdom of Great Britain and Northern Ireland
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
WTO	World Trade Organization

## Abstract

Lack of clarity about the most effective role for the state in economic growth is the biggest challenge to the international community's commitment to delivering the Millennium Development Goals (MDGs) by 2015. Governance – the outcome of politics and history – is central to economic growth in developing countries. Yet a better general governance context does not boost growth in the short-term, and basic principles such as transparency or accountability do not translate into any single 'essential' institutional arrangement for growth. Growth strategies and reforms in the investment climate in developing countries currently confront disconcerting uncertainty about what aspects of governance are really crucial for delivering economic growth, and too often ignore the importance for improving 'non-market' governance on which sustainable economic growth for poverty reduction depends.

Stimulating and sustaining economic growth may have different governance requirements. State-led development has been highly effective under both authoritarian and democratic systems, but nothing is worse for sustainable economic growth than state-led development led by an anti-developmental state. In all contexts 'governance for growth' requires effective political leadership, shared vision and a sense of national purpose, from which the technical capacities of a government to support growth dynamics can emerge.

The UK and Japan's development communities are particularly well placed to collaborate on improving 'governance for growth': from different historical paths to better governance for sustained growth, these two industrialised countries offer complimentary experience and expertise on Africa and on Asia, and share a strong common commitment to improving aid effectiveness.

## Chapter 1: Introduction – Improving the governance dynamics of economic growth

The uncertain impact of governance on economic growth – a heady mix of obdurate political ideology, confused economic theory, and complex often contradictory historical evidence – is the most important factor affecting the implementation of the aims of international development. ‘Governance for growth’ shapes the lives of the poor and vulnerable for whom economic growth is the main route out of the degradations of poverty and vulnerability. Yet we still know too little about what dimensions of the governance agenda really influence the dynamics of sustainable economic growth.

Over the last few years, past certainties over economic models for achieving growth in international development have disappeared: The World Bank’s seminal study *Economic Growth in the 1990s: Learning Lessons from a Decade of Reform* (2005)<sup>1</sup> stressed that there is no one path to growth, no one set of effective institutions, but that ‘politics trumps economics’ – good economic principles can only be implemented when in accord with both the local political climate and administrative capacity. Economic certainties of universal theories of growth are complicated by the local complexity of history and politics. Without engagement with the detail of a country’s governance, growth strategies are futile. Many in development feel unnerved. What are the guiding principles? There is constant tension between universal principles – the investment climate<sup>2</sup> and good governance – and the local variants, the ‘varieties of capitalism’.

To address this development challenge, this paper argues that the UK and Japan are well placed to provide the international community with leadership through increased collaboration. Japan (and later East Asia) and the West had different paths to development, creating a different understanding about what dimensions of governance really matter for economic growth. With the bursting of the Japanese ‘bubble’ economy fifteen years ago, UK interest in Japanese insight into development has faded. At this important juncture for the UK Department for International Development (DFID) (with the UK 2006 White Paper on international development highlighting the importance of governance, and a renewed understanding that economic growth is crucial to poverty reduction) closer development cooperation between Japan and the UK would strengthen understanding of divergent paths to sustainable development.

In the early 1960s a World Bank ‘mission’<sup>3</sup> of ‘ambitious economists who travel’, flew into Seoul to offer the apparently weak and economically illiterate government of South Korea, a former Japanese colony, ‘best practice’ international advice on how to achieve the economic growth that seemed then a very distant ambition. Forty years ago South Korean per capita income was on a par with that of Kenya, and East Africa was universally believed to hold greater realistic prospects of rapid prosperity. The ‘mission’ report firmly declared that ‘an integrated steel mill in Korea is a premature proposition without economic

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<sup>1</sup> A study on development lessons of the 1990s prepared by the World Bank’s Poverty Reduction and Economic Management (PREM) Network.

<sup>2</sup> For definition, see the World Bank’s World Development Report 2005; and Moore, H. and H. Schmitz. 2007. *Investment Climate* paper for Future State Centre Activities Phase 2 Programme 1, Institute of Development Studies.

<sup>3</sup> How the World Bank adopted and then has continued with such a pontifical term for a ‘business trip’ would be an interesting study in shifting socio-linguistics of grandiloquent self-importance.

feasibility'.<sup>4</sup> The South Korean government wisely ignored this categorical certainty from Washington. A quarter of a century later, another team of eager World Bank economists arrived on another 'mission' that in turn delivered another detailed report on the country's economic growth prospects. Without reference to (or apparent knowledge of) their predecessors' earlier efforts, they gave their blessing to the Korean dismissal of the previous generation of World Bank guidance by declaring that the state-owned Pohang Iron and Steel Company was 'arguably the world's most efficient producer of steel' and the backbone of Korea's extraordinary growth dynamics that wiped out extreme poverty in less than three decades.<sup>5</sup>

This vignette of development history from South Korea, one of the world's most successful development stories of the last half of the 20th century, says much about the dangers of trusting in adamant ahistorical 'certainties' of economic theory. Yet World Bank caution about state intervention in the economy was usually more than justified: the landscape of much of the developing world is littered with the disasters of state-led development of post-colonial independence. Too often new governance structures failed to discipline the vainglory and greed of corrupt or misguided political and business elites – with disastrous consequences for the plight of the world's poor people. Fortunately in recent years the international development community, despite regular slippage and perverse institutional incentives over learning from experience through proper evaluation, has been more willing to learn from its many well-documented failings. After a decade of focus on the expenditure side of service delivery, we have rediscovered that countries need economic growth if they are ever to escape aid dependency. We are now much clearer that local context – history, political processes, institutions, social attitudes – is crucial for achieving sustainable economic growth. Increasingly we agree that there is no 'international best practice' to be parachuted in by development experts and expensive consultants from Washington or other western capitals; good principles like 'accountability' or 'transparency' can only emerge gradually from 'what really works' in local circumstances.

This paper suggests the need to do better on two dimensions:

- a) to bring together more clearly two major strands of development thinking – better governance and improved economic growth - if the international community is to meet its objectives of the MDGs by 2015, and beyond;
- b) to promote better aid effectiveness with particular reference to the 'governance for growth' agenda between two major players in development assistance – Japan and the UK, the only G8 (Group of Eight) countries so far to honour their Gleneagles pledges of 2005 on aid for Africa.

The case for the importance of the 'governance for growth' theme for Anglo-Japanese collaboration is three opportunities: first, in 2008 Japan will hold the presidency of the G8, will be hosting the Tokyo International Conference on African Development (TICAD), and is currently attempting to reform its development agencies. Second, 'governance for growth' plays to combined strengths – DFID has been highly influential in shaping the debate on governance in the international development community; while Japan has maintained its high reputation for practical expertise on growth. Third, much of the international analysis of the governance determinants of economic growth are too dominated by Anglo-American economic perceptions of how development happens, based on a narrow focus on 'institutions' as 'technical fix' rather than an evolving process of political governance. This is a poor reflection of the complexities of history beyond the US

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<sup>4</sup> Quoted in Amsden, A. 1989. *Asia's Next Giant: South Korea and Late Industrialisation*. Oxford University Press (New York). p. 291.

<sup>5</sup> World Bank. 1987. *Korea: Managing the Industrial Transition*. Vol. 1. p. 103.

and UK experience and in particular demonstrates a limited appreciation of the political governance characteristics of Japan and subsequent ‘later developers’ that were so critical to their sustained high economic growth – despite the voluminous literature on the ‘East Asian Miracle’.

Japan has enjoyed considerable success with the impact of its aid in promoting economic growth.<sup>6</sup> Since the Fukuda Doctrine of 1978 Japan has been committed to equal partnership in development. Importantly, it enjoys a different mindset and history – a feudal society in 1868 that coped with the many vagaries of rapid industrialisation, defeat and occupation in 1945, land reform and a deeply egalitarian understanding of ‘economic growth as state-building’. The leading Meiji era Japanese entrepreneur Eiichi Shibusawa however asserted that his aim was ‘to build modern enterprise with the abacus and the Analects of Confucius’.<sup>7</sup> Japanese leaders of the Meiji reign strongly influenced by imperial Germany, were fond of quoting the Prussian economist Friedrich List:

‘History is full of examples of entire nations having perished, because they knew not and seized not the critical moment for the solution of the great problem of securing their moral, economical, and political independence, by the establishment of manufacturing industry, and the formation of a powerful class of manufacturers and tradesmen.’<sup>8</sup>

Development, especially development economics policy prescriptions – free markets or ‘rule of law’ – that are often claimed to be universal as end goals but lack a historical sense of the different paths to economic growth from the variety of states and markets.

Orthodox dogma on the causes of economic growth (the ‘Washington Consensus’ of the 1980s and 1990s) has given way, in the face of practical failure around the developing world, to a search for political feasibility in local contexts – what really works. Genuine empowerment and well-being, as the long-term objective of political and economic institutions, requires both effective democracy and economic prosperity to deliver ‘development as freedom’. But the developed world has spent hundreds of years developing the necessary governance capabilities. The last decade has taught the international community that the technocratic dimension will not work without the politics. The World Bank’s World Development Report of 1997 demonstrated that the state was central to poverty reduction, but countries cannot reform all their governance institutions at once; an incremental and realistic set of priorities is required. Growth as a priority for the MDGs suggests the need to identify much better what aspects of governance shape growth outcomes. Economic growth requires more than just ‘the maintenance of macroeconomic and political stability’. Politically divisive forms of inequality and inadequate government provision of education and health need to be addressed to create a better business climate for investment and job-creation to prevent social unrest leading to the political instability that can undermine growth prospects.

No successful high-growth country from China to Botswana has ever followed any policy prescription on ‘good’ governance, growth or the investment climate: but understanding how basic principles of economics need to engage with local politics and history remains a challenge of mindsets, professional expertise and knowledge. ‘An effective state is the

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<sup>6</sup> On some measures, its aid effectiveness is ranked well ahead of that of the UK: <http://www.e.u-tokyo.ac.jp/cirje/research/dp/2005/2005cf331.pdf> (accessed 29 February 2008).

<sup>7</sup> Quoted in Lockwood, W. 1965. *The State and Economic Enterprise in Japan*. Princeton University Press. p. 243.

<sup>8</sup> List, F. 1845 (1882 translation). *The National system of Political Economy*. p. 82.



single most important factor determining whether development takes place'.<sup>9</sup> The most important development of recent years has been the recognition that 'good governance is about good politics.'<sup>10</sup> Political governance is also central to economic growth: 'modest changes in institutional arrangements and in official attitudes to the economy can produce huge growth payoffs'.<sup>11</sup> There is an increasing acceptance by the international development community that 'just getting markets and the investment climate right' is not enough: governments need to take more proactive steps to support and sustain growth.<sup>12</sup>

This paper aims to incorporate the governance dynamics of economic development more effectively into developing countries' growth strategies. In describing the dynamics of successful economic growth, economists, too often, still argue some version of: 'What the state has provided is *simply* a suitable environment for the entrepreneurs to perform their functions' [italics added].<sup>13</sup> '*Simply*'? This paper is about the complexities behind that 'simplicity'. It argues that the international community needs to get better at finding ways to support effective political governance underpinnings that generate long-term growth. Development is a revolution involving not just economic but social and political change on a drastic scale. Countries need to create their own institutions through local processes. Reforms require careful priorities and sequencing. Changing power relations and the way that decisions are made in a society may take decades, but when opportunities do occur, change can happen with surprising speed. History suggests cautious optimism is justified, but progress requires international collaboration built on practical experience and expertise, something which the Japan International Cooperation Agency (JICA) and DFID, and the international development communities in both countries are well placed to promote. Michael Klein, Chief Economist and Vice-President of the International Finance Corporation recently noted: 'the main barriers to growth in Africa are to do with governance rather than economic policy.'<sup>14</sup> What follows is a manifesto for collaborative action playing to the comparative strengths of two major developed countries at a key time for 'governance for growth' as the crucial underpinning for all hopes of delivering the MDGs.<sup>15</sup>

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<sup>9</sup> DFID. 2007. Governance, Development and Democratic Politics. p. 1.

<sup>10</sup> DFID. 2006. White Paper: Making Governance Work for Poor People. p. 23.

<sup>11</sup> Rodrik, D. 2003. In Search of Prosperity. Harvard. p. 16.

<sup>12</sup> Hausmann, R., D. Rodrik, and A. Velasco. 2005. Growth Diagnostics. Harvard University Press.

<sup>13</sup> Chen, E. 1979. Hyper-Growth in Asian Economies. London. pp. 183–4.

<sup>14</sup> Quoted at the 2006 annual World Bank conference.

<sup>15</sup> Including the 'ninth' MDG of 'Good Governance' that various countries such as Albania, Azerbaijan and Mongolia have also adopted.

## Chapter 2: Governance for growth

Faced by the turgid jargon of contemporary political science, economics and political economy, the concise and elegant insight of great thinkers of the past is often the most inspiring. The renewed interest in ‘governance for growth’ reflects the advice Machiavelli gave Renaissance monarchs that that they would be stronger in a prosperous realm than in an impoverished and discontented one:

[The Prince] ought accordingly to encourage his subjects by enabling them to pursue their callings, whether mercantile, agricultural, or any other, in security, so that this man shall not be deterred from beautifying his possessions from the apprehension that they may be taken from him, or that another refrain from opening a trade through fear of taxes; and he should provide rewards for those who desire so to employ themselves, and for all who are disposed in any way to add to the greatness of his City or State.<sup>16</sup>

Economists have in recent decades re-discovered the truth best expounded by the great English 17th century political philosopher Thomas Hobbes that the without the effective institutions of the state

there is no place for industry, because the fruit thereof is uncertain: and consequently no culture of the earth; no navigation, nor use of the commodities that may be imported by sea; no commodious building; no instruments of moving and removing such things as require much force; no knowledge of the face of the earth; no account of time; no arts; no letters; no society; and which is worst of all, continual fear, and danger of violent death; and the life of man, solitary, poor, nasty, brutish, and short.<sup>17</sup>

In the 19th century the British philosopher John Stuart Mill argued that:

‘Where a person known to possess anything worth taking away, can expect nothing but to have it torn from him, with every circumstance of tyrannical violence, by the agents of a rapacious government, it is not likely that many will exert themselves to produce more than necessities’.<sup>18</sup>

Or in more modern terminology:

‘The roots of political development productively join with the economic when specialists in violence realise that they can best survive and prevail by promoting the prosperity of their economic base.’<sup>19</sup>

But progress in explaining why, how and when this change occurs, and what the international community can do to promote this outcome, has been frustratingly slow. Here the development experience of Japan is informative: in the early years after the Meiji Restoration of 1868, 38% of total government budget was spent paying off the samurai class (the highest, ruling class) through cancelling feudal debts, offering stipends and subsidies to start businesses.

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<sup>16</sup> The Prince: 1992 edition, p. 61.

<sup>17</sup> Hobbes, T. 1651. *The Leviathan*. Chapter 13.

<sup>18</sup> Mill, J-S. 1848. *Principles of Political Economy*. Vol. 1. p.70.

<sup>19</sup> Bates, R. 2001. *Prosperity and Violence*. W W Norton. p. 100.

Economic growth is essential to delivering the MDGs. Yet the proportion of British aid to Africa devoted to ‘directly productive’ activities (growth and rural livelihoods), expressed as a percentage of aid for ‘social’ spending (education, health, social and governance), had fallen from 371% in 1988/9–1989/90 and 208% in 1993/4–1994/5, to only 45% by 2003/4.<sup>20</sup> The Organisation for Economic Co-operation and Development’s Development Assistance Committee’s (OECD-DAC) data on sector-specific aid from all donor sources shows the ratio of assistance to ‘social’, as against ‘economic’, sectors changed in a continuous – and continuing – trend from 1:4 in 1978 to 4:1 in 2004.<sup>21</sup> Optimists may point to ‘convergence’. Poor countries will catch up with the rich (notably China and Vietnam at present; East Asia and Botswana in earlier decades). Pessimists highlight non-convergence – the rich countries carry on getting richer (per capita income in many African countries is roughly where it was at independence 40 years ago).<sup>22</sup> But in either case, economic growth really does matter for poverty reduction. And while few now doubt that governance is critical, what aspects of governance really matter to deliver the economic growth needed for sustained poverty reduction is still far from clear.

Governance is defined in various ways by different international development agencies. The basic concept seeks to capture the *process* of governing, as distinct from the government as the individuals holding state authority at any particular moment. The World Bank president in 2006 offered a definition of governance as ‘the combination of transparent and accountable institutions, strong skills and competence, and a fundamental willingness to do the right thing’.<sup>23</sup> The OECD suggests governance is about political power: ‘the use of political authority and exercise of control in a society in relation to the management of its resources for social and economic development’. The United Nations Development Programme (UNDP) interprets governance as ‘the exercise of economic, political, and administrative authority to manage a country’s affair at all levels. It comprises mechanisms, processes and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences.’ DFID recognises that governance is the political processes underpinning the capability, accountability and responsiveness of the state.<sup>24</sup>

Governance contains two different elements: the aspects of governing the state that are of *intrinsic* importance to the population, such as respect for human rights; and the *instrumental* dimensions of governance which are the attributes of the quality of governance that delivers on the needs of the population. The most fundamental of these needs – education, primary health and economic prosperity – are those that underpin all other aspirations for development. These intrinsic and instrumental sides to governance combine to deliver ‘development as freedom’ – the freedoms from want and fear, and the freedoms to improve the quality of life for all. The intrinsic and instrumental also represent the dual face of government legitimacy – ‘output’ through the state’s capacity to deliver on the needs of the population including sustained economic prosperity; and the ‘input’ from the respect and trust of the population in the institutions of state which creates the business and investor confidence needed for economic growth.

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<sup>20</sup> Killick, T. 2005. ‘Understanding British Aid in Africa’ in Court, J. (ed.) *Aid to Africa and the UK’s ‘2005 Agenda’: Perspectives of European Donors and Implications for Japan*. Overseas Development Institute.

<sup>21</sup> Killick, T. and M. Foster. 2006. ‘What would doubling aid do for macroeconomic management in Africa: A synthesis paper’. *ODI Working Paper 264*. April.

<sup>22</sup> Pritchett, L. 2006. <http://www.imf.org/external/pubs/ft/fandd/2006/03/pritchet.htm> (accessed 8 March 2008)

<sup>23</sup> World Bank external office of the president.

<sup>24</sup> DFID. 2007. *Governance, Development and Democratic Politics*.

Governance is central for successful implementation of policies which support growth. Governance affects all aspects of growth dynamics in different ways, via such diverse areas as investment, finance, education, health, and innovation. Property rights, contract enforcement and markets – in labour, property and capital – are socially constructed and politically regulated.<sup>25</sup> Governance can impact through many channels: political systems and processes; national legal systems; state bureaucratic policy process and its implementation (policy, policy action and policy outcomes often differ significantly from the plan, depending on capabilities).<sup>26</sup> In a lecture to a Glasgow audience in 1775, Adam Smith famously suggested the governance requirement for economic growth:

‘Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism than peace, easy taxes, and tolerable administration of justice; all the rest being brought about by the natural course of things.’

Yet what aspects of political systems and government capabilities are necessary to deliver growth in different developing country contexts remains far from clear. Successful high growth in East Asia was due to the existence of strong states with a clear growth agenda. While few would doubt that governance and economics are closely connected, what is being measured as ‘governance’ may not capture the relationship: not only that high-growth and low-growth developing countries have had the same governance quality over the last two decades according to standard indicators of governance, but that the average high-growth developing country actually had slightly worse governance in the 1990s than the average low-growth country.<sup>27</sup> This suggests greater effort is needed to identify better the dimensions of governance that actually deliver growth.

Governments that are concerned for the long-term good of their general population and responsive to their needs, are likely to be supportive of economic growth that will deliver better livelihoods for all; the intrinsic and the instrumental dimensions to governance are intertwined: respect for civil liberties and human rights is correlated with growth outcomes.<sup>28</sup> Governments determined to deliver economic growth must maintain political stability and show long-term commitment. The wide variety of historical trajectories towards ‘best practice’ in developed economies<sup>29</sup> shows there is no one path to sustainable growth.

‘Once one moves beyond general statements of the kind that property rights are good for growth and corruption is bad, there is much that remains unclear. Which institutions demand priority? What are the specific institutional forms that are required? Do these differ across countries according to the level of development, historical trajectory, and initial conditions?’<sup>30</sup>

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<sup>25</sup> Harriss-White, B. 2005. *India's Market Society: Three Essays in Political Economy*. Gurgaon.

<sup>26</sup> Pritchett, L. 2004. *Reform is Like a Box of Chocolates: Understanding the Growth Disappointments and Surprises*. Harvard University.

<sup>27</sup> Khan, M. 2006. Paper for World Bank annual meeting.

<sup>28</sup> Rodrik, D. 1998. ‘Democracies Pay Higher Wages’. *NBER Working Paper*; and J. Stiglitz. 2002. ‘Participation and Development: Perspectives from the Comprehensive Development Paradigm’. *Review of Development Economics* 6 (2) pp. 163–82.

<sup>29</sup> Hall, P. and D. Soskice (eds). 2001. *Varieties of Capitalism*. Oxford University Press.

<sup>30</sup> Rodrik, D. 2003. *In Search of Prosperity: Analytic Narratives on Economic Growth*. Princeton University Press. p. 8.

Although corruption is undesirable, its impact on growth, for example is unclear. Eliminating corruption in countries where levels of such activity are high may have a negative impact on growth.<sup>31</sup>

‘Government failure’ and ‘market failure’, remain contested concepts: whether and how much the state should interfere in markets? and how far private sector can or should deliver functions of government? Some countries have made rapid transitions to growth without profound governance reforms. Work on the history of growth ‘spurts’ throws doubt on whether ‘institutions’ matter for kick-starting growth – the importance of effective institutional arrangements lies in sustaining it over the medium and longer-term, when the economy is growing, providing the resources needed to implement reform.<sup>32</sup> Evidence for institutional reform impacts on initiating growth is surprisingly patchy.<sup>33</sup> Governance reforms supposedly crucial for growth have had no effect on the economic performance of African countries.<sup>34</sup> China has significantly higher growth rates than India but does not perform better along the supposedly critical dimensions of investment climate, governance such as the stability of property rights, corruption or the rule of law, but rather has other governance capacities that do seem to matter.<sup>35</sup> So causality between governance, investment and growth is unclear: governance may be critical to the investment climate, which in turn may (or may not) lead to growth; but governance also influences how investment climate can lead to growth. For example, India and Brazil with similar rates of investment (21% of gross domestic product (GDP)) grew at rates as different as 5.7% and 2.1% between 1980 and 2004. Substantial intra-national growth differences exist that cannot be explained by broad generalisations about institutional factors: there are significant examples of rapid growth and investment in some sectors within countries that are otherwise regarded as having poor growth and investment climates.<sup>36</sup> Growth differs widely by locality within countries, with local governance factors often explaining the marked regional variations in growth performance (e.g. across the Indian states of Gujarat, West Bengal and Tamil Nadu that were at a comparable level of development at the time of Independence,<sup>37</sup> and across China).<sup>38</sup>

<sup>31</sup> Vostroknutova, E. 2003. ‘Shadow Economies, Rent-Seeking Activity and the Perils of Reinforcement of the Rule of Law’. *European University Institute Working Paper No. 2003/9*.

<sup>32</sup> Hausmann, R., L. Pritchett, and D. Rodrik. 2005. ‘Growth Accelerations’. *Journal of Economic Growth*. 10(4). December. pp. 303–329.

<sup>33</sup> Hausmann, R., D. Rodrik, and A. Velasco. 2005. *Growth Diagnostics*. Harvard University Press; and Jones, B. and B. Olken. 2005. ‘The Anatomy of Start-Stop Growth’. *NBER Working Paper No. 11528*.

<sup>34</sup> Sachs, J. et al. 2004. ‘Ending Africa’s Poverty Trap’. *Brookings Papers on Economic Activity* 1. pp. 117–240.

<sup>35</sup> e.g. for accelerating resource allocation to growth sectors, prioritising infrastructure for these sectors, and in making credible support available to investors bringing in advanced technologies: Qian, Yingyi and B. Weingast 1997; and ‘Institutions, State Activism, and Economic Development: Comparison of State-Owned and Township-Village Enterprises in China’, in M. Aoki, H-K Kim and M. Okuno-Fujiwara (eds). 1998. *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Oxford University Press.

<sup>36</sup> Haber, S. et al. 2003. *The Politics of Property Rights: Political Instability, Credible Commitments, and Economic Growth in Mexico, 1876–1929*. Cambridge University Press.

<sup>37</sup> Sinha, A. 2006. *The Regional Roots of Developmental Politics in India: A Divided Leviathan*. Oxford University Press (India): Gujarat has consistently attracted a higher share of investment, West Bengal failed to capitalise on its initial conditions, and Tamil Nadu has a fluctuating performance (investment per capita in Gujarat was two and half times the all-India average by 1994, while in Tamil Nadu such investment stood at 0.85 of all-India levels, and in West Bengal at 0.47). Local politics in Gujarat developed ‘strategic capacities’ that have consistently made that state attractive to private capital –while in West Bengal and Tamil Nadu local politics have tended (at least until recently) to have the opposite effect.

<sup>38</sup> World Bank. 2006. *Governance, the Investment Climate and a Harmonious Society: Competitiveness Enhancements for 120 Cities in China*.

How much then does governance ‘matter’ for growth? Political power influences what growth strategies are realistic, and the governance capabilities needed to implement them. Growth can be politically desirable to achieve political stability, or can be politically threatening if socially divisive, so governments must also be concerned about the social impacts of growth – economic transformation inevitably causes some social upheaval including localised unemployment from ‘churning’ as companies enter and exit the market place with improvements in competitiveness and productivity. Governments always require the capacity to buy off resistance to change and providing a social safety-net for those adversely affected is crucial to facilitating the modernisation of the economy. Successful growth economies have all had the state play an important but varied role: attracting investment; improving productivity, technology, and competitiveness. Delivering economic and political stability seems critical. To achieve this, political leadership, vision and achieving a sense of national purpose have always been decisive factors.

Political competition may have differing effects on the components of both conflict and growth dynamics.<sup>39</sup> So what matters is how the political arrangements deliver effective legal systems, regulation and competition, an efficient public sector, and stable fiscal and monetary policies. What seems critical for investment and sustainable growth is that political conflicts can be settled by agreed rules, without violence, even if the institutions and the rules are highly biased towards elite interests.<sup>40</sup> Yet generalisations are difficult: even increasing political instability can surprisingly be correlated with *increases* in investment.<sup>41</sup> Different sectors and key factors of production: labour, capital, technology, even commodities, all have different political economies. Some sectors have continued to flourish even in civil wars:

‘factions had few incentives to destroy productive assets, and every incentive to use them to finance their armies ... the instability of the 1920s had almost no discernible effect on the growth of Mexico’s economy’.<sup>42</sup>

Conflict shows perhaps most starkly how growth and governance inter-link. But understanding this also suggests that the international community needs to think about the growth implications of peace settlements. Basic security is critical, but so too will be steps to make economic opportunities as well as steps to make politics more inclusive, with growth implications not just in strengthening public financial management but also in other governance reform such as justice.

The World Bank summed up its key lesson from the 1990s as the need not just to get the economics right, but to ‘get the politics behind the economics right’.<sup>43</sup> This requires getting beyond the imprecise, ahistorical and non-political use of terms such as property rights, institutions and infrastructure. Property rights, for example, are constructed through a

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<sup>39</sup> Possible decreases the rate of physical capital accumulation and labour mobilisation but increases the rate of human capital accumulation and productivity change: Pinto, P. 2005. ‘Political Competition and the Sources of Growth’. *Comparative Political Studies*. Vol. 38. No. 1. pp. 26–50.

<sup>40</sup> Przeworski, A. et al. 2005. *Does politics explain the economic gap between the United States and Latin America?* Colombia.

<sup>41</sup> Londregan, J. and K. Poole. 1990. ‘Poverty, the Coup Trap, and the Seizure of Executive Power’. *World Politics* 42:2. January; Campos, N. and J. Nugent. 1999. *Investment and Instability*. University of Southern California.

<sup>42</sup> Haber, S. et al. 2003. *The Politics of Property Rights*. Cambridge University Press. p. 347.

<sup>43</sup> World Bank. 2005. *Lessons from a Decade of Reform*. p. 125.

process of constant political contestation – requiring enough stability in the process to maintain positive risk perception while allowing property rights to adjust to new conditions and technological change. Confusion over the historical evolution of ‘secure’ property rights is often based on the shaky historical justification of the supposed impact of the ‘Glorious Revolution’ of 1688 as creating constraints on government in England; yet hardly explains the impact on property rights in Japan of the 1868 Meiji ‘Restoration’.<sup>44</sup>

The concept of ‘institutions’ has been useful to economists’ efforts to incorporate history and politics into explaining growth: ‘the single most important explanatory variable’ for economic growth is ‘political organisation and the administration of government.’<sup>45</sup> Growth theories now recognise that ‘institutions matter’:

‘I wish to assert a much more fundamental role for institutions in societies; they are the underlying determinant of the long-run performance of economies’.<sup>46</sup>

Despite, however, an enormous upsurge in research on ‘institutions for growth’, progress has been limited. The ‘institutions’ approach may not help explain how institutions affect growth, nor the political basis for effective institutions. ‘Institution’ unhelpfully conflates: the *rules of the game* (the institutions defining the structure of incentives); the *interests and beliefs of the players* (interest groups and political leaders); and the *way the game is played* (the political process interprets formal constitutional arrangements) – aspects not easily separated. ‘How the game is played depends not only on the formal rules defining the incentive structure for the players and the strength of the informal norms but also on the effectiveness of enforcement of the rules.’<sup>47</sup> The literature is confused about what is an ‘institution’ (even formal, let alone the much greater uncertainty about informal), what is an institutional outcome, and what is a ‘policy’. These different dimensions are intertwined with the importance of societal trust and cooperation, so an ‘institution’ is confused with its human capital.<sup>48</sup> Some influential studies of long-run institutional impact on growth provide an oversimplification of history through deterministic variables like ‘extractive institutions’.<sup>49</sup>

By contrast, detailed case studies are rather more illuminating on how change really happens. The impact of politics, policies and their institutional underpinnings for a country’s economic growth prospects is dramatically shown by the sharply differing fortunes of two halves of the same island – Hispaniola divided into Haiti and the Dominican Republic.<sup>50</sup> While the quality of institutions was poor in both countries until the

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<sup>44</sup> Everest-Phillips, M. 2008. ‘The Myth of “Secure Property Rights”’: Good Economics as Bad History and its Impact on International Development’. *SPIRU Working Paper 23*, Overseas Development Institute.

<sup>45</sup> Reynolds, L. 1983. ‘The Spread of Modern Economic Growth, 1850–1950’. *Journal of Economic Literature*, 21, p. 976.

<sup>46</sup> North, D. 1990. *Institutions, Institutional Change and Economic Performance*. Cambridge University Press. p. 107.

<sup>47</sup> North, D. 2005. *Understanding the Process of Economic Change*. Princeton University Press. p. 48.

<sup>48</sup> Glaeser, E. et al. 2004. ‘Do Institutions cause Growth?’ *Journal of Economic Growth*. Vol. 9 (3). pp. 271–303.

<sup>49</sup> see the influential but disturbingly ahistorical papers by Acemoglu, Johnson and Robinson on institutions and growth.

<sup>50</sup> Jaramillo, L. and C. Sancak. 2007. ‘Growth in the Dominican Republic and Haiti: Why has the Grass Been Greener on One Side of Hispaniola?’ *IMF Working Paper*. The Cold War division of the Korean peninsula and Germany also provided ‘natural experiments’ of how political regimes shape growth outcomes, but complicated by ideological divide and enormous economic influence of the ex-USSR on the growth dynamics of North Korea and East Germany.

early 20th century, political stability seems to have been noticeably worse in the Dominican Republic. Between independence in 1804 and the US military occupation in 1916, Haiti had 33 heads of state, with an average time in power of 3.4 years. By contrast between independence in 1844 and the US military occupation in 1916, the Dominican Republic had 61 heads of state, with an average time in power of only 1.2 years. This combined with the assassination in 1911 of its president, Cáceres, proved particularly disastrous for the Dominican Republic causing various revolutions, economic chaos, and a near-collapse of government institutions. Yet despite the same geography and worse ‘institutions’, it has been the Dominican Republic which over the last few decades has managed to deliver economic growth and development, while Haiti has suffered economic and political collapse. How has this happened? Like East Asia, the answer seems to lie in a complex local mix of export-led growth, and the capacity to uphold macroeconomic stability. But above all, growth and development has been as a result of achieving political stability. A ‘political settlement’ between elites in 1970 was established under the presidency of Joaquin Balaguer (he was president three times over a period of 20 years, between 1960 and 1996). The Dominican Republic has had impressive results on delivering developmental and economic progress for its population.<sup>51</sup> By contrast, Haiti has collapsed economically and politically since the turmoil leading up to the collapse of the Duvalier dictatorship in 1986. Between 1986 and 1990, there were six different heads of state. In the 1990s, Haiti suffered a series of failed presidential and parliamentary elections, coups d’état, a US.-led military intervention, and nine different heads of state. As Ha-Joon Chang strikingly observes in his new book *Bad Samaritans: Rich Nations, Poor Policies, and the Threat to the Developing World*, Korea’s economic performance over the last four decades would have been the equivalent of turning Haiti into Switzerland.<sup>52</sup> Politics has to be put back into ‘political economy’ to explain how this can happen.

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<sup>51</sup> POLITY iv; the Dominican Republic’s political stability survived the region-wide slump of the 1980s Structural Adjustment era: so the irony of the IMF case study singing its praises.

<sup>52</sup> Life expectancy at birth in Korea in 1960 was 53 years. In 2003, it was 77 years. In the same year, life expectancy was 51.6 years in Haiti and 80.5 years in Switzerland. Infant mortality in Korea was 78 per 1,000 live births in 1960 and 5 per 1,000 live births in 2003. In 2003, infant mortality was 76 in Haiti and 4 in Switzerland. The 1960 Korean figures are from H-J. Chang: *The East Asian Development Experience – the Miracle, the Crisis, and the Future*: London 2006, Tables 4.8 (infant mortality) and 4.9 (life expectancy). All the 2003 figures are from UNDP (2005), *Human Development Report 2005* (United Nations Development Program, New York), Tables 1 (life expectancy) and 10 (infant mortality).



## Chapter 3: Japanese development experience matters

Growth happens when it is politically desirable or necessary. One crucial dimension to Japan's economic recovery was the era of Prime Minister Ikeda for whom delivering economic growth meant political survival. In 1960 the renewal of the Japan-US Security Treaty provoked violent nationwide protests. A sense of national crisis shook the confidence of the Japanese political, business and bureaucratic elite, and the previous government resigned in an atmosphere of political chaos. The new Ikeda government (1960 to 1964) deliberately sought a different national vision to avoid confrontation over political ideology. Ikeda, a former Minister of International Trade and Industry, successfully refocused national attention on his plan to double Japanese GDP within a decade – which was achieved by 1967. Ikeda was described as ‘the single most important figure in Japan’s rapid growth. He should long be remembered as the man who pulled together a national consensus for economic growth.’<sup>53</sup> Japanese politics now turned on the *seichoritsu* (growth rate). Charles De Gaulle offered another epitaph, allegedly asking after meeting Ikeda: ‘Who is that transistor salesman?’

Europeans who visited Japan before the end of the Tokugawa regime’s policy of isolation in the middle of the 19th century were generally surprised to discover how effectively the country was run. The Swedish surgeon and naturalist Peter Thunberg, for example, travelling from Nagasaki to Edo (Tokyo) in 1776, was impressed how

‘both the supreme government and the civil magistrates make the welfare of the state, the preservation of order, and the protection of the persons and property of the subject, an object of greater moment and attention in this country than in most others.’<sup>54</sup>

This directly challenged the prevailing European governance concept of ‘oriental despotism’, a term invented by Montesquieu arguing that autocratic rule overrode all property rights, leaving Asia backward and poor. Others, in ways that mirror the current juxtaposition of universal post-‘Washington Consensus’ norms, in contrast a more historical evolutionary view, argued that ‘natural law’ constrained rulers, resulting in a well-governed state with low taxes and secure enough property rights to provide incentives for farmers to invest resources and effort in improving agricultural productivity.

This political strength combined with a strong work ethic led to a political system which reinforced the state’s legitimacy through building administrative capacity and political responsiveness to the needs of the population, with long-term consequences for commitment to the success of the private sector.<sup>55</sup> Japan successfully evolved from feudal to global power within two generations: from the ‘Meiji Restoration’ of 1868 to 1880, the government established enterprises in a wide variety of industrial sectors – cotton, silk, mining, shipping, shipbuilding, engineering, cement, chemicals, iron and steel. Most proved unprofitable but invaluable lessons were learnt from demonstration of new production methods. Between 1880 until the First World War, most national investment came from public expenditure in heavy industries, focusing on militarily strategic sectors

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<sup>53</sup> Nakamura, T. 1987. *Lectures in Modern Economic History*. pp. 0-81; also C. Johnson. 1986. p. 252 notes the importance of the Ikeda Plan for boosting national self-confidence essential for investor confidence.

<sup>54</sup> *Voyages de C.P. Thunberg au Japon par le Cap de Bonne-Espérance, les Isles de la Sonde* 1796, IV: 11.

<sup>55</sup> Morishima, M. 1982. *Why Has Japan Succeeded? Western Technology and the Japanese Ethos*. Cambridge University Press.

(including iron and steel) and infrastructure, particularly shipping and railroads. The Anglo-Japanese Alliance of 1902 consolidated Japan's position as an international power, while the First World War presented unprecedented economic opportunities.<sup>56</sup>

Japanese industrialisation was by no means self-evident: a German economist visiting Japanese factories in the late 1880s reported that 'Japanese workers work relatively little and that all work progresses only slowly'.<sup>57</sup> The political elites of the Meiji 'Restoration' that overthrew the feudal Tokugawa regime in 1868 were determined to preserve Japan's political independence through economic wealth and military power. Aware of the dangers of dependency, their unifying vision was to overcome this external threat: subservience to foreign powers 'is a deep-seated disease afflicting vital areas of the nation's life'.<sup>58</sup> A leading Japanese economic historian concluded that while the Meiji government had been instrumental in developing the domestic economy by integrating the different dimensions to the growth process of industrialisation, it had been able to build on well-developed nationwide market and distribution networks.<sup>59</sup> An effective state was essential and, mirroring continuing argument about modernisation theory about autocratic rule 'to get things done'. Even ardent democrats throughout the Meiji period were concerned that the constitutional government could lead to considerable rifts in the national political consensus that would set back progress in both political and economic development.<sup>60</sup>

British observers of Meiji Japan's early development prospects were scathing:

'In this part of the world, principles established and recognised in the West appear to lose whatever virtue and vitality they originally possessed and tend fatally towards weediness and corruption... The Japanese are a happy race and, being content with little are not likely to achieve much.'<sup>61</sup>

The concern at the time about corruption remains a timely reminder to understand governance challenges in the broader context of how development really happens. The Japanese in turn noted what the British advocated for development was not actually how Britain had developed: when the Iwakura Mission of 1871 to 1873 visited Europe and the US to unearth the secrets of modernisation, the Mission's members discovered not only that both technology adaptation and constitutional arrangements mattered, but also that Britain had abandoned protectionism for free trade only after it had achieved industrial leadership and gained the skills that enabled the country to prosper. The Mission summarised for the former samurai warriors now running the Emperor Meiji's government, the challenges Japan faced to catch up with the developed world:

'The strength of a country depends on the prosperity of its people which, in turn, is based on the level of output. To increase output, industrialisation is essential. However, no country has ever initiated the process of industrialisation without official guidance and promotion'.<sup>62</sup>

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<sup>56</sup> Yamamura, K. 1997. *The Economic Emergence of Modern Japan*. Cambridge University Press.

<sup>57</sup> Rathgen, K. 1891. *Japans Volkswirtschaft und Staatshaushalt*, Leipzig. p. 422.

<sup>58</sup> Fukuzawa, Y. 1875 (1932). *Bunmeiron no Gairyaku* (An Outline of a Theory of Civilization). p. 189.

<sup>59</sup> Sugiyama, S. 1988. *Japan's Industrialization in the World Economy 1859-99: Export Trade and Overseas Competition*. The Athlone Press. p. 12.

<sup>60</sup> Przeworski, A. et al. 2000. *Democracy and Development*. Cambridge University Press: shows no conclusive evidence exists that non-democratic regimes are more effective in stimulating growth, and may be less effective at sustaining it.

<sup>61</sup> Japanese Gazette. 1882. *Yokohama*.

<sup>62</sup> Quoted in: Ohno, I. and K. Ohno. 1998. *Japanese Views on Economic Development*. Routledge. p. 7.

The new Japanese government then initiated a century of ambitious vision for growth and reform through political slogans:

- *Shokusan kogyo*            Increase industrial production!
- *Fukoku kyohei*            Rich country, strong military
- *Seisanryoku kakuju*      Expand productive capacity!
- *Yushutsu shinko*        Promote exports!
- *Kanzen koyo*              Full employment
- *Kodo seicho*              High-speed growth

One hundred and ten years later, Deng Xiaoping single-handedly delivered the MDGs in China and proved that ‘politics trumps economics’ when in 1978 he declared: ‘To get rich is glorious’ and thus China’s extraordinary economic growth over the last quarter century got under way. Given Deng’s unique contribution to delivering poverty reduction, perhaps every development agency should display his famous aphorisms that succinctly teach the mix of pragmatic political skills and vision that deliver the MDGs:

- Let some people get rich first.
- ‘Do not debate!’ is one of my inventions.
- It doesn’t matter if a cat is black or white, so long as it catches mice.
- If you want to bring the initiative of the peasants into play, you should give them the power to make money.
- Cross the river by feeling the stones under your feet one at a time.
- Signal left, turn right.

Deng adeptly transformed the Chinese economy while maintaining the authority of the Communist party in the most successful development strategy of all time. Why did he and the Japanese Meiji government before him succeed? What both showed is that economic growth depends on political ideas, leadership, vision and only then the capacity to implement the supporting framework of effective organisation. Too much growth analysis focuses on the components (such as infrastructure) and not the context.

Half a century later, in 1948, the US Occupation authorities in Japan announced nine principles for economic ‘stabilisation’. Joseph Dodge, a Detroit banker sent to enforce these ‘Nine Commandments’, foreshadowing the rigidities of the ‘economics without politics’ of the international financial institutions of the 1980s and early 1990s, interpreted his mission with theological certainty. Dodge quickly curtailed inflation through stringent fiscal discipline, but while cutting off credit and government subsidies, and imposing a budget surplus, he ignored political warnings that such brusque austerity threatened not just a ‘vicious circle of contraction’ undermining Japan’s fragile recovery in industry, but also social stability. The impending atmosphere of political unrest was only averted by the sudden boom resulting from the outbreak of the Korean War in June 1950.<sup>63</sup>

Japan’s Ministry of International Trade and Industry (MITI) established after 1945, inherited the administrative structures and political mindset from the wartime planned economy – but it now focused on trade not military might. MITI played a politically as well as administratively important role in state-led development until the 1970s.<sup>64</sup> MITI

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<sup>63</sup> Dower, J. 1999. *Embracing Defeat: Japan in the Aftermath of World War II*. Penguin Books Ltd. pp. 40–41. The parallel with the ‘Washington Consensus’ needs to be qualified by a different context, for Dodge also established an undervalued yen exchange rate to stimulate exports; and created the Ministry of International Trade and Industry (MITI).

<sup>64</sup> Johnson, C. 1982. *MITI and the Japanese Miracle*. Stanford University Press.

coordinated the Japanese industries' technology upgrading enabling licenses to be secured at low cost and generally made available. MITI also collected information on finding new sources of raw materials and new markets – critical in the post-war years for overcoming the structural problems caused by the loss of its colonies, Manchuria, Taiwan and Korea. MITI's economic planning developed not just national economic vision, coordination and collaboration but also promoted effective domestic competition: the 'iron triangle' of politicians, bureaucrats and private sector achieved not just exchange of information but, in setting and enforcing targets, developed competitiveness through closing down failure. Infant industries were protected: leading industries like car manufacturing would probably never have emerged without the protectionism of the 1950s and 60s. National savings and banks allowed for the provision of cheap targeted credit coordinated with Japan's Development and Export Banks; foreign exchange controls allowed exemptions for key imports, and subsidies through cheap credit, and targeted tariffs, reducing business risk. From the mid-1970s a much larger and more diverse Japanese economy made the complexity of MITI's role and its added value less certain. Success was not necessarily obvious: in the early 1960s in preparation for opening up more to international trade, MITI tried to push through the Japanese parliament a 'Special Measures Law for the Promotion of Designated Industries' (*Tokutei-sangyo-shinko Rinji-sochi-hou*) to formally enshrine 'industrial policy' (the broad range of state strategic interventions supporting economic development) but in the face of fierce political opposition had to abandon the legislation and work instead through a system of informal 'administrative guidance' (*gyosei shido*).<sup>65</sup>

In the early 1990s when the Japanese economy was still booming and the US felt in retreat politically and economically, much attention was devoted by the World Bank (thanks in part to strong Japanese lobbying and its then rising International Development Association (IDA) funding contribution) to learning from the East Asian experience, most notably the World Bank report of 1993 *The East Asian Economic Miracle* and supporting studies on how Japan had led the region (the 'flying geese' phenomenon) in creating 'Communism that Works': high growth with equity. 'The East Asian Miracle' emphasised the overriding importance of prudent macroeconomic management and resulting macroeconomic stability as an indispensable precondition for economic growth in general and external sector development in particular. It also acknowledges the importance of selective interventions, characterising export promotion as 'a winning mix of fundamentals and interventions.'<sup>66</sup> The end of the Cold War provoked a considerable surge of interest in possible lessons for developing countries in this 'unorthodox' route to development. Japan and East Asia suggested a key role for some form of 'industrial policy' that, when done right, showed how the state not just markets really did shape effective economic development. The post-1945 state-led reconstruction of the Japanese economy had been attained through 'a greater centralisation of economic authority than had been achieved at the peak of Japan's mobilisation for war'.<sup>67</sup> Japanese post-war recovery and the subsequent success of East Asia were not built on any unique set of guiding principles or on any institutional arrangements.<sup>68</sup>

But the subsequent collapse of Japan's 'Bubble economy' and the following decade of economic malaise, along with the Asian financial crisis of 1997–8, caused an abrupt lessening of attention to what Japanese experience and ideas had to offer the international

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<sup>65</sup> Johnson, C. 1982. MITI and the Japanese Miracle. Stanford University Press . pp. 310–312.

<sup>66</sup> World Bank, 1993: p. 22.

<sup>67</sup> Dower, J. 1999. *Embracing Defeat: Japan in the Wake of World War II*. W.W. Norton & Company, New York. p. 544.

<sup>68</sup> S. Haggard, S. 2004. 'Institutions and Growth in East Asia'. *Studies in Comparative International Development*. Vol. 38. pp. 53–81.

development community. This was unfortunate not least because those studies paid scant or inadequate attention to the importance of governance, a topic in itself then more focused on technocratic intervention than on learning the lessons of politics and historical experience. The USSR's rapid industrialisation during the 1930s, seemingly achieved as a result of the dominant role played by the state, shaped development thinking after the Second World War for a generation. Development in the 1960s and 1970s focused on 'market failure', the need for a 'big push' to overcome the funding gap in the public and private capital flows needed to stimulate the growth take-off in developing countries – origins of the continuing development target of 0.7%.<sup>69</sup> The obvious post-colonial development tragedy of much of Africa and South Asia fixed attention on 'government failure' as the primary focus of constraint on economic growth:

‘the critics who propose replacing the market system by political decisions rarely address themselves to such crucial matters as the concentration of economic power in political hands, the implications of restriction of choice, the objectives of politicians and administrators, and the quality and extent of knowledge in a society and its methods of transmission.’<sup>70</sup>

The half century since Ghana's independence in 1957, of poor economic growth across much of Africa shaped by four disastrous governance 'syndromes': 'state controls' distorted prices and resource allocation; 'adverse redistribution' or politically-driven ethnic or regional expenditure engineered solely to hold on to power; 'inter-temporally unsustainable spending' or boom and bust public finances; and 'state breakdown' when coups d'état and collapse of the political process led to violence. Combined, these often created a 'reversal of fortune' – growth leaders in the 1960s had by 2000 become growth laggards (e.g. Côte d'Ivoire, Gabon, Kenya, South Africa, Togo, and Zambia). Conversely, several early laggards became growth leaders as of the 1990s (e.g. Benin, Burkina Faso, Ghana, Senegal, and Sudan).<sup>71</sup> The World Bank's Berg report 1981 'Accelerated Development in Sub-Saharan Africa: An Agenda for Action' was a turning-point in interpreting economic underdevelopment caused by excessive regulation, inefficiency and government corruption, advocating a minimalist role for the state balanced by market-led development. Botswana offered a rare but telling African success story of economic growth through clear political leadership and national purpose, seizing opportunities as they arose.<sup>72</sup>

The general development failings of governments across Africa, along with much of Latin America and South Asia, contrasted sharply with the experience of East Asia. Development experts in the early 1960s regarded countries like South Korea and Taiwan as having a far more economically problematic future than newly independent Kenya or Ghana. The total inaccuracy of so much growth diagnostics then as now lay in a limited understanding not just of government capacities but more importantly of the political intentions critical for sustained economic success.

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<sup>69</sup> Clemens, M and T. Moss. 2005. 'Ghost of 0.7%: Origins and Relevance of the International Aid Target'. *Center for Global Development Working Paper No. 68*.

<sup>70</sup> Bauer, P. 1984. *Reality and Rhetoric*. Harvard University Press. p. 21.

<sup>71</sup> Azam, J-P. et al. 2007. *The Political Economy of African Economic Growth*. Cambridge University Press.

<sup>72</sup> Auty, R. (ed.). 2001. *Resource Abundance and Economic Development*. Oxford University Press.

## Chapter 4: The ‘dialogue of the deaf’ on industrial policy

The debate over ‘market’ or ‘government’ failure posits a false dichotomy: effective development is ‘a synergy between state action and market functioning’.<sup>73</sup> Adam Smith had recognised that, noting that besides defence and justice, the state must also supply public works and public institutions

‘which it can never be for the interest of any individual, or small number of individuals to maintain because the profit could never repay the expense to any individual or small number of individuals . . .’<sup>74</sup>

Yet exactly what form or function these governance capabilities and political systems need to take to transform an economy into high, sustainable growth is far from clear: state-led development has been highly effective in both authoritarian (e.g. Korea, Taiwan, and apartheid South Africa) and democratic (e.g. the Indian state of Kerala, Mauritius, and Costa Rica) regimes, but nothing is worse for sustainable economic growth than state-led development led by an anti-developmental state. The result has been a ‘dialogue of the deaf’ using selective evidence to assert ‘market failure’ or ‘government failure’ while ignoring politics and giving short shrift to history.

Successful development has always included some state manipulation of economic incentives. All developed countries became rich on the basis of policies contrary to the strict prescriptions of free market and free trade. Alexander Hamilton, the first United States Secretary of the Treasury, in his *Reports of the Secretary of the Treasury on the Subject of Manufacture* (1791), set out the infant industry argument: new industries that could soon become internationally competitive would not be started unless the initial losses were guaranteed by government aid. This approach dominated US thinking up until the mid-20th century. Besides tariff protection, the US government promoted economic development through agricultural research, granting government land to agricultural colleges, establishing government research institutes, investing in public education, and post-war defence-related Research and Development spending with enormous spill-over effects. Throughout the 19th century the Americans made no effort to protect foreign copyrights. Only after the Second World War, with its industrial supremacy unchallenged, did the US liberalise trade (although not as unequivocally as Britain did in the mid-19th century) and started championing the cause of free trade.<sup>75</sup>

In 1841, the German economist Friedrich List criticised Britain for preaching free trade to other countries only after achieving its own economic development through high tariffs and extensive subsidies. He accused the British of ‘kicking away the ladder’ that they had climbed to reach global competitiveness:

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<sup>73</sup> Lange, M. and D. Rueschemeyer (eds). 2005. *States and Development 2005*. Palgrave Macmillan. p. 240.

<sup>74</sup> Smith, A. 1776. *Wealth of Nations*. p. 688.

<sup>75</sup> Chang, H-J. 2001. ‘Infant Industry Promotion in Historical Perspective – A Rope to Hang Oneself or a Ladder to Climb With?’ *ECLAC paper*. p. 23.

‘[i]t is a very common clever device that when anyone has attained the summit of greatness, he kicks away the ladder by which he has climbed up, in order to deprive others of the means of climbing up after him.’<sup>76</sup>

Infant industry protection was necessary at early stages of industrialisation to protect nascent manufacturing capability; free trade was only fully possible when all countries were equally industrialised:

‘between two advanced nations, a free competition must necessarily be advantageous to both if they were upon the same level of industrial progress; and that a nation unhappily far behind as to industry, commerce and navigation must above everything put forth all its strength to sustain a struggle with nations already in advance’.<sup>77</sup>

Debate on the ‘proactive state’ in relation to the trade and industry policies of developing countries focuses on the economics, yet political governance is the critical factor in success or failure: only governments can address political risk. Industrial policy advocates can point to plenty of success stories across Asia – from Japan under the Meiji government of the second half of the 19th century, to continuing state-structured economic transformation still leading the unprecedented growth in China and Vietnam today. Neoclassical economists often feel intellectually required to deny this, seeking instead to prove that East Asia ‘got it right from the wrong reasons’, doubting that governments can improve upon market outcomes given initial information and incentive problems.<sup>78</sup> So the ‘theological’ camps concerned with belief systems more than evidence can be divided into two camps:

- Atheists question the efficacy of state policies, arguing away the East Asian success; that it would either have happened anyway or did not matter, and that outside the East Asian context, industrial policy invariably failed ending up as an inward-looking policy with import-substitution along with open-ended interventions and protectionism.<sup>79</sup> A variant of this is the bizarre assertion presented to the current United Nations Growth Commission that East Asia ‘got it right for the wrong reasons’.<sup>80</sup>
- Agnostics argue that East Asia only really saw modest gains from industrial policy, that it already had the seeds of success with high standards of bureaucracy, health and education, and that, given the high risk of rent-seeking and other potentially adverse effects, developing countries ‘should be exceptionally cautious before embarking on such policies’.<sup>81</sup> This line of argument asserts that in the new era of World Trade Organization (WTO) and globalisation, the context and ‘rules of the game’ have completely changed: ‘the role of activist industrial policies is still

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<sup>76</sup> List continued: ‘Any nation which ... has raised her manufacturing power and her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than *to throw away these ladders* of her greatness, to preach to other nations the benefits of free trade, and to declare in penitent tones that she has hitherto wandered in the paths of error, and has now for the first time succeeded in discovering the truth’. Friedrich List. 1841. *The National System of Political Economy*, translated in 1885. London. pp. 295–6; see H-J. Chang. 2002. *Kicking Away the Ladder – Development Strategy in Historical Perspective*. Anthem Press.

<sup>77</sup> Op cit, p.v, quoted in M. Shafaedin. 2000. *What Did List Actually Say?* UNCTAD.

<sup>78</sup> Weder, B. 1999. *Model, Myth or Miracle? Reassessing the Role of Governments in the East Asian Experience*. United Nations University Press.

<sup>79</sup> For example, Krueger, A. 1990. ‘Government Failure in Development’. *The Journal of Economic Perspective*. Vol. 4. No. 3. pp. 9–23.

<sup>80</sup> Meeting report 2006.

<sup>81</sup> Pack, H. 2000. ‘Industrial Policy: Growth Elixir or Poison’. *World Bank Research Observer*. February 2000. Volume 15. Issue 1. p. 64.

controversial but is likely to have been important<sup>82</sup> in the past but is no longer feasible under different circumstances.

- True Believers point to the ‘East Asian Miracle’ and seek to explain how industrial policy elsewhere usually failed to conform to the Asian experience:<sup>83</sup> ‘industrial policy ... is an imperative. The idea that the government can disengage from specific policies and just focus on providing broad-based support to all activities in a sector neutral way is an illusion based on the disregard for the specificity and complexity of the requisite publicly provided inputs or capabilities.’<sup>84</sup>

These entrenched positions in economic belief systems have obscured the importance of variations in the governance dimension as the key determinant: the balance between political structures and administrative capabilities that produce development outcomes. ‘Institutional arrangements’ across East Asia were highly varied;<sup>85</sup> but the political determination to overcome external and domestic threats was a universal characteristic. Overcoming the apathy of aid dependence perhaps always requires government stimulus to the private sector to seize opportunities. Japan did this twice: the First World War and the Korean War offered the nascent Japanese private sector, along with low wages, unprecedented opportunities to exploit the learning gained from an industrial policy that narrowed the productivity gap.

Effective industrial policy principles are surprisingly clear: government support to the private sector that is always time-bound, and assessed by transparent performance criteria (often linked to export orientation that provides market discipline through learning about international competitiveness, as well as access to bigger markets); a concern to promote innovation and technological upgrading; fostering of efficient local linkages; co-ordination of public and private initiatives; and flexibility in adapting policy instruments to changing circumstances.<sup>86</sup> Industrial policy is not about ‘picking winners’<sup>87</sup> but ‘as a process whereby the state and the private sector jointly arrive at diagnoses about the sources of blockage in new economic activities and propose solutions to them.’<sup>88</sup> It is an ‘action science’, learning by doing, including how to recognise and then close down failure. Industrialisation in developing countries involves high risks because learning can be costly with uncertain returns. The state, in the early stages of development, needs to foster entrepreneurship through promoting technological and marketing knowledge; developing a shared vision of the future; creating a willingness to take calculated risks; and having the ability to raise capital – all in ways that promote rather than thwart the development of private entrepreneurship.<sup>89</sup>

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<sup>82</sup> World Bank. 2005. *Lessons from a Decade of Reform*. p. 83.

<sup>83</sup> Rodrik, D. 2004. ‘Industrial policy for the twenty-first century’. *Discussion Paper*. No. 4767. Centre for Economic Policy Research.

<sup>84</sup> Hausmann, R. and D. Rodrik. 2006. *Doomed to Choose: Industrial Policy as Predicament*. Harvard University Press.

<sup>85</sup> Haggard, S. 2004. ‘Institutions and Growth in East Asia’. *Studies in Comparative International Development*. Vol. 38. pp. 53–81.

<sup>86</sup> Amsden, A. 1989. *Asia’s Next Giant: South Korea and Late Industrialisation*. Oxford University Press; R. Wade. 1990. *Governing the Market*. Princeton University Press; and P. Evans. 1995. *Embedded Autonomy: States and Industrial Transformation*. Princeton University Press.

<sup>87</sup> ‘The governments of Taiwan, Korea and Japan have not so much picked winners as made them’: R. Wade. 1990. *Governing the Market*. Princeton University Press. p. 334.

<sup>88</sup> Rodrik, D. 2004. *Industrial Development*. Harvard University. p. 24.

<sup>89</sup> Stiglitz, J. 1996. *The World Bank Research Observer*. Vol. 11, No. 2.



Successful industrial policy can support private sector innovation through a process of rewards and constraints to support efforts to import and develop new technologies to work under local conditions (including protecting property rights); to offer educational facilities which promote appropriate technology and vocational training that support international competitiveness through diversification and technological upgrading; and enforcement of performance criteria using the disciplines of the international market. Time-bound subsidies to investment in new goods or production only work if the political determination exists for closing down failure before it becomes a vested interest – the political and administrative capacity to do this was one of the major achievements of East Asia.<sup>90</sup>

East Asia's 'iron triangle' of political, bureaucratic, and business consultation and collaboration was built on 'embedded autonomy'. A meritocratic bureaucracy's capacity to manage the institutionalised dialogue between ministries, industry associations and research institutions without 'capture' and distorting rampant corruption presents many major governance challenges. At the same time some 'infant industry' will not develop without import protection or support for domestic sales; and the start-up costs in some strategic industries (previously military under 'blood and iron' nationalism; but also long-term technological significance for modern globalised economy conditions) do require state support to survive. The post-Second World War patent system in Japan was specifically 'designed to promote technological catch-up and diffusion through incremental innovation.'<sup>91</sup> Cartels have often been instrumental in establishing an industry and then creating the international competitiveness needed to allow gradual opening up: the continuing success of Swiss banking can be traced to the creation of the Swiss Banker's Association in 1912 that, in acting as a cartel in the Swiss banking sector, was instrumental in the emergence of the Swiss financial centre.<sup>92</sup> In Switzerland, the absence of a patent law throughout the 19th century has been identified as one way that Swiss companies 'caught up' in new areas such as the chemicals industry. The patent law finally enacted in 1888 ('the most incomplete and selective patent law ever enacted in modern times'<sup>93</sup>) was simply designed to serve the vested interests of watch-makers.<sup>94</sup> Effective intellectual property rights protection appears to reduce the number of competitive sectors in which to innovate, perversely increasing the possibility of duplication of innovation, thereby hindering growth.<sup>95</sup>

Yet much of the policy advice given to developing countries is based on the OECD model of the liberal economic 'regulating state', able to define the relative responsibilities of business and government, maintain a meritocratic bureaucracy while providing macroeconomic stability and encouraging savings and investment. The political and capacity underpinnings to achieve these ends may simply not exist in many developing country contexts where the 'state' has a very different historical role and social fabric. At

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<sup>90</sup> Harrold, P. et al. 1996. 'Practical Lessons for Africa from East Asia in Industrial and Trade Policies'. *World Bank Discussion Paper*; Court, J. et al. 2003. *Asia and Africa in the Global Economy*. United Nations University Press.

<sup>91</sup> Maskus, K. et al. 1998. *The Impact of the Japanese Patent System on Productivity Growth*. Working Paper No. 99-01. Center for Economic Analysis, Department of Economics, University of Colorado at Boulder.

<sup>92</sup> David, T. et al. 2006. 'Institutions and Economic Growth: The Successful Experience of Switzerland (1870–1950)'. *WIDER Research Paper* No. 2006/101, p. 12.

<sup>93</sup> Schiff, E. 1971. *Industrialization without National Patents. The Netherlands, 1869–1912 and Switzerland, 1850–1907*. Princeton University Press. p. 93.

<sup>94</sup> David, T. et al. 'Institutions and Economic Growth: The Successful Experience of Switzerland (1870–1950)'. *WIDER Research Paper* No. 2006/101

<sup>95</sup> Horii, R. and T. Iwaisako. 2005. *Economic Growth with Imperfect Protection of Intellectual Property Rights*. Osaka.

different economic, social and political levels of development, different strategies and institutions are needed to support them and to kick-start and then maintain growth. The Korean government during its high growth years of the 1960s and 1970s could punish violation of foreign exchange controls with the death penalty. Many African states are built on 'neopatrimonial' networks of feudal patronage.<sup>96</sup> As market forces appear inadequate to deliver development, many developing countries with the aid of the United Nations Conference on Trade and Development (UNCTAD) and the United Nations Industrial Development Organization (UNIDO) have been reconsidering the use of proactive trade and industrial policies in their development strategies. 'There is no shortage of methods that can be used by less industrialised countries to promote their industries even under new WTO laws.'<sup>97</sup> These include promoting manufacturing by advancing science and technology through performance standards, and subsidising research and development, regional development and environmental protection. WTO rules still allow countries to protect specific industries threatened by a surge in imports (for up to eight years) and to protect against all imports if jeopardising balance of payments (for an indeterminate time period). 'The problems bedevilling latecomers today are not formal legal constraints but informal political pressures exerted by North Atlantic economies in favour of radical market opening. Latecomers lack a vision to guide them in responding to this pressure,' especially a politically supported vision grounded in relevant science and technology.<sup>98</sup>

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<sup>96</sup> Chabal, P. and J-P. Daloz. 1999. *Africa Works: Disorder As Political Instrument (African Issues)*. Indiana University Press.

<sup>97</sup> [http://www.unctad.org/en/docs/ux\\_tdxrt1d7.en.pdf](http://www.unctad.org/en/docs/ux_tdxrt1d7.en.pdf) [accessed 18 March 2008]

<sup>98</sup> Amsden, A. and T. Hikino. 2000. 'The Bark Is Worse Than the Bite: New WTO Law and Late Industrialization'. *The Annals of the American Academy of Political and Social Science*. Vol. 570. No. 1. pp. 104–114.

## Chapter 5: Beyond ‘political economy without politics’

The industrial policy debate has been ‘political economy without the politics’.<sup>99</sup> Industrial policy can be compared to venture capital: a successful portfolio depends on the skill (political as well as professional, at the national level) to back enough ‘winners’ and contain losses on losers. Focus must be on promoting international competitiveness, either through government support for overcoming specific externalities (research, training, product innovation and risk-taking), or for developing sectors identified as providing a dynamic comparative advantage.<sup>100</sup> These policies require effective state bureaucracies recruited on merit and motivated by competitive salaries, a transparent internal promotion process and career stability.<sup>101</sup> The attributes of the political systems that can consistently deliver these capabilities is much less certain.<sup>102</sup> Political context is central to successful economic growth of which industrial policy is one element: clear political leadership, vision and enough consensus to maintain long-term development goals is essential. How this is achieved is understood generally only in retrospect. The ‘Closed economy’ industrial policy of import substitution based on tariffs and import controls, is politically easier to maintain and politically damaging to abandon because the real costs are not transparent. The different politics of ‘open economy’ industrial policy, controlled through export subsidies and tax breaks, is that the cost is more evident and so may be politically easier to change or drop. Export subsidies are measured against performance and therefore stimulate private sector effort.<sup>103</sup> ‘Open economy’ export incentives appear to generate new entrepreneurial classes rather than be captured by traditional interests – a process currently underway in the Dominican Republic, for instance.<sup>104</sup>

Successful high-growth states have all shared a political imperative to deliver growth, and have developed the capacity to deliver this effectively through pressure from a determined leadership, political vision on the necessity of economic growth, and a sense of national purpose that shared prosperity underpins political stability. The governance of how this delivered essential prerequisites to growth (macroeconomic stability, high savings, agricultural improvements, and investment in human capital) remains valid for growth strategies today in very different low-income contexts in Africa and elsewhere: the political intent to support growth dynamics: ‘East Asian governments have explicitly taken the attitude that what is good for the private sector is also good for them (in terms of taxes, public welfare, economic growth, etc.). Therefore, the role of the state with respect to the private sector is to do everything necessary to ensure the sector’s success, and to work with the representatives of the private sector to design government policies accordingly. When governments see their own survival in these terms, the approach to the private sector is quite different. This cannot be imposed on or required of African governments. It can merely be pointed out that this is the situation in successful countries’.<sup>105</sup>

<sup>99</sup> Venables, T. et al. 2007. *Industrial Clusters and Innovation Systems in Africa*. Tokyo.

<sup>100</sup> Lall, S. and J. Weiss. 2004. ‘People’s Republic of China’s Competitive Threat to Latin America: an Analysis for 1990–2002’. *ADB Institute Discussion Paper 14*.

<sup>101</sup> Rauch, J. and P. Evans. 2000. ‘Bureaucratic Structure and Bureaucratic Performance in Less Developed Countries’. *Journal of Public Economics* 75. pp. 49–71.

<sup>102</sup> Khan, M. 1999. ‘The Political Economy of Industrial Policy in Pakistan 1947–1971’. *Department of Economics Working Paper* No. 98. School of Oriental and African Studies.

<sup>103</sup> Schrank, A. and M. Kurtz. 2005. ‘Open Economy Industrial Policy’. *Politics and Society*. Vol. 33. pp. 671–702.

<sup>104</sup> Schrank, A. 2005. ‘Entrepreneurship, Export Diversification, and Economic Reform: The Birth of a ‘Developmental Community’ in the Dominican Republic’. *Comparative Politics* 38 (October).

<sup>105</sup> Harrold, P. et al. 1996. *Practical Lessons for Africa from East Asia in Industrial and Trade Policies*. The World Bank: suggests six areas for attention in Africa: the development of training financing;

Politics is missing from the surveys and reviews of successful industrial policy in East Asia (e.g. Hernandez, 2004), so that the explanations of failure elsewhere and comparisons between Asia, Africa and Latin America are not convincing.

*Political leadership over inequality and productivity:* in Japan and Singapore for example, productivity councils secured labour collaboration in part through offering job security (at least in large companies, therefore encouraging the success of ‘quality circles’ as innovation, did not threaten jobs), but also by ensuring compressed inequality (e.g. the boss should not earn more than ten times the lowest paid in the organisation). This may explain why productivity councils, when copied to other contexts like the Philippines, Tanzania or Barbados, have had limited impact.

*Why has Nigeria’s industrial policy failed and China’s succeeded?* From independence in 1960, Nigeria has pursued state-led development with no success. In 1980, the Federal Ministry of Industry published the first formal industrial policy of Nigeria – a document that was updated in 1989 and 2003 with no evidence of any tangible impact. The 2003 Policy, reviewing the 1960s, states:

‘the country lacked the political will to execute formulated policies, the supportive enabling investment climate, technological and managerial capability; and infrastructural facilities to attract investments and sustain industrial growth.’

*Has anything changed?* Can the private sector really trust the political system’s credibility in its stated commitment to sustaining growth? From its colonial roots, Nigeria’s ‘neopatrimonial state’ has consistently lacked the sense of national purpose – nationalist vision, political incentives and organisation capabilities – to promote the image of the country as a ‘developmental state’.<sup>106</sup>

By contrast, China’s political leadership has reinforced its central authority by supporting state planning along earlier East Asian lines, modernising science and technology (science parks and national research and development projects, tax breaks and subsidised credit, for example, Beijing’s ‘silicon Valley’ established in late 1980s) and setting clear performance targets for continuing government support (based on the allocation of retained earnings and the following percentages: technology personnel; new product sales; and products exported).<sup>107</sup> At the 15th Party Conference in 1997, President Jiang Zemin described the government’s determination to transform the state-owned sector into globally competitive ‘highly competitive large enterprise groups’:

‘The state-owned sector must be in a dominant position in major industries and key areas that concern the life-blood of the national economy .... we shall effectuate a strategic reorganisation of state-owned enterprises ... China will establish highly competitive large enterprise groups with trans-regional, inter-trade, cross-ownership and trans-national operations.’<sup>108</sup>

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technical assistance for enterprises; the development of simple duty exemption schemes; export credit support; public-private training; and the development of industrial/export processing zones.

<sup>106</sup> Kohli, A. 2004. *State-Directed Development*. Cambridge University Press.

<sup>107</sup> Lu, Q. 1997. *Innovation and Organization: The Rise of New Science and Technology Enterprises in China*. Harvard. p. 235.

<sup>108</sup> Guest, P. et al. 2006. *How has China’s ‘National Team’ of enterprises performed?* Cambridge.

In the first half of the 1990s, the potential of the Chinese industry to mount a competitive challenge to Western aircraft builders was largely discounted. Today, China's international competitiveness in this field is taken seriously. Since the late 1970s, China has boomed, ignoring much of the orthodox structural reform agenda, while countries that stuck to it under donor and international financial institution (IFI) pressure in Africa and Latin America have fared less well. This has highlighted that economic growth lies in political leadership that is able to make the institutional innovations that are country-specific, and that come out of local knowledge and experimentation, primarily targeted on domestic investors and are tailored to domestic realities but disciplined by international competitiveness.<sup>109</sup>

*Sense of National Purpose:* Growth happens when the legitimacy of the state depends on its ability to deliver continuing economic development. The politics of economic growth by legitimating contentious policy and motivating individuals and social groups behind a shared vision of long-term development, is the least understood dimension to development. Successful 'late developers' have almost all experienced some 'political settlement' around elites' use of nationalism and the politics of economic growth to ensure social cohesion, although Japan's case has perhaps been the most extreme example of the struggle of a modernising state to encourage prosperity rather than violence:

'When the country was facing a strong external challenge, such as total war, economic survival, or liberalisation, national interest was often asserted strategically to reduce domestic conflicts. The shared sense of national crisis had been an important political foundation allowing competing parties to work out a solution to their domestic disputes.'<sup>110</sup>

State legitimacy matters for economic growth. The most economically successful African states, such as Botswana, are also the continent's most legitimate, so their political leaders do not need to maintain political power at the expense of development. State legitimacy in Africa is estimated to be worth 2.5% annual growth.<sup>111</sup> Economic nationalism has played an important role in economic development in all successful development. Bismarck's development ideology of 'Blood and Iron' was picked up and adopted by Meiji Japan under the slogan '*Fukoku kyohai*' (Rich country, Strong Military). The link to the military development of the state is shown across the world. From 1948 to the early 1980s, Israel's economic development, driven by the political ambition for a strong state, fostered the emergence of an indigenous capitalist class by encouraging the growth of private capital through key conglomerates initially tied to the state.<sup>112</sup> In the 1960s, nationalism was a strong force in South Korea's slogan: 'defeat communism and achieve unification', and in Taiwan's: 'retake the mainland'.

The primary function of government, to create an inclusive polity, is greatly complicated in societies like Nigeria with significant deep ethnic divisions. Type of regime – democracy or autocratic rule – is not the decisive factor.<sup>113</sup> Economic growth threatens to upset the 'political settlement' on which inter-ethnic collaboration may depend. Malaysia's 'Vision 2020' for achieving developed country status depends on a political settlement by which

<sup>109</sup> Birdsall, N., D. Rodrik, et al. 2005. *If Rich Governments Really Cared About Development*. pp. 9–10.

<sup>110</sup> Gao, B. 1997. *Economic Ideology and Japanese Industrial Policy*. Cambridge University Press. p. 295.

<sup>111</sup> Englebert, P. 2002. *State Legitimacy and Development in Africa*. Lynne Rienner.

<sup>112</sup> Hanieh, A. 2003. 'From State-led Growth to Globalization: the Evolution of Israeli Capitalism'. *Journal of Palestine Studies*. Vol. 32, No. 4, pp. 5–21.

<sup>113</sup> Przeworski, A. et al. 2000. *Democracy and Development: Political Institutions and Well-Being in the World, 1950–1990*. Cambridge University Press.

the Chinese and Indian populations that dominate the private sector are politically supported in return for growth funding the majority Malay population's social welfare and economic empowerment. National unity requires attention to equity and social cohesion through shared growth that purchases political support for the social transformation of rapid industrialisation and economic growth. Company-based trade unions were a notable feature of labour relations in Japan, Korea, Taiwan and Malaysia. Providing decent housing for low-income households was, for example, a deliberate strategy for buying political support from growth in Singapore and Hong Kong; the Housing and Development Board of the Ministry of National Development in Singapore is credited with creating a social inclusion that supported the government's development objectives through prioritising good public housing projects with ethnic quotas to prevent social polarisation.<sup>114</sup>

*In all of East Asia high-growth countries, inequality fell as incomes rose:* 'Labour has been compensated for its decreased political role through wage policies tied to increases in productivity'<sup>115</sup>. Finland's economic development after its independence from a poor, vulnerable and conflict-prone country to a modern economy with model Nordic democratic institutions was the result of a post-Civil War political consensus around the country's need for policies that delivered both growth and equity, such as land reform and compulsory schooling.<sup>116</sup> The politics of shared growth was less obvious in other high growth countries such as Gabon or Botswana, but these are small and non-industrialised economies with a strong political class: 'the political stumbling blocks to beneficial institutional change in many poor countries may have more to do with distributive conflicts and asymmetries in bargaining power.'<sup>117</sup> By contrast Nigeria's repeated call for a 'national ideology' legitimising the status quo is found in 'development' that does not threaten the existing political settlement.<sup>118</sup> As the World Bank notes:

'Even in a democratic system, the crystallisation of politics based on economic interests takes time. In Africa, most politics are regionally, ethnically, or personality based. It takes the rise of a middle class to move toward economics-oriented politics. But without such politics, it is less likely that political decisions will be oriented toward rapid economic growth and the development of the middle class. It is critical to strengthen those institutions which promote voice and accountability, and those institutions which speak for an indigenous, export-oriented private sector.'<sup>119</sup>

*Political leadership:* to pursue growth requires far-sighted individuals capable of building up the political coalition and administrative competence to deliver the long-term public goods necessary for economic growth: security, infrastructure, a culture of entrepreneurship, strong macro-economy and international competitiveness. A major ambition for development must be to understand better when and how political leadership pursues sensible growth strategies because of political competition (whether 'democratic' or 'authoritarian' systems). While effective political good leadership of the growth process may depend on happenstance, the political climate that throws up effective leaders is

<sup>114</sup> Chua, B-H. 1997. 'Political Legitimacy and Housing: Stakeholding in Singapore'. *Housing Theory and Society*. Vol.18. p. 93.

<sup>115</sup> Johnson, C. 1982. *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975*. Stanford University Press. p. 151.

<sup>116</sup> Jäntti, M. , J. Saari, and J. Vartiainen. 2005. *Growth and equity in Finland*. WDR 2006 background paper.

<sup>117</sup> Bardhan, P. (2005: 27). Inequality is remarkably high and has been practically unchanged since independence in Botswana, with a GINI index comparable to countries like Sierra Leone or Angola.

<sup>118</sup> Williams, G. 1977. 'Class Relations in a Neo-Colony: The Case of Nigeria', in P. Gutkind and P. Waterman (eds). *African Social Studies: A Radical Reader*. Heinemann. p. 286.

<sup>119</sup> World Bank. 2007. *Challenges of African Growth*. p. 163.

shaped by political competition, transparency and accountability – to emerge and be sustained.<sup>120</sup> There is also an increasing phenomenon of ‘the emergence of MBA politicians [politicians with a Master of Business Administration degree (MBA)] who are focused on improving the productivity of the private sector’.<sup>121</sup>

*Political vision for growth:* ideas or ideologies create social cohesion and provide legitimacy for supporting growth. In 1721 the shogun had passed the ‘Law against New Items’ with the state purpose ‘to ensure that absolutely no new types of products should be manufactured.’<sup>122</sup> By the end of the Tokugawa era however, traditional Confucian hostility to economic growth as the main source of national wealth, power and prestige was gradually abandoned, an ideological transformation embraced by the architects of the Meiji Restoration that made modern capitalism politically feasible in Japan.<sup>123</sup> Similar shifts are needed in many developing countries:

‘There are some countries in the world where there are political leaders with sufficient self-confidence and political commitment that they are developing their own vision of how to develop. However, that is not happening in other countries. The main issue in economic growth today is not necessarily that views are changing that much in Washington but to what extent countries are taking their own futures into their own hands.’<sup>124</sup>

Bureaucratic competence can only be improved by actively seeking to learn ‘what really works’ by identifying and implementing policy effectively: politics shapes economic growth, through the way that regime type, political instability, state institutions, economic inequality, and ethnic divisions influence economic growth dynamics. Policies come between politics and growth through ‘state institutional quality’,<sup>125</sup> but how, depends on the political process. Trade policy, exchange rate policy, budgetary policy, tax policy, monetary policy, general growth policy, price policy and investment policy all affect economic growth dynamics, and politicians, elites, political parties, parliament, the private sector, interest groups, the bureaucracy, and the media all have their own vested interests. Actively learning to manage policies is required to develop competences: the capacity to experiment has been a key dimension to China’s economic success; South Korean officials were being trained by Pakistan in the 1960s.

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<sup>120</sup> Glaeser, E. et al. 2004. Economic growth since the 1960s has to a significant extent been a consequence of having effective leadership, rather than constraints on executive authority for institutionalised credible commitment.

<sup>121</sup> World Bank. 2007. *Challenges of African Growth*. p. 179.

<sup>122</sup> Ramseyer, J. 1996. *Odd Markets in Japanese History: Law and Economic Growth*: Cambridge University Press.

<sup>123</sup> Sagers, J. 2006. *Origins of Japanese Wealth and Power: Reconciling Confucianism and Capitalism, 1830-1885*. Palgrave Macmillan.

<sup>124</sup> Rodrik, D. 2006. ‘Home-Grown Growth Problems and Solutions to Economic Growth’. *Underground Markets*. Vol. 27 (4).

<sup>125</sup> Kriekhaus J. and J. Wells. 2004. *The Politics of Economic Growth: What Do We Know? How Certain Are We?*. Paper presented at the annual meeting of the International Studies Association. March. MIT.

## Chapter 6: What is to be done? Japan's expertise on growth and the UK's on governance

Countries often remain firmly stuck in their own historical experience that culturally determines their 'world view' on 'how development happens'. Japan and the UK, ex-colonial powers on different sides of the world have very different experiences of both governance and growth dynamics. Because of their relative aid budget size and staff competences they have the potential to influence and shape the development agenda; and they matter particularly at the moment owing to the international drive to scaling up aid and improve its effectiveness, for donor harmonisation, alignment and better genuine collaboration. The World Bank's *Economic Growth in the 1990s: Learning from a Decade of Reform* (2005) provides an excellent introductory guide for putting political governance at the centre of economic growth dynamics.

This experience and how to interpret it for the modern development challenge suggests Japan and the UK can offer particularly important complimentary thinking on current ambitions, challenges and opportunities in international development. Modernity may be a Western project, for its two organisational complexes, nation-state and systematic capitalist production, have their roots in the specific characteristics of European history.<sup>126</sup> Japan, as the first non-Western country to succeed in 'mastering development', has an especially important potential voice and credibility with the developing world. Japan has continued to stress economic growth through technology adaptation and infrastructure development, themes otherwise overlooked by much of the rest of the development community until recently. Influential Japanese economists have been prepared to critique the preoccupation of neoclassical economics in Europe and the US with short-run equilibrium – markets as the balance of supply and demand – as only working, like liberal democracy, in the already advanced states, and not in the 'catching up' context of developing countries. The Japanese experience has always made it apparent that 'late developers' need to pay more attention to how the state can actively shape its private sector for international competitiveness.<sup>127</sup>

DFID is making serious efforts to scale up aid aiming to spend 0.7% of GDP on international development. DFID has emerged as one of the leading agencies in the international development community on the topic of governance. The UK's 2006 White Paper, *Eliminating World Poverty: Making Governance Work for Poor People*, emphasised that 'First and foremost, the fight against poverty cannot be won without good governance. We need to help governments and citizens make politics work for the poor'. But although this otherwise excellent document had a chapter on governance and a chapter on growth, it failed adequately to link together these two essential components of development. To do that, DFID must answer the question posed by Japan's first 'White Paper on Economic Development' (Kogyo iken) of 1884:

'Which requirements should be considered as most important in the present efforts of the government in building Japanese industries? It can be neither capital nor laws and regulations because both are dead things in themselves and so totally ineffective. The spirit sets both capital and regulations in motion ... So if we assign weights to these three factors with respect to their effectiveness, the spirit should be assigned five parts, laws and regulations four, and capital no more than one part'.

<sup>126</sup> Giddens, A. 1990. *Consequences of Modernity*. Cambridge: Polity Press.

<sup>127</sup> For example, Murakami. Y. 1996. *An Anticlassical Political Economic Analysis*. Stanford University Press.



Japan is reforming its aid effort, and in 2008 takes on the Presidency of the G8 while hosting the Tokyo International Conference on African Development (TICAD). Facing fiscal problems and comparatively under-developed civil society interest in international development, it needs international support for its vision and potential to shape the international development agenda. Yet Japan has much to offer. It deserves praise for steadfastly focusing on low-profile objectives of growth through for example delivering on the need for proper infrastructure, which only now after many detours, has again become fashionable with other major donors. Japan has been traditionally cautious on governance issues,<sup>128</sup> not least (and very differently from the UK) because development is in its own backyard of Asia where the legacy of its militarism of the 1930s and Second World War create added sensitivities to ‘meddling in internal affairs of other countries’. But Japan has started to become a ‘normal state’ in international relations. Japan has also begun to see its comparative advantage in international development in its effective post-war democracy, delivering economic growth with comparatively high social equity – the ‘good governance’ agenda matched its self-interest as well as the common good.

For many years Japanese development philosophy has been emphasising development as a process of long-term transformation in which local context (initial conditions and stages of development) matter. The Japanese development community shares a strong belief, borne out of Japan’s historical development process, that the role of the state in economic growth is more than just facilitation of market forces, but is to transform the economy in ways that only government authority and capacity to coordinate disparate individual interest makes possible. It is also practical and focused on the real economic challenges of building an adequate infrastructure, developing a country’s industrial structure and creating sustainable employment.

The ambition is a collaborative iterative process by which two major development partners, DFID and JICA, can harness their comparative advantages to find shared objectives for improving aid effectiveness around strengthened governance inputs in growth diagnostics and strategies – recognising that limitations in political leadership, strategic vision and sense of national purpose over economic growth are the universal ‘binding constraint’. Japan is both an advanced industrialised country and, as an Asian ‘late developer’, enjoys close rapport with many developing states. Japan’s economic development model still offers contemporary insights into the importance of the capital formation and technology policies that contributed to Japan’s rapid industrial capitalist growth: self-directed strategies, technological borrowing, taking advantage of shifts in comparative advantage from the product cycle, educational policy, business assistance, financial institutions, transfer of agricultural savings to industry, low wages policy, and foreign-exchange rate policies conducive to export expansion.<sup>129</sup> Japanese development offers an understanding of growth more focused on business than on applying the generalities of economic theory. A recent evaluation of the World Bank’s work on China’s noted that:

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<sup>128</sup> JICA’s 2005 Participatory Development and Good Governance Report of the Aid Study Committee suggested that good governance as the basis for participatory development, has five subcategories of goals including building a market environment.

<sup>129</sup> Nafziger, E. 2005. ‘Meiji Japan as a Model for Africa’s Economic Development’. *African and Asian Studies*. Volume 4. Number 4. pp. 443–464.

‘The terms “global value chain”, “brand”, “core business”, “outsourcing”, “research and development capability”, “the IT revolution”, and “global procurement”, are absent from the World Bank’s publications on enterprise reform’.<sup>130</sup>

Japan also offers excellence in strategic planning for development. This has been applied most strikingly to its support since 1995 of Vietnam’s transition to a market economy. Japan’s National Graduate Institute for Policy Studies (GRIPS) and Vietnamese counterparts jointly developed a practical and comprehensive national growth strategy for macroeconomics, fiscal and monetary policy, industrial policy, and agricultural and rural development. The project has proved immensely valuable both in content and in stimulating economic coordination among key sectors and stakeholders (‘growth coalitions’). Like previous East Asian successes, it used the discipline of commitment to free trade to force improved performance, and as an approach based on self-help, rather than aid dependence. This important project is credited with helping Vietnam continue its rapid economic growth with succumbing to other donor and IFI pressure to adopt a poverty reduction strategy paper (PRSP) approach that would otherwise have made Vietnam’s budget excessively biased toward ‘pro-poor’ expenditures at the cost of economic requirements including infrastructure – a point belatedly conceded by other donors’ and the World Bank’s recent ‘rediscovery’ of the importance of infrastructure for long-term development.<sup>131</sup>

Japan and UK are well placed to promote better growth diagnostics that start from governance challenges, incentives and practical capacity constraints. This begins from the policy debate around the growth components of poverty reduction strategies, to inform donor programmes on growth, underpinned by good diagnostics with an emphasis on implementation of recommendations and monitoring progress. Japanese growth expertise is perhaps uniquely placed to address a major governance question: how much of the form of governance matters to delivering essential governance functions? What institutional arrangements are universal requirements essential for economic growth? What requires local ownership and context specific policy?<sup>132</sup> Are there stages in economic and political development where new institutional arrangements become critical to maintain growth as the key to development? (e.g. China’s plans to introduce a law on property rights in 2007, after nearly three decades of economic growth that has defied the mantra of ‘secure property rights’). This requires bringing politics explicitly into the analysis of the market and not just into the analysis of the state, as political constructs, defined by formal and informal institutions of rights and obligations, whose legitimacy and therefore whose contestability is ultimately determined through political processes. Institutions shape peoples’ political actions given their motivations and perceptions, but only because they influence people’s perceptions of their own interests, of the legitimate boundary of politics,

<sup>130</sup> Nolan, P. 2005. *Evaluation of the World Bank’s Contribution to Chinese Enterprise Reform*. Operations Evaluation Department (OED). p. 13.

<sup>131</sup> Ishikawa, S. 2001. *Enshakkan Kondankai* (Report of the Advisory Committee for ODA Loans); Japanese MFA. 2002. *ODA White Paper*.

<sup>132</sup> Ha-Joon Chang characterises this as: ‘political democracy; an independent judiciary; a professional bureaucracy, ideally with open and flexible recruitments; a small public-enterprise sector, supervised by a politically independent regulator; a developed stock market with rules that facilitate hostile M&A (mergers and acquisitions); a regime of financial regulation that encourages prudence and stability, through things like the politically-independent central bank and the BIS (Bank for International Settlements) capital adequacy ratio; a shareholder-oriented corporate governance system; labour market institutions that guarantee flexibility.’: *Institutional Change and Economic Development*: WIDER. 2007. Ch. 2. p. 4.

and of the appropriate standards of behaviour in politics.<sup>133</sup> DFID is best placed to complement Japanese growth expertise with insight into the politics of growth as well as the institutional dimension of governance – development as building effective political leadership, vision and supporting national consensus on long-term growth tied to social equity.

Japan's experience and approaches to governance with a growth outcome objective should push the IFIs and other key players to do more to make theory and policy fit the facts of Asia's success, through seeking better evidence-based research on what really works, and less choosing facts to fit theory. This requires policy experimentation on what aspects of state leadership, vision, national purpose and technical capabilities can be developed in what local political context and under prevailing WTO global rules, for example through:

- developing national strategies for international competitiveness and export orientation;
- promoting economically literate political leadership and as much attention to the political and economic vision and interests of elites, as central to poverty reduction;
- matching capacity to alleviate the negative aspects of growth – environmental concerns, political and social tensions over the distribution of growth, urbanisation, housing shortages, regional variations in unemployment, as well as a welfare safety-net; and
- improving UNCTAD's organisational effectiveness – the leading international body of expertise in this area but its current impact does not reflect its potential.<sup>134</sup>

To transform, through policy actions, societal relationships into those needed for a market economy, Anglo-Japanese development cooperation with a 'governance for growth' emphasis should actively promote the role of government as providing the political vision for reform to 'catch up'. This should be matched by the capacity to implement it effectively by fostering the following:

- Support for governments to develop their leadership, strategic vision, sense of national purpose and technical capacities through active policy experimentation, 'learning by doing' to promote innovation, entrepreneurship and technological adaptation. 'Governance for growth' suggests some key areas for attention in Africa through infrastructure initiatives like the Infrastructure Consortium for Africa and the New Partnership for Africa's Development's (NEPAD) Infrastructure Project Preparation Facility; and investment climate policy and initiatives like the Investment Climate Facility and the Africa Enterprise Challenge Fund.
- Long-term planning: the wish and capacity to think long-term needs to be taken more seriously – such as by implementation of National Plans of Action produced by countries completing the African Peer Review Mechanism linked to changing expectations, creating political vision beyond the current limitations of most PRSPs, and is also an important potential coordination process in itself, by which political leadership, officials and the private sector need to agree on the obstacles to growth and practical ways to implement reform.
- Mitigation of impacts of growth: 'Economic growth is sustainable only when the opportunities and fruits of growth are perceived to be shared equitably by the standards of that society.'<sup>135</sup>

<sup>133</sup> Chang, H-J. 2001. *Breaking the Mould: An Institutionalist Political Economy Alternative to the Neoliberal Theory of the Market and the State*: United Nations Research Institute for Social Development (UNRISD).

<sup>134</sup> [http://www.unctad.org/en/docs/wpd168\\_en.pdf](http://www.unctad.org/en/docs/wpd168_en.pdf) [accessed 15 March 2008]

<sup>135</sup> Ohno, K. 2002. *East Asian Experience in Economic Development and Cooperation*. National Graduate Institute for Policy Studies. p 5.

- Developing the inter-disciplinary capacity for economists and governance experts to talk a common language.

As Kenichi Ohno has rightly observed:

‘It is not that Japan wants to deny every aspect of the dominant development thinking. In fact, there are many things Japan can learn from it. However, as a non-Western country with different developmental experience of its own, Japan should be able to contribute more to global development thinking through constructive criticism rather than uncritical endorsement. Japan should also offer a dissenting view when Western systems are hastily imposed on a society with an entirely different history and social structure from the West.’<sup>136</sup>

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<sup>136</sup> Ohno, K. 2001. *Global Development Strategy and Japan's ODA Policy*. Tokyo. p 3.