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Winds of Change

The Impact of Globalization on Europe and Asia

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Abstract

There are diverse ideas about governance around the world, and this paper studies them through the following questions: (a) what does the available evidence tell us about the political and institutional requirements for sustained economic growth? (b) What do we need from the state to secure growth? (c) How do a country's internal characteristics support or impede its growth? (d) How does the external environment of a country influence its economic growth prospects? These elements are then put together into a model of growth, from which we derive conclusions about governance arrangements. Thus the paper outlines a simple framework within which to think about the political economy of growth that can be summed up in five points: good government, with secure political conditions; credible macroeconomic stability; savings and investment high enough to sustain adequate growth; openness to the world economy; and the discipline of external engagement. It then argues that the growth model needs to be underpinned by suitable governance arrangements, and suggests that good governance has two main elements, each quite complex in practice, namely: protection of property rights, and accountability of government



"I would suggest that the rate at which countries grow is substantially determined by three things: their ability to integrate with the global economy through trade and investment; their capacity to maintain sustainable government finances and sound money; and their ability to put in place an institutional environment in which contracts can be enforced and property rights can be established. I would challenge anyone to identify a country that has done all three of these things and has not grown at a substantial rate." Larry Summers (2003)

Introduction

What are the political requirements for a country to achieve successful economic growth? These are often thought of in terms of democracy and an associated liberal economic system in which most goods, services and resources are allocated through a system of interacting markets. However, while not entirely wrong, this is much too simple a view of the world, since democracy *per se* is neither necessary nor sufficient for economic growth and the term 'liberal economic system' is much too vague to be helpful. We all think we know what it means, but when pushed to be specific, I imagine we would each want to highlight different aspects of the system as its key or essential features.

Moreover, the sorts of answer we would offer would most likely depend on the part of the world on which our attention was most strongly focussed. To illustrate this, let me give three examples. First, Commission (2001) is considering governance within the EU, so it naturally takes for granted that functioning states are in place, along with the rule of law and much of the regulatory framework we take for granted in developed, market-type economies. This is why the report is able to dwell on what can only be considered relatively high-level and fine-tuning aspects of governance, to do with transparency, information flows, improving accountability, and making policies more effective and coherent. One can hardly disagree with the attention given to such matters, but they don't have much resonance or relevance for other parts of the world.

Second, and in marked contrast to this, Keefer (2006) is concerned with governance in China and India. Neither country is considered to have better than average values for key governance indicators, though both took off economically in the wake of some significant improvements, and both have better governance than do many other low-income countries.



Also, the sheer size of each country proved helpful since it facilitated competition between regions, together with experimentation and learning - thus Keefer argues that a small state with the same quality of governance would have grown far more slowly than did China and, more recently, India. The key was to reach a point where the government in each country could make credible commitments to entrepreneurs that they would be permitted to enjoy the fruits of their investments (i.e. without fear of expropriation). Such a fundamental issue doesn't even rate a passing mention in Commission (2001), of course.

Last, CfA (2006) raises concerns about economic and political governance in Africa. This report sees governance in even more basic terms, as the question whether there is an effective state in place, or not. While emphasising that state-building *per se* is largely for the African countries themselves, the report does also suggest ways in which the developed countries can help the process, notably by supporting capacity-building and accountability. In the African context, the latter means a lot more than it might in the EU, since it includes measures to do with budgetary transparency to make it harder for elites to plunder natural resource revenues; and measures to tackle corruption and assist the repatriation of stolen state assets.

Governance is also increasingly discussed at the level of individual enterprises in developing countries, where it has a part to play in facilitating the financing of new investments, especially when financial markets themselves are also evolving and strengthening in the countries concerned. Thus Oman (2003) presents four detailed case studies of Brazil, Chile, India and South Africa to illustrate the importance of good governance at the corporate level. These studies distinguish between relationship-based and rules-based systems of corporate governance, arguing that a transition to the latter is critical for long-run economic growth based on productivity improvements.

Given such diverse ideas about governance, my aim in this paper is to stand back somewhat from the specific economic system we are most familiar with in order to examine some broader questions, namely:

- What does the available evidence tell us about the political and institutional requirements for sustained economic growth? (Section I)
- What do we need from the state to secure growth? (Section II)
- How do a country's internal characteristics support or impede its growth? (Section III)
- How does the external environment of a country influence its economic growth prospects? (Section IV)



- How can we put together the various elements to formulate a useful model of growth processes (Section V), and hence draw conclusions for the most appropriate governance arrangements in different countries, including both the political economy and the business/enterprise aspects (Section VI)?

Through addressing these questions, I shall arrive at some findings about governance around the world - both at the political and at the business levels - that will be highly relevant to the overall theme of this conference. These findings fall into two main groups. The first is a set of more general observations about important aspects of governance applicable to any country. The second group will adapt and specialise these general observations to bring out some particularly interesting findings applicable in different ways to the diverse countries of the Eurasian land mass. By the end, I hope that we shall achieve both a better understanding of the growth processes and experiences that can be observed across Eurasia in recent decades, and learn from these to help design better policies for those countries still striving to achieve more rapid and sustainable economic growth.

The paper outlines a simple framework within which to think about the *political economy of growth* that can be summed up in five points: good government, with secure political conditions; credible macroeconomic stability; savings and investment high enough to sustain adequate growth; openness to the world economy; and the discipline of external engagement.

It then argues that the growth model needs to be underpinned by suitable *governance arrangements*, and suggests that good governance has two main elements, each quite complex in practice, namely: protection of property rights, and accountability of government.



I. The Evidence

To explain why some countries grow and become richer, while others languish in poverty, is one of the great challenges of economics. Not surprisingly, many studies have been done to identify the conditions that appear to be most conducive to sustained growth, though much is still not fully understood in this extensive literature, and much remains controversial.

Setting out from the simplest possible growth model leads to the idea that economic growth ought to depend principally on the growth of factor inputs (notably capital and labour, possibly also land; and the inputs may also be quality-adjusted in an appropriate way), together with growth in overall productivity. The latter term tends to appear as a 'catch all' term that picks up any elements not covered by the growth of factor inputs, and so it is often decomposed further into a variety of sub-components. This is what results in much of the diversity in the associated empirical literature on the question of growth.

The initial focus on factor inputs directs attention towards investment, which increases the capital stock, as well as towards diverse education and training activities that boost the effective labour force by enhancing labour force quality. From reviewing growth experience in many countries, it is clear that moderate to high rates of investment, usually at least 20% of a country's GDP, have to be considered a *necessary* condition for sustained growth, most of this investment being funded from domestic savings. It is very rare for FDI, for instance, to contribute more than a fairly modest fraction of a country's total investment outlays. A high rate of investment, however, is definitely not *sufficient* to ensure rapid growth, since the investment actually undertaken can turn out to be extremely inefficient, as was the case in most of the former communist countries in at least the last decade of communist rule. Hence it is critical to have in place adequate institutions to ensure that the *selection processes* determining which investment projects are implemented and which rejected reward productive projects - at least on average, since some mistakes are bound to occur - and generally penalise bad ones. Among other things, this means that investment projects should not be selected as a political favour to some interest group, or as an element in state patronage.

As regards labour force developments, countries mostly fall into two principal groups. In countries where a large fraction of the workforce is still employed in low-productivity agriculture, or in out-dated, inefficient industry, much growth can be achieved by the



movement of workers out of these sectors into faster growing, higher productivity sectors such as more sophisticated manufacturing and the services sectors. Much of the workforce might still be poorly educated, and lack modern skills, but shifting workers into higher productivity sectors boosts output and economic growth. In time, this approach reaches its limits, when there are no more low- productivity sectors from which workers can be drawn. In countries like this, our second group, growth can only be sustained through continuous improvements in productivity brought about through constant innovation and modernisation of production, and by improving educational standards to boost labour-force quality. The innovation aspect of this analysis was strongly emphasised in Parente and Prescott (2002), who concluded that support for and receptiveness to innovation were fundamental for sustained growth nowadays. Ireland is a country that has adopted this approach for over two decades now with notable success, its relative income within the EU rising very substantially since 1980 or so.

So far, of course, this discussion has only dealt with the supply side of economic growth, but no country can achieve and sustain growth unless there is also a growing demand for the resulting output. This demand can, in principle, stem from any of the main components of aggregate demand that we normally distinguish in the national accounts, namely personal consumption, public consumption, investment and net exports. We now comment on each in turn.

As countries grow, we normally expect real wages to rise, living standards to improve, so increases in personal consumption are very likely to contribute to the rising demand that keeps growth going. Indeed it is quite hard to understand what growth is for, if not to improve the living standards of the population. Consequently, there is not much to say about this component, except that it clearly cannot contribute much to the expansion of demand if a country chooses to hold down wages quite strongly. As regards investment (which comprises both investment in fixed capital, and stock building), while its share in GDP is rising to a level appropriate for sustaining moderate to rapid growth, its growth can provide part of the required expansion in total demand. But once the share of investment has risen to its desired level, it will contribute only in proportion to that share.

This leaves the two most interesting components of demand, namely public consumption and net exports. On the former, total government spending consists of public consumption (government demand for goods and services) plus transfer payments such as social security spending (unemployment pay, income support, publicly provided pensions, and the like). Transfer payments essentially redistribute incomes within the private sector, and to that extent might contribute a little to aggregate demand (by shifting income from



those with a low marginal propensity to consume to those with a much higher one), but they require taxation to finance them, with its associated deadweight losses. Likewise, funding the government's demand for goods and services - which means defence spending, outlays on publicly funded health and education services, public administration, and so on - also requires taxation unless the government is willing to rely heavily on deficit spending and monetary emissions. While such a tactic is commonly observed, it is well known to be highly undesirable given the general desideratum to maintain sound macroeconomic conditions as a background condition for growth.

There is considerable evidence that higher government spending as a fraction of GDP, typically associated with higher taxes, is harmful for economic growth. Thus Barro (1991) found that across a large sample of countries, cutting the share of government spending in GDP (where spending here means both government consumption plus transfer payments) by 10 percentage points would raise the average growth rate of per capita GDP by about 1.2% per annum, a substantial gain. In the rich countries of Western Europe, the combination of high government spending (with the associated high tax rates) and slow growth might not be too bad since living standards are already high, but for poorer countries wishing to catch up it would be an economic disaster. Hence it is rather reassuring to learn from Åslund (2006) that the CIS countries, mostly growing rapidly since the late 1990s financial crisis that hit the region, have opted for quite low shares of government spending in GDP, around 25% or so, in contrast to the much higher shares adopted by most of the countries of Central and Eastern Europe (typically around 45% of GDP). Åslund (2006) also makes the interesting point that in countries with relatively weak, not very capable, and often corrupt states, it is also helpful for growth to keep government spending down. To put it another way, bad government had better be small government.

Now consider foreign trade, the role of exports and imports in supporting growth. Sometimes, when countries liberalise their trade as part of some 'reform package', they find that imports rise rapidly while exports languish, resulting in trade deficits and concerns about the credibility of the original liberalisation. Moreover, if net exports (exports *less* imports) are becoming increasingly negative, far from promoting and supporting overall economic growth, they slow it down. Nevertheless, most of the countries that have grown rapidly in the past few decades have done so on the basis of an increasingly strong engagement with the world economy, with exports growing much faster than GDP as a whole, the share of exports in GDP therefore rising quite sharply over a decade or so. From this perspective, the 'trick', if I may express it that way, is for countries to find goods and services that they can export



competitively onto the world market in increasing volumes. Countries with reserves of oil and gas, or plentiful supplies of other important minerals and raw materials (such as copper, timber), have a good starting point, though their success is also subject to the vagaries of commodity market price fluctuations. Elsewhere, we can at least see *ex post* what has proved to be successful in given countries: an increasingly wide range of manufactured goods in China, software and other business-related services in India, electronic products from Taiwan, and so on. The trouble is, few of us could have predicted *ex ante* exactly what would be successful in which country. This unfortunate fact makes it quite hard to offer concrete advice to new countries seeking to embark on export-led growth. In practice, countries have to try out a variety of different products in the world market and only then will they discover what will work for them. *Picking winners* is rarely a good strategy.

However, we do know that deliberate disengagement from the world economy is a seriously bad policy. This was undoubtedly a factor in the poor performance of the former socialist countries from the 1970s onwards, for instance, their share of world trade declining steadily over the period. The centralised planning system paid little attention to comparative advantage, and treated trade as a minor extension of the domestic economic balances. A similar disengagement was also a factor in China's relatively weak economic performance before the internal reforms and economic opening that started in the early 1980s (soon after successful agricultural reforms in the late 1970s). More recently, Broadman (2006) has argued that, based on their current policies and practices, the former socialist countries fall into two groups as regards their engagement with the world economy. Thus the countries of Central and Eastern Europe and the Baltics are viewed as being fully engaged, encouraging FDI and extensive modernisation to shift their exports towards products requiring more sophisticated technology and yielding higher value added, while much of the CIS is tending to be more inward looking, trading with each other on the basis of older technology, more out-dated products, and not engaging so much with the wider world economy. For the moment, the CIS approach cannot be regarded as too dreadful, since the region, as we noted above, is growing very strongly. But Broadman (2006) does question whether current growth will prove sustainable without more open trade policies. The countries of South Eastern Europe are tending towards the CIS approach to trade policy, inward looking and not very supportive of exports, tending to protect established firms long after their 'sell-by date'. Broadman suggests, correctly I think, that such small countries can only grow and do well by adopting strongly export-oriented policies, and hence aligning themselves - in terms of trade policy - far more with the rest of Central and Eastern Europe. It remains to be seen whether they will do so.



Much of sub-Saharan Africa is poorly involved in the world economy, again with declining shares of world trade since 1960. This has resulted from a complex mix of poorly designed policies and weak institutions, and effective remedies are not easy to design and implement. What is quite unmistakable, though, is the outcome of generally lagging economic performance, with only the last few years looking a little brighter.

Considering wider issues for a moment, Dixit (2005) reviews much of the recent literature on what he terms 'recipes' for successful growth. Some of this is based on approaches to growth that became fashionable for a time, such as the early postwar fashion for development planning, and some approaches based on the experience of particular countries deemed to be success stories. The trouble with these is that success rarely lasts, and as soon as one particular development model comes to be advocated widely, the countries on which it was based encounter problems. This reflects the sheer difficulty of fully understanding development processes, and our failure to construct any generally valid models. It also reflects, as Dixit points out, the widespread tendency to neglect the key factor of 'luck', which plays a notable part in explaining the postwar economic success of countries such as Japan, among others.

From the econometric work that Dixit surveys, it appears that various geographical factors have been found to be significant. Thus being land-locked, and being a tropical country, are factors sometimes found to be disadvantageous, though it remains unclear what any so afflicted country is supposed to do about it (and in any event, the evidence is mixed)! Institutional factors are perhaps more interesting, since institutions can be changed, albeit not easily. However, the institutional features found to be most significant are such things as openness to foreign trade - which we discussed above - and legal arrangements to protect property rights and business contracts, sometimes summed up as an aspect of the 'rule of law' (see Dam, 2006). These can take many concrete forms, and the econometric work provides few clues that could assist us in advising countries on exactly what legal framework they should adopt to support private sector business. In any case, this whole area, has much to do with the nature of the state, to which we now turn.



II. The State

What do we expect from the state when thinking about its role in processes of economic growth? First, and most fundamentally, we would expect the state to have a monopoly over the means of enforcing order in the given country, so that it can protect property rights and business contracts, levy taxation, and manage the public budget. This entails state control over the armed forces, as well as the police and other security forces. It also implies that the state is not faced with competing warlords or militias claiming to control certain parts of the country. This requirement implies that a number of territories around the world cannot be said to possess a fully functioning state. For instance, think of Afghanistan, Lebanon, Somalia, Palestine, Iraq, and a few others.

Defining the key characteristic of the state in this way raises two questions: (a) What is to stop the military from simply taking over full control of the state, e.g. by means of a coup?¹ (b) If the state is strong enough to protect property rights, what is to stop it from overriding these rights and expropriating private agents when they turn out to be successful in their business ventures? The short answer is 'not much', but a longer answer would have to refer to 'history, experience and custom'. Establishing the 'rule of law', meaning both effective civilian control over the military, and the protection of private property rights and business contracts from state predation and general criminal activity, has proved extremely difficult in the countries where it can be said to be firmly in place.

In the UK, for example, it took civil war (in the seventeenth century) and major reforms of parliament for the latter to wrest control over the government's budget from the sovereign; and the judiciary has long cherished its independence from the executive. In the US, the Constitution was deliberately designed with a separation of powers between the executive (President and his cabinet), the legislature (the House of Representatives, and the Senate), and the courts (especially the Supreme Court). The resulting system can appear extremely cumbersome and messy, but the diverse checks and balances built into it provide considerable protection - both from governmental interference and from wrongful behaviour by other private agents - for private business entities.

In contrast, it is useful to remark on a major country such as Russia, where the concept of 'rule of law' is not well understood, and is certainly not a routine part of the way in which economic governance is thought about. It may well be the case that the Russian



military are reasonably well under civilian control. But it is harder to claim that the judiciary is yet fully independent of political processes, though it is undoubtedly rather more so than it was under the former communist system. And for business, both small and large, there remains a significant gulf between the laws formally in place, and their implementation at grass-roots level. In addition, it remains far too easy for the state itself to take action - which to the outsider can appear little short of capricious - against particular businessmen who might have fallen out of favour (e.g. Mikhail Khodorkovsky and the Yukos affair), or against particular companies suddenly judged to be on the point of making too much money (e.g. Shell's activities on Sakhalin Island)². Such actions seriously undermine the 'rule of law'. Meanwhile, other companies apparently behaving badly get away with it because they are perceived to enjoy high-level political protection: e.g. Gazprom.

How, then can we make a state accountable, and limit its scope for arbitrary intervention, either in relation to the government's own actions or in relation to the private sector? It is often claimed that democracy *per se*, in the limited sense of periodic voting to choose both parliamentary representatives and the government, plays a major role in this respect. It does play a role, certainly, but I would be cautious about placing too much reliance upon it. For there are many states where voting takes place from time to time, where it would be difficult to have much confidence in the electorate's effectiveness in constraining executive power.

More positively, however, there is evidence that where an elected parliament effectively controls the government's budget, scrutiny over public spending is greater, the higher is the prevailing tax rate. Ironically, this suggests that a government that chooses not to tax very much can do pretty much what it likes since it will face little scrutiny - so what taxes it raises can be allocated quite corruptly, and can be misappropriated with little risk of serious challenge. This is indeed the situation in more than a few countries.

It turns out, too, that possession of substantial natural resources, such as oil or gas, is not only - on average - bad for growth³, but it also undermines any democratic scrutiny of public spending since the government can spend a lot without having to raise much tax revenue. This aspect is discussed in a recent paper, Collier and Hoeffler (2005), which sketches a simple model in which high resource rents both weaken public scrutiny and strengthen patronage politics; the paper finds considerable empirical evidence to support the hypotheses it develops. Resource-rich countries where public scrutiny is weak, and where much money is undoubtedly diverted into improper channels, would include Nigeria and Saudi Arabia. However, resources are not always bad news, since Kazakhstan appears to



be performing remarkably well (no doubt with some corruption, but not enough to slow down the country's rapid growth), and Norway has apparently managed its natural resources exceptionally well, with almost no reported corruption.

Though not discussed in the Collier and Hoeffler paper, it seems to me that aid flows to some countries could play the same role in the political process as resource rents, and hence might have similar undesirable effects on the political aspects of economic governance.

Not only should governments be accountable for their budgetary spending, but the bureaucracy should be accountable for delivering and implementing the government policies that have been approved. Making a civil service accountable in this way is not easy. In part it is a matter of employing staff who are sufficiently well trained and sufficiently professional to want to do a good job, perhaps guided by some form of civil service code of behaviour. But if it were that simple, accountability in this sense would not be regarded as the widespread problem that it is. Some of the problems that impede accountability include the shortage of personnel with the right education and training; the lack of transparency at various levels of government (e.g. how can anyone monitor funding of, say, secondary schools if the education ministry fails to publish any information about its funding allocation?); weak management of staff (why should teachers be diligent when no one even monitors and reports on their attendance?); low wages that provide an incentive to seek out opportunities for corruption; over-complex rules and regulations that provide these very opportunities; and so on. The problems are usually easier to list than the solutions, unfortunately.

When government failure is pervasive, it is also important to ask what sorts of economic transactions can still take place, effectively in the absence of a properly functioning legal framework. One naturally thinks here of small-scale, local trading networks, in which various forms of informal mechanisms can arise to police transactions (some interesting models of such trading networks can be found in Dixit, 2004; Fafchamps, 2004; and Greif, 2006). However, even larger scale business can be conducted without having a proper legal setting. Russian business in the early to mid-1990s is a case in point, where much anecdotal evidence suggests that mafia-like organisations quickly emerged to 'help' settle business disputes and enforce contracts. Such private sector solutions do, to an extent, work, but I suspect they would not be widely considered especially desirable. Moreover, in such conditions, the property rights that get protected are presumably those of the (relatively wealthy and well connected) people who can pay for the necessary services.

There is a presumption in the above discussion that if property rights are to be protected, or contracts honoured, then this must be ensured by the state exercising



sovereignty over the territory concerned. But this need not always be the case. In the case of failed states such as Somalia, some business can be pursued using the legal or banking system of an agreed Middle Eastern country, and such deals are reportedly quite common. And even for states that operate perfectly well, many international business deals specify, as part of any contract, which country's law shall be used in the event of a dispute - it need not be the law of either contracting party, but can be the law of some agreed third country whose legal system is widely respected.

In thinking about the state and its various roles in economic development, there are a couple of final observations worth making here. First, there is the broad question of *causality*, namely whether good institutions foster growth or the other way around. To what extent does growth itself encourage the development of good institutions, including an effective state? The evidence about this is decidedly mixed and ambiguous. However, I would not personally advise a country to wait until its state was set up properly before it sought to embark on some type of growth-promoting or enhancing strategy. In practice, countries start from where they are, and we all have to live with that.

Second, there is the interesting tendency for clearly bad political institutions to persist. This has been investigated theoretically by Acemoglu (2006), in a model with various groups competing for power where it can be to the advantage of a group in power - in effect - to impoverish other groups in order to retain power. A fairly extreme instance of this phenomenon is probably Bolivia, the only country in South America whose per capita income is almost the same now as it was back in 1950 (in other South American countries, real incomes have at least doubled) (see Wiggins et al., 2006). The rich elite have been close enough to political power to ensure that their property rights would be protected, without them having to pay much attention to those of other groups. Now that a more radical leader, Morales, has finally been elected, it is interesting to speculate whether he will seek to fundamentally redistribute wealth by expropriating the rich - but thereby risking a military coup that might reverse his reforms - or whether he will be clever enough to redistribute only moderately, increasing the chance (in my view) of bringing about a more lasting change in Bolivian politics. In general, very strong interest groups in a society can constrain change, and hence lead to the persistence of inefficient political institutions. Often, our understanding of the mechanisms of political and economic change is insufficient to enable us to do much about such situations, except, perhaps, at a time of major economic crisis when even the elite might be persuaded to accept some changes.



III. Internal Conditions for Growth

Much of what we need to say here has at least been touched on above, so it will be possible to be quite brief, and simply present a series of points to sum up the position. In doing so, it is tempting to be as comprehensive as possible, but that runs the risk of forcing us to conclude that sustained growth is either unlikely or impossible. Casual observation, however, suffices to show how wrong such a conclusion would be. Hence we need to distinguish between a limited number of internal conditions that should be considered essential for growth, and a possibly longer list of conditions generally found to be helpful, that we shall regard as desiderata.

Essential conditions

- Political stability. Governments may be weak or strong, more or less democratic, but private sector development is not helped by a strong perception of political instability, with a high risk of coups, civil war, possible reversals of earlier major reforms, and the like. Some interesting theoretical analysis of the conditions for political stability, including the conditions for democratic consolidation, is presented in depth in Acemoglu and Robinson (2006). Further analysis of the economics of government failure and the principles of good government can be found in Besley (2006).
- Macroeconomic stability. It is hard to be precise here, but it is clear that countries with inflation rates in excess of 100% almost never exhibit economic growth. Similarly, countries usually find that government deficits exceeding 10% of GDP are rarely sustainable for long, and the same can be said for large trade deficits except in a few cases where countries are able to attract sustained FDI inflows to offset a trade deficit. It is important not only that macroeconomic policies are conducive to stability in this fairly loose sense, but that the macroeconomic stance should be credible to the private sector.
- Investment of around 20% of GDP or higher. Except in short recovery periods (such as following a war, or a deep recession), almost no country has sustained growth for long without achieving high rates of savings and investment. As noted above, this



investment does, of course, also need to be efficiently allocated to productive projects.

This is all that I would consider essential, but there are many other conditions that I would regard as desirable, and for which there is a good deal of empirical support from experience around the world.

Desiderata

- Steadily improving quality of labour force, as a result of improved education and training.
- Improving quality of capital stock as a result of policies to encourage innovation, technological upgrading, R&D, and the like.
- Appropriate microeconomic conditions need to be in place, namely: competition policy, the legal framework for business, other elements of the business and investment environments in general (see World Bank, 2006; World Bank, 2004).
- Appropriate institutional conditions are also desirable, including conditions for good governance, both political and at company level.

IV. The External Environment

The external environment of a country offers both constraints, opportunities and challenges, some helpful for growth, others less so. Not much has been said about the various features of a country's external environment in previous sections of this paper, and so our discussion here will need to be substantially more elaborate than our brief remarks above on the internal environment.

A clearly negative factor for growth is involvement in a war with a neighbouring country, or in civil war. Not only do such events distract policymakers' attention from relatively mundane issues of economic policy, but the fighting damages and destroys



productive assets, diverts key manpower from production, and seriously disrupts access to markets. It also encourages out-migration, often of the best educated and most skilled segments of the population. All this was evident, for instance, in the fighting between Armenia and Azerbaijan in the early 1990s, in the Yugoslav wars of the early to mid-1990s, in Tajikistan's and Georgia's civil strife, and in many other places. Nearly as bad is the situation of countries whose neighbours or major trading partners are engaged in warfare, or threatening warfare, since the external political stability that is generally helpful for economic development is then not assured.

Once political stability is assured - both internally and externally - it is natural to think next of the various modalities of engagement with the world economy. Deferring discussion of international alliances and international institutions, the four main aspects of this engagement are: (a) trade; (b) FDI; (c) migration; and (d) remittances. We already discussed trade and FDI briefly above, emphasising their benefits.

Migration, if it is mainly out-migration of the relatively skilled, is a mixed blessing. On the one hand, it usually reflects the lack of well paid jobs for skilled workers in a given economy (which one hopes would, in due course, be overcome as the economy starts to grow), but on the other, migrating workers often send back to their families in the home country a share of their income - remittances - and these flows sometimes provide a significant share of a country's foreign exchange earnings. Often, migrating workers will return home after a few years, bringing both new skills, and often some capital, with them. In that case, temporary migration can be very beneficial. But in less favourable cases, some countries are left with almost no highly educated personnel, almost no one with modern skills. Breaking out of such a position is then immensely hard, since even primary school teachers, nurses, middle-level civil servants may be in terribly short supply. This issue was highlighted, for Africa, in CfA (2005), though convincing and effective remedies were not well developed there.

Overall, then, trade and FDI are normally beneficial to a country, while the balance of advantage in regard to migration and remittances is mixed. It can also change over time, of course. Ireland is a good example of that, with decades of out-migration reversing substantially in the past couple of decades, as sustained growth and rising incomes increasingly made the country an attractive place to work, with lots of new job opportunities. Former emigrants, as well as many non-Irish workers, flocked to the country to participate in its economic boom.

For many countries, the international context of their engagement with the world economy is defined by the various agreements and organizations they belong to. At the



simplest level, this mostly means their membership of various free trade areas (FTAs) or Customs Unions (CUs), and their membership or otherwise of the WTO. Much of the world is covered by a variety of FTAs, of which the best known outside Eurasia (to which we revert below) are probably NAFTA, Mercosur (large parts of South America), and the ASEAN (South-East Asia) FTA. In Africa, too, there are many FTAs, some bilateral, some covering groups of countries. Indeed so complex is the pattern of FTAs on the continent that some observers have described it as a 'spaghetti bowl'. Most of the agreements are not fully implemented, with most African countries still lacking the technically trained staff to do so effectively, and in practice the excessive complexity almost certainly serves to inhibit rather than encourage trade (especially as each agreement tends to include its own provisions regarding 'rules of origin'; see Krishna, 2006).

Across the Eurasian landmass the picture regarding trade agreements is extremely mixed. For China, there are trade agreements with the EU and the USA, plus a growing list of bilateral agreements between China and mostly Asian partners; the idea of forming a large FTA encompassing the ASEAN countries plus China has also been mooted, and preparatory work is under way. For the CIS countries, there is an FTA covering all twelve states. However, this was agreed in 1994, and has never been ratified by all CIS members, so it cannot be regarded as especially effective. Since the mid-1990s there has been a CU among Russia, Belarus, Kazakhstan, Kyrgyzstan, and later, Tajikistan, but this too has never been fully ratified, the agreement sets out no timetable for implementation of the CU, and little has been done to harmonise either inter-group or external tariffs or other trade provisions. This CU became the Eurasian Economic Area in 2000, at the instigation of Kazakhstan, but there remains little meaningful progress to report.

Within the CIS, the situation of Kyrgyzstan is not untypical. As noted, the country belongs to the CIS FTA and the above mentioned CU. It also has bilateral FTAs with nine other CIS members, and belongs to several other multi-state preferential trading agreements, some involving states outside the CIS. The WTO has warned that this complexity can undermine the transparency of Kyrgyzstan's otherwise rather open and liberal trade and investment regime, and can tend to lock the country into inefficient trade with CIS partners. Countries often seem to think that agreeing to lots of trade deals can help them to integrate more effectively with the world economy, but unfortunately, the opposite is the case, especially where the state is relatively weak and lacks the administrative capacity to manage all the deals it signs up to.



Moving West, the EU is now by far the world's largest and most effective CU, with 27 member states since the latest accession of Bulgaria and Romania in January 2007. Within the Union, internal tariffs are zero, and the common external tariff is fully implemented. While some temporary restrictions on the movement of labour are in force for the new member states, for the most part the EU fully implements the so called four freedoms: the free movement of goods, services, capital and labour across the Union. All member states have benefited greatly from the rapid growth of intra-EU trade, and from the EU's trade with other parts of the world. Moreover, although the EU does sometimes bow to sectoral lobbies and impose special trade restrictions from time to time (e.g. textiles trade with China since mid-2005, footwear trade with China since mid-2006), and imposes some quotas on imports from non-members of the WTO (e.g. on steel imports from Ukraine, Russia and Kazakhstan), the Union's general stance is to favour open and liberal trade. This is notwithstanding the special provisions in force regarding the agricultural sector, as part of the Common Agricultural Policy. Since trade policy matters are handled at EU level, the EU has often been able to prevent member states from restricting imports to protect specific domestic firms in distress. This relatively tough approach has undoubtedly contributed, over the years, towards enhancing the competitiveness of EU exporters. In this sense, membership of the EU serves as an external constraint - and mostly a very desirable one - on the governments of member states.

For the recent accession states, the eight transition economies that joined the EU in May 2004 plus the two new ones, the prospect of EU membership also constrained the governments of these states. It did so, essentially, because the EU required all the incoming states to implement pretty much the entire *acquis communautaire* into their respective domestic legislation, and the process of doing so - once accession approached, and a timetable was set out - was subject to annual monitoring and reporting by the EU⁴. Frequently, when implementing reforms, governments of the accession states were able to refer to, and indeed to blame, the EU for what they were doing, and this did help to get some reforms through against domestic opposition. Though implementing the *acquis* thus compelled the incoming states to complete the economic reforms needed to construct functioning market-type economies, it also required them to take on board a lot of measures that, without the prospect of EU membership, one would not have wished to recommend. In this sense, the *acquis* is more than a little top heavy for a set of mostly small and not very prosperous states. However, the governments concerned evidently took the view that it was a price worth paying for the ultimate benefits of full membership - let us hope their judgement proves correct. For countries with no prospect of eventual EU membership, such as Russia,



for instance, one might well wish to see more liberal economic reforms, but I seriously doubt whether many economists would advise Russia to seek much guidance from the provisions of the EU's *acquis communautaire*.

Besides the *acquis* itself, the accession states also had to convince the EU of two other conditions, namely that they were stable democracies (held to include respecting minority rights and supporting the 'rule of law'), and that their economies were able to withstand competition from the existing EU member states⁵. This led to some interesting situations where pressure from the EU required the incoming states to protect significant minorities, such as Hungarians in Slovakia and Romania, gypsy populations in several countries, and ironically, Russians in the Baltic States.

The new member states of the Union are expected, in due course, to join the European Monetary Union (EMU) and to adopt the Euro as their currency (no other countries are to be permitted the British opt out). Slovenia has already made the Euro its official currency as from January 2007, as a key stage in that process, but the other new member states are still probably some years behind. This is because they need to manage their economies in order to fully satisfy the Maastricht criteria which require: (a) inflation should be no more than 1½ % p.a. above the inflation rate of the three member states with lowest inflation; (b) the general government deficit should not exceed (other than for occasional short periods) 3% of GDP; and (c) the ratio of gross government debt to GDP should not exceed 60% of GDP (there are some other lesser conditions that we leave out of consideration). From the standpoint of maintaining credibly stable macroeconomic conditions - emphasised above as vital for growth - it is hard to dispute the notion that some conditions along these lines could be helpful. However, I am aware of no economic arguments for these particular reference numbers (i.e. 1½ %, 3% and 60%) to be used, and can only surmise that they were adopted because the original members of the Eurozone proved just about able to satisfy them - but could not have managed anything more stringent.

There is a risk that insistence on exactly this set of criteria might force some countries to deflate more than they would otherwise wish to, which could be damaging. On the other hand, once firmly inside the zone there is a risk in the opposite direction, namely that some departures from the Maastricht conditions might be tolerated by the European Central Bank without any penalty being imposed on the errant member states. Such departures might appear perfectly reasonable in the short-term, but in principle they do nevertheless undermine the credibility of the official Eurozone policy stance. The disciplines of the Eurozone are, on balance, good for countries such as Italy that have tended to operate an



overly lax fiscal policy, and for the new member states where fiscal discipline is also not yet deeply embedded in official or popular thinking about the economy. In this sense, the Eurozone conditions provide a valuable external anchor, strongly encouraging sound domestic macroeconomic policy in the member states. But for this to work, the conditions do need to be credibly enforced.

That said, it should be apparent by now that adoption of the *acquis* and adherence to the Maastricht conditions do not guarantee rapid economic growth for the member states of the Union, they merely provide a supportive framework, within which there is much scope for the exercise of domestic policy to support or hinder growth. Thus individual member states grow at quite different rates, with both catching up and lagging behind from one decade to the next. Sound macroeconomic policy is necessary but not sufficient for sustained, rapid growth. Drawing on this, and previous sections, we discuss below what additional conditions ought to be in place for a country to grow strongly.

To conclude this section, we briefly consider how membership of international organisations can place further constraints upon a country's domestic economic policies, sometimes aiding growth, sometimes possibly not. Several states in Eurasia receive assistance and advice from the World Bank and IMF, but for the most part their roles are so small as to seem fairly inconsequential for the purposes of the present analysis. Accordingly, we confine attention to the role of the World Trade Organization (WTO). The WTO's principal task is to set and monitor the main rules that govern the conduct of international trade. To this extent, the WTO sets constraints on all its member governments, as well as providing a disputes settlement mechanism to handle disagreements over trading matters. It is easy to find fault with specific features of WTO rules, but probably better on balance for world trade to remain largely rules-based within the WTO framework; likely alternatives to the WTO, including a return to tit-for-tat protection around the world, are not very appealing, and are frankly quite dangerous for the health of the world economy.

The WTO exerts greater influence over countries seeking to join the organization, since it often seeks commitments not only regarding that country's trade policy *per se*, but over many aspects of domestic policy considered to affect foreign trade indirectly. Several countries across Eurasia have gone through this WTO accession process relatively recently and their Accession Protocols have indeed offered significant commitments regarding their domestic economic policies; e.g. Georgia, 2000; Moldova, 2001; China, 2001; FYROM, 2003; Armenia, 2003. In these situations, the WTO, to some degree, not only serves as a useful external anchor to sustain good trade policies, but also helps to foster improved



domestic policies in some areas, such as competition policy and energy policy (among others).

Some important countries in Eurasia are still outside the WTO, notably Ukraine, Russia and Kazakhstan (plus a few other, smaller countries). All three have been in negotiation with WTO since the early to mid-1990s, with many meetings of the relevant Working Parties, but also many gaps in the negotiations when not much activity was going on. Some of this reflected changes of government or economic policy in the countries concerned, affecting their changing perceptions of the urgency of WTO accession, and their willingness or otherwise to offer acceptable concessions to various trade partners. At the time of writing, Ukraine seems close to concluding an agreement regarding its accession (entry may well occur by summer 2007), but the other two countries appear to need more time. Since Ukraine's economic growth is likely to depend heavily on success in exporting manufactured products, accession is especially important to ensure that Ukraine's exports have secure access to their major markets. For Russia and Kazakhstan, their major exports are energy products and raw materials, and these face few restrictions in the world market. Hence WTO accession is less urgent for them, though still valuable in the longer term as their economies diversify more into manufacturing and tradable services.

V. Assembling a Model

Bringing together the various elements discussed above, it is now time to sketch out the resulting model of growth and development.

The model we propose involves five key features:

- good government, with secure political conditions;
- credible macroeconomic stability;
- savings and investment high enough to sustain adequate growth;
- openness to the world economy, certainly in regard to trade, and desirably in regard to FDI inflows;
- the discipline of external engagement (e.g. belonging to WTO and an FTA).



Although the above analysis already makes clear that meeting all these conditions is no easy task, there are enough success stories around the world to demonstrate that it can be done. Moreover, the available success stories do not conform to any simple, standard blueprint, which shows us that many combinations of these features are capable of yielding sustained economic growth accompanied by improving living standards. Nevertheless, there is some commonality, and I propose to argue in this section that it can usefully be discussed under the heading of 'good governance and sound supportive institutions'. In putting forward such a claim, naturally, I shall not be asserting that success stories have obviously 'good' governance and institutions; and that economic failures have the reverse. Unfortunately, our world is not that straightforward. Accordingly, I proceed here in three stages. First, I examine what we ought to mean by *good* governance and institutions; second, I explain the conditions under which governance and institutions turn out to be *good enough* to foster successful growth; last, I outline some implications of this discussion for *economic policy*.

Good governance and institutions

While identifying and characterising the good is not so easy, we can certainly identify the very bad. For brevity, let me simply mention Zimbabwe (currently experiencing the highest inflation in the world, and with output and employment falling rapidly) and North Korea (still a hard-line communist regime, with living standards massively lower than in South Korea, despite a similar starting point around 1950 or so); Nigeria (too much oil revenue stolen by the authorities), and Somalia (state collapse) are other examples. These countries were deliberately chosen for their diversity, but despite that they do have some common characteristics that point the way to some useful lessons.

What are these characteristics? I think two are really critical: (a) the failure to protect property rights; and (b) the lack of accountability of the state. The second is much the more fundamental.

On property rights, Zimbabwe has expropriated thousands of white farmers without compensation in recent years (resulting in massive declines in farm output and exports), and the government has cleared numerous small traders and operators in the informal economy from major cities, ostensibly as part of a 'clean up' campaign. When the courts have resisted these moves, judges have either been fired, or have fled abroad, fearing persecution. The result is a situation in which few private businesses can feel secure in the property rights, contributing to the general collapse in private investment in the country. The North Korean



government recognises few private property rights except those of very small traders, some workers in arts and crafts, and private plots in agriculture. Virtually all other private economic activity remains illegal. In Nigeria, the legal framework is in place to protect property rights, but its effectiveness is undermined by a complex mix of corruption and patronage, not helped by a slow and very inefficient court system. Those who can find their way through the 'system' can prosper, but for others it must be more like a lottery. An important observation here is that economic agents not only need their property rights protected from predation by the state, but they also need protection from other private agents; neither aspect is secure enough in Nigeria. Last, Somalia has had no effective state in place for nearly two decades, and even when there has been some sort of central authority it has been unclear whether this would support any sort of sound property rights protection. Hence there is little basis for private economic activity other than the limited forms that can survive through small, informal networks (and even these might be subject to 'protection' from the current local warlord/bandit) and deals based on the property rights and courts of some other country (and even then, one imagines that business risks must be exceptionally severe, to put it mildly).

Accountability is a more complex idea, and potentially it has several distinct dimensions or aspects. To understand these, it is simplest to proceed by asking some simple questions:

- Can governments be changed, and if so, how often and through what mechanisms? Notice that this is not just a simple question about democracy in the sense of voting periodically for alternative political parties, since even if there is only one major party there can still be some competition for the top leadership. Also, while we would naturally like elections to be free and fairly conducted according to the high standards of such bodies as the OSCE, I am not necessarily taking that for granted either.
- How easy is it for the government in power either to ignore the constitution or to change it to entrench the power of the current leadership (Zimbabwe has done both, with apparent impunity)? This is a more complex question in those states, such as the UK, with no written constitution. Then the question really asks how easy it would be for a government to change the prevailing understandings and conventions about the way government operates in the country.
- What effective constraints are in place to prevent a ruling group from misappropriating the country's revenues for personal gain, and hence oblige the group - at least to an acceptable extent - to fulfil its fiduciary responsibilities? In



practice, this means having a central bank strong enough to withstand government pressure (with bank governors facing no risk of being fired or worse!), strong parliamentary oversight of the government's finances (or equivalent), and a supreme court also capable of resisting government pressures (again, with judges safe from government persecution). In recent years, none of this holds in Zimbabwe, little in Nigeria (explaining the country's huge illegal diversion of oil revenues).

- What role is played by the parliament (or some equivalent body) in preparing, debating and passing legislation (as compared, for instance, to rule by decree)?
- To what extent, if at all, are bodies outside government and the legislature consulted over proposed legislation, and how far do their views 'count'? For instance, if there are to be changes in the laws governing private-sector business, might an association of business lawyers be consulted, or chambers of commerce?
- What role is played by the parliament in reviewing and reporting on various aspects of government policy? If the parliament reports very critically, can the government ignore the report with impunity?
- If citizens or firms consider that the government has acted illegally in some matter, will the courts hear their case, and if the court finds against the government, will the government take any notice? (e.g. might a minister resign or be fired? Or might policy be changed?)
- Are the media permitted to criticise the government and its policies, without fear of arrest or closure? Related to this, are the media free to publicise the views of diverse political interest groups or parties, not merely those of the current ruling group?
- Are citizens themselves - either individually or through organisations like policy research centres or NGOs - free to criticise the government and its policies, without fear of arrest or other penalty (such as loss of their job)?

For the four countries taken as examples of bad practice, it is reasonably clear that not many of these points could be answered especially positively, with the possible exception of Nigeria in some respects. Of the four, only Nigeria is currently enjoying some economic growth, and one suspects that is despite rather than because of the government's economic policies (except, to an extent, in key but basic areas like maintaining macroeconomic stability).



Good enough governance and institutions

Within the Eurasian region, it is worth quoting from some recent *IMF Country Reports* (my italics):

The authorities saw spurring investment spending as key to boosting growth. Staff concurred but also noted that the really binding growth bottlenecks seemed to be insecure property rights, corruption, and a regulatory jungle—structural deficiencies that were also reflected in underdeveloped financial markets. (Report on Ukraine, February 2007).

Structural reforms outside the banking sector remain very slow. The authorities agreed that structural reforms are behind schedule and claimed that high oil prices and robust growth make it difficult to mobilize political support for reforms. (Report on Russia, December 2006).

Directors urged greater progress in addressing structural obstacles to job-intensive, inclusive growth.....More broadly, efforts should continue to improve the business climate and reform education, as well as to alleviate rural poverty through promoting agricultural growth. (Report on India, February 2007).

These comments all apply to countries that are currently growing quite rapidly, and as the second comment states, this in itself tends to discourage countries from undertaking major economic reforms. For reforms are frequently seen - at least by top political elites - as neither necessary, nor even desirable. Yet many countries find it hard to introduce reforms in more difficult economic times, so these attitudes significantly impede the reform process. For these countries, and many others facing similar conditions, it is therefore interesting to consider what steps could be taken that might 'unblock' reforms, and hence how we might improve overall economic functioning.

Within the EU, there have long been concerns about the Union's slow growth and lagging competitiveness, these concerns finding expression in the so called Lisbon Strategy agreed by the EU in March 2000. At its launch, the Strategy was designed to encourage member states to boost European spending on R&D (with an eventual goal of spending 3% of the Union's GDP, just under double the starting point), accompanied by measures to make



labour markets more flexible and to improve education and skills. In the early years, responses by the member states to this new challenge ranged from minimal to modest, so in 2005 the whole process was reviewed and relaunched (see Commission, 2005).

According to Commission, 2005, pp.3-4 (my italics and emphasis):

Today, we see that progress has at best been mixed. While many of the fundamental conditions are in place for a European renaissance, there has simply not been enough delivery at European and national level. This is not just a question of difficult economic conditions since Lisbon was launched, it also results from a policy agenda which has become overloaded, failing co-ordination and sometimes conflicting priorities. For some this suggests that we should abandon the ambition of 5 years ago. The Commission does not agree. The challenges we face are even more urgent in the face of an ageing population and global competition. Unless we reinforce our commitment to meeting them, with a renewed drive and focus, our model for European society, our pensions, our quality of life will rapidly be called into question.

The need for urgent action is confirmed by the report from the High Level Group chaired by Wim Kok last November. It identifies a daunting challenge. According to Kok, "The Lisbon strategy is even more urgent today as the growth gap with North America and Asia has widened, while Europe must meet the combined challenges of low population growth and ageing. Time is running out and there can be no room for complacency. Better implementation is needed to make up for lost time". Faced with this challenge Europe needs to improve its productivity and employ more people.

*On current trends, the potential growth of the European economy will halve over the coming decades and reach **just over 1% per year**.*

Across the EU, therefore, I would see the recent lack of reforms as a consequence of the complacency born of a different kind of economic success: not rapid growth as in the emerging economies, but rather the enjoyment of already high incomes and living standards (except for the new entrants, which might be expected to strive to catch up, as Ireland did, and Spain is doing). This complacency is evidently something we can live with for a while, but eventually Europe is likely to be overtaken economically by the more dynamic parts of the world, and perhaps then our leaders will take notice and address the challenges already outlined clearly in the Lisbon Agenda.



Thus for the fast-growing countries of Eurasia, as well as for the already prosperous countries, the socio-political configuration needed to promote further economic reforms is not very favourable, in my view. Nevertheless, in terms of the two main requirements for good governance that we identified above - protecting property rights and ensuring accountability of government - many of the conditions that we would like to see are already there. But there are some worrying gaps, such as Russia's politically coloured property-rights protection, and the political pressure on much of the media there; the poor property rights protection in Ukraine; the limited opportunities to change or criticise the government in Kazakhstan (which, for the time being, matters less than it might, given the strong growth orientation of the government - in other words, it delivers results). Many similar examples could be given.

Good governance is also a matter for firms. In that context it is usually interpreted to mean protection of shareholders' rights, especially those of significant minority shareholders, but I think that is too narrow a conception. Other relevant interest groups might also include the workforce, a firm's customers, its bankers and other lenders, and the local community where its production takes place. Thinking along these lines makes governance seem like a very complicated notion, involving some rather delicate juggling. It becomes even more so if we choose to take on board modern notions of corporate social responsibility, with the idea that firms should strive to uphold high environmental standards (promoting their 'green' image), high labour standards, and so on. However, given the focus of this paper on issues of growth and efficiency in modern economies, we would be as well here to emphasise the need for firms to be profitable, innovative, and inclined to invest in new products, services and markets. Institutional arrangements that promote this will likely prove most effective both for firms' own success, and for maximising their contribution to growth and development in the wider economy.

Economic policy

What does the above tell us about the approach we should adopt when advising a country about its future economic policy? At the risk of appearing simplistic, I shall simply list a few points that seem to me to merit careful consideration.

- Be modest. By this I mean two things: first, we should not exaggerate what we know and understand about the requirements for growth and development; second, we should not rush in with recommendations just because something isn't quite 'as we



do it in Western Europe and the US'. If something is working tolerably well and an economy is growing quite satisfactorily, we should not rush in to 'fix' it. Instead, we should be trying to understand why it works as it does, in case the country concerned might itself offer lessons for others. There is no simple, single model, either of economic systems or economic policy.

- If there is an identified problem that we seek to address (e.g. lack of a functioning system for settling business disputes), then where possible we should give advice that builds on practices, institutions and organisations that already exist, and are familiar in the country concerned. That is more likely to be successful than an approach that seeks to transplant a 'ready-made solution' from another country.
- Beware of the 'scattergun' approach to policy advice. This is the approach that, essentially, advises a country to undertake reforms in practically every area of economic policy, usually trying to make the country's economic arrangements look quite like those of the US or UK, or some other supposedly 'model economy'. While if we recommend enough things, there is a good chance that some of them will be valid and sensible, the approach is intellectually lazy. Moreover, if taken seriously by the recipient country, especially if the latter is small and poor, then its public administration is likely to be seriously overloaded by the resulting tasks. This surely cannot serve the presumed end of boosting the country's economic performance. Better to focus on two or three key recommendations, I would argue, though at times this runs up against the incentives often faced by policy advisers (in the sense that they - or their line managers - might not feel they are providing 'value for money' if they advise a country to do so little).

Finally, in providing such advice, I strongly concur with the view of Rodrik (2004), who argues that we should identify the key constraints (institutional, policy, or whatever) that appear to be blocking growth in a given country, and focus our policy advice on these areas. This, of course, is a difficult message to implement, since it demands very careful analysis of the country concerned, not merely at the level of its laws and official policies, but at the far deeper level of the institutions and practices that influence their implementation and effectiveness.



VI. Conclusions on Governance

Our story is already too long, but let me conclude by trying to sum up where we have reached. First, we have sketched a model of what we may term the *political economy of growth* that we summed up in five points, repeated here for reference:

Model: Political Economy of Growth

- good government, with secure political conditions;
- credible macroeconomic stability;
- savings and investment high enough to sustain adequate growth;
- openness to the world economy, certainly in regard to trade, and desirably in regard to FDI inflows;
- the discipline of external engagement (e.g. belonging to WTO and an FTA).

We then argued that such a model needed to be underpinned by suitable *governance arrangements*, both at the level of government and at the level of firms. Focussing on the former, we suggested that good governance could be thought of as a mix of two main elements, each quite complex in practice. Thus:

Governance Arrangements

- protection of property rights
- accountability of government.

For countries not yet prosperous and not yet growing very much, their most urgent need must be to improve governance arrangements in ways that make government promises to respect and protect private property rights credible enough to stimulate the entry of new firms into the market, and to encourage growth in private investment. This is very much what happened in China, for example. No one would claim, I believe, that China's governance arrangements conform to any supposed 'ideal' model, but they are amazingly better than the near anarchy that prevailed during the terrible years of the Cultural Revolution (mid-1960s to mid-1970s). Moreover, hard lessons learned then convinced China's leaders that they would be judged on the economic success that they delivered, not on their ideological rectitude,



and this has helped to make their economic promises credible. Formally, a good deal of China's economic arrangements is still not governed by clear, legally enforceable property rights in the Western sense, but they work because people believe in them. Running an economy is like a repeated game, in the sense that once promises are made and kept, economic agents increasingly believe that they will continue to be kept. This facilitates further growth.

In contrast, Nigeria's leaders have stolen oil money for decades and are expected go on doing so, with the result that few people expect rapid improvements in publicly provided services like education and health care, or in basic infrastructure. Some growth is possible under these conditions, but not much, and most ordinary people remain shockingly poor. When government promises are repeatedly broken, most sensible people expect that to continue and hence adapt themselves as best they can to that situation.

Across Eurasia, with very few exceptions, most countries are not among the poorest in the world, and as we saw above, most belong to one of two groups: (a) the already prosperous countries of the European Union; and (b) the rapidly growing but poorer countries of the CIS, China, India, and a few others. For both groups of countries, we saw that despite shortcomings, property rights protection was sufficiently in place to foster growth where it was needed, and accountability conditions are either good, or recently improved. We saw that for different reasons, both groups of countries might now be quite disinclined to rush through further economic reforms, except as and when they identified pressing economic or social problems that needed attention.



Endnotes

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1. The frequency of military coups, spells of military dictatorship, and, indeed, civil wars around world shows that this is not a condition to be taken for granted anywhere. But an extensive investigation of this aspect of the 'rule of law' is beyond the scope of this paper.
 2. A little outside the scope of this paper, but nevertheless developing a really interesting idea about property rights and the oligarchy in Russia, is the recent paper, Braguinsky and Myerson (2007).
 3. See, for instance, Sachs and Warner, 2001; also Mehlum *et al.*, 2006, for an extension of the analysis to illustrate the role of institutions in influencing the outcomes in particular countries.
 4. The *acquis communautaire* is the full set of rules, regulations and legislation governing the EU, and it is often estimated to run to many tens of thousands of pages. The process of monitoring each country's progress in implementing the *acquis* can be studied by reviewing the Commission's annual monitoring reports, some of which were extremely critical on certain topics. See the relevant part of the EU website: http://ec.europa.eu/enlargement/index_en.htm
 5. These three conditions together: implementing the *acquis*; operating as stable democracies; and being able to withstand economic competition from existing member states, are often referred to as the Copenhagen criteria for accession. They were first adopted at the June 1993 European Council meeting that took place in Copenhagen.

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