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Institutions in Transformational Governance: Lessons for Africa

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Institutions and governance capabilities are important determinants of the path and pace of development. Institutions are rules that describe how resources are allocated or choices and decisions are made, while governance capabilities describe how power and authority are used to enforce or ensure adherence to particular rules. Both are important for explaining the stability and credibility of property rights, the efficiency of markets, how political decisions about resource allocation are made, and how and to what extent important market failures can be addressed. Much of the institutional and governance advice given to developing countries in Africa and elsewhere has focused on the definition and protection of property rights, and the institutions and governance capabilities required to make markets more efficient. We describe this as the good governance reform agenda, or market-enhancing governance, because it focuses on the enforcement of market institutions. While this is undoubtedly important, there are structural reasons why the adherence to a rule of law and the enforcement of property rights across the board are necessarily weak in developing and emerging countries. The enforcement of property rights and a rule of law becomes stronger gradually in line with the emergence of a broad-based productive economy, but it also contributes to the efficient operation of this economy. This two-way relationship between the enforcement of and adherence to the institutions of a market economy and economic development is not in dispute. The important policy question, however, is how to accelerate social transformation in the direction of a broad-based and inclusive economy in developing country contexts where market institutions are hard to significantly improve in the short to medium term. The experience of developing countries that have achieved rapid social transformation is that these countries had a different and complementary set of transformational or developmental governance capabilities and institutions. These institutions and governance capabilities differed in detail across successful countries because their political settlements were different, but they had some common characteristics in terms of the problems that they solved. They assisted the transformation of property rights from traditional rights to forms that were more appropriate for the emerging capitalist market economy, overcoming specific market failures—in particular those constraining the achievement of organizational capabilities in emerging firms—and allocating and managing political resources to achieve sufficient political inclusion for political stability. At the same time they induced the creation of broad-based productive capabilities across the regions, tribes, ethnicities, religions, or other cleavages within the country.

1 | Introduction

In the last two decades, many African countries have achieved high rates of growth. However, the sustainability of the improvements in welfare that have begun to be seen depends on whether the growth is associated with processes of social transformation that result in a change in the organization of production across society. This typically involves a change in the sectoral distribution of activities across the country, generally with a growing share of activities in “modern” sectors of manufacturing, higher productivity agriculture and agro-industries, high-productivity services, and so on. If this social transformation can be sustained, the result is a broad-based and inclusive improvement in capabilities, and therefore of welfare across society.

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However, African countries face many challenges in sustaining such a broad-based social transformation. It requires, among other things, ensuring that growth is largely based on the development of employment-generating productive sectors, in particular manufacturing. This in turn requires changes in property rights to enable appropriate changes in the organization of production, assistance for the development of competitive capabilities in firms, and political arrangements that ensure stability without reducing economic dynamism.

Appropriate institutions and governance capabilities for enforcing these institutions are critical if social transformation is to be triggered and sustained in difficult developing country contexts. Institutions describe rules for making decisions and allocating resources. Policies also describe rules, and are therefore similar to institutions, but are typically easier to change on a regular basis than institutions. Governance describes how authority is used, and in particular, how public authority is used to enforce institutions and policies or to ensure adherence to these rules. Clearly, institutions, policies, and governance go together, and poor development outcomes can be the result of either: institutions and policies not being enforced because the state lacks appropriate governance capabilities; or the institutions and policies being inappropriate or inadequate for addressing the most important development challenges facing the country.

It is therefore important to jointly identify the institutions and governance capabilities that countries need to develop if they are to sustain their economic and social transformations. The institutions should be appropriate for addressing the economic and political challenges that the country faces. But they should also be such that they will achieve development results given feasible governance capabilities that the particular country has, or can feasibly develop. This means that the design of institutions also has to take into account specific economic, political, and historical conditions of particular countries that determine their governance capabilities. Institutions have to be effective, and effectiveness depends on governance capabilities, and this is why the best design of institutions can vary from country to country, not only if we compare Africa with East Asia, but also across African countries themselves.

In this paper, I discuss some of the important factors that determine the characteristics of institutions appropriate for accelerating the transformation in Africa. This discussion will inevitably require some review of the types of development challenges that developing countries face, without which we cannot discuss institutions and governance capabilities.

The paper's central argument is that the social transformation required to achieve higher standards of living in developing countries needs a set of transformational or developmental institutions and governance capabilities that are often at variance with the standard market institutions and "good governance" capabilities that most development policy advice focuses on. We also discuss the types of institutions and governance capabilities that are instead required for such a developmental transformation.

African countries have received much policy advice from development partners, often backed with conditional financial support, urging them to implement "good governance" reforms. Good governance has come to mean a combination of institutions and governance capabilities that support the creation and enforcement of property rights, the enforcement of a rule of law, a significant reduction of corruption, and the improvement of political accountability. These reforms have, in principle, enjoyed broad support across society because many of these goals are desirable in themselves. Who can be for corruption or against a rule of law?

But the economic case for these institutions and governance capabilities is *also* that these reforms are sufficient to *make markets more efficient* by reducing the transaction costs of enforcing contracts and providing efficient public goods. The underlying institutions are clearly defined property rights and transparent, accountable, and noncorrupt political rules for making laws and spending tax revenues. In terms of standard economic theory, these institutions and governance capabilities should make markets work better and enable states to provide essential public goods through taxation. Unfortunately, this institutional agenda does not address many substantive constraints that block the achievement of broad-based inclusive growth in developing countries. What is worse, this agenda identifies a set of institutions and governance capabilities that is very difficult to enforce in the typical developing country context.

It is not surprising that the implementation of these "good governance" reforms has not achieved significant results in Africa or elsewhere in the developing world. In particular, the implementation of good governance has faced two sorts of problems.

First, in conditions of substantial economic underdevelopment, enforcing these institutions has proved very challenging, because enforcing formal property rights and a rule of law presupposes economic and political conditions associated with advanced economies. It assumes that tax revenues are available for enforcing a general structure of rights, which is in fact an expensive proposition.

Second, formal institutions like property rights and a rule of law can only be effectively enforced if they are sufficiently aligned with the interests of dominant economic and political organizations. Again, in conditions of economic underdevelopment, the most powerful organizations are not yet potentially competitive and often do not support the enforcement of these institutions as they are unable to make sufficient profits on the basis of market contracting. Instead, the powerful are often more interested in violating rules as a strategy of accumulation. Thus we see limited enforcement of formal property rights and the rule of law across developing countries. Market institutions on their own are insufficient under these conditions, and additional institutions and governance capabilities are required to organize the social transformation through which a productive capitalist sector can emerge. This may require restructuring property rights in specific ways to accelerate the emergence of competitive firms, and assisting the development of productive capabilities within such firms. A more demanding set of institutions and governance capabilities is therefore required for organizing a developmental transformation. We refer to these as *developmental* or *transformational institutions* and governance capabilities.

Much of the standard good governance advice on institutions and governance is based on comparing countries with high productivity with those with low productivity. When we make this comparison, it is indeed the case that the former have much stronger market institutions. However, if we investigate the processes that drove the transformation of the former from lower- to higher-productivity societies, we find that the property rights transformations and the development of capabilities that underpinned these changes were often driven by very different institutions and capabilities. Historically, developmental transformations have involved an important role for politics and the state, not in enforcing some preexisting structure of rights, but rather in *changing* property rights structures and *creating opportunities* for creating new productive enterprises while managing political stability in contexts where the potential for conflict is very high.

Markets, defined as institutions supporting voluntary contracting, have always been important for enabling economic activity but have rarely played a dominant role in *driving* the transformations that created a large number of competitive enterprises in a developing country.[2] The most damaging aspect of the good governance agenda is that it has focused policy attention on a series of reforms that can at best be marginally implemented, and therefore have a marginal effect on the efficiency of markets, while ignoring the institutions and governance capabilities that are necessary to develop the capabilities and organizations that could benefit from these market institutions. For developing countries, a small improvement in the efficiency of markets will not address the more fundamental problem that they have very limited productive capabilities to benefit from enhanced market access. What they lack are economic organizations that are productive enough to be competitive in a global economy.

This is why the growth that has recently accelerated in a number of African countries over the last few decades remains vulnerable. It has often been driven by minerals and relatively few productive sectors, primarily in services and agro-industries. But for broad-based development to be truly sustainable, social, political, and institutional processes have to support the continuous development of new productive capabilities and organizations across the economy, particularly in manufacturing. This requires strong governance capabilities not limited to or focused on the governance capabilities that the good governance agenda concentrates on.

Social transformations are also likely to be periods of elevated levels of social conflict, because these changes inevitably create winners and losers. Periods of rapid change and the generation of new incomes and rents also create incentives and opportunities for some parties or groups to exclude others from access to power and resources. However, lasting political stability requires a continuous increase in political inclusion, combined with a growth in productive capabilities. There are no blueprints for political institutions that work across developing countries because their initial conditions and in particular their political settlements (the distributions of organizational power) are different. Nevertheless, political institutions that allow political inclusion are important because rapid transformations do not just happen, they have to be organized and the changes have to have sufficient support for reasonable levels of enforcement. Otherwise, progress may either be unnecessarily slow because of resistance, or rapid retrogression can suddenly happen because significant opposition can suddenly erupt. A better understanding of what these transformations involve can help identify the tasks that have to be accomplished, even if the precise institutional and policy solutions will be different across countries because of different initial conditions and political settlements.

In the rest of this paper, section 2 outlines the arguments for market-enhancing institutions and governance, which we describe as the good governance agenda. Section 3 introduces the alternative argument for transformational institutions and governance, followed by three sections discussing in turn important aspects of transformational governance: section 4 looks at the transformation of property rights, section 5 at the institutions and governance required to develop organizational capabilities in emerging firms, and section 6 at political institutions and political inclusion. Section 7 concludes.

2 | The limits of the good governance agenda

From the perspective of institutional economics, the "good governance" agenda focuses on strengthening institutional rules that could make markets more efficient by reducing transaction costs. The promotion of good governance can be described as a "market-enhancing" institutional strategy. However, there are other developmental institutions and governance capabilities ignored in the good governance approach. We will refer to these as developmental, transformational, or growth-enhancing institutions and governance capabilities.

Much confusion has been created by cross-country econometric exercises that have found that richer or better-performing countries score higher in terms of their good governance or market institution scores. The problem is that even the most sophisticated econometric techniques are inadequate for conclusively proving causality: was there a prior improvement of property rights, the rule of law and other good governance institutions in countries that achieved growth and development? And, do these improvements explain their transformation? A careful examination of the case study evidence on historical transformations suggests that no country achieved significant good governance capabilities

[2] Brenner 1985; Wood 2002; Khan 2004, 2005b.

before they developed their economy, and that other developmental institutions and governance capabilities played a significant role in these transformations.[3]

This finding is not surprising, because good governance institutions (like broad-based property rights and a rule of law) are expensive public goods and it is difficult, if not impossible, to achieve these fully in poor economies with limited fiscal resources. Moreover, the effective enforcement of these rules is unlikely unless powerful organizations in society support enforcement in their own interest. This alignment of interests assumes that many powerful organizations are already productive enough to be able to benefit from enforcing market institutions like property rights and a rule of law. In fact, if productivity and competitiveness are sufficiently low, the early enforcement of market institutions may actually be detrimental for many powerful organizations in developing countries. In contrast, advanced economies with powerful productive firms have the capacity to pay for public goods like property rights and a rule of law, and have an effective demand for these goods because powerful organizations want these institutions in their own interest.

The critical policy questions are whether significant improvements in these good governance institutions are possible in developing countries *before* a broad-based productive economy has emerged, and if significant improvements in these institutions are a necessary *precondition* for development. The historical evidence suggests that significant improvements in property rights and the rule of law are not possible except in line with the gradual growth of a broad-based productive economy, and that while the latter is helped by the development of these institutions, other institutions and policies are even more important to accelerate this progress. This is not to deny that improvements in market institutions are possible and that these can make some difference, but these differences are unlikely to explain the huge differences in developmental outcomes across countries.

These nuances are missed by looking at cross-country data on institutions, governance, and economic performance in an ahistorical way. The last can suggest that market institutions were instrumental in driving growth and prosperity. This is because by looking at end-states, we can easily miss the interactive *processes* through which both economies and market-enhancing institutions jointly developed over time. How did successful countries improve their good governance characteristics over time? Did they succeed in somehow enforcing market-enhancing property rights and good governance and *then* develop rapidly as a result? Or did they have *other* governance capabilities that allowed them to grow, with good governance capabilities also developing as productive organizations emerged who both demanded and were willing to pay for the enforcement of formal market rules?

Economic history looked at through the relatively crude methods of econometrics can miss the complex two-way causality between economic development and market institutions. It can suggest that market institutions were necessary and sufficient for driving development.[4] Instead, a case-study approach to economic history looking at the transformations of particular countries and the important nonmarket processes through which property rights were transformed and productive capabilities developed, strongly suggests that developmental institutions and governance capabilities were critical in accelerating transformations.[5]

3 | Transformation challenges for governance

Rather than simply attempting to enforce stable property rights and a good rule of law, successful countries had specific institutions and policies for transforming firm structures, adopting technologies, supporting the development of organizational capabilities, and protecting critical rights to sustain rapid transformations. These institutions and governance capabilities helped implement strategies to accelerate accumulation and technology acquisition, improve resource allocation, and achieve political stabilization using pragmatic strategies that differed from country to country. Some developers were dramatically successful, others less so. However, for very good reasons, the governance capabilities and political arrangements in successful countries display considerable variation, implying that there is no single blueprint for successful transformational governance.

Moreover, policies and institutional arrangements that worked well in one context can be associated with weaker or negative results in others. For instance, institutions that supported capability development in domestic industries had very positive effects on productivity growth in countries like the Republic of Korea, where the political settlement allowed firms receiving support in these ways to be effectively disciplined. In Pakistan in the 1960s, however, similar policies for supporting infant industries had less dramatic effects. Here, firms could block subsidy withdrawal using their political networks and had much lower compulsions to raise productivity. Indeed, in some countries or for some sectors, some strategies of protection and subsidies may actually have had negative effects on productivity growth.

The large variance in the outcomes associated with targeted interventions is of course a major reason that orthodox policy advisors have tried to reduce the policy space for developing-country states to implement industrial policy. Instead, they encouraged states to focus on reforms to make markets more efficient, including good governance reforms. Implicitly, these policies aim to prevent developing countries from making mistakes by reducing the discretion of their states. Yet the attempt to protect developing countries from the dangers of policy autonomy is both patronizing and deeply damaging.[6] Even if some developing-country states have made costly mistakes in the past, societies cannot be put on sustainable growth paths by introducing the "right" policies

[3] Some of this evidence is reviewed in Khan (2004, 2005b), Meisel and Aoudia (2008), and Khan (2012a).
[4] For instance Acemoglu and others (2001, 2002).
[5] Khan 2012a.
[6] Fukuyama 2005.

from outside and limiting the autonomy of their states to make variations thereafter.

Growth requires a continuous adaptation to changing economic and political circumstances and this most vital capability of experimentation and adaptation can be destroyed or stunted by strategies that aim to constrain the policy autonomy of policy makers. Even the most ideological supporters of market economics will concede that, within broad limits, sustaining growth requires a large amount of policy autonomy to respond to crises in creative ways. Indeed, crisis and challenge can be caused by the operation of markets themselves, a fact we are occasionally reminded of during global financial crises. The historical reality is that the ability to act autonomously may be even more important at earlier stages of development because there is actually a wide range of variation in successful strategies of social transformation.[7]

As societies begin with different political, social, and economic conditions, it is not surprising that they do not follow the same strategies and paths of transformation. Nevertheless, there have been a variety of strategies of transformation with different degrees of success. We can learn from the ways in which successful countries addressed specific problems during their transformations even though the precise instruments and methods cannot be copied and replicated in different contexts.[8] The real irony is that none of the successful transformational economies of the last 50 years appeared to have followed the "good governance" strategy in making their transition to high levels of productivity and broad-based productive capabilities. By setting apparently plausible but unachievable institutional and governance capabilities as policy targets, the global policy discourse has set other developing countries a goal that they cannot possibly achieve and that is unlikely to help them to traverse the developmental transformation any better.

Societies have to devise their own institutional strategies that can pragmatically address their growth challenges as best as possible given their political constraints. As the political settlements of countries can be widely different, identical institutional solutions to support transformations will not work. However, this does not mean that country specificity can be used as an argument to justify any institutional strategy. There are many flawed institutional strategies that may emerge either because of poor policy advice or because of rent-seeking activities within these countries. That is why even if blueprints cannot be copied, an institutional analysis of feasible growth-enhancing institutions is critically important. The only general lesson is that developing countries should not attempt to implement particular institutional blueprints without first asking if it is feasible to implement and enforce these institutions in that context, and second whether those institutions will address the issues that are constraining growth in that country. Cross-country experiences can tell us a lot about the *types of problems* that institutions had to address to sustain transformation. Similar problems will have to be addressed in any developing country, even though the particular institutions and governance capabilities that best address these problems will necessarily be somewhat different. This framework allows us to have productive discussions about feasible and effective institutional design across countries.

The cross-country evidence of social and economic transformations tells us that successful countries addressed a number of critical challenges that enabled them to sustain their social transformation over extended periods. Their institutions and governance arrangements allowed high rates of accumulation, relatively efficient resource allocation to growth sectors, and technology adoption combined with rapid learning of organizational capabilities to use these technologies competitively. The historical evidence in Asia and elsewhere suggests that developmental transformations have required institutions and policies that addressed critical market failures that would otherwise have constrained the achievement of these objectives.[9]

We know how particular institutions achieved this in different countries. We also know that these institutions worked effectively because of the specific political settlement in each country that allowed particular institutions to be effectively enforced. The starting point for a policy discussion is to ask how these problems have been addressed in a particular country, if at all. Is there a better way of addressing these problems in our country, given differences in political settlements and initial economic conditions? The growth-enhancing (or transformational) approach to institutions and governance identifies problems that were addressed by successful transformation countries. This can help other countries address these problems with plausible institutions and policies given their own institutional and political conditions, and perhaps with greater social justice and with fewer costly mistakes than the earlier developers.

In understanding the challenges facing Africa, we need to keep in mind the structural features of developing countries that constrain sustained economic and social transformation.[10] Three areas stand out. First, developing countries need to manage the allocation of rights over valuable resources like land and natural resources, given that property rights are weakly defined at early stages of development. Historical evidence and economic theory both suggest that contrary to the expectations of economists who believe that stable property rights can be created in any context provided there is sufficient political will, the weakness of property rights in developing countries is structural and not entirely due to the greed of political leaderships or to their inadequate will to enforce a rule of law. Second, transformational institutions need to assist emerging economic organizations like firms and farms to raise their technical and organizational capabilities so that they can become competitive using modern technologies. This process of learning is subject to significant market failures that need corrective interventions;

7 Khan 2012a, 2012b.
8 Amsden 2001.
9 Amsden 1989; Wade 1990; Khan and Jomo 2000; Lall 2003.
10 Khan 2005b.

transformative institutions and governance are critical here. Finally, sustaining transformation requires political inclusion to be satisfactory, and political institutions are vital in ensuring this.

4 | Transforming and managing property rights

Developing countries do not already have a good rule of law and well-defined property rights because they have too few competitive organizations that can pay for the provision of these public goods and that demand these goods as essential for their own continuing prosperity. Property rights and the rule of law therefore become gradually better over time as countries develop an increasing number of productive and competitive enterprises that can pay to enforce these rules and that can effectively demand the enforcement of these rules as essential for their own prosperity.

Sustaining inclusive growth across a range of sectors and firms depends on the effectiveness of states in creating and managing institutions that enable the changes in property rights required for sustaining a viable transformation. Transformative institutions that can improve the allocation of land and other natural resources can therefore play a vital role in sustaining growth. These institutions could, for instance, assist land reform or administrative land allocation processes that follow appropriate rules to direct land toward more productive uses while protecting the vulnerable. In the absence of land markets that are already working well, developing countries need such institutions and governance arrangements to accelerate the property rights transformation in ways that have broad social approval, and are as transparent and equitable as possible. In particular, the vulnerable have to be protected and adequate compensation paid as land use is changed, while the rights of new users also have to be protected to enable investments to take place.

The pace of development can be seriously slowed—even stopped—if a society lacks rules for land acquisition in high transaction cost markets and for the transfer of land to new high-value uses. These rules have to have social acceptance and not be opposed by significant sections of society. If these institutions are absent, the supply of land for growth sectors can be constrained, as has happened, for instance, in some parts of India in the last two decades. High rates of development require rules for acquiring land and for compensating previous users of land, rules for allocating land to new uses—and perhaps withdrawing rights from new users who fail to use land in designated ways—and protecting the rights of high value land users. If these transformative institutions are effective, eventually a growing number of land users will become competitive market players with high productivity, and they will eventually be able to pay for and demand the protection of property rights as a public good. At that point, well-working land markets are likely to emerge, and the role of transformative institutions will decline. Market transactions will then largely be able to drive development, with a more limited role for states, transformative institutions, and governance in addressing market failures.

5 | Technology acquisition and organizational capabilities

Successful economic transformation always involves the development of many domestic firms that are internationally competitive. Transformational strategies therefore must involve institutions and policies for technology acquisition and for capability development within firms. This process could in theory be organized through private investments based on market contracting if markets were efficient enough. But developing countries suffer from significant market failures. This is well recognized, but what is to be done? The problem of market failure is usually attributed to the absence of institutions like property rights and governance arrangements that can enforce a rule of law. However, as argued earlier, it is unlikely that market-enhancing governance reforms that seek to address this can be sufficiently well implemented in developing countries to heavily reduce these market failures.

Instead, the transformational governance approach directly attacks the most significant market failures constraining the development of competitive firms. A number of market failures can prevent investment in sectors that require the absorption, adaptation, and learning of advanced technologies.[11] The most important is arguably the set of factors that prevents investment in learning-by-doing through which firms acquire organizational capabilities and thereby become competitive. Entrepreneurs and their firms in late developers have to face more competitive firms in other countries that are far ahead of them in organizational capabilities. To survive, they have to rapidly acquire the tacit knowledge required for using modern technologies within their organizations at levels of productivity that make them competitive. The acquisition of these organizational capabilities through learning-by-doing requires heavy investments in learning, as firms are insufficiently profitable or may even initially be loss-making while acquiring the requisite capabilities.

These investments in learning face major contracting failures because investors who may want to invest in these learning processes cannot be sure that their contracts can be enforced to protect their money and earn a return. These contracts are potentially complex because they have to ensure that teams within the firm put in the requisite steep learning effort to make the learning effective. Investors also need to be able to withdraw what is left of their investments if the performance of the firm looks unpromising at a later date. As these types of complex contracts face enforcement uncertainties in developing countries, market failure can prevent private investors from organizing the financing for learning-by-doing. This is an important reason why competitive enterprises emerge so slowly in these contexts. As explained earlier, it is not credible to try and address this and other market failures by attempting to make markets sufficiently efficient using good governance institutional reforms.

[11] Khan 2013b.

Instead, technology adoption and learning are likely to be much faster if the market failures are directly addressed with public policies. Effective transformational institutions and governance capabilities are needed to provide direct solutions to critical market failures. With this important market failure, transformational institutions and policies have to provide public resources for learning with effective withdrawal conditions to discipline firms, so as to ensure high levels of effort in the learning process.[12] It is now widely recognized that the rapid growth of the East Asian tigers was supported by states that provided resources for learning-by-doing and capability development but with effective capabilities to withdraw these resources and discipline nonperforming firms in different ways. The experience of East Asia shows that while the institutions and policies for assisting learning differed widely, in the successful cases, institutions and governance arrangements could be effectively enforced to create credible incentives and compulsions for learning.[13] These critical transformational institutions therefore allowed much faster rates of transformation.

However, the transformational institutions that intend to provide support for technology and learning can also be poorly designed. This could either be because the institutions fail to provide enough support to firms on the right terms to create incentives for effective learning-by-doing, or it could be that the rules and associated enforcement arrangements are not credible in that political settlement because they do not create compulsions for supported firms to put in high effort.

For instance, if supported firms are powerfully connected to politicians with short time horizons, an institution that provides subsidized credit from public sector banks and sets conditions for their withdrawal if there is underperformance is unlikely to be credible. More complex institutions for supporting learning are required in these cases, as we see in the case of successful learning in the Indian automobile industry and the Bangladeshi garment industry. Otherwise, public resources will be unproductively captured by firms and result in infant industries failing to grow up. These differences in institutions and governance capabilities are important explanations of developmental differences across countries. The design of critical transformational institutions so that they are effective given the political settlement is therefore one of the major challenges for countries attempting to achieve transformation.

Relative to the high-growth Northeast Asian countries, the initial conditions for implementing strong transformational institutions are relatively adverse in many African countries, both initial entrepreneurial capabilities and the suitability of their political settlements for enforcing discipline on firms. Nevertheless, the experience of other Asian countries like India and Bangladesh, with political settlements similar to many African countries, shows that challenges of developmental transformations can be addressed even in countries with adverse political settlements. However, here the institutions and policies have to be carefully designed so that incentives and credible compulsions for high-effort learning are created. In particular, transformational institutions have to be more modestly designed in these contexts, and seek to assist the development of competitiveness in only a few sectors at a time. The sectors would have to be carefully chosen, but usually the choice is relatively obvious given the available skills of the workforce, international market conditions, and so on. For instance, in many African countries, electronic components assembly, garments and textiles, footwear, food-processing industries, telecommunications, and tourism are obvious choices.

The strategies for developing competitiveness by supporting learning-by-doing and developing organizational capabilities would have to be compatible with existing technocratic and political enforcement capabilities. In many cases, this would mean that initial experiments would have to be on a relatively small scale and scaled up if successful. Undoubtedly, any country will make mistakes, as all previous countries have. Perhaps the most important correction required to our current way of thinking is that the adoption and learning of technological and organizational capabilities is an incremental process that involves making mistakes and learning from them.

Most of the literature on transformational learning strategies refers to the Northeast Asian experience, particularly the Republic of Korea, during the 1960s and 1970s. During this period, the financing of capability development took place through institutions and policies that gave sizable upfront resources to firms, with enforceable conditions of withdrawal that ensured high effort in raising competitiveness. However, for historical reasons, the East Asian economies were unusual in that they had political settlements that allowed the enforcement of tough conditions on the domestic firms that received this type of support.[14]

In the Republic of Korea, significant “rents” or policy-created incremental incomes were allocated ex ante to large firms to provide time and resources for learning-by-doing. The financing provided to the *chaebols* through low-interest loans, protected domestic markets, and export subsidies came with credible sanctions if export targets were not met. The buoyant global markets at that time and the ability of diversified *chaebols* to start exporting quickly meant that export performance was a good indicator of effort. The political and institutional conditions in the Republic of Korea also allowed corrective and sometimes punitive action to be taken against recipients of subsidies if export and other evidence suggested low levels of learning effort in the firm. For instance, the state could not only withhold export subsidies if export growth was not achieved, it could also reallocate the ownership of plants to different *chaebols* if they were more likely to acquire the necessary organizational capabilities, ensuring high effort in acquiring the requisite productive capabilities by the firms receiving support.

When other developing countries, such as India and Pakistan, had attempted similar types of industrial policy support for

[12] For more details, see Khan (2013b, 2013d, 2015).
[13] Khan 2000b; Khan and Blankenburg 2009.
[14] Khan 2009; Khan and Blankenburg 2009.

infant industries in the 1950s and 1960s, they discovered that they lacked the institutional and political conditions that could impose credible conditions for ensuring high levels of effort by firms receiving support. As a result, effort was often low and technological and organizational capabilities developed much more slowly. Indeed, many firms and sectors supported at that time never became competitive.[15]

Today, these instruments for financing capability development would only make sense if market conditions for a contemporary late developer allowed a similar export-oriented manufacturing growth strategy, and if the political and institutional conditions allowed the enforcement of similar conditions on firms receiving support. Not only have the rules for participating in global trade changed, but the relevant features of the political settlement in the Republic of Korea that allowed its state to monitor and discipline particular types of rents were very different from those in most developing countries.[16] If the only instruments available for financing the development of organizational capabilities were the ones the Republic of Korea used, most developing countries' institutions of industrial policy would fail because they typically lack the political settlements that would allow the enforcement of relevant conditions on firms receiving support.

Fortunately, the Republic of Korea's model of centralized subsidy allocation is not the only one for addressing contracting failures affecting learning.[17] The experience of successful sectors in developing countries with very different political settlements shows that other types of financing instruments and institutions can be effective, even when governance conditions appear adverse for the type of industrial policy used in the Republic of Korea.[18] The critical requirement is only that the institutional and political conditions have to be appropriate for creating credible incentives and compulsions for high effort given the financing instruments that are used. This is borne out by examples of successful technology adoption in *some* sectors in Bangladesh, India, and Thailand.[19]

Effort can be forthcoming if the financing instruments not only provide the resources for financing learning, but also create compulsions on firms by imposing conditions for high effort that are credible, given the enforcement capacities of the state. If this can be done, the state still has to do some monitoring and enforcement, but this can be successful if it is restricted to conditions that the state can credibly oversee.

The development of India's automobile sector is one such example. In the 1980s and 1990s, it made the transition from a protected and largely inefficient sector producing low-quality cars for the domestic market to become a major global player. This was made possible by a unique combination of industrial policy institutions that financed capability development in the 1980s in the sector, based on a combination of public and private financing instruments.[20] Under the earlier strategies of centrally administered protection, there was no compulsion on India's protected automobile manufacturers to make the effort to achieve competitiveness in global markets. But the new strategies in the 1980s provided public rents with conditions attached that resulted in credible compulsion for high effort in building the organizational capabilities of producers.

When domestic companies had received support in the 1960s and 1970s, the state failed to impose effective conditions on them. The learning effort, and therefore productivity growth, was low, resulting in the production of globally uncompetitive cars. Change came in the 1980s when Japan's Suzuki became a joint venture partner in a public sector Indian automobile company, and Maruti-Suzuki was born. In contrast to previous strategies for financing, this time there were credible conditions that induced high effort. Suzuki was given access to the significant rents in the protected domestic market, where tariff protection was still around 85 percent in the 1980s. However, Suzuki was told it had to achieve 60 percent local content within five years. Denying Suzuki access to the domestic market if the target was not met was a credible threat given the institutions that the Indian state possessed, and this forced Suzuki to transfer organizational and technological capabilities to local component suppliers. This marked the beginning of India's development of a globally competitive components industry that allowed it to manufacture its own branded globally competitive cars in the 1990s.

To meet local content requirements, Suzuki had to invest substantial resources and effort in upgrading organizational and technical capabilities, not only in its own joint-venture plant, but also along the entire Indian supply chain for automobile components. Suzuki's incentive was the significant rent it could achieve after meeting the local content target. But to get there, it had to invest in learning and in the transmission of organizational capabilities to a range of Indian component producers. The company had no possibility of capturing the rent without delivering the transfer of organizational knowledge, and this ensured the success of the strategy. Suzuki invested in and worked with its local suppliers to improve their quality-control procedures and internal organization of production to achieve the level of local content it had committed to. The results of its effort to transform the productive capabilities of India's tier-one and tier-two producers were spectacular. Maruti rapidly became the dominant model in the Indian market.

Clearly, this instrument cannot be used for countries that have already joined the World Trade Organization, which generally does not allow domestic content conditions. Nor would it work in countries whose domestic automobile market is relatively small. But this example shows how the design of credible institutions and financing conditions can have a remarkable effect on learning effort in countries where standard infant-industry protection strategies have failed to induce much learning effort.

[15] Little and others 1970; Khan 1999, 2011, 2013c.
[16] Khan 2010, 2012c.
[17] Khan 2000a, 2000b.
[18] Khan 2013d.
[19] Khan 2009, 2011, 2012c, 2013a.
[20] Khan 2009, 2011.

This institutional arrangement was repeated in subsequent government-supported deals in India's automobile sector, allowing other major foreign automobile producers access to the rents in the Indian domestic market in exchange for further investments in the organizational capabilities of domestic component producers over the next decade. By the late 1990s, Indian automobile component producers were competitively entering the export market in their own right, and winning international quality recognition, such as Deming Prizes.

The viability of a globally competitive but domestically owned automobile industry depends on the presence of domestically owned globally competitive tier-one and tier-two components producers who can produce the parts required for a domestically produced car. By the 2000s, the emergence of a broad range of globally competitive Indian components producers allowed Indian auto companies such as Tata and Mahindra to launch Indian-branded cars.

Other examples of successful learning from Bangladesh, India, and Thailand show that organizational capability development can be successfully financed in contexts very different from that of the Republic of Korea, provided that appropriate institutions and financing instruments exist. The Bangladeshi garments industry emerged in a very similar way with incentives created by specific institutional arrangements for a company from the Republic of Korea, Daewoo, to transfer organizational capabilities to a Bangladeshi-owned company, Desh, which rapidly achieved the capabilities of competitive global production of garments. As Desh was an entirely local company, with local management, many middle managers of Desh later left to form their own companies, allowing rapid replication and growth of the sector. Bangladesh went from being a novice in the garments industry in the late 1970s to becoming the second-biggest exporter after China today.

But unlike East Asia, these examples are limited to single sectors and neither India nor Bangladesh have achieved a broad-based transformation yet. Nevertheless, their examples may be more relevant for African countries whose political settlements are closer to the South Asian countries than to Northeast Asian ones, and developing globally competitive productive sectors one at a time may be the only feasible approach in these countries. Successful transformational strategies in South Asia were based on combinations of institutions and financing instruments that were appropriate for the context, and created incentives and compulsions for high effort in developing productive capabilities that were credible given the enforcement capacities of the state.

6 | Political inclusion

The good governance approach suggests that the political institutions of multiparty democracy are essential for ensuring the legitimacy of the laws that are passed, and therefore the enforceability of a rule of law. They are also argued to be essential for achieving political stability and accountability because political competition is assumed to allow conflicting demands to be legitimately resolved and for political leaders to be held to account. However, democracy too has been difficult to institutionalize in developing countries and the evidence suggests that it has had anomalous results. Even where forms of democracy exist there, it has often proved very difficult to organize elections in rule-following ways such that the results of elections are widely accepted. Sitting governments often tend to use administrative powers to tilt the playing field in their favor. In other cases, ethnic, tribal, or religious minorities feel permanently disadvantaged, absent strong enforcement of the rights of citizens. These problems of institutionalizing democracy are linked to the general problem of enforcing a rule of law in developing countries.

Beyond these problems, the limited access to resources through the formal budget means that a ruling coalition rarely wins elections or stays in power simply on the basis of what it promises to do with the budget. Rather, electoral victory or even the sustainability of an autocracy typically involves patron–client exchanges where supporters of parties or leaders are rewarded with benefits that are off-budget, such as government contracts, access to bank loans, or even in some cases, opportunities for some types of corruption. For lower-level supporters, there can be a promise of assistance with jobs, assistance in legal or other conflicts with other citizens, or occasional cash handouts. All this means that democracy in developing countries often involves high levels of rule violations and corruption, and the outcomes are never fully satisfactory accountability-wise, given the dominance of patron–client politics.

What is relevant from the perspective of transformational institutions is that developing countries with Western-types of democracies are not necessarily more inclusive in their growth, nor do they systematically achieve greater political and economic stability than countries that do not have these institutions. The most dramatic transformational success stories, like the Republic of Korea, Taiwan, or China did not have democratic institutions of the Western model during the critical years of growth acceleration and structural transformation.

On the other hand, many other developing countries with authoritarian regimes did very poorly, with massive resource capture and outflows of capital. Similarly, some democracies, like Malaysia or Thailand in the 1980s or some states within India today have achieved sustained high levels of growth and structural transformation with democratic political institutions, while other democratic states have faced political instability, contested elections, capital flight, and high levels of political corruption.

In other words, the political institutions of democracy appear to be neither necessary nor sufficient for successful transformation, though they are clearly desirable in their own right.[21] Nor do the political institutions of authoritarianism of different types produce determinate results. We can make sense of this anomalous evidence if we remember that the ways in

[21] Przeworski and Limongi 1993; Przeworski and others 2000; Khan 2005a.

which particular political institutions work in developing countries depend on the distribution of power across different stakeholders and organizations in that society. Just like economic institutions, political institutions work differently in different political settlements.

Like economic institutions (such as those relevant for the operation of industrial policy), political institutions also matter for economic transformation. Political stability and political inclusion are important for sustaining transformational processes. Political institutions set the rules of engagement for political actors. These rules affect whether groups with the potential to disrupt growth if they are excluded can access political power to achieve inclusion. The rules also determine whether the groups included in political power and with access to political resources have the incentives and compulsions to become productive players, or are only interested in unproductive resource capture. Meeting both these conditions of inclusion and incentives for productivity is not easy, but absent these conditions, both democratic and less democratic political institutions can fail to achieve sustained transformational success.

Political inclusion can be achieved in multiple ways, and some ways of achieving inclusion can be consistent with high rates of transformation, while other mechanisms can slow or disrupt transformation. Similarly, political exclusion can in the short term enable an acceleration of investment and growth, but in the longer term it almost invariably has a negative effect on the sustainability of growth and transformation. Political institutions and the political settlement are therefore important determinants of the outcomes achieved.

A common mechanism through which political inclusion is achieved in many developing countries is to incorporate political leaders from different ethnic groups, religious identities, tribes, or castes within the broad “ruling coalition.” This strategy, which can be broadly described as political patronage and clientelism, can achieve political stability because it provides critical intermediaries in different groups with access to resources, which they can then use to satisfy demands from their own clients, and so on, down the political chain. This can undoubtedly create political stability relative to political institutions that do not allow all relevant groups within a country a similar access to resources.

On the other hand, the institutions that enable this type of inclusion can have very different effects on the sustainability of growth and transformation. If the patronage to regional or tribal leaders results in resource flows used unproductively, the upshot can be very destabilizing in the longer term. Growing demands for redistribution are likely to emerge from further groups that feel deprived, but the economy may not be generating enough new resources through growth to meet these demands. If the political system keeps diverting resources to emerging power brokers in different regions, tribes, or ethnicities, this will eventually divert resources from productive uses, while creating further dissatisfaction lower down in society as people see their leaders getting rich without delivering jobs and prosperity sustainably.

Political institutions that provide resource flows to a diversity of groups within the country but also ensure that these beneficiaries become productive job-creators can create a combination of inclusive politics and growth that is sustainable. Political institutions therefore have to work in tandem with economic institutions to ensure that entrepreneurs and businesses emerge across all the different ethnicities, tribes, religions, and regions of a country, so that political resource flows are combined with emerging, sustainable economic activities.

This is a difficult but critical task that has to be achieved by political institutions, regardless of whether the overall characteristics of these institutions are somewhat more democratic or somewhat less democratic along the Western benchmark of competitive multiparty democracy. Focusing simply on the latter without asking if these institutions are achieving inclusive political and economic outcomes can soon generate disappointment. Democracy can lead to significant resource capture by powerful elites who use these resources unproductively and thereby constrain social transformations. Equally, authoritarian regimes that politically exclude significant groups without ensuring that businesses and jobs emerge across all regions, ethnicities, tribes, and religions may also face internal turmoil and even conflict. Indeed, to survive, many authoritarian regimes engage in the most unproductive types of patronage to buy off regional groups, often at the cost of huge resource wastage.

The challenge is therefore to design institutions that achieve political inclusion across all relevant groups in that particular society, with strategies of capability development discussed earlier, which can convert a growing number of individuals into productive entrepreneurs.

6 | Conclusions

Comparative historical evidence based on a more detailed process analysis than is possible using econometrics alone shows that the institutions of good governance, such as broad-based property rights and a rule of law, emerge gradually and in line with the social transformation of a society, rather than emerging first and then driving the social transformation. These institutions are increasingly important as societies become more developed and complex, and as a growing number of high-capability productive organizations emerge that demand—and can pay for—the enforcement of these institutions. Growth and social transformation also depend critically on other transformational institutions and governance strategies that maintain political stability, achieve political inclusion, and assist in creating productive enterprises through capability-development strategies.

Transformational institutions are not easy to develop and their shape and form vary across countries. This is because the most appropriate political and economic institutions that can maximize developmental success depend very closely on the distribution of political power in countries, their historically inherited political organizations, and the bases on which they are organized and on their initial economic conditions. The political and economic institutions that worked in East Asia are no guide to those that may work well in sustaining transformation in Africa.

We can learn a lot, however, from East Asia or even more from South Asia to understand the *types of problems* that economic and political institutions need to solve to achieve higher rates of social transformation. We can then ask in the context of specific countries in Africa, what the design of these institutions and governance capabilities need to be to solve similar problems of property right transformation and protection, capability development of emerging firms, and political inclusion. Such an approach can help identify and develop transformational institutions and governance capabilities in countries that are going through their own processes of social transformation.

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