

Vulnerabilities in Market-led Growth Strategies and Challenges for Governance

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Summary: This paper is the first in a series of four papers developing an alternative approach to growth-enhancing governance in poor countries. Its argument follows an earlier paper where we argued that ‘market-enhancing’ governance, also referred to as ‘good governance’ is not strongly correlated if at all with growth in poor countries (even though many of the goals of good governance are desirable in their own right).

The core argument is that ‘growth-enhancing governance’ refers to governance capabilities for correcting significant market failures that poor countries face when they try to catch up with advanced countries. For a long time, this debate has been dominated by a discussion of the North East Asian NICs like South Korea and Taiwan, which clearly had very strong growth-enhancing capabilities. Since most developing countries clearly do not have these capabilities, the conclusion was that this was an interesting but not very relevant discussion for poor countries.

Our argument is that while the grand capabilities of the North East Asian countries are indeed unviable policy goals for most developing countries, there is no alternative to developing specific, carefully selected growth-enhancing governance capabilities on a country-by-country basis. To establish the importance of this approach, we select five ‘second tier’ growth economies: Thailand, the states of Maharashtra and West Bengal in India, Bangladesh and Tanzania, which are all frequently described as market-led growth stories. The assumption is that growth in these economies took off without much state assistance, and in fact in some cases directly as a result of abandoning interventionist policies. We argue that this view is only partially true and can even be misleading. We show that even in these second tier countries, business-government relationships, accidental rents and rent creation and the presence of appropriate governance capabilities for managing these rents were critical for explaining the development of critical capabilities and for sustaining the growth that happened, the sectors that grew, and indeed the vulnerabilities of these economies. All these economies have vulnerable growth processes precisely because the range of sectors and technologies that could benefit from growth-enhancing governance capabilities is typically limited. Moreover, in many cases, the understanding of the growth process is inadequate, and many of the domestic stakeholders can be unaware of the unintended consequences of many of these arrangements.

This paper sets the background for a detailed analytical examination of specific aspects of growth-enhancing governance in these countries in subsequent papers.

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1. Introduction

The importance of economic growth as an essential condition for achieving broader developmental objectives is now frequently recognized in international policy discussions. The Growth Report of the Commission on Growth and Development (2008) is a recent statement of this recognition based on the experience of developing countries and international financial and policy institutions. It is clearly important to focus on growth, not to the exclusion of other objectives, but indeed to enable broader developmental objectives to be achieved. The Growth Report takes care to point out that growth is a complex process involving experimentation and the ability to respond to evolving problems. It rightly points out that there is no blueprint of necessary and sufficient conditions that can be identified, and responses that are appropriate at one stage of development may become a problem if continued for too long.

The report identifies five broad areas where *policy* appears to have been important for achieving sustained high growth in the post-war period. A first broad group of policies were important for supporting high levels of accumulation. A second group of policies promoted innovation and imitation and accelerated or sustained the technological catching up that development involves. A third group of policies achieved macroeconomic stabilization. A fourth set of policies ensured the effective allocation of land, labour and capital. And finally there were policies that ensured social inclusion and were important both for achieving developmental goals but also for maintaining the political sustainability of the growth regime (Commission on Growth and Development 2008: 34). The report makes clear that countries used different policies and instruments to achieve these goals, and all countries did not perform equally strongly on all these fronts all the time. Nevertheless, sustained growth over long periods of time did require policies that achieved a significant level of success on all these fronts.

These interconnected areas are broadly defined and cover most of the main issues relevant for understanding the growth process in developing countries. All these policy areas are also strongly interconnected. The debates over macroeconomic management have a separate literature and will not be examined further in this work. However, aspects of investment, technology acquisition, factor allocation and political stabilization are strongly interconnected with each other and with the institutional and political governance capabilities that are our focus. We argue that governance capabilities that support appropriate policies in these areas are critical for the most important processes underpinning growth in developing countries.

As the Growth Commission report sets out, there is considerable debate and empirical variation observed in the policies that achieved the outcomes that contributed to sustainable growth across countries. Our theoretical framework approaches this debate in a particular way. Our starting point is the observation that developing countries suffer from serious and sustained market failures that constrain catching up. Many of these are well known in the literature, but in recent years, the response to market failures has been to focus on a narrow set of governance reforms that are aimed at enhancing the efficiency of markets and thereby reducing the extent and severity of market failures. The focus of these governance reforms have been market-enhancing rather than to directly tackle the market failures that constrain

accumulation, technology acquisition and other constraints on growth in developing countries (Khan 2007a, 2008b).

While progress on market-enhancing governance capabilities is desirable, we have argued in an earlier paper that historical evidence suggests progress along these directions is unlikely to be rapid or extensive in most developing countries for a number of structural reasons (Khan 2008b). As a result, sustaining growth in poor countries also requires governance capabilities and policies that directly address specific market failures. These governance capabilities may be described as growth-enhancing governance capabilities to distinguish them from the narrowly market-enhancing governance capabilities. The hypothesis that we explore in this paper is that by accident or design, successful countries had a number of governance characteristics and policies that were able to overcome critical market failures in their specific context defined by their initial conditions and global market conditions. The triggering of growth in countries that were previously not growing could be due to complex and fortuitous sets of reasons involving changes in global market conditions, financing opportunities, but also changes in domestic institutions and politics that allow new capabilities to be developed or existing capabilities to be better used. But sustaining growth over time requires the continuous evolution of institutions and policies to deal with new constraints and opportunities. Sustaining growth therefore has higher governance and capability requirements than triggering growth, a fact that has been frequently observed by analysts of growth takeoffs.

The discussion about governance capabilities necessary for sustaining growth has for a long time been dominated by the experience of the industrial policy regimes of North East Asia (for instance Amsden 1989; Wade 1990). This discussion raised questions about the applicability of these insights for most developing countries that clearly did not have the strong growth-enhancing governance capabilities of the East Asian tigers. The more recent growth experience in South and South East Asia and in Africa appears to be driven to a much greater extent by 'market forces'. As the North East Asian countries were also market economies which grew by taking advantage of global market opportunities, what 'market forces' actually means in this context is that there appears to be less significant government interventions in South and South East Asia and in Africa, and these countries appear to be growing by leveraging already existing technological and productive capabilities or new opportunities in commodity markets.

In reality the picture is of course more complex. In the more developed sectors of the stronger countries particularly in South and South East Asia, technological progress in recent years has indeed been based on developing existing capabilities within firms using market incentives and opportunities. But as we shall document, i) existing capabilities were themselves very often the result of past capability-building programmes where governments were closely involved and ii) the continuation of growth even in market-driven societies has depended on appropriate business-government relationships for addressing changing sets of market failures. It is particularly misleading to ignore history, if only because it begs the question of where further generations of capabilities and globally competitive firms may be coming from to spread growth to new sectors and regions. At the same time, as we shall see, fortuitous global conditions or specific business-government relationships also allowed the development of some new technological capabilities in a few of these

countries. But in general, the governance capabilities responsible for driving growth in these later developers in South and South East Asia are considerably different from the ones that were observed in the North East Asian developers.

An important difference with North East Asia is that in most of the cases we will look at in South and South East Asia and in Africa, the critical governance capabilities did not emerge through design, but often emerged in fortuitous ways. Sometimes local governance capabilities evolved such that global opportunities could be exploited in new ways, sometimes global opportunities changed so significantly that existing domestic capabilities were sufficient for triggering growth. As global conditions change, or as domestic political and institutional arrangements evolve, some of these fortuitous conditions may no longer hold in the near future. For many poor countries, therefore, the governance capabilities and opportunities that are allowing some countries to enjoy growth are therefore vulnerable in different ways. To understand the role of governance capabilities in triggering and sustaining growth in poor countries better, we need to identify the role of formal and informal governance arrangements in countries that actually enjoyed growth accelerations.

This chapter sets the background for an extensive development of this hypothesis in a number of related papers by looking at the growth process in a number of developing countries and the governance arrangements underpinning growth in these cases. We look at five cases of moderate to high growth over 1980-2005 and ask how these growth stories were driven and the types of market failures that may constrain future growth in these countries. The cases we focus on are Thailand, the states of Maharashtra and West Bengal in India, Bangladesh and Tanzania. All these states experienced moderate to high rates of growth in the last 25 years. A closer look at these growth stories shows that while there are important differences between them in terms of the sectors and technologies they deployed, there are also important similarities.

In all these cases, many of the critical investment and technology capabilities on which their competitiveness was based were not primarily developed through deliberate government policies. In some cases these capabilities were inherited from previous regimes of industrial policy that on the whole had failed but which nevertheless allowed the development of pockets of competence that were later deployed in global markets. In other cases, capabilities developed accidentally as a result of global or domestic policies that had other objectives. In other cases previous development created firms which had the capability to develop technological capacity in-house. While the sources and drivers of growth were different, these countries demonstrate a number of interrelated vulnerabilities in the governance and policy framework underpinning their growth strategies. These vulnerabilities are not equally serious in all cases, but they point to areas where governance capabilities and policies could be examined to make growth more sustainable over time.

2. Background

The background to this paper is an earlier paper on growth and governance which identified a number of critical areas for further research (Khan 2007b). That paper contrasted two different approaches to improving governance conditions in poor countries. The debate over the appropriate governance conditions that promote growth

in poor countries is related to broader questions within economics about how to identify and deal with critical market failures in developing countries while minimizing the cost and seriousness of government failures.

The ability to compete in global markets has rightly been identified as an essential condition for sustaining growth. However, it is often wrongly concluded that since competitiveness is critical, it is sufficient to introduce free markets and expose domestic producers to the discipline of global markets. This is because there are no markets without market failures, and market failures are particularly significant in developing countries in ways that will be discussed in later sections. The adoption of free markets in the presence of market failures can often mean the adoption of policies that prevent backward domestic producers getting assistance to achieve competitiveness in global markets. In these conditions, low wages are no guarantee of inward capital flows or investments by domestic investors in ways that will lift up the average living conditions of the country. Indeed, the historical experience has been that the adoption of free market strategies in the presence of market failures and where domestic producers are far away from the global frontier of technology and productivity can lead to a collapse of domestic productive capacity rather than a rapid improvement in productivity.

The possibility that free markets could lead to divergence rather than convergence was most powerfully experienced by many developing countries during their colonial history when free trade policies were accompanied in most cases by a growing divergence between themselves and the advanced countries. For instance, from 1873 to 1947 Indian per capita income declined from around 25% of US per capita income to under 10% of the US level (Clark and Wolcott 2002). This happened during a period of virtual free trade as India was only allowed minimal tariff protection, a period when there was relatively strong protection of the rights of foreign (British) investors and virtually no restrictions on the repatriation of capital and profit. The proximate cause of this relative decline was simply that it was not profitable to invest in higher productivity manufacturing industries or in modern agriculture in India. The low productivity of Indian workers was so low that even low wages compared to the home country did not give India a competitive advantage for prospective British investors in most industries. This problem remains today for most sectors in most developing countries.

This is a puzzle because temporary levels of low productivity in poor countries should be countered by long-term private investments in upskilling and training, and even in investments in critically required ancillary infrastructure. Given the vast wage differentials the long-term extra returns should justify these investments in most cases. The puzzle disappears only when we look for the significant market failures in capital, land and labour markets that prevent these investments. Without any corrective assistance and strategies to overcome these market failures, the only areas that are likely to grow in a poor free-market economy are sectors which have already achieved international competitiveness. These are typically low technology and low value added sectors where the productivity gap with more advanced competitors is likely to be low and the wage differential can more than compensate for this, giving the developing country a competitive advantage in these sectors.

The challenge of development is that in most developing countries there are very few sectors that already have developed international competitiveness or have good prospects of developing international competitiveness rapidly. The rapid growth that some developing countries have experienced in recent years can be traced to their achievement of global competitiveness in a few sectors like garment stitching, cut flowers, simple toy and shoe manufacturing or simple food processing and packaging. A few other developing countries like India have achieved global competitiveness in a small number of high technology sectors like software, iron and steel and some narrow sectors of manufacturing. When we look at these success stories historically, we find that in each case global capabilities were built up through very specific processes that overcame critical market failures. In many cases these processes were accidental, in other cases they were partial successes of broader policies that on the whole were not successful and were abandoned in most developing countries during the 1980s and beyond. As a result the challenge of replication and spread remains for most of the economy, even in relatively successful developing countries.

There have been two broad types of policy responses to the market failures constraining growth in poor countries, and the governance for growth debate has to be understood in this context. The first and more traditional response was to address specific market failures with interventions that created incentives or compulsions to move the outcome closer to what a more efficient market may have achieved. For instance, subsidies to investors may help to compensate for temporary backwardness and the difficulty of raising private capital given market failures in capital markets. Indeed, interventions to correct market failures were very common in the 1950s and 1960s as developing countries attempted to reverse their performance under colonialism. This strategy was in the end disappointing in many developing countries because the range of market failures which policy-makers tried to address were too broadly defined, and in most cases existing governance capabilities were not remotely sufficient to enforce the requirements for success with such a broad range of interventions.

While there were some attempts to improve the governance capabilities required to effectively manage these interventions, these governance requirements were not sufficiently recognized at the time. In the absence of a sufficient effort to develop these governance capabilities, interventions to correct market failures often resulted in poor outcomes. In particular, infant industries refused to grow up, subsidies were captured by all manner of powerful groups with no contribution to production and public sector enterprises continued to underperform. Clearly, providing implicit subsidies was not enough without incentives and compulsions created by appropriate institutional design and governance capabilities that ensured that the intervention had the desired effect.

A possible response to this experience would have been to conclude that perhaps the range of interventions needed to be scaled back to target critical market failures, and that appropriate governance capabilities needed to be developed to ensure the success of these interventions. Instead, the response from the late 1970s onwards was to abandon this strategy in its entirety. But the new strategy that gained growing credence was if anything even more ambitious as it sought to address market failures by making markets more efficient across the board. This began with liberalization as developing country states were persuaded to withdraw from activities that they were

not doing very successfully anyway. However, it was soon recognized that liberalization does not work too well in the context of the high transaction cost markets in developing countries, and reforms were needed to make these markets more efficient. And so governance entered mainstream policy discussions as part of a strategy to reduce transaction costs across the board. It was explicitly understood that the governance capabilities to be developed or strengthened were the ones necessary for the operation of efficient markets, not the capacities required to address specific market failures.

The governance reform strategy that emerged in response was the ambitious ‘good governance’ strategy where a number of core governance capabilities are addressed which should *in theory* reduce market transaction costs and allow private contracting to proceed more efficiently. In theory, *if* these improvements in transaction costs were *significant* enough, the market failures that were preventing investment in new sectors in poor countries may disappear. However, our contention is that while many of the good governance reforms on which so much attention is being focused in developing countries are desirable in themselves, they are unlikely to be implemented to a significant degree in the near future for *structural* reasons that primarily have to do with underdevelopment rather than with the political will of the ruling coalitions in these countries (Khan 2007b). It is from this perspective that we argue that a different set of ‘growth-enhancing’ governance capabilities should also be pursued that may enable these countries to effectively implement specific strategies of investment and technology upgrading.

We therefore distinguish between two broadly defined governance reform strategies. The first can be described as a strategy of promoting ‘*market-enhancing governance*’ (also known as good governance) focusing on improving general market efficiency and contract enforcement. We have argued that the historical evidence does not support the argument that poor countries that grew fast did so because they first achieved significant improvements in market-enhancing governance capabilities (Khan 2007b, 2007a, 2008b). The second is an alternative strategy of focusing on ‘*growth-enhancing governance*’ capabilities that allow the resolution of specific market failures (Khan 2007a). The strongest support for the growth-enhancing governance route comes from the experience of the North East Asian rapid developers like South Korea and Taiwan, which are now widely recognized as having used significant interventions to overcome market failures to enhance investment and accelerate technology acquisition (Amsden 1989; Wade 1990; World Bank 1993).

However, it is also recognized that the handful of successful interveners had very specific internal administrative and political governance capabilities that most developing countries do not have (Khan 2000b). If growth-enhancing governance capabilities were defined in this ambitious sense of achieving capabilities to implement broadly defined interventions to correct market failures, it would be difficult to argue that countries with much less favourable initial conditions should attempt to attain these. However, there are two responses to this observation. First, obviously for countries with weaker initial conditions for addressing market failures the scale of intervention has to be less ambitious than that in the North East Asian countries. One reason for the disappointing performance of many developing countries with catching-up strategies was clearly that they had tried to do too much. Across the board protection and strategies of technology acquisition simply got

rapidly captured and became sources of inefficiency rather than reducing market failure. Secondly, the types of corrections for market failure that will work in particular countries may differ significantly depending on their initial political and institutional conditions. This is an even more fundamental point which is based on the observation that successful countries used many different strategies of correcting market failures, and strategies that worked in one country often failed in another (Khan 2008b). This makes it particularly important for developing countries to have some methodology for understanding what needs to be done and designing programmes that are more likely to work given their specific conditions.

The rest of this paper is structured as follows. To explore the ways in which market failures can constrain growth and can be overcome through specific strategies, we will look more closely at the experiences of five developing economies that grew rapidly over the last 25 years. By looking at the characteristics of growth in these economies, we establish that growth was a product both of participating in global markets but in many cases was also dependent on specific responses to significant market failures. Business-government relationships operated in many different ways to address these market failures, and very often informal arrangements were very important. However, unlike the North East Asian countries which had significant governance capabilities to manage the interventions necessary for correcting market failures, we will see that in these second tier growth stories, the mechanisms through which significant market failures were addressed were often accidental and sometimes the outcome of interventions that had other objectives. This makes growth in many second tier countries very vulnerable to changes in conditions that alter the market failure or the political and institutional arrangements that allowed it to be partially or fully addressed. It also means that growth is patchy and partial even in successful second tier countries because systematic mechanisms do not exist to propagate growth into new sectors and regions, building on the success of the existing growth sectors. We hope that by examining these ad hoc solutions to growth constraints, we may acquire a better understanding of the governance requirements that second tier countries should aspire to attain.

3. Five Growth Stories

The Growth Commission report (2008) identifies 13 countries that grew at a rate of 7 per cent a year or more for at least 25 years since 1950. All these countries are very diverse, including apart from the usual suspects in North East Asia, countries like Oman and Botswana where natural resources played a significant role and domestic non-mineral productive capabilities remain limited, Brazil where growth eventually collapsed in the 1980s and 1990s and Indonesia where growth has been shaky since the 1997 crisis. So clearly even 25 years of high growth is no guarantee that institutional and governance conditions are appropriate for achieving a transition to a high income economy of the OECD type where a relatively broad-based prosperity is based on the indigenous productive capabilities and competitiveness of its capital and labour.

To focus on critical growth-enhancing governance conditions required for the rapid spread of productive capabilities across society, we examine growth processes in a number of rapidly growing second-tier countries. The economies we select are all high-growth ones but are economies that are not identified with strong governance

capabilities for accelerating the transition to a broad-based productive economy. In this sense, the second tier countries in our list differ significantly from the strategies and initial governance conditions of comparators in North East Asia which made a sustained and successful transition to high income status by developing broad-based domestic productive capabilities.

Table 1 Income and Population in our Five Growth Economies 1980-2005

	1980		2005	
	GDP per capita (constant 2000 US\$)	Population (millions)	GDP per capita (constant 2000 US\$)	Population (millions)
Tanzania	..	19	324	38
Bangladesh	230	89	400	153
West Bengal	243	54	554	84
Maharashtra	340	62	821	102
<i>India</i>	<i>229</i>	<i>687</i>	<i>588</i>	<i>1095</i>
Thailand	796	47	2494	63

(Sources: EPW Research Foundation 2003, 2007; World Bank 2008).

The five economies we look at over the period 1980-2005 are Tanzania, Bangladesh, the states of West Bengal and Maharashtra in India, and Thailand. Table 1 summarizes the relative development and populations of these economies and Table 2 summarizes the growth rates achieved in different sectors of these economies. Our five economies were selected to achieve a diversity of characteristics in a small group of growing economies which we could examine using a comparative case study approach. All of them were in different ways removed from the capability development model of North East Asia. They were also different from each other in the types of strategies and business-government relationships through which specific market failures were addressed.

The richest country in our group is Thailand, one of the countries included in the 13 countries in the Growth Commission's list. It is a country that was already a middle income country in 1980 and made significant progress since then, notwithstanding the 1997 crisis. Yet its growth has recently been assessed as fairly vulnerable because of the slow spread of technological capabilities in the critical manufacturing sector (World Bank 2006). As Table 2 shows, industry and manufacturing have been the drivers of growth in Thailand. Industrial technology has moved higher up the value chain, with Japanese inward investment playing a significant role. However, the concern is that much of the new electronics and higher technology sectors have been more of the assembly type, using relatively unskilled labour, with value addition within Thailand being limited. The question for Thailand is how to sustain this upward movement up the value chain and to broaden the role of domestic technological capabilities.

Table 2 Comparative Growth Rates of GDP and across Sectors 1980-2005

Growth Rates %	Thailand	India	Maharashtra	West Bengal	Bangladesh	Tanzania	OECD	World
GDP								
1980-85	5.3	5.2	3.9	4.6	3.7	na	2.6	2.5
1985-90	10.2	6.3	7.4	4.4	3.4	na	3.7	3.7
1990-95	8.2	5.2	8.5	5.8	4.3	1.6	2.0	2.3
1995-00	-0.7	5.7	11.6	7.0	5.1	3.9	2.9	3.2
2000-05	5.3	6.7	9.1	6.8	5.3	6.3	2.0	2.8
1980-2005	6.0	5.6	8.9	5.8	4.4	na	2.7	2.9
Per Capita GDP								
1980-85	3.6	3.0	1.8	2.4	1.3	na	2.0	0.8
1985-90	8.7	4.2	5.0	2.2	1.1	na	3.1	2.0
1990-95	6.9	3.4	6.4	3.9	2.1	-1.6	1.3	0.8
1995-00	-1.7	3.9	9.6	5.4	3.0	1.4	2.3	1.8
2000-05	4.4	5.2	7.5	5.5	3.3	3.7	1.4	1.5
1980-2005	4.7	3.7	6.8	4.0	2.2	na	2.1	1.4
Agriculture								
1980-85	4.3	3.4	0.8	6.2	2.8	na	2.7	1.5
1985-90	4.0	4.2	7.9	4.8	1.6	na	0.9	0.8
1990-95	-0.3	3.1	3.6	5.8	1.7	2.9	-0.4	0.6
1995-00	1.6	2.3	2.5	3.4	4.7	3.0	3.4	2.2
2000-05	1.9	2.4	-1.8	2.6	2.4	4.9	0.5	1.6
1980-2005	2.3	2.9	3.4	4.6	2.7	na	1.2	1.2
Industry								
1980-85	6.7	5.9	3.4	2.2	5.5	na	1.6	1.4
1985-90	13.8	8.0	7.4	4.4	5.4	na	3.9	3.9
1990-95	10.9	5.9	5.5	5.1	7.2	-0.9	0.8	1.5
1995-00	-0.2	4.8	5.8	6.8	6.3	7.2	2.3	2.7
2000-05	6.7	7.2	4.1	4.4	7.1	9.2	1.3	2.0
1980-2005	8.0	6.2	5.6	5.2	6.4	na	2.1	2.5
Manufacturing								
1980-85	5.4	7.1	2.9	1.9	4.5	na	na	na
1985-90	14.5	8.1	8.1	4.6	4.6	na	na	na
1990-95	11.6	7.1	5.8	3.2	7.9	-0.3	na	na
1995-00	1.7	4.3	6.0	7.3	5.5	5.3	na	na
2000-05	6.9	6.7	3.5	3.8	6.5	7.7	1.7	na
1980-2005	8.5	6.4	5.8	4.5	6.1	na	na	na
Services								
1980-85	4.9	6.1	6.6	5.3	3.8	na	2.7	2.8
1985-90	9.7	6.9	7.1	4.3	3.5	na	3.6	3.6
1990-95	8.0	6.7	9.3	6.8	4.1	1.3	2.3	2.6
1995-00	-1.6	8.2	7.8	9.1	4.7	4.2	3.3	3.4
2000-05	4.6	8.1	9.0	9.9	5.5	5.9	2.3	2.7
1980-2005	5.5	7.1	8.0	7.1	4.2	na	2.9	3.1

(Sources: Based on data from EPW Research Foundation 2003, 2007; World Bank 2008). West Bengal and Maharashtra data begin in 1981.

In terms of levels of development, there is a significant gap between Thailand and the other economies in our list. Thailand's experience is therefore interesting both in its own terms and also to help identify some of the problems that other second tier countries are likely to face in the future. Next in terms of prosperity come two relatively rich states within India. India is one of two countries (along with Vietnam) that the Growth Commission believes may soon join their definition of the high-growth group. But India is a very diverse subcontinent and includes states that are very poor and growing slowly. We look at two Indian states, Maharashtra and West Bengal that have been relatively high growth states within the Indian Union during the growth spurt that began around 1980 and therefore some issues affecting the sustainability of India's growth can be examined through a detailed examination of these states (Purfield 2006).

The debate over the drivers behind India's growth spurt since 1980 has focused on the relative importance of liberalization, macroeconomic conditions and shifts in the pro-business stance of government (S. Ahmed and Varshney 2008). It has generally ignored the importance of the technological precursors to the growth spurt. We will argue that these historical technological capabilities that were developed in an earlier phase of industrial policy regimes played a critical role in determining the types of sectors that led growth in India, and the regions that particularly benefited. Looking for the technological capabilities which served as the precursors to growth is strongly supported if we shift our attention from the narrowly Indian debate to the fact that a growth takeoff happened across the Indian subcontinent, including in neighbouring Bangladesh and Pakistan, which also experienced a roughly 1.5-2 per cent growth acceleration around 1980. To explain this broader takeoff, we need to look at deeper capability development trends and changes in the political context which affected all three major South Asian countries at around the same time.

Turning to the detailed story within India, the two states we look at provide two very different perspectives on the capability challenges and governance constraints within India. While Maharashtra has long been the premier industrial state in India, the slowing of manufacturing growth more recently highlights the challenges that may be faced by other Indian states where manufacturing is currently doing well but which are behind Maharashtra in terms of overall manufacturing maturity. The interesting fact highlighted in Table 2 is that in this most industrial of Indian states, growth during the post-1980 spurt was led by services and supported by agriculture. In contrast, West Bengal had suffered a long decline in the industrial prominence it had enjoyed in colonial times. In the 1980s when the communists consolidated their electoral power in the state, the state government's strategy was to focus on agricultural reform and growth. As a consequence, its growth was driven in the 1980s by agriculture. But the state is currently attempting a transition to a growth strategy led by services and manufacturing as the prospects of further agricultural-driven growth are weak given the ecology of the region and the constraints faced by smallholding agriculture. But it has so far achieved relatively modest success, particularly in making a breakthrough in industrial growth.

Next in our list of countries in terms of the level of development is Bangladesh, which is an interesting comparator with West Bengal (because of its geographical, social and cultural proximity) and interesting also as a comparator with India because it too experienced acceleration in its growth rate sometime around 1980. Unlike West

Bengal, growth in Bangladesh was driven from the outset by a strong performance in low-wage labour-intensive manufacturing sectors like garments. Against all expectations Bangladesh emerged as a major player in the global apparel market and began to diversify into its backward and forward linkages. In a 2008 PricewaterhouseCooper report on the growth prospects of developing countries beyond the BRICs, Bangladesh was included in a list of 13 economies that were most likely to achieve significantly higher growth than the OECD countries over the period 2006-50 (Hawthornthwaite and Cookson 2008).

Finally, the poorest country in our group, Tanzania, displayed significant growth in the 1990s. Growth figures for Tanzania are only available from 1990, but it appears that in line with a number of other African countries, recent growth only took off in the late 1990s assisted by the global commodity price boom and strong performance in commodity producing sectors. The Tanzanian economy allows us to explore a different set of governance and growth vulnerabilities in economies where commodities play an important role.

It is important not to compare economies that are significantly different in terms of their populations because the economic and political opportunities and constraints can change significantly with population size. Our economies are all relatively populous ones. Tanzania is the smallest and Bangladesh the biggest in terms of population. The two Indian states are comparable in size to our other countries. Aggregate figures for India are also provided in Table 1 and Table 2. The diversity of India and the country-sized populations of its major states justifies treating Indian states rather than India as a whole as the relevant comparators in comparisons of this type. However, the integration of Indian states into a bigger political and economic federation does make the two Indian states different from the others because they enjoy both specific advantages and disadvantages compared to the others.

It is clear from the aggregate and sectoral growth rates shown in Table 2 that all our economies were converging ones as their growth rates were higher than the OECD average for GDP and per capita GDP growth. This is true for the entire period 1980-2005 and for almost every five year sub-period for all of these economies. This picture is repeated when we look at agriculture, industry and service sectors within these countries. While the leading sector differed across economies, in every case the growth rate of every sector for each sub-period and for the 25 year period as a whole was higher than the OECD average for that sector. The cases we look at also had higher growth rates than the world as a whole for GDP, GDP per capita and for each sector over this period. However, we also know that convergence with the advanced countries represented by the OECD even over a 25 year period is not sufficient to remove poverty or to sustain growth into the future. Many developing countries can be in the converging group for significant periods without eventually making a transition to prosperity. *Some* of these countries will graduate into the ranks of high-income OECD countries, but many more will eventually face problems and slow down or even fall back into the group of diverging countries.

Table 3 Conventional Good Governance Indicators for Sample Countries 1996

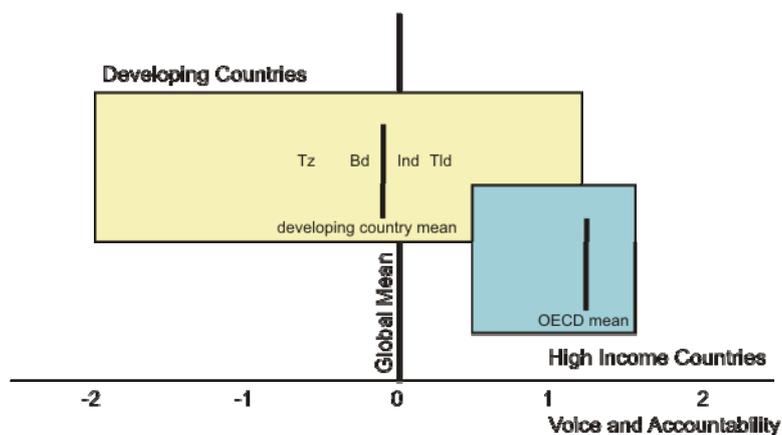
Sample Countries	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Bangladesh	-0.23	-0.89	-0.64	-0.22	-0.77	-0.49
(Standard Error)	0.23	0.33	0.27	0.33	0.23	0.26
India	0.12	-1.12	-0.20	-0.01	0.29	-0.36
(Standard Error)	0.23	0.29	0.23	0.23	0.19	0.17
Tanzania	-0.64	-0.31	-0.84	-0.06	-0.42	-1.10
(Standard Error)	0.23	0.29	0.27	0.33	0.23	0.26
Thailand	0.29	0.05	0.46	0.45	0.58	-0.31
(Standard Error)	0.23	0.29	0.23	0.23	0.19	0.17
Average for Sample Countries	0.03	-0.19	-0.06	0.15	0.05	-0.22
Range of Sample Countries	-0.64 to 0.29	-1.12 to 0.05	-0.84 to 0.46	-0.22 to 0.45	-0.77 to 0.58	-1.10 to -0.31
Developing Countries Unweighted						
Average	0.07	-0.10	0.01	0.19	0.16	-0.20
Range	-2.01 to 1.21	-2.90 to 1.05	-1.77 to 0.96	-3.13 to 1.29	-2.27 to 1.22	-2.09 to 1.29
High Income OECD Countries						
Unweighted Average	1.22	0.96	1.76	1.00	1.59	1.68
Range	0.50 to 1.59	0.15 to 1.37	0.81 to 2.43	0.35 to 1.58	0.70 to 2.08	0.58 to 2.30

(Source: Kaufmann, et al. 2008) The indicators for each category of governance are scaled to have a global mean of 0 and standard deviation of 1.

Since the performance of market economies depends quite integrally on governance structures (though not necessarily just market-enhancing governance structures), the sustainability of growth is likely to be integrally linked to the types of governance structures that are operating. Table 3 shows conventional governance indicators for market-enhancing governance in our five economies for 1996, the earliest year for which governance indicators are available from the World Bank. This year corresponds to a point roughly halfway through our period of growth 1980-2005. These indicators are aggregates of perception surveys looking at characteristics of governance that are significant from a market-enhancing governance perspective. If market-enhancing governance and market efficiency were responsible for the faster growth of these economies, we would expect these governance indicators to be significantly different from the developing country average.

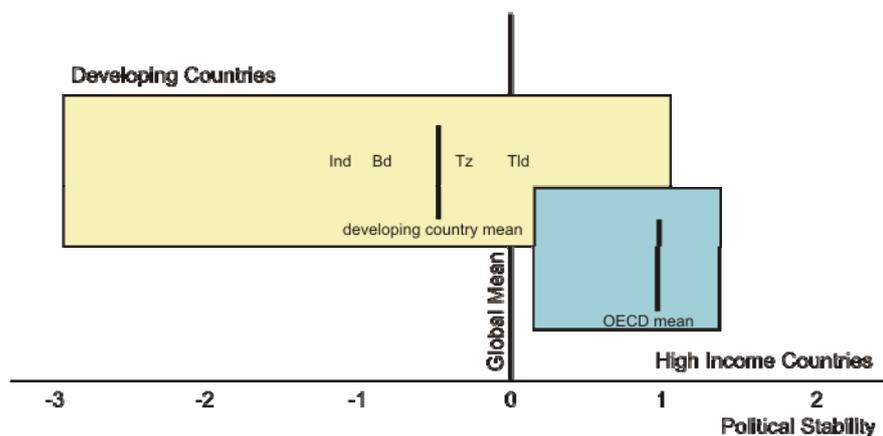
A comparison of our economies with others shows that in terms of conventional good governance scores they were not significantly different from the average developing country. We only report aggregate figures for India because comparable state level indicators are not available. The significant standard errors of these scores are also noteworthy because for most categories of governance, the scores of most of our growth economies are not even significantly different from each other. Thailand as the most developed of our economies is a partial exception to this observation. Note also that although scores are available for subsequent years, it is not possible to compare the performance of a country over time using this data because the scores are normalized to have a global average of 0 every year. This means that a country's score can change year to year with no change in its real governance performance simply because new countries have entered the data set or because the performance of other countries has changed. In any case, though not reported here, the picture that emerges when we look at scores in subsequent years for our growth economies is not significantly different from that of 1996. The information for 1996 is summarized below in Figure 1 to Figure 6. Only the horizontal axis is relevant in these figures.

The higher of the two boxes shows the range of scores for all developing countries and the developing country average, and the positions of our five economies within the developing country group. The lower box shows the range and average scores for advanced OECD economies. The global average for each indicator is 0 by construction.



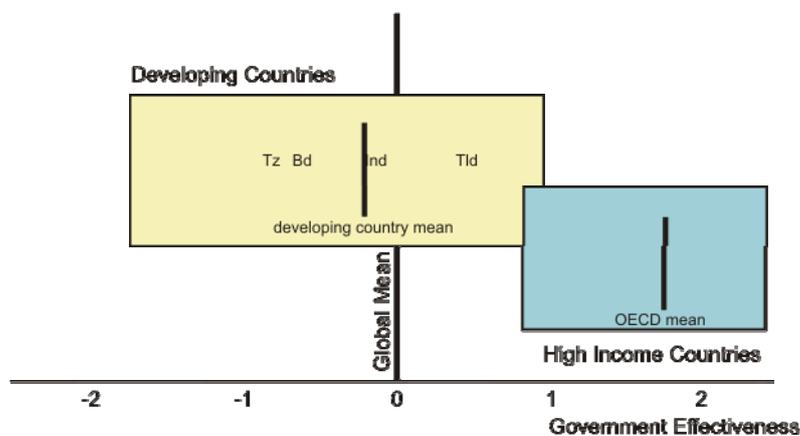
Note: Tz = Tanzania, Bd = Bangladesh, Ind = India and Tld = Thailand. Scaled only along horizontal axis.

Figure 1 Relative Good Governance Scores 1996: Voice and Accountability



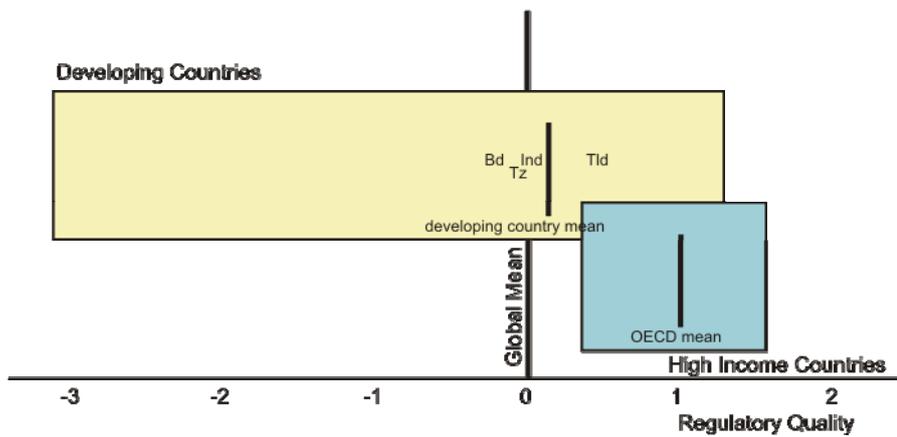
Note: Tz = Tanzania, Bd = Bangladesh, Ind = India and Tld = Thailand. Scaled only along horizontal axis.

Figure 2 Relative Good Governance Scores 1996: Political Stability



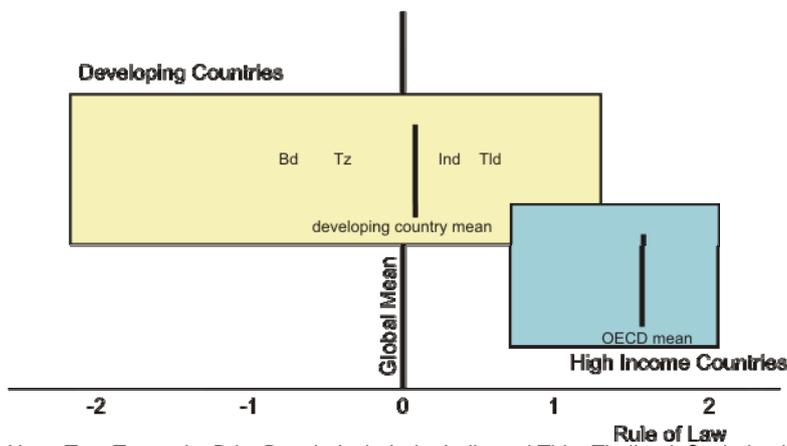
Note: Tz = Tanzania, Bd = Bangladesh, Ind = India and Tld = Thailand. Scaled only along horizontal axis.

Figure 3 Relative Good Governance Scores 1996: Government Effectiveness



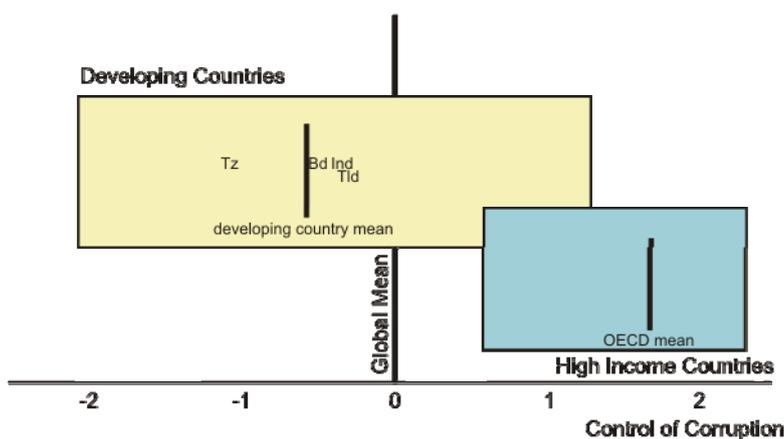
Note: Tz = Tanzania, Bd = Bangladesh, Ind = India and Tld = Thailand. Scaled only along horizontal axis.

Figure 4 Relative Good Governance Scores 1996: Regulatory Quality



Note: Tz = Tanzania, Bd = Bangladesh, Ind = India and Tld = Thailand. Scaled only along horizontal axis.

Figure 5 Relative Good Governance Scores 1996: Rule of Law

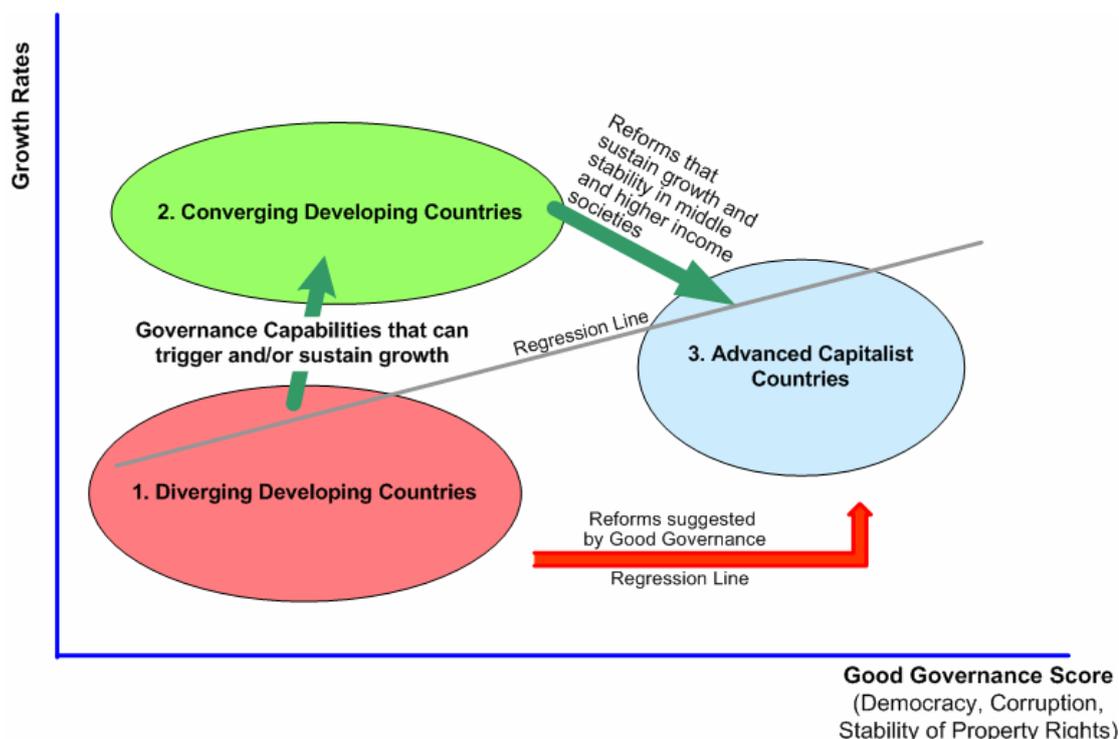


Note: Tz = Tanzania, Bd = Bangladesh, Ind = India and Tld = Thailand. Scaled only along horizontal axis.

Figure 6 Relative Good Governance Scores 1996: Control of Corruption

It is clear that on every aspect of market-enhancing governance our economies were significantly removed from the standards of good governance defined by advanced OECD economies. Moreover, they were not outstanding performers within the overall

developing country group as their scores were clustered around or below the mean developing country score. Given the standard errors reported for these scores in Table 3, there are in most cases no significant differences in the good governance scores of these countries from the developing country average for that score. This observation is not surprising given the more general empirical characteristics of good governance scores of developing countries that we reported in Khan (2007b). Our growth economies can therefore be located in group 2 in Figure 7 which is reproduced from that earlier work.



(Source: Khan 2007b)

Figure 7 Governance Characteristics of Growth Economies

The governance characteristics of the different types of growth economies in group 2 are the primary focus of our investigation. We know that group 2 economies include many different types of growth stories, some more sustainable than others. Some converging economies have significant growth-enhancing governance capabilities that allow them not only to grow fast for a while, but to sustain this growth and spread it across the economy to make a sustained transition to prosperity. The North East Asian countries were examples of countries with such governance capabilities. Other countries may be in the converging group because they have some sectors or regions or minerals which produce globally competitive products and where business-government relationships have either consciously or accidentally developed to solve particular problems constraining growth.

The historical experience suggests that group 2 economies can display significant variability in their governance conditions and in the sustainability of their growth paths. The only thing that *is* clear is that developing countries do *not* in general solve the market failures that constrain their growth through good governance capabilities. In theory significant improvements in good governance characteristics may have helped to improve the efficiency of markets and thereby contributed to sustaining

growth. But in reality such improvements are structurally beyond the reach of developing countries which are significantly below upper middle income status. The cross-country empirical evidence strongly supports that conclusion (Khan 2007b, 2008b) and the evidence provided for our five economies in Figure 1 to Figure 6 is consistent with this broader observation.

The growth-enhancing governance capabilities which appear to trigger and sustain growth in group 2 economies are likely to be specific political relationships and institutional solutions that deliberately or accidentally address specific market failures. We need to understand these capabilities on a case by case basis to identify how they work and the specific vulnerabilities they face. But we can also identify broad types of problems that these capabilities address so that more general conclusions can be drawn about policy in these and other economies.

The viability of the growth process for converging developing countries depends on the appropriateness of these arrangements for meeting evolving market failure challenges and the sustainability of these arrangements within the broader political settlements within their societies. In addition, in some societies growth in some sectors or regions may be viable, but there may be limited scope for spreading growth to other sectors or regions. Our aim in subsequent sections is to identify important characteristics of our growth stories to examine the mechanisms through which market failures constraining growth were overcome to identify possible vulnerabilities that may make growth uncertain or unsustainable in some or all of these countries.

4. Growth-enhancing governance: An analytical framework

Markets provide access to trading opportunities and must therefore be a necessary condition for sustaining growth. But history as well as economic theory tells us that market access may not be of much use for a developing country if it does not have the capabilities to produce goods and services in a global marketplace or even for its domestic economy. The capabilities embodied in machines are relatively easy to attain. But effective entrepreneurial and technological capabilities to use machines effectively and competitively require significant amounts of *tacit knowledge* that owners, managers and workers can only achieve through ‘evolutionary’ learning-by-doing and putting in high levels of effort over time (Nelson and Winter 1982; Stiglitz 1987; Lall 1992; Lall and Teubal 1998; Lall 2000a, 2000b). Theoretical contributions of this type pointed out that even in poor countries, an increase in factor throughput through the economic system cannot be sufficient for achieving growth or sustaining it. It is also necessary and perhaps even more important to have complementary improvements in technological capabilities so that the country can rapidly make profitable use of technologies that are new to the country.

Most developing countries make relatively slow progress in ‘learning to learn’ these critical capabilities on an ongoing basis (Stiglitz 1987). This can be a critical problem slowing down their growth and can easily result in a spurt of growth driven by high levels of investment eventually becoming unsustainable in a competitive global economy. Indeed, in the absence of rapid development of these capabilities, the rate of investment will also slow down since new production facilities will not be profitable. In other words, the level of investment cannot over time be independent of the success of the country in acquiring new entrepreneurial and technological capabilities. While

investment can assist in developing the capabilities to learn and to create the institutions and governance capabilities for sustaining learning, high levels of aggregate investment are not in themselves sufficient to ensure this. Since attaining these capabilities is hugely beneficial for society collectively, it is useful to ask why many developing countries find it so difficult to make sustained progress here.

Activities and resource allocations that may make society better off, for instance by introducing capabilities that raise productivity or allow the production of new goods and services should in theory also make the coalitions of private agents introducing these activities better off even if they have to compensate all those who lose out from these changes. If these capabilities do not in fact emerge, the growth constraints faced by developing economies can be looked at in terms of the factors that are preventing *private contracting* from producing the entrepreneurial and technological capabilities that would result in sustained and broad-based growth. As markets are simply systems of private contracting, if contracting fails for any reason to achieve socially beneficial outcomes, these are by definition ‘market failures’.

Arithmetically, if the costs of contracting were low, private agents should always be able to introduce the new capabilities that raise social productivity and privately benefit from their introduction. Therefore low growth in poor countries can be seen fundamentally as a problem of failed contracting because even with the limitations of poor infrastructure and labour quality, the significantly lower wages in developing countries should justify equally significant investments to raise productivity to leave both investors and society better off. The incentives are particularly great because even a relatively small improvement in productivity could make a poor country competitive given its already significant wage advantage, and cheaper non-tradable services and infrastructure as well. If these investments do not take place, we can conceptually look for the causes in terms of different failures of contracting somewhere along the line.

By definition, contracting failures are always due to some of the relevant costs of contracting (transaction costs) being too high. Sometimes these costs cannot be reduced over a practical period in any feasible way, in which case the market failures in question are not really relevant for policy. In other cases either the costs of contracting can be reduced or remedial action taken to achieve a second-best result. In both cases, the search for market failures takes us to the institutional and governance capabilities that need to be developed to make society better off. Note that this ‘partial equilibrium’ way of thinking about market failures is simply an organizing device for looking for institutional and governance constraints on growth. A market failure framework does not necessarily make any presumption that a theoretical perfect market would maximize global welfare if it could be achieved. Indeed, a perfectly competitive general equilibrium market model may be a very misleading benchmark for thinking about policy issues in general (Stiglitz 1996).

Market failures should therefore be treated as organizing devices for thinking about the institutional and governance issues blocking technological progress and capability development. As a potentially large number of market failures could be theoretically identified, it is an empirical matter as to which ones are the most important in specific cases. Moreover, from a pragmatic perspective it is important to identify market failures that can be addressed rather than market failures which may be important in

principle but for which no immediate solution can be found because, for instance, the institutional and governance requirements for addressing them are unachievable. Thus looking for failures of contracting is not just an empirical matter but also to some extent a matter of judgement and politics to identify important institutional and governance constraints that need attention *and* which can feasibly be addressed in that particular country to enhance or sustain growth.

When societies evolve policies to respond to market failures, new income flows are inevitably created as a result of these responses. These are by definition rents, and the creation of rents induces further activity in the form of rent seeking that can subvert any potential correction of market failure. Rents in our discussion are policy-induced income flows that would not exist in the absence of that policy. They can be value and welfare-enhancing for society or the reverse, depending on the type of rent and the institutions determining how the rent is ‘managed’ (Khan 2000a, 2007b). In theory, not all rents are socially damaging, and many rents are the products of addressing market failures so they signal potential improvements in growth or welfare. Rent seeking however describes all the activities where resources and effort are used to influence the creation, allocation or destruction of particular rents (Khan 2000b). Rent seeking always has a social cost because resources are used up that could have been used for consumption or investment. But the net effect of any process of rent creation and rent seeking clearly depends on a comparison of the possible social benefits of the rent in question and the social costs of the rent seeking. The liberal discussion of rents and rent seeking is one-sided because it assumes that rents are always socially damaging as is the rent seeking cost, so that the net effect can never be positive.

Major Market Failures Constraining Growth in Developing Countries			
<p>Capital Market Failures</p> <p>i) Absence of credible risk-sharing slows investments in new sectors and technologies</p> <p>ii) Missing institutions and incentives result in low savings</p>	<p>Labour Market Failures</p> <p>i) Significant positive externalities result in inadequate investments in training and learning</p>	<p>Land Market Failures</p> <p>i) High transaction costs in land markets constrain land purchases and prevent scale economies and expansion</p>	<p>Knowledge Market Failures</p> <p>i) Impossibility of defining rights over ‘discovery’ and other forms of learning in developing countries results in low investments</p>
<p>iii) Restrictions on entry and exit, low transparency and poor rule of law can lower savings and the efficiency of investments (liberal economists)</p>	<p>ii) Restrictions on entry and exit in labour markets can distort employment and investment decisions (liberal economists)</p>	<p>ii) Weakly defined property rights and rule of law increases the cost of protecting assets thereby discouraging investments (shared consensus)</p>	<p>ii) Weakly defined intellectual property rights slows down investment in R&D and new technologies (shared consensus)</p>

Figure 8 Potential Sources of Major Market Failures in Developing Countries

A number of important market failures that are widely recognized as important constraints for developing countries are summarized in Figure 8. This is not intended to be an exhaustive list, but simply to indicate important variants of market failures affecting investment, technology acquisition and the development of entrepreneurial and labour capabilities that drive and sustain growth in poor countries. The list is divided roughly into two halves. The top half lists market failures which cannot be

directly addressed in the short to medium term by trying to make the overall market more efficient. The response in these cases has to be second-best solutions which create incentives and regulations to move market outcomes closer to socially desirable ones. There are governance implications to make these policies effective, but these are not necessarily market-enhancing governance capabilities. The second half lists market failures that are identified primarily by liberal economists which could in theory be addressed by making markets across the board more efficient through market-enhancing policy and governance reforms.

Market failures in Capital Markets

i) Absence of credible risk-sharing constrains investment in new technologies and sectors. In investment markets developing countries suffer from significant principal-agent problems which constrain outside investors from investing in risky and uncertain productivity-raising investments. Typically many investments in developing countries will only be profitable if the productivity and skills of workers, middle managers and suppliers can be raised sufficiently to compete in global markets or even to survive in domestic markets without a growing level of implicit protection or subsidy. This type of productivity growth and learning involves significant effort by workers and managers within the firm and suffers from uncertainty even if the effort within the firm is forthcoming.

Individual owners of firms can be expected to be unwilling to absorb significant risks as individual investors and so investment in new technologies that require the development of new capabilities and involve learning is unlikely to be financed by bank lending if borrowers have to put up high quality collateral as security. In principle outside investors would be willing to share this risk for a part of the proposed return. But they will only do this if they are assured that the firm will actually declare its true returns in the future and pay out the agreed share. They will also want the assurance that there are mechanisms through which they can influence firm activity if things are going wrong or withdraw their share of the capital if required. However, these contracts between outside investors and firms typically do not happen in developing countries.

The market failure here can be traced to the difficulty if not impossibility of having credible and enforceable contracts in developing countries that shares the risks and returns between outside investors and firm insiders. The result is that outside investors with capital do not invest except in relatively safe investments where workers and managers already have capabilities at or close to the level that make them internationally competitive. Simple technologies are preferred because skill and capability requirements for these are close to what is already available in the country. This makes risks and returns relatively easy to predict. And equally, given the reluctance of outside risk-sharing investors to commit funds for long-term capacity development by firms, firm owners and managers are unlikely to absorb all the risk themselves and seek capital from banks at fixed interest rates unless it is for technologies that are going to be profitable very quickly. For both sets of reasons, investments in developing countries are likely to be overwhelmingly in technologies in which workers and managers already have capabilities that enable them to be globally competitive immediately or relatively rapidly.

The market failure in sharing risk is significant because it limits financing for investments in technology upgrading and upskilling the workforce. This constrains overall investment in developing countries because the number of sectors that are globally competitive or very close to global competitiveness is limited by definition. Investments in new sectors and technologies or in regions where capabilities are low are likely to be very restricted. At a deeper level, this important constraint on investment can be traced to poor contract enforcement, but if contract enforcement and transparency cannot be significantly improved through market-enhancing governance, second-best steps can be taken that can enhance investments involving learning in new sectors (Khan 2000a). These steps may include the provision of credit by development banks or incentives for investment in new sectors to overcome the market failure, but these policies are only likely to work if appropriate governance capabilities are developed in parallel to ensure that moral hazard and other problems with second best solutions are effectively addressed.

ii) Missing institutions and incentives that result in low savings. The mobilization of savings in developing countries is one of the important tasks that states have traditionally set themselves. Since trust and contract enforcement are critical for setting up and extending banking structures, the mobilization of savings is unlikely to happen through private initiatives alone in developing countries given the weakness of the general environment of contract enforcement and trust. In addition, in poor countries the private incentives for significant investments in banking infrastructure in remote or poor areas is likely to be very weak. But without these investments the mobilization of savings that is required for achieving greater prosperity will also be set back. As a result, without significant effort by developing country states the mobilization of savings is likely to be insufficient. This effort will have to include setting up the institutions and the governance capabilities for extending the banking structure and adjusting incentives for savers and banks. Given the limited private incentives for investing in the infrastructure of a banking structure in remote areas in poor countries, second-best incentives are likely to be required for banks to mobilize savings (Hellman, et al. 1997).

iii) Restrictions on entry and exit, poor transparency and rule of law. Given the definition of market failure, it is also possible to argue that some types of contracting in capital markets are impeded by regulatory restrictions. These include regulatory restrictions that limit entry and exit into capital markets, absent or weak governance capabilities to enforce transparency by borrowers and lenders and weak contract enforcement through the rule of law. Liberal economists focus on these sources of potential market failure in capital (and indeed other factor) markets. Governance capabilities to enforce transparency and a rule of law are indeed weak in developing countries and this can help to explain why capital markets fail to provide significant investments for capacity building and technology upgrading.

However, the liberal approach to addressing capital market failures has problems that we have already encountered in our review of market-enhancing governance in general as a strategy for ensuring growth conditions in developing countries. The requisite improvements in governance capabilities to enforce transparency across the board and a rule of law may be practically unachievable in most developing countries. In such a context, some regulatory controls on capital markets may indeed be creating

unnecessary rents and rent seeking, but others may be relatively efficient second best responses to market failures.

For instance, in a context of market failures preventing significant investments in technology upgrading and learning, the government may provide implicit subsidies on some lending through the domestic banking structure, but for this to work restrictions on capital mobility may also be required to prevent cheap money from flooding out of the country in search of easy arbitrage options. In assessing which restrictions are indeed damaging and which are not, a holistic approach is required. Policy-makers and analysts need to assess whether the restrictions at issue are simply value reducing ones or are second-best responses to deeper market failures that cannot be feasibly removed using market-enhancing strategies.

Market failures in Labour Markets

i) Positive Externalities in Investments in Human Capital. When developing countries fail to attract investments despite significantly low wages, they are typically suffering from even more significant productivity disadvantages compared to their more advanced competitors. Overcoming these productivity disadvantages requires investments in on-the-job training for workers, managers, suppliers and others related to the production process. This training is not something that can be provided in formal educational establishments because the knowledge is primarily tacit knowledge that can typically only be acquired through learning-by-doing.

Firms that employ workers and managers in a sector where they do not already have sufficient productivity to achieve competitiveness vis-à-vis competitors are implicitly financing learning-by-doing by accepting lower or negative profits. This is an investment for the firm that in theory may pay off in the future when employee productivity rises through learning. However, the net benefit the firm can expect to achieve through this investment is always going to be less than the social benefit because the firm will only capture benefits from trained personnel as long as they stay with the firm, but the social benefit of training is embodied in the greater productivity of personnel even when they move out of the firm.

This is a source of positive externalities and is a market failure because the failure of contracting solutions that can give the firm the full return on its investment in training can be expected to result in underinvestment in training and upskilling. These positive externalities, together with the absence of appropriate risk sharing institutions in capital markets has traditionally been an argument for subsidies for infant industries in developing countries. However, what has often not been understood is that these second-best responses to these market failures also require appropriate governance capabilities if they are not to be undone by moral hazard and other problems.

ii) Restrictions on entry and exit into labour markets. As with capital markets, liberal economists point to entry and exit restrictions in labour markets as a source of market inefficiency that they argue can be easily addressed through labour market reforms. These market restrictions were typically introduced to protect labour from arbitrary hiring and firing decisions or to protect wages. In some circumstances these restrictions can indeed have contrary effects. In particular, excessive restrictions can have the effect of restricting employment growth and leading to the choice of capital-intensive technologies by employers. These responses slow the spread of the benefits

of growth to the unemployed poor. In addition, sometimes these regulations can even have deleterious effects of workers within the protected sectors because they can lead to employers using contract or short-term labour or subcontracting parts of the production process to the informal sector.

At the same time, some labour market regulations are clearly desirable to prevent a decline of employment conditions to levels that are socially unacceptable. This is particularly important in developing countries with large pools of unemployed labour where the bargaining power of labour may be limited. Moreover, while getting rid of labour market regulations can have positive effects on employment, it is an empirical question as to whether this will be sufficient to achieve strong growth given the significant market failures in capital and labour markets that constrain investment in new technologies and sectors. Finally, labour market regulations are not a purely economic matter. The maintenance of political stability and good employer-labour relations is politically desirable and in the long run feeds back into creating the conditions for sustained economic growth. Unfortunately, the reform discussions in many developing countries focuses on labour market regulations despite the fact that comparative evidence across developing countries does not suggest that full labour market flexibility is either necessary or sufficient for sustained employment and productivity growth in poor countries.

Market failures in Land Markets

i) High transaction costs in land markets. Investors in developing countries often find it impossible to acquire through the market contiguous land close to infrastructural amenities. This is because of structurally high transaction costs in land markets, which is in turn traceable to poorly defined land rights, multiple claims on land, poor contracting institutions and often very fragmented land ownership. These transaction costs can frequently preclude the setting up of new economic activities or the expansion of existing ones except at very high cost. This in turn slows down economic transition, the introduction of new products and services and the expansion of successful activities rapidly to capture changing market opportunities.

Transaction costs in land markets should not be confused with the price of land, though for the purchasers the difference may not be very obvious. The net effect is that the price of buying a piece of land effectively becomes so high that potential investors are put off. Potential investors find that to acquire a substantial piece of contiguous land they have to deal with potentially dozens or even hundreds of potential sellers, many of them may have competing or overlapping claims which will require a long time to settle, and many smallholders can holdout for better prices when the deal is almost done. In some cases, there may be no formal rights at all, and the potential investor has to deal with different types of occupants with traditional or entirely missing rights. The cost of resolving all of these problems and actually acquiring the required land is the transaction cost in question.

The traditional response to the failure of land markets even in advanced countries has been to have some form of public purchasing policy for land. Often the acquisition of land for major infrastructure projects like roads begins with a public enquiry where alternative routes and fair compensation rates are discussed followed by compensatory purchase orders to acquire the land for the project. In developing countries a much wider range of projects may require public land use legislation and

assisted purchases. These public interventions are second-best responses to high transaction costs that cannot be immediately reduced by market-enhancing governance reforms like stabilizing property rights or improving the rule of law. These reforms will typically take a long time to take effect, but sustaining growth requires immediate policies to overcome these market failures.

However, second-best strategies are open to serious risks as well. The possibility of a political capture of such policies by powerful groups, of inflicting social injustice on vulnerable groups whose land may be forcibly acquired at unacceptably low prices (or perhaps even with no compensation) and therefore the eventual possibility of serious conflicts are just a few of the obvious dangers. The institutional and political capacity to overcome these market failures is an important growth-enhancing governance capability that developing countries have in different measure.

ii) Weakly defined property rights and rule of law. By definition the market failures in land markets are due to transaction costs that are to a large extent excessive because of weakly defined property rights and a weak rule of law. While this is not in dispute, the market-enhancing governance programme of addressing these transaction costs by direct governance reforms that aim to make property rights better defined and improve the rule of law are open to question for reasons that were extensively discussed in Khan (2007b). These governance priorities are theoretically reasonable but practically unimplementable given significant structural constraints in developing countries.

Market failures in the Knowledge Market

i) Absent rights over 'discovery' and other forms of learning. The creation of knowledge is costly and risky and requires incentives. Thus while knowledge should be a public good at some stage, innovators in advanced countries are typically allowed to treat new knowledge as a private good for specified lengths of time. This creates rents for innovation, and in turn spurs investment in innovation from which society collectively benefits over time. This is typically achieved by creating property rights over new knowledge in the form of patents and other forms of intellectual property rights. However, in developing countries the critical knowledge is typically about learning about existing technologies and discovering what a country is good at doing. The investors who discover this knowledge are unable to reward themselves for this risky activity because this knowledge cannot be patented or protected with intellectual property rights in the same way (Hausmann and Rodrik 2003).

The absence and indeed impossibility of defining property rights over discovery and learning means that although in principle a socially beneficial contract between investor and society could be made, this contract is not enforceable since the property rights do not exist. This in turn results in insufficient investment in the critical activity of discovery and learning in developing countries. Since this problem cannot be addressed by market-enhancing governance reforms, the only possible solution is to look for second-best solutions. An example would be subsidies to investors in discovery and learning type activities in developing countries. All such strategies require the careful development of appropriate governance capabilities on the part of the state, an issue to which Hausmann and Rodrik do not give sufficient attention. In the absence of such capabilities, subsidies for learning are simply likely to be misused or captured by well-placed or powerful individuals in that society.

ii) *Weakly defined intellectual property rights.* Just as in advanced countries, developing countries can in principle also suffer from market failures due to the absence or weak enforcement of intellectual property rights. These property rights are relevant for investment in innovation and in the development of new products and processes. The enforcement of intellectual property rights, and by inference the protection of Schumpeterian rents is clearly of much greater relevance for advanced countries (Khan 2000a). However, some developing countries may have pockets of innovation and firms that are involved in the development of new products and processes. These areas will obviously be assisted if a reform strategy that improved the protection of intellectual property rights was successful. The downside of a global strategy of protecting intellectual property rights is that the option of rapidly copying existing technologies is drying up for many developing countries. The net benefit for developing countries of a stricter regime of global intellectual property rights is not clear (Stiglitz 2007: 103-32).

‘General’ versus ‘specific’ policy approaches to market failure

The discussion on market failure highlights significant differences in policy approaches to the problem. Almost all economists can agree that market failures exist and are significant in explaining growth constraints in developing countries. As we have seen, the liberal approach seeks to address market failures through generalized strategies that seek to make the market more efficient by removing restrictions on markets and developing market-enhancing governance to reduce market transaction costs. This approach is summarized in Figure 9.

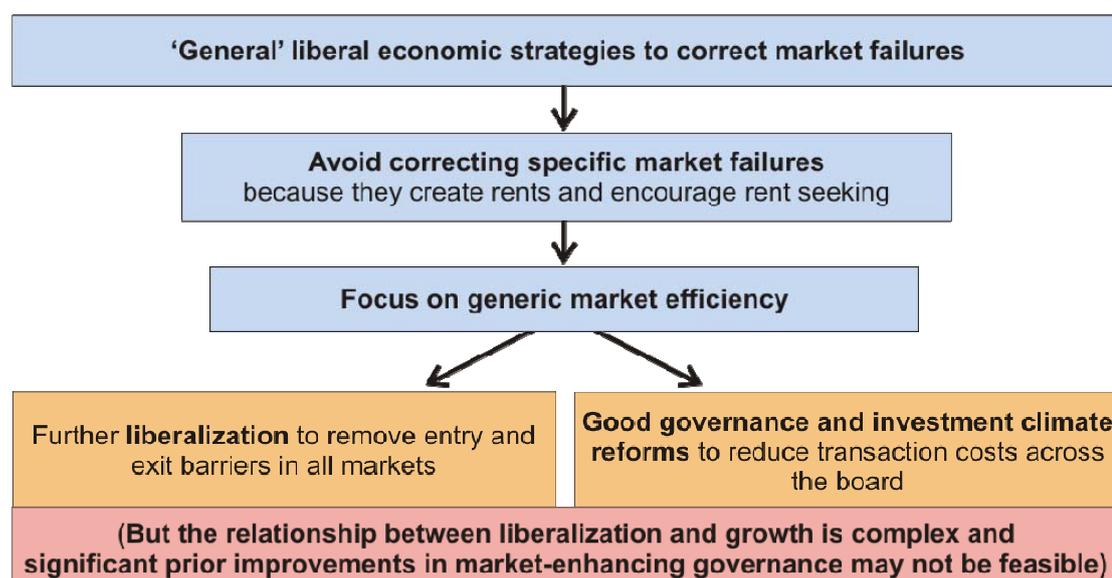


Figure 9 Generalized (Liberal) Economic Responses to Market Failures

The main thrust of the liberal approach is that particular interventions to overcome specific market failures should be avoided as these create rents in particular markets and result in rent seeking efforts that may subvert the goals of the intervention. There are also questions about the ability of policy-makers to identify market failures correctly. The conclusion is that the risk of government failure is significant and therefore specific government interventions should be avoided (Krueger 1990). To avoid these problems the liberal approach suggests that markets should be made more

efficient using a two-pronged policy approach. The first prong is to push ahead with removing restrictions on markets using liberalization. The second prong is to make the overall market transaction costs lower using good governance reforms that are essentially market enhancing in theory.

In contrast, the alternative approach to market failures recognizes these dangers but argues that there may be no effective alternative to improving the capacities of governments to deal with specific market failures. We have already come across the reasons for this in our discussion of the limitations of good governance approaches: there may be very real practical limits to the improvements in overall transaction costs that are achievable in any economy and particularly in developing economies. Thus, as a realistic proposition we have to also focus on the problem of how to devise specific strategies for overcoming particularly important market failures affecting economic performance.

The work of Stiglitz and others has shown that not only are there major market failures in market societies, there are in fact pervasive market failures due to information asymmetries and other reasons (Stiglitz 1996). These asymmetric information problems alone mean that market societies require extensive rents to operate reasonably efficiently because rents create second-best incentives to improve market outcomes in this context. Many of these rents such as reputation rents or efficiency wages appear spontaneously through private institutional arrangements. However, Stiglitz would argue that significant market failures are not addressed in this way, particularly very important ones, where concerted government action is required. The problem is that the correction of specific market failures does indeed face the problems that the liberal critique identifies, and some of the major problems are summarized in Figure 10.

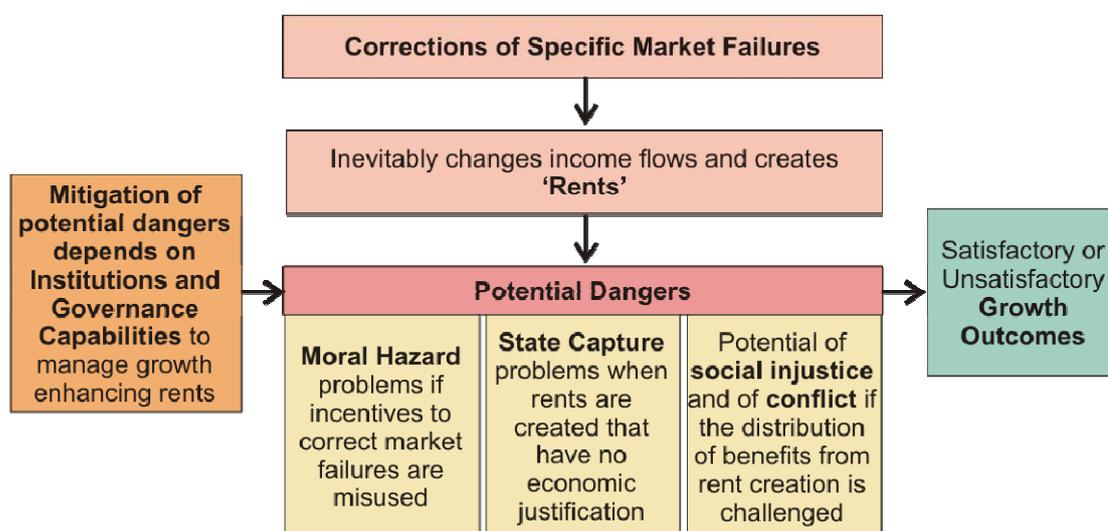


Figure 10 Strategies for Addressing Specific Market Failures

Policy and institutional responses to deal with specific market failures inevitably change income flows of market participants and by definition create ‘rents’ defined as income flows that would not otherwise have existed in the absence of these policies or institutional responses (Khan 2000a, 2000b). In some cases rents can signal distortionary policies that reduce welfare or growth prospects, but even growth and

welfare-enhancing policies would have rents associated with them. The problem is that because rents are typically associated with state policies, there is a very strong incentive to engage in rent seeking activities of different types to influence the type and allocation of rents in society.

As Figure 10 summarizes, policies to correct specific market failures can then result in a number of types of problems. First, there is a problem of moral hazard where policy creates some new benefits for some market participants but fails to achieve the desired policy goal. For instance, subsidies to assist training or making credit lines available to new startup companies to overcome capital market failures may simply be wasted without achieving the desired result. For this not to happen, governance capabilities of oversight and policy withdrawal are required so that the rents are not permanent and may be withdrawn if results are not achieved. The more narrowly defined the policy is, the more plausible it may be to develop the governance capability to administer the policy reasonably effectively. A second problem is the policy-making agencies of government may get captured by rent seekers who may engineer solutions to market failures that do not really exist, simply to benefit from the rents created as a result. Limiting these possibilities require governance capabilities for ensuring that state capture cannot reach damaging proportions.

Finally, policy responses to market failures may be politically controversial because the solutions to market failures may benefit particular constituencies or groups. The same market failure can be addressed by many different policy approaches with different distributions of benefits. For instance, a negative externality can be addressed by taxing the emitter of the externality, by subsidizing the emitter not to emit, by regulatory limits on emission, or by creating property rights on the externality-generating activity. Each solution has different transaction costs and therefore chances of success, but more significantly, also has different distributions of benefits, even if the net social benefit of addressing the externality is the same in all solutions. What this suggests is that if the distribution of net benefits is excessively adverse for powerful or significant groups in society, or if they have significantly adverse welfare implications on marginal groups, then even if the policy enhances growth overall there may be resistance and opposition that in turn will have social costs in the form of conflict. Once again, success in solving specific market failures requires governance capabilities to ensure that the policies that are adopted do not have excessively damaging political consequences.

'High-Capability' versus 'Low-Capability' growth-enhancing governance

As Figure 10 suggests, the type of responses to specific market failures and their outcomes will depend on the initial growth-enhancing governance capabilities of the society. If initial capabilities for growth-enhancing governance are strong, extensive and ambitious corrections of specific market failures are possible. East Asian industrial policies in the 1950s and beyond were variants of policy responses that took advantage of very fortunate initial endowments of growth-enhancing governance capabilities. The historical and policy literature for these countries is relatively well developed and some of the governance conditions that enabled spectacular success to be achieved in some of these countries are discussed in Khan (2000b). It is less often appreciated that even in second tier countries that are growing rapidly, and which have much weaker growth-enhancing capabilities, growth is necessarily underpinned by responses to specific market failures, but this time achieved in more ad hoc,

informal and therefore more vulnerable ways consistent with less extensive growth-enhancing governance capabilities.

Figure 11 summarizes our argument in this section. There are many different ways in which specific market failures could be addressed, and the nature and success of these responses will depend on initial growth-enhancing governance capabilities. To simplify we make an exaggerated distinction between ‘high-capability’ and ‘low-capability’ countries defined by their initial growth-enhancing governance capabilities. In reality of course there is a range of variation, not a simple binary distinction. In addition, there are a range of relevant governance capabilities here and countries cannot be ranked along a single vector of variation. But the simplification allows us to highlight a number of issues relevant for our subsequent argument. In particular, we want to highlight that even low-capability countries addressed specific market failures constraining growth and technology acquisition to some extent, and understanding these processes has important policy implications.

The experience of formal industrial policy is relatively well understood. A number of countries, primarily in North East Asia, but to some extent also including countries like Malaysia, used a wide range of correctives for the types of market failures summarized in Figure 8. Their policy responses to market failures differed, but in each case they also had significant initial (growth-enhancing) governance capabilities to mitigate the risks associated with their particular strategies (Figure 10), and therefore the overall results were little short of spectacular (Khan 2000b). However, many other countries that attempted very similar industrial policy responses fared a lot less well simply because they did not initially have (and could not rapidly develop) the governance capabilities to manage the range of rents that were created through these interventions.

This experience has all too readily led to an apparent consensus that responding to specific market failures is not advisable for most developing countries (World Bank 1993). This conclusion, while being excessively pessimistic, had an element of truth to it. The very specific governance capabilities that ensured success in countries using variants of industrial policy responses were different across these countries depending on the types of growth policies they were pursuing. Both the importance of governance capabilities and indeed the variations in governance capabilities across these successful first-tier newly industrializing countries are relatively well known (Khan 2000b). The poor performance of other developing countries that adopted similar strategies of infant industry protection and incentives for technology acquisition can also be convincingly linked to the absence of appropriate governance capabilities for ‘managing’ the extensive rents that were created through ambitious interventionist strategies (Khan 1999, 2007a). The adoption of market-enhancing strategies in the 1980s in these less successful countries led to much better economic results in many of them.

The argument in this section is summarized in Figure 11. The assumption that second tier countries following more liberal economic policies did not have to address market failures is mistaken. The difference is that in countries where initial growth-enhancing governance capabilities were weak, viable responses to specific market failures constraining growth turned out to be very different from those in high-capability governance economies. Unlike industrial policy responses, the second tier countries

generally did not have selective formal policies to accelerate growth and technology acquisition. Instead, the formal policy framework in second tier countries in general has been non-discriminatory and non-selective.

However, it is not true that second tier growth economies did not have to address the market failures affecting their growth. In fact, even when developing countries adopted non-selective and therefore passive (market-promoting) policy frameworks, the significant market failures blocking significant aspects of growth remained. When these countries occasionally displayed high rates of growth, closer inspection reveals very specific ways in which critical market failures were addressed.

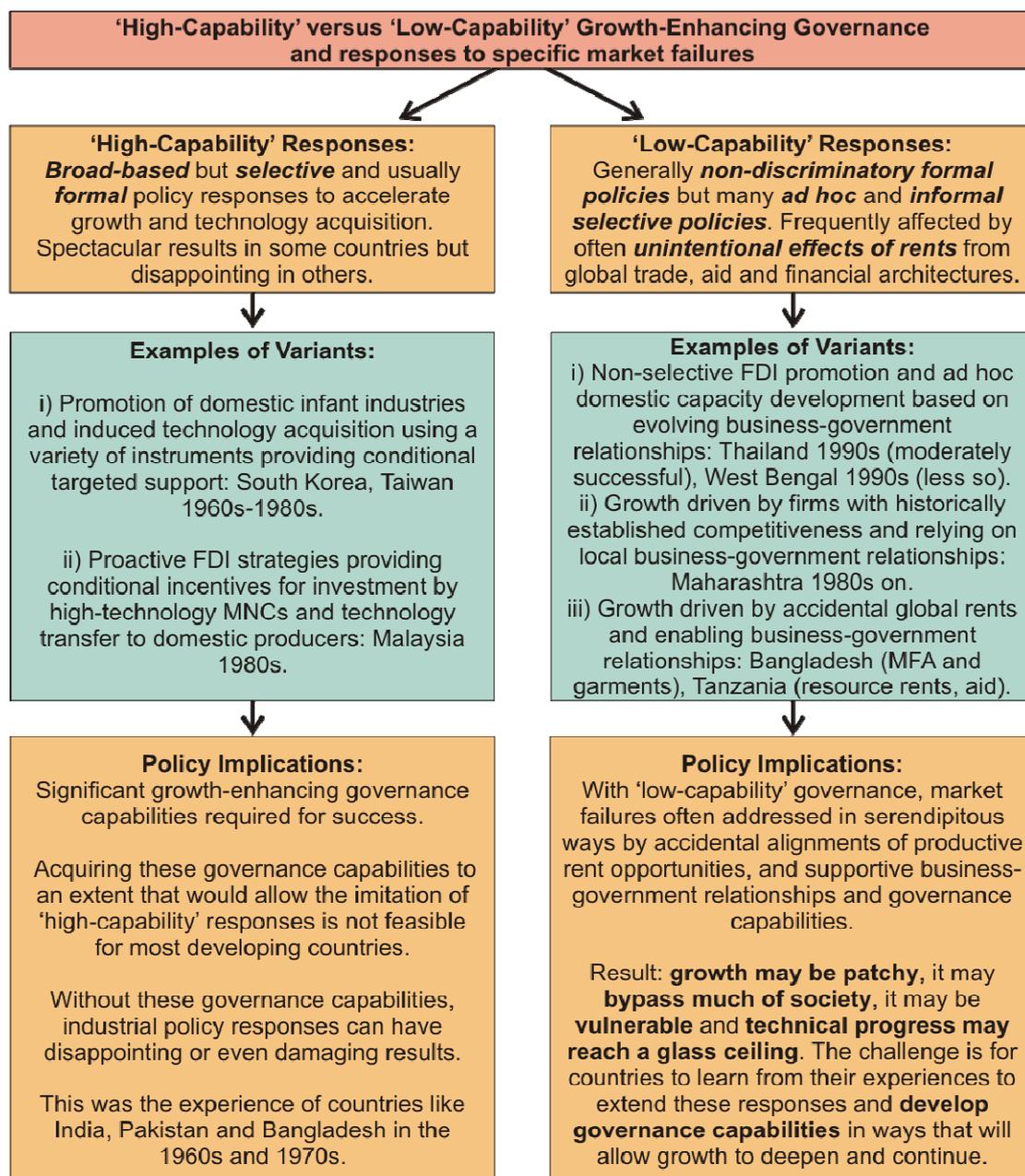


Figure 11 'High-Capability' versus 'Low-Capability' Responses to Market Failures

While 'low-capability' responses to specific market failures were to a larger extent formally non-discriminatory and non-selective policies, growth even in these

economies depended on a variety of informal, ad hoc and accidental mechanisms that provided specific responses to critical market failures. In some cases, the critical rents associated with overcoming important market failures were created as accidental rents as a result of changes in global aid, trade or financial architectures. A very good example of this is the accidental effect of the rents created by the Multi-Fibre Arrangement (MFA) on technological capability acquisition in the garment sector in Bangladesh.

Thus, when second tier developing countries did achieve significant growth they usually did this because they managed to address at least some significant market failures in these ad hoc and incremental ways. However, the solutions that emerged in these countries were not necessarily the product of conscious or planned rent management. Figure 11 also summarizes aspects of the ‘passive’ responses that emerged in our five growth economies that are examined in subsequent sections.

Important policy implications follow from our comparison of ‘high-capability’ and ‘low-capability’ responses to the market failures constraining investment and technology acquisition. Clearly, for most developing countries, attempting to develop the governance capabilities that would enable them to imitate one of the ambitious ‘industrial policy’ responses is not very feasible. But equally, when growth is triggered and sustained in low-capability countries through ad hoc responses to market failures, we expect the growth process to be more vulnerable. In these cases, critical market failures are often addressed in serendipitous ways, relying on accidental convergences between rent opportunities, business-government relationships and actually existing governance capabilities. As a result, it is not at all surprising that the growth process is much patchier in these countries, benefiting certain regions and not others, and benefiting some sectors while leaving others behind, and so on.

We would also expect growth to be much more vulnerable to disruption in second tier countries both because the growth challenges are changing and there are frequently no formal mechanisms for responding to new challenges. This is very likely to be the case if the initial conditions for growth were created through responses that were informal and perhaps accidental in the first place. Secondly the nature of the business-government relationships may be changing independently in many cases because of ongoing changes in the underlying political forces in society. When this happens, the continuation of a particular response to market failure may become untenable even with no further changes in market challenges. Finally, the solutions that allowed a partial move up the technology ladder for some sectors or firms in a country may not be sufficient for more challenging capability adoption problems even for those sectors or firms. Thus, sudden glass ceilings may also emerge in the path of a country’s technology adoption strategy.

Looking at some of the diverse ways in which market failures are addressed in second tier countries will shed light on problems that are not well understood. Many of these countries experienced accelerations of growth during a general shift towards liberalization and market-enhancing policies and governance in the 1980s. In many countries growth was entirely attributed to the adoption of liberal policies. As a result, the ways in which significant market failures had been and continued to be addressed and the ways in which this may have contributed to their growth spurts were not

extensively examined. One difficulty in second tier countries has been that when specific arrangements emerged to address specific market failures, they often did so without any explicit plan or intentionality behind them. Nevertheless, the structure of incentives and pressures that made specific arrangements work can still be described as a ‘rent-management system’ as a useful shorthand, as long as we remember that the management of rents does not necessarily imply that the rents that addressed specific market failures were either created or managed by a highly coordinated state *with the intention* of achieving the correction of specific market failures constraining growth.

The policy significance of our examination of this process is two-fold. First, our case studies will help to outline the importance of overcoming market failures that constrain the development of entrepreneurial and technological capabilities even in developing countries that are ostensibly growing as a result of liberalization and market-promoting reforms. Liberalization by itself does not necessarily address these important constraints to growth. But secondly and more importantly, there are important policy lessons to learn from the ad hoc mechanisms through which significant market failures were and are being addressed in developing countries. These ad hoc arrangements amount to a variety of business-government relationships through which market failures are addressed by creating rents that (often accidentally) allow greater investment and capability creation that in turn result in stronger growth. Very often informal institutional arrangements, power relationships, patron-client networks and other mechanisms far removed from the world of good governance are involved in the creation and ‘management’ of these policies. Sustaining growth therefore requires first understanding these processes and then seeing if incremental policies can be devised to extend and deepen the types of responses that have already emerged in particular countries.

Our aim in documenting these processes in this and subsequent papers will be to identify the nature of the problems that developing countries need to solve, but not necessarily to advocate the specific types of informal and ad hoc solutions that evolved in different countries. Our intention is instead to open up a discussion about the types of institutional arrangements that could be devised over time that would be better regulated and perhaps more formal, in the first place *to spread these successes more broadly within these same societies*. As we shall see, growth is very patchy and limited to specific sectors and regions in most second tier countries, and this reflects the arbitrary ways in which market failures constraining growth have historically been overcome in these countries.

To develop incremental strategies that work, policy-makers would be helped by an understanding of the governance arrangements that have partially worked in the past to identify how associated governance requirements need to develop in parallel so that policy extensions do not fail because of a failure of management and implementation. An examination of the serendipitous ways in which responses to market failures worked in these countries is therefore a useful way for countries to understand and learn from their own success. An important caveat should however be kept in mind. Because countries have very different political settlements, defined as the distribution of power between the classes and groups within that country, their capacity to enforce and manage different types of corrections to market failures are also likely to be very different. Therefore we would expect feasible and effective strategies of incremental reform to be different across countries depending on their political settlements and

other initial conditions. However, by applying a consistent methodology to a number of developing countries we can hope to identify patterns and types of responses across broad types of political settlements which may simplify research into subsequent groups of countries.

In subsequent sections we will examine important aspects of the growth processes in each of our five growth economies. We will identify how significant market failures were addressed, and the vulnerabilities in the mechanisms through which conditions for triggering and sustaining growth were achieved. This background will set the scene for a detailed investigation of specific aspects of growth-enhancing governance in subsequent papers.

5. Thailand: Rapid growth with lagging technological capabilities

Thailand is by far the richest economy in our sample. In 2005 its per capita income was three times higher than the next richest economy, Maharashtra, and almost eight times higher than Tanzania, the poorest economy in our sample (see Table 1 on p. 11). It is also an economy that has developed rapidly relying to a much greater extent on liberal economic policies compared to most other East Asian economies. It is therefore a useful comparator for the rest of our economies where ambitious intervention policies were abandoned in the 1980s because of problems with implementing ambitious market failure corrections. Despite its higher per capita income, Thailand therefore has aspects of relatively low state capability in managing growth-enhancing interventions. Moreover, unlike many other East Asian and particularly North East Asian countries, Thai politics since the 1970s has been fractious with a gradual and halting transition to more open democratic politics over this period. This too makes it a useful comparator for our other economies, none of which have been successful in imposing effective forms of authoritarian rule.

Overview

Table 4 Thailand: Phases of Growth 1951-2003

Period	Real GDP Growth	Real GDP Growth per capita
1951 to 1986 (Phase I) Pre-Boom	6.5	3.9
1987 to 1996 (Phase II) Boom	9.2	8.0
1997 to 1998 (Phase III) Crisis	-6.1	-7.1
1999 to 2003 (Phase IV) Post-Crisis	4.0	3.3
Whole Period 1951 to 2003	6.2	4.2

Source: Warr (2005) Table 1.1

The turning points in growth trends in Thailand since 1950 are shown in Peter Warr's classification (Warr 2005) reproduced in Table 4. We also know from our Table 2 (p. 12) that while growth in agriculture and services in Thailand was high throughout the period 1980-2005, manufacturing has been the driving sector in the sense that this was consistently the fastest growing sector over this period.

Till around the mid-1980s, Thai manufacturing growth was driven by policies that created new incentives for investments in risk taking in new sectors. A few large domestic conglomerates were the main beneficiaries, relying on close relationships with politicians to get access to rents and resources that drove this early growth. Intense competition between competing business-politics factions ensured that the clientelism involved was relatively competitive and primarily involved in delivering rents to emerging capitalist conglomerates. These features of the rent-management system of the time ensured that the market failures preventing the development of basic industrial capabilities were overcome without excessive waste, and a relatively dynamic capitalist sector emerged (Khan 2000b: 101-4; Phongpaichit and Baker 2008: 267-9).

By the late 1970s this rent management system began to face intense strains and began unwinding. An aspect of rapid Thai growth was the availability of plentiful natural resources that could be captured by emerging capitalist conglomerates in resource-using industries. When the supply of natural resources began to run out it became clear that the institutional compulsions for productivity growth within the conglomerates had not been that strong, and this pattern of growth began to reach its limits. This coincided with a reduction in US interest in and aid to Thailand with the end of the Vietnam War and the effects of the oil shocks. As in other countries, the exposure of weaknesses in early growth-enhancing strategies did not lead to an investigation of governance improvements that may have addressed these problems but rather in the adoption of a more explicitly market-oriented strategy. Under World Bank guidance, Thailand began a programme of liberalization of its trade regime in the early 1980s, incentives were created for export-oriented manufacturing in the mid-1980s and by the late 1980s restrictions on international capital flows were relaxed making foreign capital inflows easier (Phongpaichit and Baker 2008: 4).

The economic boom that followed from the mid-eighties till the late nineties in Thailand was driven by a combination of existing Thai conglomerates getting access to cheap foreign capital as well as investments by foreign investors in joint ventures with Thai partners. The relocation of significant production facilities in Thailand was assisted by the fortuitous developments that led to the Plaza Accord of 1985. This led to the revaluation of the yen against the dollar and led to a significant Japanese interest in setting up offshore production in South East Asian countries like Thailand which had achieved an industrial base and also had low wages and a currency tied to the dollar. Clearly, the shift to a more liberal trade and capital regime led to an inflow of investments from foreign partners only because some domestic productive capabilities had already developed as a result of earlier strategies. But the political economy which had allowed Thai conglomerates to get access to rents and grow in the earlier period failed to provide effective governance to ensure that these resources were always used productively. As these governance capabilities did not improve, the underlying problem eventually affected the new capital flooding in.

The influx of capital and technology led to a boom with very high growth rates for a decade after 1985. But weaknesses in governance capabilities also led to a significant amount of speculation and bad lending. The boom of the 1980s and 1990s was followed by the financial crisis of 1997. While the East Asian financial crisis had important exogenous causes, such as a slowdown in global demand for East Asian exports, the shock revealed in an exaggerated way a number of weaknesses in the

Thai model of economic growth. Export orientation and liberalization had not addressed the problem of how to raise productivity and competitiveness within the domestic conglomerates in Thailand. In the restructuring that followed, Thai conglomerates sold out very systematically to their foreign partners and this led to a much more significant presence of foreign capital in Thailand's corporate sector (Niyomsilpa 2008; Wailerdsak 2008). The new corporate sector that emerged after 1997 was one where the presence of domestic capital in high-technology sectors was significantly reduced, with their focus shifting to less risky areas such as suppliers to multinationals and the service sector (Phongpaichit and Baker 2008).

The underlying theme in the Thai growth story is therefore the unsatisfactory performance of domestic Thai corporates in raising their productivity and global competitiveness. The crisis of 1997 shook out a lot of domestic capital from sectors where they had failed to acquire competitiveness. While growth in the 2000s returned to the pre-boom growth rates, this was now a very different type of growth. Thailand's new growth strategy abandoned the attempt to create a dynamic domestic capitalist sector using specific policy instruments such as local content ratios and ownership laws. Instead, the new strategy after 1997 became one of becoming an attractive base for foreign direct investment and responding to the needs and requirements of primarily foreign investors in Thailand's new growth sectors like automobiles and electronics (Phongpaichit and Baker 2008: 267-73).

The new approach raises new types of questions about the vulnerabilities Thailand may face in the future. First, as Japanese economists have pointed out, while Thailand has achieved the agglomeration economies that have attracted Japanese and other direct investment, there appears to be a 'glass ceiling' preventing the absorption of technical capabilities that would allow the economy to break free of dependence on foreign technological leadership (Ohno 2006: 14-17). Clearly if this glass ceiling cannot be broken through there will be a limit to potential income growth in a middle-income country based solely on being a manufacturing outpost for the assembly of designs coming from more advanced countries. At some point the transition to an economy that does its own creative technological leadership has to be contemplated because most of the value-added in modern production comes from ownership of designs and brands. This raises questions about the types of market failures that may be constraining that transition in Thailand.

Secondly, even if the policy objective is to enable Thailand to fully exploit the opportunities coming from its new position as a base for assembly operations for multinationals, it has to address the market failures and institutional constraints that limit the skill base of its workers and managers. Since multinationals are unlikely to take the risks of investing to the fullest extent in skills development because of the types of market failures discussed earlier, even a gradual move up the value chain through multinational investments requires government investments in training and skills development or other measures to overcome the relevant market failures (Brimble and Doner 2007; Phongpaichit and Baker 2008: 274-77). In each case, significant governance capabilities are likely to be required to enable the strategy in question to be effectively implemented (Ohno 2006).

Policies/Rents	Governance	Outcomes/Vulnerabilities
<p>Rent allocation and rent capture to create domestic conglomerates, 1950-</p> <p>Formal rents based on fiscal incentives, import and export controls, licensing and zoning laws.</p> <p>Informal rents based on ability to negotiate terms on formal rents, and preferential access including to privatized assets, loans, licenses, natural resources and insider information.</p>	<p>Governed by Competitive Clientelism: Access to rents was relatively competitive because of competition between patrons in politics.</p> <p>Entry of new clients could not be permanently blocked and together with hard budget constraints for individual factions ensured that clients knew that assets had to become competitive. A permanent stream of rents was not feasible.</p>	<p>Rapid growth of large domestic conglomerates in relatively low technology manufacturing: Dramatic growth (particularly 1960s onwards) in low-tech sectors where learning periods were short.</p> <p>But competitive clientelism also damaged autonomy of critical agencies: by the late 1980s and 1990s the Bank of Thailand, the NESDB and other agencies became targets of ruling factions.</p>
<p>Rent allocation by technocratic agencies like Board of Investment (BOI) to accelerate learning and technology acquisition, particularly 1980-1997</p> <p>Examples are targeted BOI incentives for specific technology acquisition strategies including duty concessions, time bound entry barriers, local content conditions supported by specific incentives.</p>	<p>Requires specific technocratic and political (growth-enhancing) governance capabilities</p> <p>Effective technocratic capabilities existed in some agencies and there were moments of political support for such strategies even in overall context of competitive clientelism.</p>	<p>Some upgrading and diversification through conditional support particularly over 1980-97</p> <p>Examples include diesel engines 1980-85, cathode ray tubes 1985 onwards.</p> <p>But growing politicization of agencies in a context of cheap capital imports limited development of these capabilities. BOI moved to support firms independent of nationality by mid-1980s.</p>
<p>Non-discriminatory rent allocation to all technology providers including FDI, particularly 1997-</p> <p>Abandonment of local content, local ownership and setting of national technology priorities.</p> <p>Initially rents were provided by cutting tariffs and taxes but as these are bid down further incentives require difficult public investments in education and skills.</p>	<p>Negotiated through active business-government dialogues and regulated by international agreements such as WTO and FTAs</p> <p>FTAs and WTO limit capability of governments to induce learning by doing in new sectors by creating temporary rents. Governance focus shifts to ensuring quality of skills in formal education.</p>	<p>Rapid growth of FDI in assembly operations where agglomeration economies already exist</p> <p>Automotive sector success story but ownership of technology and bulk of profits is foreign.</p> <p>Growing challenge of increasing domestic value added. Country vulnerable to relocations of foreign capital. Domestic populist backlash is a continuous danger.</p>

Figure 12 Governance and Growth in Thailand: Patterns and Vulnerabilities

Figure 12 summarizes the recent experience of growth in Thailand by looking at three different types of intended and unintended policy responses to market failures in that country that are separately recognized in the literature as having played important roles in driving aspects of growth and technology acquisition. The next three subsections discuss these patterns of rent creation and the associated governance capabilities that assisted or hindered growth through investment and technology

acquisition. This investigation also helps us to identify vulnerabilities in the growth patterns observed in Thailand. As the most advanced of our group of growing economies, these observations will also help to structure the discussion of growth and vulnerability in our other economies.

Rent allocation and rent capture to create domestic capitalist conglomerates

We know from historical observations that the availability of an investible surplus in a country and the formal availability of profitable production technologies from around the world are not sufficient to ensure the entry of domestic entrepreneurs into productive activities. Market failures in land, labour, capital and technology markets can prevent the transition of merchant and trading capitalists into productive activities (Figure 8). The most basic constraints in the path of a productive capitalist transition are the market failures that prevent the simplest technologies attracting capitalist investment. In these cases the relevant market failures are preventing even enterprises that would have been profitable immediately to access the land, labour and other resources that they need to set up in production at a price (including transaction costs) that is attractive for the individual capitalist investor.

Historically at early stages of capitalist development, the emergence of the first few generations of firms has typically involved significant non-market transfers of assets and resources to productive firms, a process that Marx described as ‘primitive accumulation’. The non-market aspects of resource transfers in high transaction cost markets are necessary whenever market failures imply transaction costs that are high enough to prevent productive firms and investments emerging purely through market transactions. At the same time, non-market transfers or influences on market processes can also easily go wrong and result in very poor outcomes for production and productivity.

The first set of policies shown in Figure 12 is related to the creation or capture of rents in ways that enable the initial emergence of potentially productive capitalists. At a general level, all these processes involve *making extra resources available to potential investors* using a variety of political mechanisms to overcome the obstacles in the path of the resource agglomerations required to set up capitalist production. An initial thrust towards capitalist production could be based on rather crude rent allocation to already existing merchants and traders provided minimal governance conditions are present to limit excessive levels of moral hazard and capture of these resources by entirely unproductive groups. In common with other developing countries, Thailand displays significant non-market influences on asset and resource transfers as soon as its traditional economy is exposed to rapid processes of change in the early twentieth century. But here, in common with more successful transition stories, a significant productive sector rapidly emerges through these processes.

Thailand’s transition to a modern middle income country began as late as the 1930s when the absolute monarchy was overthrown by a coup d’état. At that time Thailand had plenty of traders and merchants, mostly of Chinese descent, who were engaged in the global rice trade. With the partial exception of a few firms engaged in rice and timber milling, shipping, banking and cement, there was virtually no modern capitalism (Wailardsak 2008: 34). In common with many other developing countries, the availability of a potentially investible surplus in the hands of a trading class and the formal availability of potentially profitable technology were insufficient to

overcome the market failures that prevent the entry of domestic investors into production activities. Overcoming these market failures was not helped by the virtual free trade that Thailand had been constrained to follow for a century. Trade policy has historically been a cheap and simple way in which developing countries created rents encouraging potential investments in industry that were blocked in the absence of these incentives.

Although Thailand was never formally a colony, the Bowring Treaty of 1855 with the British Empire had limited import duties to 3% of value and thereby effectively prevented any protection of domestic industries through trade policy. Between 1855 and 1950 the growth rate of per capita income was estimated at a dismal 0.2% per year (Manarungsan 1989). This poor performance was similar to many other poor countries where colonial rule imposed virtual free trade policies in the nineteenth and early twentieth centuries. The military-bureaucratic elites who came to power through the 1932 revolution identified the need for industrial development and of import substitution as a mechanism to achieve that goal. However, there was no immediate shift in policy towards industry because of antagonisms between the Thai bureaucratic-military elites and the traders of Chinese descent who would be the beneficiaries of an industrialization drive. Nevertheless, the stage had been set for the gradual emergence of a long-lasting strategy of agricultural taxation and industrial protection through which modern Thai capitalism was to emerge (Phongpaichit and Baker 1997: 112-42).

Thailand was fortunate in having significant endowments of arable land. As a result, agricultural taxation could play an important role in providing investible resources directly through savings and taxation and indirectly by easing the financing of discriminatory rents to support the industrial transition that began around 1950. The extensive land frontier also enabled Thailand to have access to foreign exchange through agricultural exports at an early stage of development. Initially Thailand was a significant agricultural exporter, with rice alone accounting for 50% of the value of exports in the 1950s. Agriculture itself grew at a very respectable 4% per annum over 1970-1990, largely because of the availability of plentiful land rather than any significant growth in yields (Siamwalla, et al. 1993). These agricultural characteristics enabled a significant taxation of agriculture and agricultural exports that financed and enabled a range of policies creating incentives for industrial investment (Siriprachai 2007). By 1980, the share of manufacturing in GDP overtook agriculture, growing to 22% compared to agriculture at 21%, and by 1985 manufacturing exports had overtaken agricultural exports (Phongpaichit and Baker 1997: Table 5.3 and 5.4).

As in many developing countries at that time, the importance of inducing the initial investments in industry was widely recognized by governments and particularly military governments. Rent creation to trigger the initial transition was 'organized' through a number of formal as well as informal processes. Shortly after Field Marshal Sarit Thanarat took power in 1958, a series of formal policies were adopted that demonstrate implicit recognition of market failures blocking the entry of traders into production even if they were planning to adopt the most basic low-risk technologies. The Board of Investment (BOI) was established in 1959 to create incentives for industrialization using a broad range of tax and tariff concessions. A National Economic Development Board was set up (later renamed the National Economic and Social Development Board or NESDB) to draw up five-year plans and coordinate

across sectors. The Investment Promotion Act of 1960 made it easy for investors, including foreign investors, to get access to land. Profit repatriation and protection from nationalization were guaranteed for foreign investors. Labour unions and strikes were outlawed (Phongpaichit and Baker 1997: 128). These policy interventions raised the potential rate of profit in a wide range of productive activities and by definition created rents for investors in these sectors.

In addition to the formal policies, the political shift in the direction of a business-politics rapprochement led to an equally important set of informal arrangements through which business clients of political patrons could expect access to additional rents. Clients could expect to negotiate the terms of formal policies and to have formal policies preferentially interpreted. As Warr (1993: 38) points out, BOI policies were often applied in a discretionary way and the incentives offered often differed among firms in the same industry. Businessmen with political connections could expect preferential access to privatized assets, government contracts, licenses, loans, land and natural resources and insider information about imminent policy changes and opportunities. These policies were not just incidentally important in Thailand. The biggest productive conglomerates emerged through these processes, and they have continued into modern times when their necessity is more difficult to justify.

For instance, the owner of the largest textile conglomerate in Thailand in the late 1970s, Sukree Photiratanangkun had begun life as the owner of a small fabric store. His transition to capitalist production began with his acquisition of a privatized spinning and weaving mill on preferential terms and being able to supply blankets to the army, both based on his contacts within the Sarit government (Doner and Ramsay 2000: 158-9). In 2005, the richest man in Thailand in the Forbes list of global billionaires was the liquor magnate Charoen Sirivadhanabhakdi. Son of a Chinese immigrant street vendor of fried mussels, Chaoren's enterprising abilities and capacity to make deals with politicians makes his story one of the classics of dynamic primitive accumulation in Thailand (Treerat 2008). Even more famously, the future prime minister Thaksin Shinawatra would in the space of five years in the late 1980s go from having virtually nothing to become one of the richest entrepreneurs in Thailand by leveraging insider contacts to his advantage in the booming telecommunications sector (Pathmanand and Baker 2008: 106-8).

What is remarkable is that out of this formally unregulated rent seeking and rent creation based on murky patron-client networks, an emergent industrial capitalism entered basic technology sectors like textiles and drove industrial growth in Thailand at unprecedented rates in the 1960s and 1970s. It is also clear that these informal arrangements were not created consciously to address specific market failures. The interesting question is how these processes effectively if unconsciously addressed these market failures, albeit at considerable cost in terms of other unintended consequences and wastage. From 1963 to 1975 manufacturing output and employment quadrupled (Phongpaichit and Baker 1997: Table 4.2). Apart from agribusinesses processing food, there was growth in glass, cement, iron and steel, paper manufacturing and above all textiles.

There were a number of formal and informal regulatory characteristics governing this rent creation system that can help to explain these relatively favourable outcomes. Even during periods of military governments, and particularly during the quasi-

civilian governments of the 1970s and beyond, patron-client politics in Thailand was characterized by intense competition between factions controlled by different patrons (Doner and Ramsay 2000; Khan 2000b: 101-4). The fragmented nature of Thai political competition was reflected in the 14 charters and constitutions that the country had between 1932 and prior to the 1997 constitution, none of which made it easy for a single political party to control government. Secondly, key macroeconomic agencies of the state, including in particular the central bank, the Bank of Thailand (BOT) were relatively insulated from factional politics. Initially at least, these agencies were able to resist patron-client politics from affecting monetary or exchange rate policy. Finally, autonomous redistributive factions were weak in Thailand. Unlike most other developing countries, Thailand had not been colonized and so powerful social movements had not developed that immediately engaged in redistributive politics.

The combination of these characteristics of the governance environment had a number of consequences for the rent creation process enabling primitive accumulation in industry. First, although rents could be captured by or created for particular aspirants through their contacts with patrons, clients had no credible strategy to make any of these rents permanent. Rent recipients knew there would be intense competition from potential new entrants who could approach either their own patron or other patrons. The only way of ensuring income flows into the future would be to leverage the temporary advantage offered by the rent to invest in the productive venture and generate market profits rapidly. Profit generation was essential to reinvest in the patron-client relationship and thereby ensure that their patron remained loyal to them and could continue to dominate in the competition against rival patrons to assist the client with further rents in the future.

Secondly, the absence of autonomous redistributive factions meant that businesses receiving rents had no bargaining power with their patrons apart from the return they could eventually offer them. If they could not rapidly generate profits from their investment their patron may look elsewhere for a better return or be superseded by other patrons with more lucrative clients. In countries where business clients could easily buy independent organizational power from powerful political factions the calculations became more complex and inefficient producers were more likely to preserve their rents by politically blocking attempts by their patrons to re-allocate rents to others (Khan 2000b). A more detailed analysis of these conditions will follow in a subsequent paper on non-market transfers.

On the negative side, Thai competitive clientelism had built-in instabilities that always threatened the capacity of this informal governance system to remain efficient. The dynamism of the system depended significantly on the inability of patrons to generate resources for themselves by influencing macroeconomic policy such as interest or exchange rate policy or by creating unassailable monopoly rents. As long as political patrons could only create temporary sectoral or firm level rents, the competition for these rents and the entry into new productive activities that they allowed was potentially very beneficial for a capitalist transition. This fine balance was not consciously created or maintained and began to be undermined by developments over time.

First, by the 1980s, the growing political power of factions began to undermine the capacity of technocratic agencies to manage macroeconomic aggregates. Competitive

clientelism had initially been characterized by an implicit deal between technocrats in the Bank of Thailand and other economic agencies on the one hand and politicians on the other whereby the technocrats managed the macroeconomy and the politicians allocated sectoral and firm level rents that were by necessity temporary. Christensen and Siamwalla (1993: 7) summed this up as follows: “The technocrats would not encroach on the sectoral and macroeconomic mismanagement which benefits the political masters, while the latter would allow the technocrats to keep control over the macroeconomy” (quoted in Doner and Ramsay 2000: 171).

By the end of the Prem Tinsulanond government in 1988, these Chinese walls began to be undermined as new more robust politicians hired and fired technocrats to assert control over the economy in ways they thought were required (Rock 2000: 196-9). The outcome was not only that serious macroeconomic damage could be inadvertently inflicted, but also that ruling factions could attempt to capture much more significant and long-lived rents by using macroeconomic management, thereby upsetting both the dynamic incentives for profit-seeking by business clients and also raising the stakes in political competition.

Secondly, the nature of political competition changed after 1997 due to a number of interrelated reasons. The failure of the political system to respond to the needs of domestic capital encouraged more business interests to directly enter politics and in the case of Thaksin Shinawatra to set up a political party that would eventually win power. A new constitution also emerged in 1997 as a result of strong social mobilization for democratization and against the powers of the shady military-bureaucratic elites who traditionally wielded significant power in Thai politics. The new constitution was deliberately crafted to give primacy to elected political parties and to allow a single strong party to dominate parliament with strong executive powers given to the prime minister.

This combination of factors had the unintended effect of encouraging an attempt at creating a monopolistic clientelist model by Thaksin and his Thai Rak Thai party which used populist politics to win electoral power and centralized rent allocation to enrich a ruling group of business interests to the exclusion of others. The tensions this strategy resulted in led to Thailand’s latest military coup in September 2006 (Chaiwat and Phongpaichit 2008). Not surprisingly, the 1997 constitution was abrogated and an interim constitution was promulgated in 2006, followed by a new constitution in 2007. These dynamics will be discussed in detail in later papers but clearly since the late 1980s the conditions that ensured the rapid emergence of new productive capitalists through competitive clientelism began to be undermined.

Rent allocation for learning and technology acquisition

This first type of rent creation that we have discussed so far enabled variants of primitive accumulation. At least for a while, this type of rent creation can have positive effects in many contexts simply by overcoming the market failures that create high entry costs for entrants into productive sectors. However, other market failures are more difficult to address, including in particular those that constrain risky investments in learning when the productivity gap between the catching-up country and its more advanced competitors is significant. Here as we have argued there are more complex problems of positive externalities and principal-agent problems between outside investors in the firm and the management and workers of the firm.

Overcoming these market failures once again requires temporary rents but here the conditions for effectiveness are more demanding. But without parallel success in learning and technology acquisition the initial entrants are likely to remain in basic technologies and be unable to respond to entry by lower tier countries.

If temporary rents are created without discriminating across sectors, or are available for unpredictable lengths of time, these rents may still assist entry but self-selection by rational investors will ensure that entry happens primarily in sectors where the productivity gap with competitors is low. A low productivity gap is essential to ensure that entrants can achieve profitability relatively rapidly. Investors may then be able to survive if the rent is withdrawn. More importantly, if they have a reasonable chance of becoming profitable quickly they can invest in the political relationships that created these rents to generate further rents in the future. But to achieve entry into technologies and sectors where the gap with competitors is more significant would require a more concerted policy approach with a greater assurance that rents will last for a minimum learning period. And for this to work, there also has to be credible exit strategies for rent providers.

The competitive clientelism in Thailand described earlier may give the impression that concerted policy action for technology acquisition would be well-nigh impossible in this context. Such concerted strategies were certainly difficult, but interestingly, not entirely absent in Thailand over the period we are interested in. In particular in the 1980s during Prem Tinsulanond's quasi-civilian government, economic agencies exercised considerable effort to promote technology acquisition. The country had by then already acquired a diversified base of basic technology industries and needed to upgrade into more value-generating industries where entry was constrained by significant productivity disadvantages. Technocratic agencies like the NESDB, the Bank of Thailand and the Finance Ministry had significant capabilities that had not yet been undermined by political appointments. And Prem's military-backed government was less short term in its perspective and less constrained by political imperatives of having to deliver to coalition partners who may have had their own business clients to promote or protect.

Indeed some observers have detected technocratic capacities to make targeted policy interventions in Thailand from the early 1960s. The Commercial Banking Act of 1962 promoted the growth of a small number of large domestic banks by limiting bank entry, limiting the operation of foreign banks and undermining informal credit markets. The effect was the successful expansion of a small number of family-owned commercial banks that further accelerated industrial growth by making credit available to Thai entrepreneurs (Rock 2000: 187). By the 1980s the BOI was implementing ambitious technology upgrading strategies. An example is a project with three joint venture firms to introduce the production of diesel engines for agricultural machinery in Thailand. Policy measures included rent creation using targeted import duties to protect domestic markets, reductions of duties for required imported raw materials, entry barriers into the sector to protect initial investors, and a four-year target for achieving 80% local content. The project was monitored throughout and protection was reduced for those firms that failed to meet the local content requirement at the end of the period (Rock 2000: 189-90).

But by the mid-1980s the conditions for supporting domestic capital in technology acquisition were being weakened. The growing politicization of rent allocation created pressures within technocratic agencies to look to foreign technology providers and investors. At the same time exogenous changes in the global financial system following the Plaza Agreement of 1985 made Japanese investors very interested in countries like Thailand. Net inflows of FDI almost quintupled from the 1980-85 annual average of 6.1 billion baht to 28 billion in 1988 and 45.7 billion in 1989, mostly driven by a huge increase in Japanese FDI (Phongpaichit and Baker 1997: Table 5.5). These levels were roughly sustained right through till the crisis of 1997. For reasons that will be discussed in the next subsection, FDI inflows accelerated even further *after* the 1997 financial crisis. These inflows and the interest particularly by Japanese conglomerates for joint ventures in Thailand had important effects on the incentives for technological upgrading by Thai capital. If Thai capital could make easy profits by going into joint venture partnerships with foreign investors, it was difficult to persuade them to undertake difficult and risky technology upgrading investments on their own with the types of rents that the technocrats could provide local investors.

Changes in the global context therefore had significant (and eventually adverse) effects on the incentives of domestic capital. With hindsight we can argue that Thai growth-enhancing policies to counter these tendencies were inadequate. The significant increases in foreign capital inflows led to changes in BOI rules by 1986 allowing it to offer incentives to foreign investors in export industries (Phongpaichit and Baker 1997: 151). Although initially this was intended to allow technical partnerships with domestic capital and encourage technology transfers, eventually this further weakened the possibility of implementing policies to develop domestic technological capabilities. As the role of foreign conglomerates increased in the Thai economy, so did their bargaining power. As a result, they were less willing over time to engage in discussions about technology transfer conditions that implicitly increased their costs of production. Indeed by 1994 BOI was allowing 100% foreign ownership of export-oriented ventures (Niyomsilpa 2008: 66-7)

In the early years of this transition, partnerships with foreign firms were technologically beneficial to Thai firms in terms of technology transfer and the development of local technological capabilities. In the late 1980s the BOI developed policies to deepen the capacity of Thai firms to produce cathode ray tubes (CRTs). The BOI worked with a major Thai company, the Siam Cement Group to lead the project, supported by the usual mix of fiscal incentives and entry protections and invited foreign partners to participate. Mitsubishi was selected as the foreign partner and Thai firms associated with the project rapidly progressed from assemblers to producers (Rock 2000: 190-1). However, the incentives for technological upgrading for Thai partners in many of the joint venture projects that were emerging were insufficiently strong. The tendency was for Thai partners to be engaged in a supportive and supplier role to the foreign assembler. The weakness of the Thai partners in these technology upgrading strategies became apparent in the aftermath of the 1997 financial crisis. The shakeup that followed led to the logical development of this strategy in a direction that formally abandoned attempts at creating a globally competitive but domestically owned Thai capitalist sector.

Table 5 Thailand: Growth of Output and Productivity

GROWTH RATES	Pre-Boom 1981-86	Boom 1987-96	Crisis 1997-98	Recovery 1999-2002	Whole Period 1981-2002
All Sectors					
Output	5.46	9.50	-5.93	4.11	6.01
<u>Factor Contributions</u>					
Capital Stock	3.22	4.80	1.81	1.04	3.42
Labour	1.35	2.68	1.29	1.88	2.05
Land	0.03	0.01	0.01	0.01	0.02
<u>TFP</u>	0.86	2.00	-9.03	1.17	0.54
<u>Labour Productivity</u>	2.55	7.56	-5.83	3.36	4.21
Manufacturing					
Output	5.80	13.19	-4.82	7.06	8.42
<u>Factor Contributions</u>					
Capital Stock	4.11	7.44	3.21	1.59	5.08
Labour	1.54	5.08	2.65	2.26	3.38
<u>TFP</u>	0.15	0.67	-10.68	3.21	-0.04
<u>Labour Productivity</u>	3.07	6.04	-7.65	2.44	3.33
Investment Share (% of GDP)	28.3	38.4	27.1	22.8	31.8

Source: Calculated from Warr (2005) Tables 1.3 and 1.4, and World Bank (2008)

The data in Table 5 show some interesting patterns for productivity growth in the Thai economy and its manufacturing sector. Technical progress can be measured either by labour productivity growth or TFP growth. Each measure has advantages and disadvantages but TFP in particular has serious measurement and conceptual problems, which is why it is often a controversial measure. Calculations of TFP growth in Thailand are particularly problematic and the results vary across studies because of inadequate data on factor shares. But the ranking of TFP growth across periods in Table 5 is consistent with the ranking across studies in the survey of available TFP studies on Thailand by Bosworth (2005).

For the economy as a whole, both labour productivity growth and TFP growth rates were highest during the boom of 1987-96. In the second growth phase of 1999-2002 both labour productivity and TFP growth rates recover but are lower than before. In the second period both labour productivity and TFP growth rates are around a half that achieved in the earlier period. A somewhat different picture emerges for the manufacturing sector. As with the economy, labour productivity growth is highest during the 1987-96 boom and is only about a third of this rate during the recovery of 1999-2002. But TFP growth in manufacturing is almost negligible in the first period because of the very rapid growth of capital stock. TFP growth is considerably higher in the second period in the manufacturing sector largely because of a much slower growth of capital stock.

This evidence suggests that till the 1997 crisis the policy interventions of the Thai state had a greater effect in sustaining high rates of investment in manufacturing,

thereby achieving very high rates of labour productivity growth. The significance of the low TFP growth rates in the pre-crisis manufacturing sector is open to interpretation. Clearly, much of the growth in manufacturing at this time was *extensive growth* based on a rapid expansion of a relatively low-tech manufacturing base. There were successful examples of technology upgrading and new technologies were continuously being introduced but not very rapidly or aggressively. Many of the relatively high-tech investments by foreign investors (for instance in automobiles) took place towards the end of this period and many production units were not operating at full capacity when the 1997 crisis struck. A combination of all these factors could explain why the average labour productivity in the manufacturing sector was rapidly growing as new firms set up in the sector, while the slow growth of TFP could be capturing the relatively slow technical upgrading within existing firms and low capital utilization in some new high-technology projects. The interpretation of low TFP growth is however problematic and the Thai TFP figures are particularly sensitive to assumptions made about the shares of capital and labour in the economy, the corrections made to factor quality, and the appropriate weights to use for aggregating the contributions of labour and capital (Bosworth 2005). The change in the pattern of growth and productivity after the 1997 crisis is the subject of the next subsection.

Non-discriminatory rent allocation to technology providers

The 1997 financial crisis was a watershed in the development of Thai growth and governance strategies. The combination of the first two processes outlined in Figure 12 had by the 1990s resulted in a fairly diversified if moderately low-tech manufacturing base. But the growth and governance strategy was beset by internal problems that made it difficult to sustain the move into higher technology sectors. These internal problems, together with the shift of Japanese and other international investors towards South East Asian countries like Thailand in the late 1980s had a very significant effect on the viability of these strategies given the limited political capability of Thailand to evolve viable internal responses to these challenges. Instead, by the mid-1990s, higher technology investments in Thailand were driven by joint venture investments with foreign, largely Japanese conglomerates.

Initially, Thai firms did very well in the new arrangement, becoming actively involved as joint venture partners with Japanese technology providers. In addition, they benefited significantly as first and second tier suppliers and in many cases this resulted in significant technology acquisition by Thai companies². But there were inadequate incentives and support for the development of Thai technical capabilities in these sectors, and indeed the incentive was for Thai companies to be rent-mediators enabling the entry of FDI seeking to take advantage of incentives offered by BOI to joint ventures and the agglomeration economies in Thailand, given the relatively deeper development of a manufacturing base in Thailand compared to most other South East Asian countries. The gradual eclipse of Thai capital in high-technology sectors was radically accelerated by the financial crisis of 1997, after which the third strategy of rent allocation shown in Figure 12 begins to emerge as the dominant one. Instead of using rent allocation to accelerate learning and technology acquisition by

² First tier suppliers manufacture parts that are directly used in the assembly of the final product (say cars). Second tier suppliers supply sub-assemblies and parts to first tier suppliers, while third tier suppliers provide replacement parts. The technical sophistication and quality control requirements are typically in a declining order across these tiers.

domestic capital, the BOI strategy begins to transform into one of non-discriminatory rent allocations to any technology providers, who happen increasingly to be foreign ones, and abandoning local content and ownership requirements and the attempt to define national technology priorities.

The dynamics behind this transition are best illustrated by the most successful sector to develop out of this emerging partnership with Japanese capital: the automotive sector (Niyomsilpa 2008). Although Thailand had been trying to encourage a domestic automotive industry since the 1960s, it was only with Japanese joint ventures in the 1980s that the sector made significant progress. But even in 1996, the last normal year before the crisis, total production was around 600,000 units, almost entirely (>97%) for the domestic market. The 1997 crisis led to a significant structural break in policies and structures. The BOI was forced to rapidly abandon local content requirements and ownership requirements, and less productive Thai capital was forced to rapidly sell out their shares in joint venture enterprises to their erstwhile foreign minority partners, becoming either minority partners themselves or moving out of the industry altogether. Fortunately for Thailand, the sunk costs of Japanese investors in the automotive industry were large enough for them to decide to take a major stake in Thailand and buy out their joint venture partners in a context where the economy appeared to be facing a meltdown. The buyout of Thai capital in this and other high-technology sectors in the immediate aftermath of the crisis explains why net FDI flows to Thailand increased in 1997-99 compared to the earlier years, before falling back to relatively low levels of net inflows by 2002-03 (Warr 2005: 32-6).

The results were dramatic. By 2006, barely a decade after the crisis, the Thai automotive sector was producing almost 1,250,000 units, 44% for the export market. It had become the single largest sector in Thai manufacturing, employing over 100,000 workers, accounted for 8% of total exports and Thailand had shot up to fifth place in world rankings for production of commercial vehicles. The only 'problem' was that this was no longer a Thai sector. Five multinationals (four Japanese and one American) controlled 98% of the Thai automotive sector, and even of the 200 first-tier part suppliers, only 20 remained in Thai hands (Niyomsilpa 2008: 61). Only a decade ago, there were several hundred domestic firms playing a dominant role in the sector, both as first-tier part suppliers but more importantly as joint venture partners in the core manufacturing processes.

As we have seen, the transition to a new rent strategy had been happening gradually anyway, with a growing involvement of Thai technology policy-making with strategies to attract FDI into specific high-technology sectors. This was the direction in which learning rents were being deployed by technocrats from the mid-1980s onwards. At the same time, the incentives for domestic capitalists to engage in productivity improvement and technological capability development became weaker after the significant increase in the availability of foreign capital and joint venture participation in the mid-1980s. To make matters worse, the politicization of rent allocation began to affect the efficiency with which learning rents could be managed and this also affected the capability of technocratic agencies to allocate selective rents to domestic capitalists to achieve technology upgrading. The transition to a different rent strategy was therefore happening anyway, but was dramatically accelerated by the 1997 crisis.

The crisis forced Thai policy-makers to respond rapidly to enable a fire sale by Thai owners of joint venture companies most of whom became technically bankrupt immediately after the crisis broke. To enable significant Japanese investment in a core high-technology sector like automobile production, policy-makers had to make rapid changes to the regulatory and policy framework. In particular, incentives in the sector had to become non-discriminatory across domestic and foreign owners, local content conditions had to be lifted to allow Japanese conglomerates to achieve regional specialization across South East Asian countries and foreign ownership restrictions had to be lifted across the board (Doner, et al. 2005; Niyomsilpa 2008: 69-77). Thai players who remained in the industry did so as suppliers, and in most cases slipped down into second or third tier supplier status.

These changes had important consequences for the policy-making framework and the types of rent strategies that Thailand and its BOI could henceforth support. The price of allowing foreign conglomerates define Thailand's place in global production networks meant that the country would have to fit into global locational strategies of conglomerates. This in turn required achieving free trade relationships with countries in which the conglomerates had located other parts of the production process, so that bodies could be made in one country, transmissions and brakes in another, and engines and designs imported from Japan. Not surprisingly, Japanese conglomerates became major policy players in Thailand, pushing for the implementation of the ASEAN Free Trade Area (AFTA) and a free trade agreement (FTA) with Japan. Under AFTA, tariffs on automotive exports with ASEAN countries were reduced to between zero and five per cent. The FTA with Japan was finally signed in 2007 and enabled imports of steel and auto parts from Japan for processing and assembly in Thailand. These policy changes made perfect sense from the perspective of Japanese conglomerates seeking to rationalize their regional production bases and enabling them to specialize parts of the production process in particular countries. However, these agreements essentially removed the capability of future Thai governments using trade policy as an instrument to develop domestic technological capabilities in other sectors or areas, or even within the Thai automotive sector.

Thailand was remarkably successful in adopting the new policy approach to technology partnership with foreign conglomerates. Non-discriminatory rents were rapidly conceded by the Thai side in the form of concessions on tariffs identified by conglomerates. These areas were identified by foreign conglomerates themselves in line with their own regional specialization plans (Niyomsilpa 2008: 77-81). On the positive side of the ledger, the relatively strong governance capabilities Thailand displayed in engaging in policy dialogue with foreign conglomerates (who also rapidly learnt how to operate through political patrons), and its ability to deliver on agreements on trade and investment policy meant that Thailand was an important beneficiary of the regional specialization strategy of global production conglomerates, especially Japanese ones. On the negative side, Thailand lost almost all policy autonomy in terms of the second type of national technological capability development strategy.

Does it matter? This is a vastly important question not just for Thailand but for poorer countries developing with similarly weak growth-enhancing governance capabilities. On the one hand, Thailand's quick responses in promoting the third strategy of rent management enabled it to attract a significant amount of FDI in the aftermath of a

financial meltdown. Even though profit repatriation significantly reduces national value added, substantial domestic value addition took place through employment and the development of domestic supplier capabilities, even if in lower value-adding second and third tier supplier positions. On the other hand, it is important to remember that Thailand attracted Japanese multinationals as a location for automotive and electronics production because of more than two decades of domestic capacity building using rent strategies for domestic technological capability building. It is not clear where the next pockets of domestic capabilities are going to come from to attract the next wave of multinational investment. This is a particularly important question for poorer developing countries who are abandoning domestic capacity building at a much earlier stage than Thailand. The consequence may be to attract multinational resource extraction and basic assembly companies but not much else.

Table 5 tells us that post-1997 Thailand enjoyed slower labour productivity growth in manufacturing despite the growth in exports in higher technology manufacturing products like electronics and automobiles. Manufacturing also apparently enjoyed much higher TFP growth compared to the pre-1997 boom period. This TFP figure can make sense if we remember that significant investments had been made in the pre-1997 period in large-scale production facilities such as for automobiles and electronics but scale economies were only achieved in the post-1997 period with the expansion in output and exports. This could explain the higher productivity growth in the manufacturing sector as a whole, given the significance of these growth sectors. But the lower labour productivity growth is consistent with a lower rate of growth of investments in the second period in the manufacturing sector as a whole and the slower expansion of the manufacturing sector as a result. Given the limited number of sub-sectors within manufacturing where Thailand would be globally attractive for multinationals, it is understandable why the earlier rate of growth of manufacturing may be difficult to sustain in a new policy regime where sub-sectors have to be attractive *ex ante* for global conglomerates.

Japanese industrial policy economists point out that the strategies that Japan and South Korea used to develop capabilities are no longer available to next tier countries because of the restrictions set by the WTO and FTAs (Ohno 2006). The abandonment of all variants of the second type of growth strategy outlined in Figure 12 may be too premature. The challenges that many developing countries are likely to face in the coming years may make it imperative of re-visit the operation of the WTO and of FTAs that many developing countries have signed up to. Indeed apart from these internationally negotiated constraints there are possibly more important internal constraints that prevented Thailand and many other countries from effectively implementing technology upgrading strategies in the past. These too need to be examined and strategies of the second type need to be devised, even in limited forms, that are likely to work in particular political contexts.

If these constraints cannot be overcome as many presume, then the only way in which a catching-up country can attract further technology transfer from multinational conglomerates is to provide non-specific implicit rents to any sector a multinational is interested in investing in. Once tariffs and taxes have been bid down, the only way to attract multinational investors from other countries competing for the same investments is through public investments in infrastructure and in the education of the workforce. These types of strategies are of course supported by the investment

climate approach of the World Bank, but they also follow logically from a rents approach to technology development if we believe that the third type of policy approach (in Figure 12) is the only one available to developing countries. The hope then would be to use public investments in skills development and public goods to attract multinationals in particular sectors and thereby achieve significant economies of scale and clustering economies in these sectors. If successful, such a strategy would tie in particular stages of production to particular countries as part of the global production processes of multinationals. Eventually this may encourage multinationals to outsource more and more of their production processes to local producers.

But as Ohno (2006) points out, even the two most advanced South East Asian countries, Malaysia and Thailand, have not graduated to the stage where domestic producers are developing their own design and production capabilities based on outsourcing by multinationals. The prospects of lower level developers to make it there are even bleaker given that their initial endowments of already achieved pockets of technological capability are significantly less developed than that of Malaysia and Thailand. The constraints faced by countries like Thailand in making the third strategy work better are not difficult to understand. The public investments in education that may make multinationals locate significant parts of their design and high value-adding production processes in countries like Thailand are difficult to achieve in the short run. In any case, many of the skills are of the learning-by-doing types that are difficult to impart in classrooms and design institutes. Developing countries following this strategy may then be in a catch-22 situation. Under this strategy, local production capabilities will only move up if the multinational moves up the value chain in its local production, allowing domestic producers to move into the spaces vacated. But the multinational will only move up if domestic producers can fill the gaps and local skills and management capabilities are available for the more difficult production and design processes. And these are unlikely to develop locally without learning-by-doing being organized for domestic capital.

An important political consequence of the type of strategy that Thailand has pursued since 1997 is the emergence of political populism and anti-foreign feelings. Thailand is one of the few countries in the developing world that was not colonized and therefore has had a better than average relationship with more advanced countries. But even here, the aftermath of the 1997 crisis and the failure of the Thai state to protect domestic capital resulted in a significant political backlash and the growth of political populism (Chaiwat and Phongpaichit 2008). Unfortunately for Thailand, the Thai Rak Thai party and its leader Thaksin Shinawatra did not use their massive popular mandate to evolve a different growth strategy for Thailand. Instead, Thaksin took the easy road and used his political power to carry out more selloffs of Thai assets, including a number for his personal benefit. The sale of his stake in Thailand's biggest mobile phone provider AIS (Advanced Info Services) to Temasek of Singapore in 2006 involved using his executive power to change the remaining ownership restrictions in the service sector to enable the sale to take place, and further changing tax laws at the last minute to relieve his family of capital gains tax (Pathmanand and Baker 2008). This was the beginning of the end for Thaksin, but the forces unleashed after 1997 led Thailand to the brink of political chaos. This too has significance for other countries travelling the same road.

As the most advanced economy in our sample, Thailand has faced challenges and choices about national technological capability development that are soon likely to affect some of our other catching-up economies. The debate about the importance of national capability development and the alternative of relying on foreign-owned companies for employment generation is one that is likely to be replayed in many catching-up countries in the near future. The shift in Thailand away from national capability development to technology acquisition by making the country attractive for FDI may have been initially driven by the low incentives of domestic capital to engage in serious technology upgrading and the politicization of the rent allocation process. But once the policy shift had taken place, the space for policy interventions to develop domestic technological capability became even narrower. Serious questions remain about some of the economic and political implications of relying so greatly on the profitability calculations and commitment of foreign technology providers. The implications of this strategy for technological upgrading in developing countries will be discussed in greater detail in a later paper.

6. South Asia: Background to the growth acceleration of the 1980s

The growth experiences of Maharashtra, West Bengal and Bangladesh in the 1980s illustrate important differences in the responses of different parts of South Asia to the challenges of more open economies. But all these economies also have some relevant similarities which it is useful to discuss before treating each economy separately.

Overview

All three South Asian economies experienced growth accelerations in the context of the general acceleration in South Asian growth in the 1980s. The scale of this acceleration is shown in Table 6.

Table 6 The South Asian Growth Acceleration in the 1980s

Growth Rates %	India	Pakistan	Bangladesh
GDP			
1960-80	3.5	5.5	1.7
1980-90	5.6	6.1	3.6
1990-00	5.8	3.7	4.7
2000-05	6.7	4.9	5.3
Per Capita GDP			
1960-80	1.2	2.6	-0.8
1980-90	3.4	3.5	1.2
1990-00	4.0	1.2	2.6
2000-05	5.2	2.4	3.3

Source: Based on data from World Bank (2008)

In India and Bangladesh the acceleration in GDP growth rates and per capita GDP growth rates was around 2% per annum in the 1980s compared to the two decades from 1960-80. In Pakistan, the acceleration was somewhat less significant at around 1% in per capita terms and 0.5% in GDP growth rates. In Bangladesh and India, both GDP and per capita GDP growth rates creep up over the 1990s and beyond. In Pakistan the acceleration collapses in the 1990s partly because its economy was

exposed to shocks from the worsening situation in Afghanistan. Growth begins to recover in Pakistan in the 2000s but faced new challenges in 2007-08 in the context of a difficult transition to democracy and a global financial crisis.

If we exclude Pakistan's performance in the 1990s and focus on the 1980s, it is clear that all South Asian countries enjoyed accelerations in their growth rates at about the same time. In the intense analytical and policy debate about the factors that triggered India's growth acceleration, the comparative regional data is often ignored. Looking at the region forces us to look for explanatory factors that could explain a simultaneous acceleration in the three South Asian countries given that the content and sequencing of their gradual moves towards liberalization were very different. At a general level there is little doubt that growth in South Asia accelerated at a time when the industrial policy structures that had been established in the post-colonial period in these countries were collapsing. The conventional explanation of the growth takeoff has come almost exclusively from economists looking at India, and has therefore focused largely on the liberalization that began there in the 1980s (Acharya, et al. 2003; Panagariya 2004; Virmani 2004a; Rodrik and Subramanian 2005).

However, it is important to remember that this was not the first time in history that South Asia had adopted liberal market policies. Like Thailand and most other developing countries, India had suffered under colonial free trade policies with low growth, particularly in industry and the modern sector. The post-colonial strategies in all of the newly independent South Asian countries were therefore heavily influenced by implicit notions of market failures constraining development in poor countries. Both India and Pakistan (Bangladesh became an independent country in 1971) adopted different variants of domestic capacity building strategies. While South Asian catching-up strategies had not been as successful as those in East Asia, our argument is that the growth takeoffs across South Asia in the 1980s cannot be understood without taking account of the limited and patchy but critically important technological and entrepreneurial capabilities that were developed through these strategies in the three decades prior to 1980. Moreover, the role of the state in mediating accumulation and primitive accumulation, in providing formal and informal incentives to accelerate investment were developed over this period. Many of the formal structures of intervention became impossible to implement by the 1980s across these countries, largely because of the growing fragmentation of politics. This allowed sectors and regions that had already developed capabilities to break free and drive growth by finding niches where their already developed capabilities had global competitiveness. This happened at around the same time across South Asia.

This perspective helps us to develop an analysis of growth vulnerabilities and governance challenges in these economies that is significantly different from that coming from conventional analysts whose focus is largely on how to deepen liberalization. In particular, we will argue that the South Asian economies have very limited formal institutional and governance capabilities for developing *new* capabilities outside the sectoral and regional pockets where they have already emerged. This has resulted in unbalanced growth in terms of regional distribution, income distribution and sectoral specialization of growth sectors. This poses serious challenges for extending South Asian growth to the wider excluded population who no longer benefit from any specific, even partially effective strategies of capacity building and entrepreneurial support which are possibly the only mechanisms for

ensuring the accelerated creation of broad-based national productive sectors. But we will also see that a variety of political and governance responses have emerged in the three South Asian economies we will look, with different strengths and weaknesses. An extension of this approach to other South Asian economies will further enrich these insights, and subsequent papers will place these responses in the context of a more general analysis of responses to market failures in second tier growth economies.

The First Liberalization: growth with limited capabilities under colonialism

It is important to understand exactly why the limited liberalization that happened in the 1980s and 1990s has such radically different effects compared to the liberalization that was forced by colonial rule. The difference in performance of the Indian subcontinent in the two periods is a dramatic illustration of the fact that free markets are not likely to magically help an economy if that economy has nothing to sell and the productivity gap is so vast that even a significant wage gap does not help. This is likely to be true in general for most underdeveloped areas even today. As we have discussed, significant market failures can prevent capability development solely through private initiatives and long-term private investments seeking to capture significant profits in the future by investing in capability development.

In the late nineteenth century, British colonial rule introduced virtual free markets for India (consisting then of India, Pakistan and Bangladesh). This meant the integration of India into global markets with almost no tariff protection for its domestic industries. In addition, British rule guaranteed the property rights of British metropolitan investors in India. Yet, despite free trade, low Indian wages, the effective protection of the property rights of British investors and the possibility of full repatriation of profits and capital, industrial investment in India from Britain remained very limited. Most foreign investment over this period was financed by the reinvestment of trading and other profits made in India (Ray 1979: 14; Rodrik and Subramanian 2005). British investment in industry was almost entirely concentrated in the jute industry where India had a global monopoly rather than in areas where competitiveness had to be achieved through investment in technology and the upgrading of labour productivity. As in Thailand, free trade did not result in the emergence of domestic production capabilities. From 1860 to 1945, India's per capita income grew at a derisory 0.5% per annum (Hicks, et al. 1989: 217).

Indian merchant capital (dominated by the Marwari and Parsi communities) initially focused on trade and stayed away from industry. When the American Civil War disrupted supplies of cotton textiles in the late nineteenth century a cotton textile industry developed around Bombay (Ray 1979: 4). But by 1911, the industrial census recorded that there were only 7000 units throughout British India that employed more than 20 workers each, and more than a third of these did not use any mechanical power (Gadgil 1944: 121). A few major developments did of course take place. The giant Tata iron and steel plant at Jamshedpur was established and began production in 1911, without any tariff protection, but not without critical government support that enabled production to commence. Given the global reach of the Tata conglomerate today, with stakes in iron and steel production, in the automotive sector and in software, it is interesting to recall how this Indian giant emerged to set up its first steel plant. In a context where there was no formal support to Indian capital, Tata's relationship with the British Raj was an early example of how the political access of

advanced sections of Indian capital even with a colonial state could sometimes (with a bit of luck in the shape of the First World War) result in industrial development.

During the planning and construction phases, TISCO (the Tata Iron and Steel Company) received extensive government support in the form of geological surveys, reduced transport costs, access to land and water rights, simplified import arrangements for construction materials and an agreement that the government would buy 20,000 tons of steel rails annually for ten years at the landed import price (Morris 1983: 589). Even so, Tata faced crippling financial costs while setting up and learning to produce in Jamshedpur. But Tata's diplomatic and cooperative attitude to the government, and the needs of the colonial government during World War I eventually helped Tata develop into a giant (Ray 1979: 27). As Rothermund (2000: 55-6) points out, if it had not been for the war, the visionary strategy of Jamshedji Tata would probably have ended in failure and the man may well have been remembered as a reckless gambler. Tata was in many ways unique for this period in entering a relatively technologically advanced sector on the basis of a personal vision (but one that almost did not pay off despite critical government support). For the period as a whole, Bagchi (1972) provides estimates of private industrial investment in India from 1900-39 which show steady but not spectacular investment over this period, with little evidence of any acceleration.

However, the state assistance that TISCO received was quite exceptional. This support (and the exceptional entrepreneurial and risk taking capacities of Jamshedji Tata) allowed Tata to establish itself in manufacturing in a context of significant market failures, high transaction costs and high risks facing initial investors. Industrialization was not one of the objectives of the early raj. Tariffs which had been allowed by British administrations in Canada, Australia and South Africa, and which played a crucial role in the development of industry in those countries, were expressly disallowed in India on the grounds of the 'Open Door' policy. In the 1880s Indian customs revenues were only 2.2 per cent of the trade turnover, compared to 21 per cent for Brazil at the same period (Maddison 1971: 57). However, from the early twentieth century onwards, and particularly after the First World War and the growing penetration of India by Japanese textiles, the pressures of expatriate British capitalist interests in India finally began to succeed in getting the state to support industry. Some assistance to Indian industry eventually came in the form of tariffs, state purchase contracts, preferential infrastructure provision and interventions in commodity and labour markets, without which Indian industry had no chance of taking off (Bagchi 1972: 420-43). Under growing pressure from Indian capitalists, by 1925, the average level of tariffs rose to around 14 per cent from a pre-war level of 5 per cent (Maddison 1971: 57).

How should we assess the performance of India under British free market policies? It is unfair to compare growth in the early part of the twentieth century with growth today because compared to the late twentieth century the earlier period was one of relatively slow growth in the world economy. The appropriate comparison of India's performance is therefore with other contemporary developing countries. The most obvious comparator is Japan, which entered manufacturing at around the same time as India, but with much stronger government support for industry following the Meiji reforms. A comparison with contemporary Japan shows that the real weakness in India's industrialization was not so much the aggregate investment or growth in this

early period, but how sustainable it was in terms of meeting Japanese competition and later the competition from other emerging competitors. Effectively, the sustainability of growth depends on investing in technologies that have the potential of achieving high rates of productivity growth, and then succeeding in actually raising productivity using these technologies. Here, comparative studies on the performance of Indian and Japanese cotton textiles show that while in 1906 India supplied three-quarters of the Chinese yarn market, by 1914 Japan had grabbed the biggest share, and in another ten years had reduced India's share of the Chinese market to under a quarter (Koh 1966: 148). This devastating defeat in the single major Indian-owned manufacturing sector had far-reaching consequences for India's subsequent industrial development.

Thus, despite a few lasting success stories, the overall effect of free market policies imposed on India induced it to become in the main a provider of raw materials to the empire and a market for British manufactured products. India's growth rates stayed well behind that of advanced countries resulting in *divergence*, meaning that the gap between Indian per capita incomes and those of advanced countries increased over this period. In 1873 India's per capita income was around 25% of US per capita income at that time. By 1947, the very low growth rates in India had widened the gap and India's per capita income was less than 10% of the US level (Clark and Wolcott 2002: Figure 1).

Capability development with dirigiste policies 1947-1980

The economic history of the Indian subcontinent in the period of planning and industrial policies has been relatively well trawled in the literature. The 'license raj' has been extensively blamed for India's 'hindu rate of growth' which Virmani graciously reclassifies as India's socialist rate of growth (Virmani 2004a). But in fact if we look at the subcontinent as a whole over this period, both 'socialist' India and the 'pro-capitalist' Pakistan adopted very similar strategies of protecting domestic industries and attempting to build up domestic technological capabilities. Their policy choices can be easily understood if we remember the dismal experience with industrial growth and development under the colonial free trade regime.

Both countries achieved much better results in growth and industrialization in the two decades after independence than they ever had under colonial rule. In both cases a variety of instruments were used to provide implicit subsidies to enable the setting up of new firms and industries. But South Asian political economy prevented the degree of discipline in the management of implicit subsidies that would have allowed these ambitious strategies to deliver the types of results observed in North East Asia. Nevertheless, new technological capabilities, new capitalists and new entrepreneurs were created who could lead the growth accelerations observed across the Indian subcontinent from the 1980s onwards.

Table 7 Dirigiste Growth in India

	1901-30	1931-47	1952-67	1968-81	1982-91	1992-2001
Agriculture	0.5	0.2	1.8	3.3	3.5	2.7
Industry	0.9	1.2	6.3	4.1	7.1	5.7
Services	1.6	1.7	4.8	4.3	6.8	7.6
GDP	0.8	0.8	3.4	3.8	5.6	5.6
Per capita GDP	0.4	-0.5	1.4	1.5	3.4	3.5

Source: Acharya et al. (2003) Table 2.1.

Table 7 shows the growth acceleration in India with the new policies that addressed some of the market failures that had constrained growth earlier. The growth of GDP was around 3 per cent higher in the three decades after independence compared to the previous fifty years. The jump in the growth rate of industry was even more marked. A very similar growth takeoff happened in Pakistan (including Bangladesh as East Pakistan) in the decades following independence using policies that were quite similar. We do not have separate figures for the growth rates of the parts of India that became Pakistan, so we can only compare Pakistan's performance with the aggregate Indian one. Table 8 for Pakistan breaks down the 1950 to 1965 period into smaller segments and shows that the growth acceleration happened gradually in Pakistan. The acceleration in the growth of industry was however immediate. Table 6 also shows that for 1960-80 as a whole, Pakistan's growth rate had outstripped India's.

Table 8 Dirigiste Growth in Pakistan (including Bangladesh)

	1950-55	1955-60	1960-65
Agriculture	1.3	1.4	3.5
Industry	9.7	6.4	11.9
Services	2.5	2.7	5.5
GNP	2.6	2.4	5.3
GNP per capita	0.2	0.0	2.7

Source: Lewis (1969): Table 1.

Protection and subsidies proved to be extremely effective in driving investment in sectors that had previously been neglected. Import substitution as a method of developing new capabilities was initially extremely successful in both India and Pakistan. Table 9 shows the dramatic growth of production in sectors like machine tools and chemicals. In Pakistan, the diversification was even more dramatic because there was virtually no industry in the Indian territories that became Pakistan in 1947 (Lewis and Soligo 1965; Papanek 1967; Lewis 1969).

Table 9 Rapid Import Substitution in 1950s India

(Percentage of domestic market supplied by imports)	1951	1971
Iron and Steel	25	13
Aluminium	73	4
Sugar Machinery	100	1
Machine Tools	90	30
Sewing Machines	41	<1
Bicycles	65	<1
Nitro-Fertilizers	84	37

Source: Datt and Sundharam (1991: 339)

In India, the Dutt Committee reported in 1969 that in terms of licenses awarded, the top 73 industrial houses accounted for 56% of the total proposed private corporate sector investment in machinery and 60% of its investment in capital goods (which includes buildings etc) (Datt and Sundharam 1991: 142). Despite the concentration of much of the implicit subsidies for learning in industry to a relatively small group of players, we also know that the management of these subsidies was poor. Subsidy withdrawal from underperforming industries and firms virtually never happened and that therefore productivity growth in the emerging new sectors was therefore going to be low (Kohli 1994; Khan 1999; Chibber 2003). Labour productivity and TFP growth

rates in the 1960s and 1970s in India and Pakistan were indeed low (Khan 1989; I. J. Ahluwalia 1991; Bosworth, et al. 2007). When investment, particularly in new sectors and technologies is assisted through protection and subsidies, there is an allocative efficiency loss but the strategy can be justified if there is a productivity gain in the new sectors over time. If this dynamic gain is low, then the overall productivity gain for the economy may be low or even negative, even if firms are being set up in new areas and new technological capabilities are being acquired. Something like that seems to have been happening in South Asia in the 1960s and 1970s.

The Second Liberalization: capability-led growth acceleration 1980 onwards

There has been an extensive debate in India about the causes of the growth acceleration around 1980. The problem was that the formal removal of rent-creating restrictions in the economy did not attain any significance till the 1990s, while the growth acceleration clearly occurred a decade earlier. To make sense of this puzzle, Rodrik and Subramanian (2004; 2005) argue that the reforms of the 1980s that triggered growth were pro-business rather than pro-market reforms, essentially signalling a shift in government attitude rather than a shift in policy. This attitudinal shift was apparently significant enough to unleash the animal spirits of investors, and their investment drive spurred the growth acceleration. In contrast, the mainstream consensus is that the acceleration in the 1980s actually began in earnest towards the end of the decade, that there was already some liberalization by that time, and that the growth spurt of the 1980s would not have been sustained without the deeper liberalization of the 1990s (Panagariya 2004, 2005; Virmani 2005; Kochchar, et al. 2006; Rajan 2006; S. Ahmed and Varshney 2008).

This debate misses or at least downplays some important aspects of the growth takeoff. The dynamics of what happened in the 1980s cannot be captured without looking at some broader aspects of the political economy in which these changes were taking place. If we look across South Asia in the 1980s, governments began making pro-business and pro-market comments not just in India, but in Pakistan and Bangladesh too. In all these countries at about the same time there were similar hesitant movements towards liberalization and (unlike India) towards some privatizations as well. These moves were driven by a number of factors.

First, the politics of clientelism had reached an impasse in all three countries by the mid-1970s. The growth in the numbers of clientelist factions and the strength of the redistributive demands coming from ever newer sections of the intermediate classes resulted in attempts at control using authoritarian populism that rapidly failed in all three countries. In India, Indira Gandhi's Emergency of 1975-77 resulted in her surprise election defeat and the gradual transition towards weak coalition governments at the centre, a feature of Indian politics that is steadily deepening even today. In Bangladesh Mujibur Rahman tried to establish a populist authoritarianism by setting up a one-party state in 1975. His attempt was strongly resisted by many factions including some within his dominant party. These dissensions were the background to Mujib's assassination by army officers many of whom had been freedom fighters. The country then witnessed a series of weak military governments and military-civilian governments till a transition to a weak and fractious democracy in 2000. In Pakistan similar events were unfolding with Bhutto's attempts to stay in power with increasingly dictatorial methods, leading to his deposition by the army in 1977. Here too, there was a brief interlude of a military government till 1988, which

though relatively stronger than in Bangladesh was even less interested in maintaining the old system of control over the economy.

The failure of all attempts to construct authoritarian populist regimes in South Asia in the mid-seventies marked the end of attempts by central governments to manage rent allocations in any systematic way. 'Liberalization' was less a series of policy measures and more the reflection of a change in the political settlement that ruled out focused rent allocation by the centre to emerging productive sectors. This transition did not mean the end of redistributive rent creation. On the contrary, the mobilization and competition over redistributive rents has steadily increased over time, resulting in a gradual increase in the intensity of political conflicts, political corruption and political violence across all these countries. The eventual announcements of liberalization, for instance about removing licensing requirements was in most cases a formal recognition of a reality where licensing had long since stopped being implementable. Hence it is not surprising that many of the effects of liberalization were observable long before the formal announcements, though the formal announcements did have additional effects in accelerating what was already happening.

Secondly, the effects of the collapse of the politics that allowed even the limited attempts at centralized rent allocations would not have had any necessary positive effects if *significant pockets of productive capabilities* had not already emerged in all these countries. This was the significant difference of this round of 'liberalization' compared to the experience under colonial free trade. The importance of the capabilities created by the pre-1980 industrial policy regime and the subsequent performance of the Indian economy has been frequently recognized (Aghion, et al. 2005; Rodrik and Subramanian 2005; Kochchar, et al. 2006). However, the implications of the previous strategies of capacity development are often underestimated. It is clear that there is a strong relationship between the rent allocation strategies that created these pockets of capabilities and the success of the liberalization that followed. But if this is true, there are important implications for sustaining the growth that has been achieved over the last two decades and ensuring that this growth creates jobs for broader sections of the population and spreads to regions that have so far not participated in this growth. These implications will be further examined in our subsequent sections on Maharashtra and West Bengal.

It is relevant that while the dominant entrepreneurs in every South Asian country had in the 1950s wanted protection and subsidies, by the 1970s, new classes of entrepreneurs had emerged who had accumulated enough and achieved sufficient productive capabilities to find the continuation of protection unnecessary and onerous. The regulatory structures were particularly onerous for productive entrepreneurs given the growing fragmentation of political clientelism in these countries and therefore the capture of more and more rents by all manner of unproductive coalitions. Thus, by the 1980s there were powerful coalitions of new capitalists in all these countries but particularly in India who were not only already operating outside the formal structures of rent creation that they no longer needed, but also felt positively hemmed in by rent-creating regulations that had become dysfunctional for them (Das Gupta 2007).

By incorporating these two underlying factors it is possible to make more sense both of the strengths of the takeoffs that happened in South Asian countries as well as the vulnerabilities that their specific growth paths faced. We can explain why the sectors driving growth and the relative success of the post-‘liberalization’ growth strategies have been very different across different parts of the Indian subcontinent and even within India. The specializations of regions after liberalization have been very strongly related to the prior development of technological and entrepreneurial capabilities and not very strongly related to the distribution of factor endowments as economic theory may have led us to expect.

A number of features that we can observe in the growth stories in South Asia are consistent with an approach that focuses on the prior development of capabilities as a critical explanatory variable for the subsequent growth experience of the region. First, there are significant differences in growth rates across regions within the subcontinent and these differentials are widening, rapidly increasing the gap between richer and poorer regions and states. This is consistent with a capability approach because the development of capabilities in the period prior to liberalization was itself patchy and regionally concentrated. Governance capabilities in South Asia for growth-enhancing corrections to market failures were weak from the outset. Even before the liberalization of the 1980s, the biggest beneficiaries of rent-creation strategies to assist investment and capacity development were firms and entrepreneurs who had favourable political connections, were located in areas where the state was investing for political or accidental reasons, or who could leverage prior capabilities and capital.

The link between capabilities and the regional and sectoral pattern of growth is however complex, and will be developed in a later paper. Corporate conglomerates in India can obviously choose where they locate, particularly after the de-licensing of locational decisions. But the range of corporate capabilities and the labour skills they can draw on are limited. Therefore, with deregulation there was a considerable amount of relocation by corporates, typically favouring some southern and western states in India, but this was at the expense of the regions the corporates moved out of or did not invest in. Many observers of this relocation (Besley and Burgess 2004; Aghion, et al. 2006) concluded that this was evidence of the importance of labour market regulations constraining manufacturing growth in India because the winners from deregulation were states with lower levels of protection for labour. Even if this observation is true, the small differences in labour costs could result in some amount of relocation that would temporarily help less industrially developed states that have almost the same levels of labour productivity and skills as the more developed ones. But a general weakening of labour protection and indeed a lowering of wages would not thereby necessarily result in an acceleration of productivity growth. And even without labour market protections, existing entrepreneurial and technological capabilities would not relocate to the really backward parts of the country where they were most needed.

Secondly, a capabilities approach can explain the sectoral distribution of growth based on prior capabilities that were acquired in the past. The emerging specializations in these countries have less to do with factor endowments and the efficient choice of technologies by markets. For instance, the importance of high value-adding services in India’s growth story is well known. The skills underpinning India’s excellent performance in global services were a by product of previous expenditures in

technical education that were closely related to the broader context of technology and capability acquisition. Thus India's most dramatic success story could be said to be the direct result of 'defective' policies (Basu 2003), which created globally competitive capabilities in specific sectors. These defective policies included overinvesting in higher education and closing the economy to IBM and other multinationals in 1977, which allowed the development of skills in a public sector replacement to IBM. This public sector company, CMC, became an incubator of skills that later fed India's software sector.

If growth in populous South Asian countries is driven by specific manufacturing and service sectors that one way or another had already achieved international competitiveness, this has important implications for the regional and sectoral spread of growth. We shall see that many of the most important beneficiaries of market-driven growth have been entrepreneurs and their employees who had already achieved competitiveness for accidental historical reasons specific to their sectors and economies. As a result, the sectors that were driving growth were specific to particular countries and regions, and competitive sectors were also regionally concentrated. Not surprisingly, one of the features of this growth spurt across South Asia has been the rapid worsening of income distribution as growth accelerated, suggesting that growth was largely being driven by a relatively small number of individuals, regions and sectors that had the capability to benefit from market opportunities (ADB 2007: 49-59). These sectors greatly increased their incomes, leaving the rest rapidly behind.

Table 10 South Asian Growth Rates of Gross Domestic Product 1980-2003

	1980-90	1990-2000	2000-03
India Average	5.6	5.6	6.0
Rich Indian States	5.7	5.8	5.9
Poor Indian States	5.1	3.8	3.6
Maharashtra	6.0	5.8	6.7
West Bengal	4.3	6.7	7.1
Bangladesh	3.6	4.7	4.8
Pakistan	6.1	3.7	3.3

Source: EPW Research Foundation (2003; 2007), Ahmed and Varshney (2008: Table 3)

Note: Rich Indian states in this table are Tamil Nadu, Gujarat, Haryana, Maharashtra and Punjab. Poor Indian states are Bihar, Uttar Pradesh, Orissa, Madhya Pradesh and Rajasthan. Group growth rates for each period are weighed averages of state growth rates using state domestic products as weights.

A striking demonstration of this is the gap between rich and poor states in India. Table 10 shows the growth rates of GDP for South Asia since 1980. The group of poor Indian states have significantly underperformed compared to both the average Indian growth rate and that of the rich Indian states. In the 1990s and beyond, the poor Indian states performed worse than Bangladesh and only slightly better than Pakistan which was going through serious political crises. Table 10 also shows the performance of Maharashtra and West Bengal, the two high-growth Indian economies that we will look at in subsequent sections.

Clearly the gap between rich and poor states is rapidly growing, in contrast to the expectation that market driven growth should equalize incomes across an integrated economic territory through the free movement of labour and capital. Studies of

growth rates in rich versus poor states in India show that the divergence in their per capita incomes is steadily increasing (Sachs, et al. 2002). In 1970, the richest state in India had a per capita income around 3.4 times that of the poorest state. By 2004 this ratio had grown to 4.5 and is growing all the time (Purfield 2006: 5). As Purfield (2006: 9) points out, India's five poorest states account for 40 per cent of its population, while the five richest states are home to only a quarter of its population. If current trends in economic growth continue, as they are likely to in the absence of radically different economic strategies, political strains are likely to emerge between richer and poorer states over economic strategies, redistributive strategies, the use of tax revenues, and migration.

Table 11 Divergence in South Asia 2000-2004

Country	Growth of Per Capita Income			Per capita income in US\$ 2004/05
	1980-90	1990-2000	2000-2004	
India National Average	3.3	4.1	4.4	653
Rich Indian States	3.6	4.8	4.5	688
Poor Indian states	2.6	1.8	1.8	280
Bangladesh	2.2	2.7	3.7	436
Sri Lanka	2.6	4.2	2.3	1031
Pakistan	3.7	1.2	2.2	661

Source: Purfield (2006: Table 2), ADB (2007), (EPW Research Foundation 2003). Directorates of Economics and Statistics of Indian state governments, World Bank World Development Indicators.

Note: Rich Indian states in this table are Tamil Nadu, Gujarat, Haryana, Maharashtra and Punjab. Poor Indian states are Bihar, Uttar Pradesh, Orissa, Madhya Pradesh and Rajasthan. Indian data for first two periods are of 1981-91 and 1991-2001. Grouped per capita incomes are population weighted. The national per capita income for India reported by ADB and the World Bank appears to be somewhat greater than would be consistent with figures for state per capita incomes from state governments.

Table 11 shows available data on *per capita* incomes and growth rates. This data is consistent with the data on aggregate GDP, showing that in the 1990s the dispersion of growth rates of per capita incomes *within* India was greater than the dispersion observed *between* the major countries of South Asia. It is important to remember that many low growth states within India like Bihar and Uttar Pradesh are the size of countries in their own right. Bangladesh, which is often considered to be a relatively poorly performing part of South Asia, was performing considerably better than some of the largest Indian states not only in terms of the level of per capita income but also in terms of the growth of per capita income in the 1990s and beyond.

The rapid growth in the gap between rich and poor states within India is also shown graphically in Figure 13 for the 14 biggest states of India. The Gini coefficient is a measure of the degree of inequality in their per capita incomes. A higher value indicates more inequality. The figure shows graphically that the rapid growth in inequality appears to have begun in the 1980s at around the same time as the growth takeoff. These observations have policy significance from the perspective of current discussions about the types of economic integration that are appropriate for SAARC countries. Clearly being part of an integrated Indian union with 'free trade' as well as formally unrestricted movement of labour did not ensure that high growth rates were spread evenly. Moreover, factor mobility and market forces did not ensure that these growth rates got equalized over time through the movement of labour and capital

between states. If anything, Table 10 suggests that the gap in the growth rates between rich and poor Indian states has been widening over the 1990s.

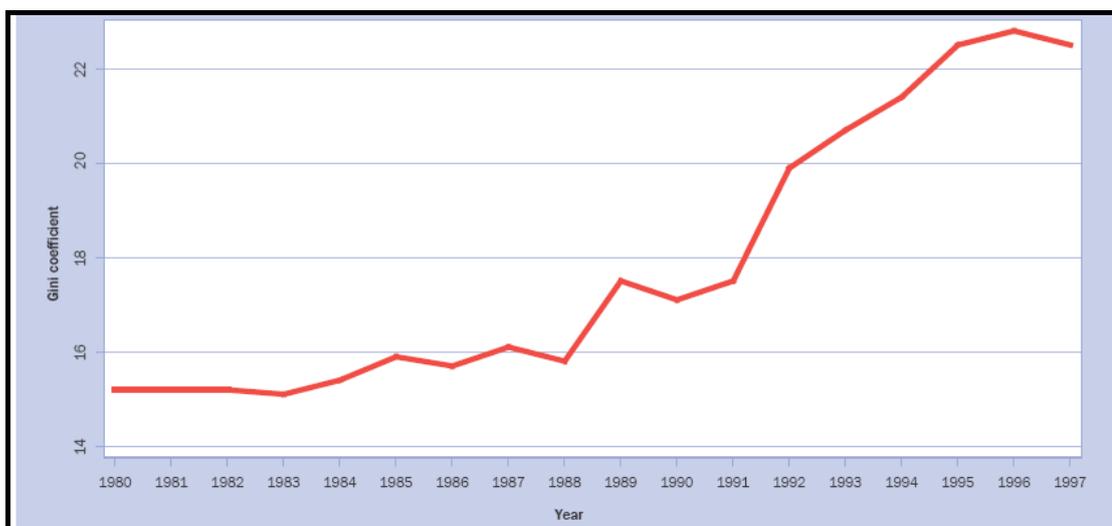


Figure 13 Degree of Interstate Inequality in India (14 Major States)

Source: ADB (2007: Table 5.4) based on Ahluwalia (2000: Table 3).

The most serious implication of a capability driven approach to the analysis of growth is that it points out that for all its weaknesses some basic technological and entrepreneurial capabilities were developed during the dirigiste period. But these capabilities were developed in pockets and the number of beneficiaries given the size of the population was miniscule. After liberalization these entrepreneurs have driven growth, drawing on pools of skills and capabilities in the labour market that were also the inherited human capital from the past. However, liberalization did not result in the removal of all the relevant market failures. The entrepreneurs and regions driving growth had to develop new and evolving arrangements with politicians, bureaucrats and themselves to continue to address the market failures that affected them. The patterns of growth that ensued can be better understood by looking for these new and evolving arrangements and their implications.

The fact that liberalization could not by itself remove potentially significant market failures that could slow down the acquisition and development of new skills has at least two types of implications. First, we would expect the ensuing growth to be driven by capabilities already developed, and therefore to be concentrated in regions, sectors and heavily dependent on high levels of human capital that relatively small sections of the population possess. But secondly, we would expect to see new and evolving strategies through which different pockets of growth deal with market failures. As a result, we would expect to see significant learning and skill development to be continuing within some of these pockets, particularly in firms with high technological capabilities and in firms with foreign technology partnerships. But we would expect the nature of this technology enhancement to benefit those who had already reached minimal levels of competitiveness and to be sensitive to the continuing resolution of market failures through a variety of formal but now increasingly informal mechanisms.

The implications of both sets of consequences are consistent with the observation that large sections of the population may have very slow benefits trickling down to them despite very high growth rates at an aggregate level. This proposition is supported by estimates for the persistence of poverty across the Indian subcontinent, even though absolute poverty may be declining through different trickle down mechanisms. The Arjun Sengupta Commission Report (National Commission for Enterprises in the Unorganized Sector 2007) outlined what researchers like Barbara Harriss-White (2003) had been saying for some time, namely that the informal/unorganized sector accounted for something like 92% of the Indian workforce. The commission also estimated that 77% of India's workforce had a per capita daily consumption of less than 20 rupees (roughly 50 US cents). Clearly, the constraint on broad based growth in countries like India comes from the productivity of much of the workforce (and the market failures constraining improvements in this productivity) rather than the high costs of labour. Indeed, there are significant pockets of poverty even within high growth and high per capita income states like Maharashtra.

Productivity and FDI

The growth acceleration of the 1980s was also associated with a productivity turnaround. Both the growth of labour productivity and of total factor productivity (TFP) displayed an improvement after 1980 compared to the previous decades. Table 12 shows that most studies find roughly a 2 per cent increase in labour productivity growth and a 1.5 per cent increase in TFP growth rates after 1980. When labour productivity and even more so TFP growth rates are measured in a complex economy like India, changes in trends are likely to reflect the net effect of many different processes. Nevertheless, multiple concurrent measurements suggest significant changes in underlying processes in the Indian economy around 1980.

Table 12 India's Productivity Acceleration

Acharya et al.	1951-67	1968-81	1982-91	1992-2000
GDP	3.8	3.4	5.3	6.5
TFP	1.4	0.7	2.0	2.6
Bosworth, Collins & Virmani	1960-80		1980-2004	
Output per Worker	1.3		3.8	
TFP	0.2		2.0	
Virmani	1951-80		1981-2004	
NDP per Worker	1.3		3.5	
TFP	0.7		2.4	

Sources: Acharya et al. (2003: Table 2.2), Bosworth et al. (2007: Table 3) and Virmani (2004b: Table 1)

These observations are very likely to be the result of a combination of labour shakeouts in existing establishments (possibly rather limited), the closing down of some unprofitable companies, the relocation of some production to alternative locations to allow changes in factor proportions, improvements in X-efficiency in a context of greater competition, better capacity utilization as a result of liberalized imports of spare parts and machinery, changes in product mixes and technologies

particularly to take advantage of export opportunities, and the introduction of new and better technologies, sometimes through joint ventures and foreign direct investment. It is statistically very difficult to identify the importance of these various possibilities. Possibly all of these played a part to some extent.

Thus the observed productivity growth is likely to be attributable to some allocative and X-efficiency gains that are likely to be step changes and unlikely to generate sustainable improvements in growth *rates*, as well as perhaps some new processes of technology acquisition, investment in new sectors and learning-by-doing that could result in lasting improvements in productivity growth. It is clearly of significant policy interest to be able to discriminate between short and long term changes in the rate of growth of productivity. While the data do not enable us to directly answer this question, we can address it partially and indirectly by looking at the evidence on technology upgrading and spillovers being achieved by joint ventures and FDI in India.

India has enjoyed a significant increase in FDI after liberalization. According to Reserve Bank of India figures, from a negligible base in 2000, FDI had increased to almost 20 billion dollars in 2007. At the same time, however, outward investment by Indian conglomerates like Tata also increased dramatically to over 11 billion dollars, implying a net inflow of around 10 billion dollars. Nevertheless, the potential benefits of FDI are not just net increases in investment, but also new technology acquisition that may not otherwise have happened. In 2007 A T Kearney's business surveys ranked India second only after China as the most desirable location for FDI globally. What did this inflow indicate about Indian competitiveness and growth prospects?

A number of studies on the effects of FDI in India support a capability-based analysis of the drivers of growth in post-liberalization developing countries. Siddhartan and Lal (2004) find that multinational investment can have positive spillover effects on the value-added per unit labour cost in domestic firms, but only if the initial productivity gap between the domestic and foreign firms was small. Where the productivity gap was initially large, the value-added per unit labour cost of domestic firms either declined or did not increase in the presence of foreign investment. Similar results are reported by Kathuria (2000) and Balasubramanyam and Mahambare (2003). These results are not at all surprising since we expect firms to absorb learning by observing and transacting with more advanced firms in their sector and then carrying out the appropriate investments in learning only if they already have significant technical and entrepreneurial capabilities. Balasubramanyam and Mahambare also point out that multinational investment in India has focused largely on sectors that already have significant technological capabilities, again as we would expect.

Finally, although FDI in the late 1990s only accounted for 5% of gross domestic capital formation, the share of multinational affiliates in the sales of the organized private corporate sector in India is relatively high. At the end of the 1980s this share was estimated at around 23%. More recent estimates of the share of foreign affiliates over the period 1970-94 are between a third and a quarter of gross sales in India's manufacturing sector (Balasubramanyam and Mahambare 2003: 51). The anomalous experience of Thailand with domestic capability development in a context of extensive multinational participation was discussed in Section 5. The presence of

multinational affiliates can be positive or negative for domestic capability development and much depends on the initial capabilities of domestic firms in the same sector and their strategies of developing these capabilities further. Here there are some positive signs of capability development in India, for instance in the automotive sector which is important in Maharashtra, and which we will refer to in the next section. But in general, increasing domestic productive capacity across broader sectors is one of the most important challenges facing South Asian countries.

7. Maharashtra: Industrial success and slowdown

Some of the earliest modern industrial investments in India took place in areas in and around Mumbai (Bombay) in what is now Maharashtra. The first tax mill, the Bombay Spinning Mill was set up in 1854. Under the British, Maharashtra was part of the vast Bombay Presidency which at one time stretched as far north as Karachi in what is now Pakistan, and included the state of Gujarat. The modern state of Maharashtra emerged when Maharashtra and Gujarat split in 1960, as part of the linguistic reorganization of Indian states. Despite this, Maharashtra remains a very cosmopolitan state, with non-Marathi speakers accounting for 30 per cent of its population of roughly 100 million in 2005. In 2005 Maharashtra was also the richest state in India in per capita terms, with the exception of a number of very small states and territories like Goa, Pondicherry, Delhi and Chandigarh.

Table 13 Sectoral Shares in GDP Selected Indian States 1981-2005

		1981	1991	2001	2005
Maharashtra	Agriculture	26.7	38.7	15.3	11.3
	Industry	36.0	29.8	28.6	29.8
	Services	37.2	31.6	56.0	58.9
West Bengal	Agriculture	30.1	30.6	29.5	24.1
	Industry	31.2	28.4	21.0	21.7
	Services	38.7	41.0	49.5	54.2
Tamil Nadu	Agriculture	24.3	18.8	16.3	12.3
	Industry	35.0	36.7	32.3	29.3
	Services	40.7	44.5	51.4	58.4
Gujarat	Agriculture	37.3	27.85	14.9	15.3
	Industry	30.4	36.37	40.6	42.1
	Services	32.3	35.78	44.5	42.6
India	Agriculture	34.4	29.6	23.2	18.3
	Industry	25.6	25.8	25.3	27.6
	Services	40.1	44.6	51.5	54.1

Sources: EPW Research Foundation (2003; 2007), World Bank (2008). Figures are for shares of value-added in state gross domestic product at current prices.

The state is also one of the most industrially advanced in India. However, as we can see in Table 2 (on page 12) the growth of industry has slowed down in the 1990s compared to a spurt of growth in the late 1980s, while the growth of the service sector has been accelerating. Table 13 shows that as a result, while Maharashtra still has a share of industry slightly higher than the Indian average, Gujarat has left it far behind in terms of the share of industry in State Domestic Product, and Tamil Nadu and a number of other southern states are likely to overtake it soon. But it is also interesting

that with the exception of Gujarat, Indian states have displayed either flat or declining shares of industry in GDP over the 1980s and 1990s. Gujarat is an interesting outlier. Its significantly different performance could be either due to a very different internal set of formal and informal mechanisms for dealing with growth and market failure or simply a reflection of its significant petroleum and petrochemicals sector or some combination of both.

Overview

As the state where some of the first investments in India's modern industrial sector began in the nineteenth century (the other being West Bengal), Maharashtra's stagnant and even declining industrial share after liberalization is significant. Our assessment of the factors that may explain this trajectory will clearly be of interest for other less mature Indian states, but also for our general understanding of the challenges of learning and capability development in developing countries. Maharashtra and other Indian states that have rapidly grown in the post-1980 period have rapidly begun to resemble much more advanced countries in the characteristics of their declining industry shares and rapidly rising shares of their service sectors even though their per capita incomes are a fraction of those in the advanced countries they have begun to resemble.

Maharashtra was one of the biggest beneficiaries of the Nehruvian industrial policy regime that operated till around 1980 in India. Maharashtra received a significant share of industrial licenses, more than could be justified by its population or even its initial position in industry, particularly since one of the proclaimed goals of industrial policy was to achieve regional equity. Maharashtra's experience was radically different from West Bengal which got a significantly smaller share of licenses and loans from industrial financing banks, starting from an initial position that was quite similar to Maharashtra. Clearly, even before 1980, the operation of Nehruvian policies did not just follow formal rules. An important part of the implementation depended on the specific business-government relationships in particular states, and therefore the commitment with which state governments pursued their interests with the centre. In addition, differences in the centre's attitude to particular states could also make a difference. Business-government relationships are therefore an important part of the explanation of the different performance of Maharashtra and West Bengal between 1950 and 1980.

Underpinning the strong business-government relationships in Maharashtra were powerful business houses and their dominant entrepreneurs playing a leading role in financing politicians and parties on a long-term basis. The origins of these strategies can be traced back to the inception of the Indian national movement when leading Bombay-based capitalists played a key role in financing national political figures like Gandhi. This tradition continued through the industrial policy period and into the 1980s, giving many Bombay-based businesses an advantage over others. Thus, there were similarities in these patterns of business financing of politics in Maharashtra and some aspects of business-government relationships in the competitive clientelism in Thailand. In contrast, the financial relationships between business and politics and the time horizons with which they operated were on a different scale in West Bengal, with correspondingly different outcomes.

Policies/Rents	Governance	Outcomes/Vulnerabilities
<p>Rent allocation to big business for learning on a significant scale 1950-80</p> <p>Licenses, credit, limited amounts of industrial land allocated to investors.</p>	<p>Cross-cutting Indian problem of disciplining learning rents BUT significant expansion of industrial base</p> <p>Big business has long-term relationships of financing politics: As a result both sides can take a long-term pro-industry view.</p>	<p>Deepening Industrialization of Maharashtra</p> <p>Maharashtra gets a significant share of industrial licenses.</p> <p>High growth of all industrial sectors.</p>
<p>Rent-creation for growth sectors continues after liberalization based on strong business-politics relationships 1980-90</p> <p>Negotiation of incentives, formal policies, land, and implicit subsidies for technology upgrading continue.</p>	<p>Stable and long-term relationships between business groups and key politicians continue</p> <p>But under growing threat from populist, nativist and exclusivist types of populism playing on persistent and high levels of poverty.</p>	<p>Growth Acceleration in Industry 1985-90</p> <p>Driven by higher technology sectors like automobiles and pharmaceuticals.</p>
<p>Populist redistributive rent creation by fragmented ruling coalitions 1990-</p> <p>Mobilization of intermediate class supporters using budgetary and off-budget rent creation.</p> <p>Populist strategies of mobilization such as those based on Marathi nationalism.</p>	<p>Traditional parties split and less stable coalition governments emerge</p> <p>Business less able to maintain long-term relationships with politics in this context.</p> <p>BJP-Shiv Sena coalition government emerges in 1995.</p>	<p>Shift of investors into areas where learning risks and other sources of market failures were lower</p> <p>Rapid growth of high-valued services (financial services, software) and deceleration of industrial growth after 1990</p>

Figure 14 Governance and Growth in Maharashtra: Patterns and Vulnerabilities

After 1980, these relationships continued and allowed Maharashtra to implement liberalization in a way that continued the provision of incentives to businesses in a context of long-term relationships. A number of significant high technology sectors like automobiles also began to develop rapidly during this period. But the extension of the industrial sector and the continuation of incentives to create new entrepreneurial entrants began to face a number of challenges. A fundamental problem began to emerge in the 1990s with the fragmentation of politics and the growing strength of

populism as an alternative strategy for parties to mobilize electoral constituencies. The emergence of a Shiv Sena-BJP coalition government in 1995 marked a strategic shift in strategies of electoral competition using populist strategies.

These changes in the political economy of the governance environment correspond with a slowdown in *industrial* growth rates in the state. Even though a number of manufacturing firms with significant technological and entrepreneurial capabilities had emerged in the state, the need for long-term and credible relationships with politics did not disappear. Our hypothesis is that even firms using highly skilled labour require methods of financing learning periods for many categories of workers as they continue to move to higher technologies. As the financing of industrial learning involving large groups of workers is risky, we can understand why in a more volatile political environment entrepreneurs would prefer to invest in service sectors. Enterprises using highly skilled workers in services are more likely to become competitive rapidly as long as skilled workers are available.

Thus, the relationships between business and government that allowed manufacturing to be assured of long-term relationships of support began to change in the early to mid-nineties as the politics of Maharashtra began changing. Figure 14 summarizes the main types of rents and interventions over this period in Maharashtra, the governance conditions determining their effects, and the economic outcomes they were associated with.

An industrial policy winner

At the time of independence in 1947, Maharashtra and West Bengal were virtually level in terms of their presence in the manufacturing sector measured in terms of numbers of factories and workers, though Maharashtra was ahead in terms of value-added. This is shown in Table 14. In the subsequent period, Table 15 shows that Maharashtra's performance in terms of getting industrial investment licenses far outstripped West Bengal and indeed all other Indian states. As other states began to industrialize under industrial policy, the shares of the two early starters would inevitably come down. Table 16 shows that the decline happens mostly for West Bengal, with Maharashtra's share declining much less. Finally Table 17 shows the significant differences in underlying industrial growth rates between Maharashtra and West Bengal which produced these dramatic outcomes. While Maharashtra's growth rates were close to the Indian average, it has to be remembered that Maharashtra at that time was already considerably ahead of other states, and by growing at the average rate it was virtually maintaining its share of Indian industrial production.

Table 14 Registered Factories in Major Indian Provinces 1946

	No. of Registered Factories	Total Employees	Percentage of Total Employees	Value Added (Rs Crores)
West Bengal	1218	509120	33.6	57.3
Bombay	959	500267	33.0	87.7
Madras	1244	144931	9.6	15.3
UP	559	166763	11.0	21.7
Bihar	316	93523	6.2	19.7

Source: *First Census of Manufacturing Industries in India, 1946*, reported in Dasgupta (1998: Table 2).

Table 15 Statewise Industrial Investment License Allocations 1956-66

	License Applications	Percentage of Applications	Licenses Issued	Percentage of Licenses Issued
Maharashtra	3645	25.9	2741	27.4
West Bengal	2296	16.3	1649	16.5
Madras	1263	9.0	970	4.7
UP	1087	7.7	672	6.7
Bihar	688	4.9	517	5.2
Andhra Pradesh	487	3.5	332	3.3
Mysore	420	3.0	327	3.3

Source: *Report of the Industrial Licensing Policy Inquiry Committee 1969*, reported in Dasgupta (1998: Table 3)

Table 16 Statewise Employment and Value Added 1959-1978

	% of Total Employment 1959	% of Total Value Added 1959	% of Total Employment 1978	% of Total Value Added 1978
Maharashtra	21.2	26.6	17.8	25.0
West Bengal	23.1	23.2	15.0	12.2
Gujarat	10.3	9.7	8.3	10.0

Source: Figures from *Annual Survey of Industries*, reported in Dasgupta (1998: Table 4 and Table 17).

Table 17 Annual Growth Rates of Industry 1960-70

	Basic	Intermediate	Capital	Consumer
Maharashtra	15.5	7.1	8.6	5.3
West Bengal	0.9	3.8	1.2	2.3
India	9.1	7.2	9.4	5.1

Source: Based on *Annual Survey of Industries*, reported in Banerjee (1986: Table 2). In the Indian classification Basic Goods include the products of mining and quarrying industries, metals and chemicals and cement, Intermediate Products are products that are inputs into other industries, including yarns, jute sacking, tyres and leather.

Maharashtra's success in maintaining its rate of industrialization in all sectors of manufacturing deepened its technological and entrepreneurial capabilities throughout the industrial policy period. A key component of this was the supportive investment climate in the state, defined in terms of supportive business-government relationships. The significant success of business houses in the state in winning industrial licenses is an indicator of this relationship, given that the allocation of licenses was inevitably at least partially a political process.

One factor that distinguished Maharashtra from states like West Bengal was the prominent role played by its early entrepreneurs in funding individual leaders of the Indian National Congress. The nationalist entrepreneur Dadabhai Naoroji who backed the Congress during the anti-colonial struggle exemplified this trend. Other entrepreneurs like the Birlas had close connections with Mahatma Gandhi. After independence these relationships between big business houses and the Congress continued. When Maharashtra and Gujarat became separate states in 1960, Maharashtrian chief ministers like Vasant Dada Patil and later Sharad Pawar maintained close long-term relationships with particular business houses such as Bajaj

and Ambani. An important implication of this was that the electoral strategies of Congress leaders in Maharashtra could rely to a significant extent on donations from business houses. Initially, at least, politics in Maharashtra was therefore somewhat insulated from populist budgetary allocations and more responsive to the needs of business.

Long-term relationships between business and politics can create favourable outcomes for both. Business can gain by having the confidence to invest long-term, and politics can invest in these investments by contributing implicit and explicit subsidies to overcome market failures preventing long-term investments. The danger of monopolistic or oligopolistic arrangements here were somewhat mitigated by the fact that by then Maharashtra already had a fairly diversified capitalist sector and it would not be credible for a particular business house to try and use political power for zero sum games against other houses.

A number of institutions emerged during this period which continued to play a role in the 1980s and beyond. One was the Maharashtra Industrial Development Corporation (MIDC). One of its important functions was to provide land for small and medium enterprises. The corporation would acquire land and sell it to investors at a higher price, using the difference to develop infrastructure in the estates. Initially, the plan was to develop a few large industrial estates near urban centres like Mumbai, Pune, Nasik, Aurangabad and Nagpur. But the outcome was so successful that it was soon extended to every district town and eventually to every taluka town. It has so far built 229 industrial complexes on 60,000 hectares of land, and built 2423 kilometres of roads as part of infrastructure development for industrial development. It is one of the most successful industrial development corporations in India.

The MIDC was effective *not* because it was free of patronage and corruption. On the contrary, the Chairman of the MIDC was always the minister of industries, and the allocation of plots and the fixing of lease rates, exemptions and so on were the subject of considerable patronage and corruption. Rather, the political leadership had an incentive to make MIDC work because their long-term relationship with capital meant that there was a realistic prospect of industrial growth in the state, and the development of estates and other incentives for investment were therefore credible strategies for politicians wanting to maximize their income over time.

Implicit subsidies for industrial investments in the form of incentives were provided by the State Industrial and Investment Corporation of Maharashtra (SICOM), set up in 1966. Assistance to investors was provided in the form of investments and advances to projects which would otherwise not have been able to raise capital given capital market failures and the risks involved in learning in new industries. This too was an aggressive institution, rapidly expanding its scope of lending to industry. Its assets in 1967 amounted to 30.3 million rupees, but grew rapidly to 412.4 million rupees by 1973. In contrast, the equivalent organization in West Bengal, the West Bengal Industrial Development Corporation saw its assets growing from 3.8 million rupees in 1968 to 45.9 million rupees in 1973 (D. Banerjee 1986: 70). SICOM was also charged with helping with the acquisition of land and infrastructure and providing other incentives to bigger investors who were outside the remit of MIDC.

Growth acceleration after 1980

The acceleration of growth in Maharashtra does not really become apparent till the mid-1980s. This was partly because the late 1970s and early 1980s were a period of conflict between the Congress Party in power at the centre and the gradual loss of power by Congress in the state. In 1978 the first non-Congress government of the Progressive Democratic Front under Sharad Pawar came to power, only to be dismissed by Indira Gandhi in 1980. A weak Congress government replaced this coalition, but Congress did manage to rule the state till 1995. Industrial growth in the early 1980s was also low because of the effects of the Bombay textile strike of 1981-2. The strike went on to become the longest strike in India's post-independence history. The defeat of the textile workers marked the transition of the state out of older technologies into newer ones. Most of the textile mills with which Maharashtra had begun its march to industrialization were now closed down. After the strike a mere 58 mills remained in operation employing the last 20,000 workers in the sector (Katakam 2005). But after all this, growth took off rapidly in Maharashtra in the mid-1980s, with a significant acceleration of manufacturing and industrial growth rates.

A number of manufacturing sectors in higher technology sectors emerge as drivers of growth during this period. The heavily protected automotive sector in India had produced cars like the Ambassador for a long time with very limited product improvement. This changed in the 1980s, with the joint venture between Maruti Udyog Ltd and Suzuki in 1982, pushed through by the prime minister's son Sanjay Gandhi. This opened the doors for foreign technology to be acquired by other Indian automotive producers, and in Maharashtra one of the main players was Mahindra and Mahindra. This company had specializations in tractors and jeeps, but now began to upgrade its technology and introduce new models. Tata Motors also has significant operations in Pune, as did the industrial giant Bajaj Auto with its specialization in scooters and three-wheelers. Collectively, Maharashtra now produces around 30 per cent of India's tractors, 70 per cent of its medium and heavy trucks and 90 per cent of three wheelers. In aggregate, 38% of India's value added in automobiles is produced in Maharashtra.

The automobile sector is one of India's success stories and is achieving a global position in the production of cheaper cars. Technology acquisition has been driven by joint ventures and foreign technology acquisition but so far the kind of takeover by foreign capital that we described in Thailand has not happened in India. Partly this is because Indian producers in the automotive industry have acquired deeper technological and entrepreneurial capabilities. But paradoxically, the difficulty of negotiating informal political arrangements necessary for operating in a context of high transaction costs and significant market failures may deter majority foreign owned companies attempting to operate in India for some time in areas like automobiles where significant long-term learning and capability building issues are involved. This may be greatly to India's advantage as it seeks to raise its technological capability.

Although Maharashtra scores as a labour-friendly state in some classifications of labour market flexibility (for instance Aghion, et al. 2006), workers who came out of the textile strike would probably find it hard to believe this. It is hard to avoid the suspicion that this classification of Maharashtra was influenced by the fact that its industrial sector is shrinking and if this has to be explained by conventional economic

theory, labour market flexibility is the most likely candidate. In October 2000 the state government of Maharashtra under pressure from business, proposed wide-ranging revisions to labour legislation that would render them virtually useless for protecting workers. Finance Minister Yashwant Sinha, in his Budget Speech of 2001 announced that the government would liberalize the use of contract labour and permit employers to dismiss workers and close down units employing up to 1000 workers. This led to another round of strikes in 2001, which resulted in a compromise where unconditional dismissals were allowed for firms employing up to 300 workers. In addition, the government liberalized contract labour laws under the Special Economic Zones Act of 2002, though this is still subject to judicial review.

But the acceleration of industrial growth in Maharashtra between 1985 and 1990 proved to be short lived. Over the next 10 years, despite the ‘labour market reforms’ and the substantial stocks of technological and entrepreneurial capabilities, industrial and manufacturing growth in Maharashtra decelerated.

Political fragmentation, populism and the shift to services

From the 1990s onwards, politics in Maharashtra started to become more fragmented and populist. There was a steady growth of nativist and communal politics, with parties like the Shiv Sena mobilizing Marathis against outsiders, and the BJP trying to construct a Hindu coalition. The success of these strategies was underlined by the formation of the BJP-Shiv Sena government in 1995. The emergence of these political strategies has to be understood in the context of what was happening in Maharashtra to poverty levels and the exclusion of large numbers from the benefits of growth over these years. A negative consequence of the close cooperation between industrial capitalists and politicians in Maharashtra was that the development prospects of the majority of the population in agriculture and informal services were not addressed rapidly enough. Agriculture in particular performed very poorly. And within agriculture, resources, in particular water, were diverted into cash crops like sugar that were artificially protected and provided huge rents to politicians rather than to the broader population dependent on agriculture.

Despite the fact that Maharashtra had one of the highest per capita incomes in India, it was a different story with respect to poverty. The estimates of poverty by the Lakdawala Committee for 1988 show that Maharashtra came ninth amongst the fifteen large states of India in terms of rural poverty, with 42 per cent of the rural population living below the poverty line. This compares with an Indian average of 39 per cent. And given the much higher average per capita income of Maharashtra compared to the Indian average, the distribution of income within the state was clearly very unequal (Parthasarathy and Nirmala 1997: Table 1). A particularly gruesome aspect of this poverty was the phenomenon of farmer suicides which took on epidemic proportions in some parts of Maharashtra.

The growth of populist politics in Maharashtra has to be understood in this context (Roy 2008). Persistent absolute and relative poverty allows political entrepreneurs to mobilize clients and electorates on the basis of redistributive promises and by identifying outsiders. The prisoner’s dilemma problem that can rapidly arise is that as soon as fringe political groups start doing this, mainstream parties have to rapidly match these promises to maintain their political support. Funding from big business may not be sufficient for mainstream parties to maintain their electoral strength and

thereby resist making populist promises in such contexts. And once business delinks from the political process because the state budget and policy space are increasingly captured by populist programmes, they are likely to abandon the difficult but job-creating investments in industry and shift towards less risky projects. These will be in sectors where learning periods are less long, which therefore require less consistent support from the state, but which by definition also create fewer jobs. There is some indication that in aggregate, entrepreneurs in Maharashtra were shifting towards a new less desirable equilibrium of this type during the 1990s.

The shift towards services in one of the most industrially advanced Indian states with extensive clustering economies, technological capabilities and entrepreneurial skills is an important puzzle that we need to explain. We have also seen that as far as the formal sector working class has been concerned, the state was willing to play hardball in terms of labour market flexibility reforms that were progressing in the direction business wanted.

The long-term trend in all countries as they make a developmental transition to prosperity is for their agricultural sector to begin to decline as a share of GDP almost immediately, and for the shares of industry and services to increase. But as the country reaches upper middle income levels, the tendency is for the share of industry to begin to decline. The share of the service sector however continues to increase as a share of GDP. This is because when industry becomes productive and mature, the relative prices of its products fall compared to services. Thus, at high levels of per capita incomes, the growing share of services in an economy is an indicator of prosperity (Rowthorn and Wells 1987).

However growing Indian states have started their 'de-industrialization' at very low levels of income and this trend has accelerated in the 1990s. The interesting thing is that this is true for most of the relatively advanced states of India regardless of their per capita incomes. For instance, the declining share of industry is true for both Maharashtra, the richest state in per capita terms, as well as for relatively poorer but also rapidly growing states like Karnataka and Tamil Nadu. If we compare Maharashtra and Karnataka, the two states respectively began to display a declining share of industry at per capita income levels that were around a quarter or a fifth of the level at which more advanced countries had begun to 'de-industrialize' (Kochhar, et al. 2006: 36). Is this a problem? The answer depends on the factors we believe could explain the anomalous performance of sectoral shares in India compared to previous global experience.

One argument could be that the rising share of services simply reflects changing relative prices of manufactured and service sector products in the same way as in more advanced countries. But this is simply not the case because the falling share of industry in rapidly-growing Indian states is not a purely nominal price phenomenon with the underlying real rate of growth of industry being sustained. Rather the declining share of industry in the 1990s in Maharashtra was clearly due to the real rate of growth of industry slowing down (Table 2 on page 12). Another view coming from Kochhar (2006: 28) is that the growth of services in rapidly-growing Indian states reflects the high-skills driven growth path that these states appear to have adopted. These skills are clearly not industry-specific because the structure of industry within these states is also rapidly changing. Rather the skills in question appear to be

embodied in the high human capital of sections of the workforce, which allows rapid changes in sectoral choices in line with changing opportunities.

From this perspective, the emergence of service sector-driven growth in high-growth Indian states could simply reflect sectoral choices that maximize profits using highly-skilled labour (Kochchar, et al. 2006: 24). The latter argue that greater liberalization of labour markets may not change this trajectory for the high-growth states, but may enable low-growth states in India to grow using labour-intensive technologies. For the high-growth states, their policy response is to try to increase the supply of skilled labour, by greater investment in high-quality education. There are several problems with this diagnosis from the perspective of our approach to growth and governance.

First, the shift from manufacturing to services in the higher-growth Indian states is not neutral in terms of effects on employment, poverty reduction and possible backward and forward linkages spurring spread effects in the broader economy. This is true even if manufacturing was initially relatively capital-intensive to begin with. Even relatively capital-intensive manufacturing creates much greater levels of employment than most types of highly-skilled services. This is because in manufacturing, the highly-skilled labour is usually complementary with less skilled production line work. But in services using skilled labour the production line is typically also relatively skilled. Compare for instance automobile production with its ancillary employment generation with software development or financial services. Even more so, the backward and forward linkages of manufacturing are likely to have greater multiplier effects in most cases compared to services. Thus, when high-growth developing economies shift their skilled labour allocation from manufacturing to services there are likely to be effects for broader employment generation and poverty reduction.

Secondly, the assumption in much of the post-1980 literature on India that after liberalization market failures have been either negligible or that it has not been necessary to address the remaining ones is misleading. The evidence suggests that high growth in manufacturing in Maharashtra required strong business-government relationships even after liberalization. When these began to break down, the focus shifted to projects where ancillary learning by less skilled workers was less important. Our hypothesis (summarized in Figure 11 on page 31) is that liberalization only changed the mechanisms, both formal and informal, through which business and politics consciously or otherwise addressed market failures. How effective these mechanisms were determined the types of investments and sectors that were viable.

Finally, the argument that a relaxation of labour regulations would at least help the poorly performing parts of the Indian Union is also problematic. Even low technology manufacturing require periods of learning-by-doing. The experience of Bangladesh with its successful entry into garment manufacturing is useful in this respect and will be discussed in a later section. What that suggests is that even for entry into these labour-intensive types of manufacturing, poorer performing areas of the world need to develop specific governance capabilities.

8. West Bengal: The limits of an agrarian growth strategy

Like Maharashtra, West Bengal was one of the pioneers in Indian industrialization. Some of the very first industries set up by British capitalists in the 1850s were in what

is now West Bengal, with George Acland's jute spinning company going into production in 1855 (Morris 1983: 567-87). By the beginning of the First World War, there were 64 jute mills in operation employing almost 220,000 people. Bengali capitalists found entry difficult but not impossible and the industry continued to use British supervisors and managers far longer than say the cotton textile industry developing in Bombay. British entrepreneurs also set up the Bengal Iron Works Company in 1874 and the Bengal Iron and Steel Company (BISCO) in 1889.

By 1931 Bengal had the biggest concentration of modern factory employment in India, significantly ahead of Bombay (Morris 1983: 648-9 Map 7). In 1939 Bengal accounted for 28.7% of the industrial workers in British India, while Bombay, which at that time included the states of Gujarat and Maharashtra accounted for 23% of industrial workers (Dasgupta 1998: Table 1). From that position of dominance, West Bengal's share of Indian industrial production was down to 20.5% in 1961, 14.4% in 1970 and reached a low of 4.7% in 1996 (A. Banerjee, et al. 2002: 4203-4; Raychaudhuri and Basu 2007: Table 8).

But as we have seen in Table 2 (p. 12), by the 1980s, West Bengal had also emerged as one of the rapidly growing states of India. In the 1980s, growth was driven by agriculture and small-scale and informal sector firms. From the mid-1990s, the ruling Left Front government evolved a much more pro-active policy of promoting large-scale industry in the state, and the challenge is to develop the business-government relationships that will make this work in the context of the strong agrarian base of the Left Front.

Overview

The license raj period up to 1980 was particularly bad for West Bengal for reasons that are contested in the literature. The standard answer that West Bengal fell behind because of more aggressive unions does not fit the evidence when we look at figures for strikes and labour militancy in more successful states like Maharashtra and Gujarat. West Bengal may also have been disadvantaged by specific policies like Freight Equalization which wiped out the comparative advantage of eastern states that were located on or close to iron ore and coal deposits. But a deeper and politically more sensitive problem for Bengal was the dearth of Bengali capitalists. Its large-scale industrial base was largely owned by non-Bengalis, in particular Marwaris. But unlike Maharashtra, non-indigenous business did not develop long-term financial links with politics and politicians. The distance between politics and business in West Bengal may have trapped both sides in a prisoner's dilemma with business reserving its options by diversifying outside the state, and government developing alternative constituencies to protect itself from reliance on an alliance with potentially footloose outsiders. This may explain why West Bengal's industrial decline began long before the Left Front first took control of the state in 1967. Not only did West Bengal get a smaller share of licenses than other industrially advanced states throughout the licensing period, business houses located in West Bengal often used their licenses to invest elsewhere.

The growth takeoff of the 1980s was led by agriculture. The power base of the Left Front was in the rural areas, and while the focus of a lot of the literature has been on land reforms, the political relationship between the state and the surplus farmers also allowed public funds to be pumped into assisting agrarian investment. The very high

growth rates had very good effects on poverty reduction, but in a densely populated rice growing agriculture, the scope for sustained growth was limited without significant investments in irrigation and perhaps some consolidation of land into more viably-sized farms.

Policies/Rents	Governance	Outcomes/Vulnerabilities
<p>Rent allocation to big business for learning but with limited dynamism 1950-80</p> <p>Licenses, credit, limited amounts of industrial land allocated to investors.</p>	<p>Cross-cutting Indian problem of disciplining learning rents PLUS specific state problem of missing long-term relationships with big investors who are often non-Bengalis</p> <p>Big investors lack confidence in long term commitment of political process to incentives for industrialization.</p>	<p>'De-industrialization' of West Bengal 1950-80</p> <p>West Bengal gets a smaller share of licenses and financing compared to its competitors but its contribution to Indian industry shrinks even more rapidly as domestic business relocates.</p> <p>Growth of small scale and low productivity manufacturing.</p>
<p>Rent allocation and redistribution of land in agriculture to benefit small and medium peasant constituency 1977-1990</p> <p>Ceiling-surplus land redistributed, sharecroppers registered, agricultural subsidies distributed to target recipients through decentralized government.</p>	<p>Disciplined mass party organization operating through <i>panchayati</i> system of decentralization</p> <p>Effective targeting of rents and asset redistribution to core constituencies of small and medium peasants. Motivated by electoral calculations of ruling Left Front, which remains electorally unbeatable over this period.</p>	<p>Rapid agricultural growth for a decade</p> <p>Agricultural yields and output increase but hits ceilings due to unfavourable population density, very small size of farms, and poor infrastructure.</p>
<p>Significant Policy Shift to Big Business: 1994 Industrial Policy</p> <p>Subsidies and incentives for big business plus extra incentives for mega-projects after 2000.</p>	<p>Strong executive support but conflicts emerge with parts of the Left Front's power base</p> <p>Weakness of Bengali capital continues to obstruct the development of a strong domestic industrial constituency.</p> <p>Opposition's ability to mobilize disaffected intermediate classes makes political price of policy potentially very high.</p>	<p>Rapid growth of industrial approvals in moderately big projects and implementation of mega project in Haldia Petrochemicals in 2001</p> <p>Haldia's success balanced by failures in Singur (Tata Nano) and Nandigram (chemical hub) in 2007-08 when opposition parties successfully mobilize parts of the Left Front constituency.</p> <p>Clarity of policy weakened.</p>

Figure 15 Governance and Growth in West Bengal: Patterns and Vulnerabilities

By the early 2000s the limits of agrarian growth appear to have been reached. The state government announced a new industrial policy in 1994 that was explicitly supportive of big investments in industry, and added further incentives in 2000 for mega projects. Haldia Petrochemicals which came on stream in 2001 was an important mega-project success for the government. The scale of investment projects implemented in the state from 1991 to 2006 began to approach Maharashtra, though it remained significantly lower than in Gujarat (Raychaudhuri and Basu 2007: Table 19). But the debacle over Tata's proposed car plant in Singur and the proposed chemical hub at Nandigram revealed serious fissures in the leadership's pro-business stance given its core constituencies, some of whom began to be mobilized by the opposition to block these investments.

Figure 15 summarizes the different types of rents and policy processes describing West Bengal's economic performance over the last few decades. Each process is related to specific outcomes that depend not just on the type of rent and the market failure it was addressing, but also on the governance requirements and actual capabilities. The subsequent discussion then addresses these processes separately.

Falling behind during the license raj

The general problems of Indian industrial policy in terms of imposing discipline on business and limiting moral hazard problems associated with corrections to market failures have already been discussed in Section 6. Here we look at specific problems that affected West Bengal differentially. The problematic business-government relationships that characterized industry in West Bengal can be read off from the dramatic decline in the state's industrial status during the license raj period. In other words, not only did the state suffer from the general problem that many subsidies and investments provided by the industrial policy system provided less than optimum results, it was also getting less than its share of licenses, and its industrial growth rate slumped. There is an argument that the decline in the state's industrial fortunes began in the 1970s when the Left Front governments were in power (Raychaudhuri and Basu 2007). But in fact, the state's industrial problems long preceded the Left Front victory. Between 1956 and 1966, *before* the Left Front took power, West Bengal received 16.5% of licenses from the centre, compared to 27.4% for Maharashtra (Dasgupta 1998: Table 3). As Table 18 shows, the allocations of finance to West Bengal by state financial institutions over this period were also significantly lower than its potential competitors.

Table 18 Comparative Allocations of Finance to West Bengal 1950s and 1960s

	% of ICICI allocations 1955-65	% of IFCI allocations 1960-70	% of IDBI allocations 1964-76
Gujarat	13.3	8.7	12.7
Maharashtra	36.7	18.9	20.4
Tamil Nadu	10.3	11.7	12.5
West Bengal	8.8	10.8	7.8

Notes and Sources: ICICI = Industrial Credit and Investment Corporation of India, IFCI = Industrial Finance Corporation of India and IDBI = Industrial Development Bank of India. D. Banerjee (1986: Tables 31-33).

To some extent these figures could be reflecting a bias of the central government against West Bengal. There was also some effect of the policy of freight equalization which ensured that steel, coal and cement would be delivered between any two points

of the country for the same rail cost. This had the effect of dampening West Bengal's comparative advantage given its proximity to some of the most important iron ore and coal deposits in the country. But while these factors may have exacerbated the rate of West Bengal's industrial decline, they are unlikely to have caused this on their own. Analysts have looked at other possible explanations, such as differences in productivity between West Bengal and other states, infrastructure availability and labour militancy, but the differences between West Bengal and other states in terms of these indicators are not consistent enough to explain a persistent underperformance that began at a time when West Bengal was the dominant industrial base in the country (D. Banerjee 1998). A plausible explanation has to incorporate the role of business-government relationships in the state, independently of labour militancy, which was just as serious in other states that did better (Dasgupta 1998).

Clearly, the relationship between big business and government in the state was not one where politicians could assure business of a long term commitment to deal with emerging problems. One indication of the state's priorities and core constituencies well before the Left Front government took power is that state finance corporations in West Bengal as of 1975 did not finance any private industrial estates unlike state finance corporations in Gujarat and Maharashtra. And by 1975 West Bengal had five industrial estates set up by the state government, compared to 44 in Maharashtra, 47 in Gujarat and 29 in Tamil Nadu (D. Banerjee 1986: 65). In a land-scarce state, constructing industrial estates requires taking on peasant constituencies to support an industrial one. One clue to the difficulty of developing such a relationship in West Bengal is provided by the specific ownership structure of West Bengali industry.

In Maharashtra regional capital was always better represented though as we have seen Maharashtrian capital was not necessarily Marathi but included Gujaratis who had close political relationships with the state. In contrast, industrial capital in Bengal was till the 1950s significantly owned by the British. When the British began to leave, many of these firms were sold to Marwari capitalists who did not have close financial relationships with West Bengal's politicians. Since Marwari capital had very limited historical links with Bengali politicians and parties, this made it difficult for Bengali politicians and parties to commit themselves to industrial policies that would have primarily benefited Marwari capital. And as a result, Marwari capital, even when headquartered in Kolkata, did not commit themselves to a regional concentration of their investments in their home base, which was the pattern of business houses elsewhere. The significant observation is that all this was true long before the victory of the left parties or the labour militancy of the late 1960s. The latter was more plausibly the effect rather than the cause of a long history of industrial decline.

For instance, the largest Marwari group in West Bengal, the Birlas, applied for 601 licenses during the period 1956-66, but of these only 178 were for West Bengal (Dasgupta 1998: 3057). If the confidence of these groups in West Bengal was low, there is also a possibility, though difficult to substantiate, that profits made in West Bengal were invested elsewhere. In contrast, investments by other regional business houses appear to have been more regionally concentrated. For instance, investments of Gujarati business houses (like Mafatlal, Walchand, Sarabhai, Kasturbhai, Kilachand) were concentrated in the Maharashtra-Gujarat belt, and southern houses (like Chidambaram, Iyengar, Chettiar, Ramkrishna) were primarily in the southern belt. But Marwari business houses headquartered in Kolkata (Birla, Bangur, Modi,

Goenka, Sahu Jain) rapidly diversified into Uttar Pradesh, Maharashtra, Madhya Pradesh and Bihar (D. Banerjee 1998: 3074). By 1996, of the 42 biggest conglomerates in India, only one, Goenka, had a significant share of its activities in West Bengal (D. Banerjee 1997: 56-7). If the political relationship between government and business matters for the ways in which market failures are addressed, the ownership structure of West Bengal's industry could explain not just an important part of some of its problems in the past, but may remain an important problem for the present. West Bengal today has to compete with states with strong relationships with domestic capital such as Tamil Nadu and Gujarat (Pedersen 2001).

Agriculture-led growth in the 1980s

The growth acceleration that happened in the 1980s was initially entirely agriculture-led. Strong explicit political relationships between West Bengali politicians and big industrial capitalists had never existed, and the Left Front did not change this in the 1980s. This does not mean that close relationships between business and politicians never existed, but these were mostly short-term relationships such as politicians colluding with particular businesses during labour conflicts and lockouts. The long-term relations that may have led to coordinated plans for land acquisition, infrastructure development, and formal and informal subsidies were not in evidence. On the other hand, the Left Front was enormously successful in developing a mass base in agriculture, drawing in small and medium peasants and sharecroppers in a massive and disciplined political organization. This consolidation was helped greatly by the adoption in West Bengal in 1973 of the Panchayati Raj Act, which created a decentralized governance system that could be used to allocate funds to specific beneficiaries right down to the village level. This allowed the left parties to build loyal constituencies that could be counted on to sustain them in electoral politics. Secondly, the Left Front began a series of land reform measures that eventually had significant effects on agricultural growth.

It began by simply implementing land reform laws that were already of the statute books but never enforced. The Left Front began to enforce these rules. It also passed legislation for higher crop shares for sharecroppers and security of tenure. The latter was to be enforced through a registration of sharecroppers, the so-called Operation Barga. There is no question that these measures were associated with a significant acceleration of agricultural growth in the state (see Table 2 on p. 12). There is, however, considerable debate about why this was the case. Land redistribution alone could not explain this significant acceleration because only around 6.5 per cent of cultivated land in the state was redistributed since the late 1960s, and of this only 3 per cent was redistributed by the Left Front government that took power in 1977. And the total land under sharecropping at the time of Operation Barga was only around seven per cent. (Gazdar and Sengupta 1999: 66-7). A more satisfactory explanation would also account for the effect of the Left Front being able to direct subsidies and resources to surplus farmers (who were also their supporters), to enable a significant increase in investment in tube wells, fertilizers and other inputs (Dwaipayan Bhattacharya 1999; Gazdar and Sengupta 1999). The supply of agricultural kits and credit to peasants is also found to be significantly positively related to agricultural productivity growth during this period (Bardhan and Mookherjee 2007). In this sense, the Left Front was using developmental rent allocation to small and medium peasants to accelerate growth, knowing that land redistribution alone would not suffice. And

indeed many surplus farmers in the Eastern Indian context are in an absolute sense rather poor.

At the same time that these changes were happening, large-scale industry was doing rather badly. The loss of confidence of big business in the state government became more serious and many large corporates began to locate their headquarters outside the state. Big business that moved out at this time included Lipton, Brooke Bond, Hindustan Lever (collectively renamed Hindustan Unilever), a host of Tata Group companies, Philips, Bata, Britannia, Reckitt Benckiser (then Reckitt & Coleman), and Organon, the only multinational pharmaceutical company in Kolkata. As large firms moved out their place was taken by smaller and lower technology firms. Between 1977 and 1990, the number of registered firms in West Bengal increased from 5837 to 8960 but total employment remained virtually unchanged (Raychaudhuri and Basu 2007: Table 14). This indicates that when some big firms for instance in the engineering sector moved out their skilled workers opened smaller-scale and lower technology firms to fill some gaps in the market. The limits of these agriculture-priority policies began to become apparent by the late 1980s. The growth rate in agriculture slowed down, and as a result the growth rate of state domestic product also slowed down.

Challenges for a new pro-big business Left Front

In 1994 the Left Front government announced a new industrial policy that was now explicitly weighted to attract big business investments to the state. It welcomed foreign technology and investors, committed itself to upgrading the industrial infrastructure and strengthened a single window service for investors under the West Bengal Industrial Development Corporation (WBIDC). The WBIDC as a whole was overhauled and a party heavyweight and MP, Somnath Chatterjee was appointed its chairman. In 2000, this was followed with an even stronger set of incentives for mega-projects. Apart from subsidies for capital costs, special incentives were announced for projects above 2.5 billion rupees.

With the election of Chief Minister Buddhadeb Bhattacharya in 2001, the new policy received political support at the highest level, marking a significant shift from agriculture to industry. There were some significant improvements under the new policies. The value of industrial investment projects implemented between 1991 and 2006 were comparable to Maharashtra, though they were still less than half those in Gujarat (Raychaudhuri and Basu 2007: Table 19). A significant success of the new policy was Haldia Petrochemicals Ltd (HPL), a 10 billion rupee project, primarily producing polyolefins. It came onstream in 2000, commissioned in a record time of 36 months, with a West Bengal government stake of 51.7%. The project was already generating profits by 2004 and has significant potential downstream linkages.

Two other significant projects fared less well. A proposed chemical hub in Nandigram and the much advertised Tata Nano project in Singur were both abandoned because the Left Front government had not prepared its core constituency sufficiently. The land acquisitions for these projects were mishandled in their presentation and political handling, resulting in opposition parties using grievances to block these projects. Tata's withdrawal from Singur in 2008 is likely to leave a negative impact on the state's project of developing a new pro-industry constituency and investor confidence. The experience highlighted the importance of constructing constituencies in advance

of significant policy shifts, and also the high potential costs of delivering to business in a context of a political settlement where intermediate classes have been significantly mobilized and empowered. The types of market failure corrections that the West Bengal government can carry out in the future will clearly depend on the political constituency it can build to support these policies.

The contrast between Maharashtra and West Bengal is an interesting one. In the former business initially had strong long-term relationships with politics which became unsustainable because politics did not deliver sufficiently to broader constituencies. Politics became fragmented and difficult to negotiate for business interests. In West Bengal a disciplined political party did deliver to broader constituencies but found it difficult to connect with business interests to solve critical market failures. Clearly, sustained solutions to market failure require both. The Left Front is increasingly aware of this, but their problems would have been much easier if a Bengali capitalist class had existed in strength. It may be this is an important gap that needs to be addressed if a sustainable political settlement in support of industrialization is to be constructed.

9. Bangladesh: Growth with low-technology exports

Bangladesh was carved out of the eastern hinterland of Bengal which had virtually no industry in 1947. Unlike West Bengal which was significantly industrialized at that time, East Bengal was almost entirely an agrarian economy growing rice and jute. Even the jute grown in East Bengal fed jute mills located near Kolkata in West Bengal. The incorporation of East Bengal in the new state of Pakistan was a mixed blessing. There was some industrialization prior to the independence of Bangladesh in 1971, but once again, the agrarian surplus of East Bengal was financing industrialization elsewhere, this time in West Pakistan. A sustained growth spurt emerges only after 1980, but the previous history created some of the conditions sustaining this growth. In particular, the new politics created opportunities for primitive accumulation by Bengali elites with close connections with political power.

Overview

As in the rest of South Asia, the fifties and sixties in Bangladesh were a period of catching up under ambitious industrial policies. But the specific feature of Bangladesh was that these policies initially benefited mostly non-Bengali entrepreneurs in what was then East Pakistan. The distributive conflict against non-Bengali capital was one of the drivers that led to the emergence of Bangladesh. The previous history of state-led development and the experience of state-created capitalists in the past meant that the newly independent country began life with the new political elite very conscious of the potentially lucrative uses of political power.

The departure of Pakistani capitalists in 1971 initially led to the nationalization of large swathes of industry and services. This was the prelude to an intense period of primitive accumulation as nominally state-owned assets were transferred to private hands through the political process. This was also a period of considerable violence in Bangladesh, with armed freedom fighters demanding economic incorporation. Mujib was assassinated in 1975 when he tried to set up a one party state to impose some order on a politics that was becoming increasingly fractious. This was followed by a series of coups, counter-coups and considerable violence in the army barracks.

Policies/Rents	Governance	Outcomes/Vulnerabilities
<p>Ongoing asset and rent capture by emerging propertied classes 1971-</p> <p>Significant acceleration of primitive accumulation by Bengali elites after 1971, continuing with lesser intensity after 1975.</p> <p>Driven by the use of political power to capture or influence the granting of government contracts, land, bank loans and subsidies.</p>	<p>Attempts at centralized political control always defeated by competitive clientelism:</p> <p>Competitive clientelism weakly institutionalized in the post-1990 democracy, but vulnerable to attempts at monopolization, as in the Emergency of 2007-08.</p>	<p>Rapid growth of medium-scale capitalists after 1980s</p> <p>Competition between factions produced a relatively broad-based primitive accumulation.</p> <p>But aggressive primitive accumulation also source of intense political instability.</p> <p>Ability of state institutions to implement growth-enhancing policies weakened by factional competition.</p>
<p>Rent allocation to accelerate learning and technology acquisition since the 1950s but with poor results</p> <p>Examples include subsidized credit allocation by industrial banks up to the 1980s, tariff protection, subsidies for export promotion.</p>	<p>Technocratic capabilities weaker since 1971 and political environment unfavourable for rent-creation that is solely intended to be growth-enhancing</p> <p>But occasionally institutional arrangements can emerge if political support is strong: examples include bonded warehouses and back-to-back LCs for the garments sector in the early 1980s.</p>	<p>Formal policies to upgrade technology generally not successful</p> <p>Factional politics constrains endogenous monitoring and rent-withdrawal if that is a necessary part of a growth policies.</p> <p>Growth policies can be successful if policies are very narrowly defined and aspects of rent-withdrawal are exogenous.</p>
<p>Fortuitous learning rents for garment sector created by MFA in the 1980s</p> <p>Quota rents created by MFA had significant if fortuitous effects for technology acquisition in the garments sector.</p>	<p>Effective because of strong support for the sector by the executive and a supply of entrepreneurs emerging out of primitive accumulation</p> <p>MFA created a time-bound set of rents that could not be prolonged through domestic political processes.</p> <p>The executive had the capacity to engage in focused institutional innovations with significant effects.</p>	<p>Rapid growth of garments sector</p> <p>Unprecedented growth rates achieved by garments sector, supporting a creditable growth rate for the industrial sector as a whole.</p> <p>But extensions based on this experience required to achieve technological upgrading and movement up the global value chain.</p>

Figure 16 Governance and Growth in Bangladesh: Patterns and Vulnerabilities

The violence took about a decade to die down. In the meantime considerable primitive accumulation took place as state assets and inflows of aid financed the emergence of new elites who began looking around for productive uses for their acquired wealth. The emergence of new capital would not by itself have been sufficient to drive a growth spurt without another fortuitous accident, the Multi-Fibre Arrangement or MFA. This international accident created temporary rents and incentives for

investment in learning in the garment industry. The effect was positive because MFA did not allow a permanent dependence on rents simply because they could not be expected to last forever. And the terms of these rents could certainly not be significantly manipulated by domestic political mobilizations.

The conditions that allowed the emergence of the garments sector need to be understood because the replication of this very simple technology acquisition is by no means assured in other sectors if we do not understand the fortuitous conditions of capital availability and the simple and credible learning rents that were necessary for the acquisition of even these very simple technologies. The replication of these accidental conditions through deliberate yet limited governance capability development is a necessary precondition for the replication of these successes and their extension within these economies. Figure 16 summarizes the most important governance and growth challenges facing Bangladesh, as well as their role in explaining the growth performance of the country.

The fifties and sixties: Accumulation with limited success in learning

Early growth in Pakistan was financed largely by the trading profits of Gujarati Muslim merchants who settled in West Pakistan. The Korean War boom left large surpluses with these traders, and when a foreign exchange crisis hit Pakistan in the early fifties, the state imposed import controls which made domestic production extremely profitable. The early import substitution was primarily in textiles, generally of low capital intensity. Unlike the Indian case discussed in Section 6, import substitution in Pakistan thus began without any fanfare or planning but the evidence is that there was rapid import substitution that soon exhausted easy growth opportunities (Papanek 1967: 1-74).

Though the state did not yet have the resources to actively channel subsidies to industrialists, the imposition of import controls amounted to a hidden subsidy. Papanek reported that profits of fifty to a hundred percent a year were not uncommon in the early to mid-fifties (Papanek 1967: 33). Apart from the perception of the importance of industrialization, personal contacts also existed between the ruling Muslim League leadership and a small number of traders, dating back to the pre-partition days. 'Nation Building Companies' like the Mohammadi Steamship Company and Habib Bank Limited had been established by these traders in India in alliance with the Muslim League, and they provided obvious candidates, when individuals or companies had to be offered industrial projects (J. Rashid and Gardezi 1983: 1-8).

Apart from incentives in the form of higher prices in the domestic market, the government also directly absorbed the risks of setting up new projects by doing startups in the public sector. A month after independence in 1947 from Britain, an industries conference was convened where various forms of assistance were offered to businessmen but the response was very poor. Partly as a result of this disappointment, in 1952 the Pakistan Industrial Development Corporation was set up, with the objective of setting up and divesting working enterprises to risk-averse owners in the private sector. Four members on its board came from the leading monopoly houses, and the first head of the Corporation, an enterprising public servant named Ghulam Faruq, went on to become one of the leading industrialists of the country. The relationship between business and government was therefore close to say the least,

and the levels of accumulation and growth in the industrial sector were commensurate.

Also established in the early years were the key financial institutions that would finance investments by unknown new entrepreneurs in new industries that did not yet have a track record in the country. These were the Pakistan Industrial Credit and Investment Corporation (PICIC) and the Pakistan Industrial Finance Corporation (later Industrial Development Bank of Pakistan, IDBP) which were to assume great importance in later years (Alavi 1983: 46-50; Amjad 1983: 235-50).

The military takeover of 1958 allowed very concentrated allocations of resources to the large-scale manufacturing sector. A small number of monopoly houses that happened to be controlled by non-Bengalis became the backbone of the investment boom of the sixties in both wings of Pakistan. From 1958 to 1970, PICIC allocated 44.7 per cent of its loans to thirteen monopoly houses, and even the IDBP, which concentrated on loans below 2.5 million rupees, allocated 31.9 per cent to thirty monopoly houses between 1961 and 1970 (Amjad 1982: 51). Although these two institutions allocated about a fifth of total investible resources, leading businessmen from the monopoly houses were represented on the boards of all the state financial institutions and the Boards of Directors of other monopoly houses (Amjad 1982: 30-60, 1983: Table 9.7). By the late 1960s, the top 18 business groups controlled 35% of industrial assets while the top 44 controlled around 50% (Amjad 1982: 47).

A system of exchange controls also emerged ensuring multiple rates of exchange, so that importers of capital goods could import at an overvalued exchange rate but could export at an effectively lower exchange rate due to various export bonuses. But since export bonuses were not available for agriculture, this ultimately represented a subsidy from agriculture to industry. A differentiated structure of quantitative import restrictions and tariffs was also imposed. Growth in the late fifties and early sixties was further aided by buoyant world markets and a steady flow of aid.

Table 19 shows growth rates in different sectors between 1950 and 1980. This is the period that *precedes* our main period of interest after 1980 when formal attempts at industrial policy were largely abandoned. We have already seen growth rates for the 1980 to 2005 period for all our economies in Table 2 (page 12). The earlier growth proved to be unviable, largely because many of the higher technology firms that were being supported never graduated to self-sufficiency. Perhaps more of them may have if given more time, but political crises led to the abandonment of these strategies by the late 1970s. The important point for us is that this earlier growth for all its limitations created conditions for the subsequent growth in complex ways that needs to be understood. Even allowing for the statistical magnification caused by the initially tiny base, industrial growth in the first spurt was rapid from the mid-fifties to the mid-sixties, even in the relatively less dynamic East Pakistan.

Table 19 Growth in East Pakistan / Bangladesh 1950-80

	Manufacturing	Industry	Agriculture
1950-55	9.5	11.5	2.4
1955-60	8.5	8.6	0.3
1960-65	10.6	17.4	3.2
1965-70	5.3	7.7	2.8
1970-75	-9.8	not available	not available
1975-80	5.1	5.9	3.3

Sources: Alamgir & Berlage (1974 Apdx C Table 4, Apdx 14-A), World Bank (1984; 1986)

This success led some observers, such as Gustav Papanek, a Harvard Advisory Group economist working on Pakistan, to publicize Pakistan as a new model of growth (Papanek 1967: 2). With the benefit of hindsight, the weakness of Papanek's analysis was that this acceleration of growth depended on the state's ability to direct vast quantities of resources into the hands of a tiny capitalist class during the late fifties and early sixties. The early results of growth in Papanek's statistics concealed the fact that these accumulation strategies were based on a very vulnerable political settlement and did not reveal the limited capacity of the state to govern these subsidies to ensure that productivity growth was rapid enough to make the investments viable.

First, as in India, the state's governance capabilities for limiting moral hazard problems were not sufficient given the scale of the strategy. The result was that even by the late sixties, new enterprises set up a decade ago had not graduated to the point where they could become globally competitive without protections and subsidies continuing. The popular perception therefore was that this was a strategy for enriching privileged groups. The second weakness, closely connected to the last, was the failure to develop a broad-based Bengali capitalist class (in East Pakistan/Bangladesh). The weakness of the Bengali bourgeoisie is reflected in Table 20 since much of the growth in industrial investments in East Pakistan initially took place through a growth in the public sector, peaking at 53 percent of total investments in 1968.

Table 20 Industrial Investment in West and East Pakistan 1961-71

(Million Rupees in Constant 1960 Prices)

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
West Pak	852.94	846.15	757.05	1062.50	1221.43	1087.96	987.16	1013.79	916.87	1061.36
%Public Sector	5.1	3.9	15.6	3.2	9.8	10.8	10.9	11.6	8.3	3.2
East Pak	205.99	459.42	332.21	382.30	450.21	390.00	477.02	799.81	796.84	700.88
%Public Sector	21.7	13.8	29.8	24.3	24.3	25.0	24.8	53.0	50.7	45.7
All Pak	1058.9	1305.6	1089.3	1444.8	1671.6	1478.0	1464.2	1813.6	1713.7	1762.2

Source: Amjad (1982: Table A.9)

Nevertheless, the very limited growth of a Bengali industrial bourgeoisie began in this period. At the time of independence in 1971, one study found sixteen major Bengali

business houses, each with assets of more than Rs. 25 million, and with combined assets of nearly Rs. 700 million (S. Baranov, cited in Sobhan (1980: 15)). The bulk of the nascent industrial bourgeoisie was, however, small to medium entrepreneurs. Excluding the large jute and textile industries, state financial institutions funding the establishment of enterprises had, by 1971 given over 3000 loans to Bengalis, most below Rs. 400,000, helping to set up around 1300 units (Sobhan and Ahmad 1980: 64-5). A much bigger group of Bengali lower middle classes felt totally excluded by these policies and their response to independence was to engage in a massive acceleration of primitive accumulation through which a new Bengali capitalist class was to emerge after a decade.

Socialism and primitive accumulation in the seventies

The political break of 1971 created a new relationship between upwardly mobile Bengali elites and the state that had never before existed in East Bengal. The departure of the Pakistani capitalists initiated a new set of pressures on the state for another round of primitive accumulation but this time the beneficiaries were local. This has significant implications for the nature of primitive accumulation and the political economy of different patterns of primitive accumulation will be discussed in a later paper. The takeover of the assets of the West Pakistani capitalists by the state resulted in an immediate increase in the state's share in modern industry from 34 per cent to 81 per cent. But even this was not enough for the core support base of the new political order. The Presidential Order of March 1972 brought in addition, previously Bengali-owned factories in the jute, cotton and sugar sectors into public ownership. This raised the public sector's share to no less than 92 per cent of the assets of modern industry with a corresponding increase in the economic resources and jobs the state could allocate to its core lower middle (intermediate) class constituency (Sobhan and Ahmad 1980: Table 10.1; Murshid and Sobhan 1987: 3-4).

Employment in the public services witnessed a dramatic expansion. At the time of liberation in 1971, there were 450,000 employees of all grades in the public services, of which only 320 were officers at the level of Joint Secretary or above. By 1973 total employment in the public services had increased to over 650,000, with officers in the higher grades increasing to 660 (World Bank 1984: 109). Some of this growth was due to the change in coverage from the inclusion of new industrial units within the public sector which brought their administrative staff within the ambit of the public services. But the number of white collar staff in Bangladesh's small industrial sector would only account for a fraction of the increase.

The political party in power was a coalition of clientelist factions who now used their political power to enrich themselves (Umar 1980; E. Ahmed 1986: 27). Nurul Islam, an economist in the Planning Commission at that time describes some of the processes which lay behind this change: "By 1974 there were a number of factors which had contributed to an accumulation of surplus funds in private hands. For one thing, high profits were earned in domestic and import trading activities, including illegal trade such as trade in contraband goods and in smuggling jute and other exportables across the border. Since these transactions were illegal, the risk premium was high and hence profits, once realised, were high. In addition, many residential buildings and trading or commercial enterprises, abandoned by Pakistanis, were illegally occupied by private persons. The 'caretakers' of such commercial enterprises, hastily appointed by the government in 1972 immediately after

independence, made large fortunes through the undeclared sale of assets. Moreover, there were gains to be obtained from rental or sales proceeds of the abandoned houses which were illegally occupied by private persons. Those who had accumulated financial resources were pressing the government to commit itself to a more substantial and permanent role for private enterprise in the economy of Bangladesh” (Islam 1979: 225-6).

This accelerated primitive accumulation was not conducive for economic performance. An assessment of 1970-1975 is difficult because of the very real disruptions caused by the war, and the short life of the regime. Productivity in manufacturing was on average less than 50% of the level reached in 1970 and real wages in manufacturing, around 60% of their 1969/70 level (World Bank 1978: Vol. II Annex I.6 p. 173, 1984: Vol. II Table 9.12 p. 118). The state could not of course remain insulated from the political consequences of the collapsing economy. In addition, ironically, the primitive accumulation was itself creating a constituency which would eventually support the military in its attempts to create an environment more appropriate for investing their ill-gotten gains in industry.

By 1974, pressure from the new ‘capitalist’ class resulted in a revision of the government’s ‘socialist’ industrial policy. The ceiling on private investment was increased from two and a half million to thirty million takas. Partnerships with foreign private investors were allowed, and the moratorium on nationalization was increased from ten to fifteen years. The new military government of General Zia that took over in 1975 began a slow process of denationalization. Between 1976 and 1983, a total of 217 public sector enterprises were wholly or partially sold to the private sector or returned to their former Bengali owners from whom they had been nationalized without compensation in the aftermath of liberation.

However, significant denationalizations only began under the regime of General Ershad. Under the New Industrial Policy adopted in 1982, denationalizations of large-scale public enterprises were given priority. In the face of substantial and growing political opposition, the government divested 110 large units in little more than a year, including jute mills that had previously been owned by Bengalis, after which the programme continued at a slower pace (World Bank 1984: 149). The privatizations were supported by international agencies, but in effect they had a very limited impact on the economy. The large-scale enterprises that had been created under the Pakistani industrial policy of the sixties had never achieved full global competitiveness. When they were nationalized in the seventies they built up additional and vast liabilities on their books because of over-employment, looting and mismanagement. This did nothing to help their future viability as enterprises when they were gradually privatized in the eighties. The new owners took over the liabilities as well, wrongly believing that political arrangements could be worked out to sustain subsidies into the future. Some of the privatized firms limped on and were lucky to become moderately profitable. Many eventually closed down, particularly in the jute and cotton textile sectors.

The net effect of the Pakistani industrial policy as well as the accelerated primitive accumulation that happened in the immediate aftermath of independence did not take the country to a significantly higher technological level. Rather, the main effect was to achieve the creation of a new moneyed class through a process of primitive

accumulation that began in the fifties. By the mid-1980s, Bangladesh had a potential small to medium capitalist class who had accumulated relatively significant blocks of capital. There were by now at least hundreds of individuals who could if called upon raise \$100,000 or more of capital in the form of land, liquid capital or collateralized bank loans for investment. These individuals began to look around for simple technologies to invest in, now as economic entrepreneurs. It was at this stage that a lucky accident had a significant impact on Bangladesh's prospects.

The MFA and the acquisition of garments technologies

The growth of the ready-made garments industry in Bangladesh has often been presented as a vindication of the success of free market policies combined with the virtual absence of labour market protections in Bangladesh. But in fact investment even in the simplest of technologies involves significant risks for domestic investors who have no idea of what production in a globalized production network entails. Nor is it viable for foreign firms to invest in upskilling labour in a poor economy in low-margin low technology industries unless there is some cost-sharing and risk-sharing for the foreign firm. This is after all why all global production does not rapidly shift to the poorest countries. A combination of factors made this transfer of technology feasible for Bangladesh in the early 1980s.

An important component was the emergence of the Multi-Fibre Arrangement (MFA) in 1973 as an agreement administered by the General Agreement on Tariffs and Trade (GATT). MFA set bilaterally negotiated quotas on developing countries for textile and clothing exports. In addition, it was fortuitous that just at that time a potential investor class had emerged through the industrialization efforts and primitive accumulation described in the last two sections. Finally, Bangladesh had an 'investor-friendly' regime that saw the importance of underwriting foreign investments in the sector by informal support at the highest level. The emergence of the garment sector provides a good example of the ad hoc ways in which market failures have been addressed in second tier countries like Bangladesh (Figure 11 on p. 31). Nevertheless, the replication of this success to other sectors requires a better understanding of the conditions that made the garments takeoff possible.

The MFA restricted exports from existing developing country textile and clothing producers on the business of quantitative quotas. For countries that did not have any textile and clothing industries, like Bangladesh, there were initially no quotas (Goto 1989). This obviously created incentives for established producers who suddenly found themselves quantity-constrained to relocate to countries that did not have quotas. But developing countries that did not have a textile and clothing sector were clearly relatively poor countries which particularly suffered from market failures affecting technology acquisition and learning. To attract investors from more advanced countries who wanted to relocate, developing countries had to offer something more than just their quota-free status. After all, many poor countries were quota-free but only a very few benefited from MFA. Bangladesh was one of them and its success has to be explained in terms of specific mechanisms through which these market failures were addressed.

By the late 1970s, domestic primitive accumulation had created numerous potential investors for a sector like garments where the efficient scale of investment was in most lines at most in the hundreds of thousands or low millions of dollars. The agent

of change in Bangladesh's transition was a joint venture between a retired Bangladeshi civil servant turned entrepreneur, Nurul Quader Khan, and a South Korean multinational, Daewoo. The joint venture set up Desh Garments in 1979, a partnership where the Bangladeshi partner provided capital and arranged government support for a new potentially risky investment, and the South Korean multinational provided the training and technology transfer. That a retired civil servant from Bangladesh could sit across the table with a global multinational and offer credible equity cannot be understood outside the context of the primitive accumulation that the country had just gone through. Daewoo's calculations were straightforward. Bangladesh's access to US and other markets through MFA was an attractive business proposition but they would probably not have been willing to take all the risks of investing in Bangladesh without credible commitments from the developing country.

Equity participation from a joint venture partner provided part of this commitment, but perhaps even more important was the explicit support provided by President Ziaur Rahman to the project. President Zia's support appeared credible because he took the initiative in linking up Nurul Quader with Kim Woo-Choong, the chairman of Daewoo. His support assured the South Koreans that unexpected problems would be dealt with or at least addressed. And in fact, political support at the highest level ensured that relatively small but critical institutional innovations like the back-to-back LC (which allowed Bangladeshi producers to borrow from local banks using export orders as collateral) and the bonded warehouse (which allowed complex customs duties on imported inputs to be avoided) were quickly introduced.

Desh was remarkably successful. Between 1981 and 1987 its export value grew at an annual average of 90% (S. Rahman 2004). But the learning that was unleashed by this single project was remarkable. By the end of the 1980s, of the 130 people who were first trained by Desh in Daewoo's factories in South Korea, 115 had become entrepreneurs and set up their own garment firms! From virtually a zero base in 1980, by 2005 there were around 3500 active firms in the garments sector employing upwards of 2 million people (World Bank 2005). Primitive accumulation continued to be an important source of entrepreneurial supply. In a survey carried out in 1993, 23% of garment factory owners responded that they had originally been civil servants or in the army (Quddus and Rashid 2000). We can assume that many others had close contacts with politics and had made their initial capital through political processes.

Table 21 Bangladesh Garments: Growth Rates of Dollar Exports 1985-2006

Year	Woven	Knitwear	Total Garments Dollar Exports Growth Rates
1985-1990			45.9
1990-1995			24.1
1995-2000			14.3
2000-01			11.7
2001-02	-7.1	-2.5	-5.7
2002-03	4.3	13.3	7.2
2003-04	8.6	29.9	15.8
2004-05	1.7	31.3	12.9
2005-06	13.5	35.4	23.1

Sources: (based on Mlachila and Yang 2004: Table 1; World Bank 2005: Table 1).

The rapid emergence of Bangladesh as a garment exporting country is shown in Table 21. Exports grew at double digit rates for more than two decades. By the early 2000s, the sector accounted for around 70% of Bangladeshi exports. By 1985, such was the success of the Bangladesh garment industry that Ronald Reagan negotiated quotas for Bangladesh under the MFA. Though Bangladesh continued to benefit from preferential treatment, particularly in European Union markets, effectively, the first five years of quota protection were enough to trigger a major shift in the country's fortunes. This result had many contributing factors but they include, first, the MFA which provided substantial temporary rents that served to induce learning in a context where the rent-free wage-productivity differentials between Bangladesh and other countries had proved to be insufficient to induce the absorption even of this relatively simple technology (Khan 2000a).

The MFA worked as a system of accidental learning rents because it provided relatively moderate rents that were part of an arrangement that was formally recognized as being temporary. Bangladesh had its own quotas by 1985, and from very early on it was clear that most producers could not rely on the continuation of these arrangements for too long (M. A. Rashid 2006). In addition, Bangladesh had a favourable political regime able to make small but critical institutional innovations to support a project that had political support at the highest level. And finally, it worked because the country had at that time a supply of potential entrepreneurs who were close enough to the entrepreneurial capabilities required for this technology, and who had access to capital from earlier strategies of political accumulation. The emergence of the garments industry, together with less dramatic successes in a number of other sectors like pharmaceuticals ensured that industry has been steadily growing as a share of GDP in Bangladesh, shown in Table 22.

Table 22 Bangladesh: Sectoral Shares in GDP 1980-2005

		1980	1990	2000	2005
Bangladesh	Agriculture	31.6	30.3	25.5	20.1
	Industry	20.6	21.5	25.3	27.2
	Services	47.8	48.3	49.2	52.6

Source: (World Bank 2008)

The history of garments in Bangladesh has important implications for other countries hoping to achieve growth through low-technology labour-intensive investments. It shows that the critical triggers for this takeoff were not market liberalization on its own, but a specific set of corrections for market failures that can be better understood in terms of the framework set out in this paper. Moreover, this has implications for Bangladesh too as it attempts to move higher up the value chain. Much of its growth so far has been at the lower ends of the value chain, even though there is evidence of growing backward linkages and diversification. By 2005, roughly 45% of export value was value added in the domestic economy due to growing backward linkages in spinning, weaving, dyeing and accessories (Debapriya Bhattacharya, et al. 2002; World Bank 2005; M. N. Ahmed and Hossain 2006).

Nevertheless, on the whole, the Bangladesh garment industry operates at the lower end of the global value chain. For instance, the *average* per kilogram price of its

knitwear exports to the European Union in the early 2000s is around half that of India or China, and around one third that of Turkey (M. Rahman 2004). Within this product basket, when we compare unit prices of Bangladeshi exports with that from other countries, Bangladeshi prices are comparable to its competitors, suggesting that its lower wages do not give it any significant advantage over competitors. Bangladesh's wage rates in the garment industry are also known to be one of the lowest internationally and the lowest amongst its regional South Asian competitors (M. N. Ahmed and Hossain 2006: Figure 4).

Taking these facts together, it follows that Bangladesh has the lowest value-added per employee amongst the major garment exporting countries, but it is competitive because it has one of the lowest wages and salaries per employee (Mlachila and Yang 2004: Table 9). Mlachila and Yang's figures show that around 1997-2001, Bangladeshi value-added per employee was less than one-fifth that of China, and about a third of that of India. Bangladeshi wages and salaries were a quarter of China and just over half the Indian average. Recent trends in wages across countries suggest that these ratios are unlikely to have changed very much. It is also true that wages and conditions in the garments industry have become a growing source of friction between management and workers. In 2007 and 2008, garment industry workers were involved in strikes and confrontations for higher wages despite the state of emergency declared by the interim caretaker government.

These observations suggest that Bangladesh concentrates on a low-value product mix in its export basket, and *even within that low-value product mix*, its competitiveness is based on low wages that compensate for its lower productivity. This allows Bangladesh to sell low-value products at the same price as its competitors, most of whom can afford to pay somewhat higher wages. This situation is precarious not only because there are other low wage countries trying to enter this market, but also because the low wages of Bangladeshi garment workers cannot be taken as a given, particularly given the mobilization of garment workers over the last several years demanding higher wages and better conditions. Both moving up the value chain into higher value-added products *and* raising productivity are critically important for Bangladesh. The challenge for countries like Bangladesh is to learn from these successes and to focus on the types of market failure corrections that may be required to assist sectors like the garment sector to move up the value chain.

The story of the garment industry's success tells us that market failures in capital and knowledge markets were overcome through very specific policy and governance arrangements. The blocks of capital required for the next stage of upgrading are much larger and primitive accumulation cannot be relied upon to provide these investments. A survey of the garment sector in 2007 revealed that the available terms of financing were an important constraint to technology upgrading in the sector (Khan 2008a). Banks were willing to lend but the fixed return and collateral requirements deterred investors who were not sure about the length of time learning would take. And profit sharing investors were deterred by poor contract enforcement. This is an example of financial and knowledge market failures that require specific solutions if industrial growth and productivity improvement are to be sustained.

Our interpretation of the causes behind the rapid growth of the garment industry in Bangladesh also casts doubts on the argument that Bangladesh's success was based on

cheap labour and labour market flexibility. It is true that Bangladesh scores much higher than India on labour flexibility (it is easier to fire workers compared to India) and indeed both Pakistan and Bangladesh score higher than India on the overall ranking of 'Doing Business Conditions' of the World Bank. But the specific mechanisms through which the garment industry developed suggests that cheap and flexible labour by itself did not help Bangladesh very much before the market failures constraining investment in a new sector were overcome. Moreover, the persistence of cheap and flexible labour has not helped investment in the next stages of the value chain and low wages have remained low, with important consequences for poverty reduction and for social stability. The implication for other developing countries must be that low wages and labour market flexibility are not sufficient for a manufacturing takeoff to happen. There are significant market failures even in the adoption of simple technologies that need to be addressed. And if the market failures impeding technology acquisition can be systematically addressed, very low wages and excessive labour market flexibility may not even be necessary conditions for a manufacturing takeoff.

10. Tanzania: Growth led by natural resources and aid

The poorest of our economies is Tanzania. It was originally the former British colony of Tanganyika which became independent in 1961. In 1964 it merged with the island of Zanzibar, and the new country became Tanzania. As colonies Tanganyika and Zanzibar were less developed even compared with other East African countries like Kenya and Uganda. Kenya had the most developed colonial industrial structure in East Africa, owned by large European and Asian minority communities and multinationals. Uganda was not as industrialized but had a larger educated elite and better infrastructure (Wangwe and Arkadie 2000: 67). In contrast, large parts of the mainland rural population of Tanganyika had not settled into sedentary agriculture. There had been a few experiments with plantation farming under colonial rule, but they had not been very successful. Modern industry was almost non-existent. However, independent Tanzania had a very successful period of state-building under Nyerere and his successors. It has recently graduated into a high growth economy around 2000 but its growth is particularly vulnerable as it is to a considerable extent based on a few mineral exports and inflows of aid.

Overview

Shortly after independence, Tanzania adopted Five Year Planning, in line with most developing countries of the time. But here the almost total absence of an indigenous capitalist economy of any size made it possible to move towards a more complete state control of the economy. The Arusha Declaration of 1967 committed the country to an attempt to construct socialism using central planning. It also prohibited its leaders from any association 'with the practices of capitalism or feudalism'. The idea was to achieve an economic transformation of the country based on socialist principles and with strict limits on private sector accumulation.

Attempts were made to industrialize using planning and public sector 'parastatal' companies. A transformation of agriculture was attempted through villagization that sought to convert a migrant rural population into a sedentary one farming on collective principles. None of these experiments were particularly successful. When Uganda's Idi Amin invaded in 1978 the war precipitated an economic downturn that

eventually led to the adoption of liberalization strategies in the mid 1980s. However, some achievements of the Nyerere years were significant. The construction of a one-party democracy and the adoption of a single language, Kiswahili gradually converted a fragmented tribal society with multiple religions and languages into a relatively united nation with relatively low levels of internal strife compared to many other similar countries (Mkapa 2008).

Policies/Rents	Governance	Outcomes/Vulnerabilities
<p>Ujamaa Socialism: Rent allocation to public sector for learning and collective development 1967-1985</p> <p>Industrial development through public sector 'parastatals'.</p> <p>Agricultural development through villagization and collective farming.</p>	<p>Disciplined one party state but inclusion of all managers within state-party meant disciplining of performance would be weak</p> <p>In fact, experiment did not last long enough to test if the disciplining of non-performers was possible</p>	<p>Some industrialization 1967-78 but reversed after 1978 Uganda invasion and external shocks</p> <p>Disciplined party and aversion to private accumulation in Ujamaa period meant there were very few black African elites who could become potential capitalists when socialism began to be rolled back.</p>
<p>Liberalization and Privatization 1985-</p> <p>Privatization of parastatals primarily benefited foreign investors.</p> <p>Significant growth contribution of gold mining due to attractive rent sharing opportunities for foreign investors.</p>	<p>Arms length formal relationships with business but informal relations probably based on suspicion and short term rent sharing</p> <p>Rent sharing in mining weighted towards investors</p> <p>Key challenge of developing dynamic black African capitalist sector not addressed.</p>	<p>Rapid growth of mining sector and some growth of manufacturing and utilities particularly with foreign participation</p> <p>Significant imbalance in sharing mining rents with foreign investors.</p> <p>Slow growth of manufacturing despite very small base.</p>
<p>Significant aid rents financing social spending 1990-</p> <p>High rates of growth of public spending arithmetically add to growth rate and could raise social productivity in the long run through health and education.</p>	<p>Governance reforms aimed at donor community such as PFM, commitment to anti-corruption, progress on multi-party democracy</p> <p>Efficient service delivery in health and education may not be sufficient for achieving sustainable growth path.</p>	<p>Significant growth in public spending on health and education</p> <p>High GDP growth rates sustained by public spending but questions about whether aid at these levels can continue.</p> <p>Expectations of aid financed spending can have damaging political and economic effects if aid is suddenly suspended.</p>

Figure 17 Governance and Growth in Tanzania: Patterns and Vulnerabilities

The liberalization had moderate effects on manufacturing and less so on agricultural growth rates, but did allow multinationals to seek to develop Tanzania's significant mineral resources. Liberalization was also happening simultaneously with a significant increase in aid inflows that allowed for an increase in government spending in social sectors. This too had an effect on growth by supporting construction, expenditures in health and education and demand expansion more generally. From an unenviable position of *negative* growth of per capita income in the early 1990s Tanzania achieved positive per capita income growth in the late nineties, and a further acceleration after 2000 which gave it a growth rate of per capita income from 2000 to 2005 that was higher than the global average (Table 2 on p. 12).

Despite this very creditable success, the relatively slow growth of manufacturing and agriculture points to problems. The slow growth of manufacturing based on indigenous ownership in particular suggests there are fundamental factors preventing the development of an indigenous African capitalism in Tanzania. Unlike the brief period of socialism in Bangladesh described earlier, Tanzanian socialism was different in that it did not induce an indigenous primitive accumulation to anything like the same extent. On the contrary, Tanzanian socialism was rather orderly in comparison, reflecting the very different histories that had brought about public ownership and planning in the two countries. But as a result, an African capitalist class with the capital and enterprise to start investing even in basic technologies like garments still does not exist on a broad enough scale. And the development of this class will require significant political effort to address the market failures in land and capital markets that prevented the emergence of such a class in the past.

Ujamaa Socialism and the missing Tanzanian capitalist class

Nyerere's definition of an African socialism was summed up in his concept of Ujamaa derived from the Swahili word for 'extended family'. The Arusha Declaration adopted Ujamaa as the conceptual foundation of the state. Acquisition and personal accumulation were discouraged, and development was to be attained through collective advancement. These principles did not have any significant effect on an African capitalist class simply because it did not exist to any substantial degree. However, it did have a discouraging effect on the Asian business class, and the post-Arusha nationalization of banks, urban property and most commercial services led to increased Asian emigration. But in the absence of formal policies of promoting the development of a new African capitalist class, or significant informal policies of capturing assets by the new political elite, the development of an African capitalism remained constrained. At the same time, weak incentives and technical skills meant that African development through public enterprises was also constrained (Wangwe and Arkadie 2000: 67-70).

Ujamaa was a system of rent allocation through protection and nationalization that was addressing a set of market failures that many other developing countries were trying to address at that time. If Tanzania's economic development had been constrained by capital and information market failures preventing the development of infant industries, temporary protection may well have been justified. But as we discussed in Section 4, these strategies are only effective if governance capabilities can be developed to minimize moral hazard and rent capture problems. We have seen that in other second tier countries where these governance capabilities were weak,

similar policies nevertheless led to some development of technological capabilities and the accumulation of capital by protected individuals that led to forms of capitalist growth when these systems of protection broke down. In Asian countries, a variety of relationships subsequently developed between emergent capitalists and the state. The distinguishing feature of Tanzania and some other African countries was that the starting point was less developed and the infant industry policies lasted for much shorter periods, so that when the break with state-led development occurred in the mid-1980s, indigenous African elites were not poised technologically or financially to take advantage of these opportunities to the same extent.

A critical difference between Asia and Africa in this respect was that the African starting point was less favourable and the catching up policies lasted for a very short period of time. After the Arusha declaration of 1967, infant industry policies and planning only began in earnest sometime in the 1970s. When parastatals and marketing boards were first set up their initial performance was poor as we would expect. The problem was that these strategies had very little time to have either their intended effect or to set off unintended processes of accumulation within Tanzania. Idi Amin's infelicitous invasion of Tanzania in 1978 that resulted in a costly war, followed by rising oil prices due to OPEC policies meant that the Tanzanian economy was in serious fiscal crisis less than a decade after the adoption of these policies.

The economic performance of the country over this short period does not necessarily tell us very much about the likely trajectory it would have followed in the absence of shocks of this magnitude. We know that economic performance was not stellar, but we would not expect that given the structural problems, in particular the absence of any significant technological and entrepreneurial capabilities. Between 1965 and 1980, the growth rate of GDP was 3.9 per cent, with agriculture growing at 1.7 per cent, industry at 4.2 per cent, and manufacturing at 5.6 per cent. But in the next five years, from 1980 to 1985, following the external shocks, the growth of GDP collapsed to 0.8 per cent, of agriculture to 0.7 per cent, of industry to -4.5 per cent and manufacturing to -4.6 per cent (Shitundu 2002: Table 7.2)

The initial response of the government was to protect its policies from what was perceived to be a temporary shock. The National Economic Survival Programme of 1981 was followed by a home grown Structural Adjustment Programme in 1982 and a campaign against economic 'saboteurs' in 1983 (Utz and Moon 2008). But the international climate was shifting against socialism and planning and internal support for these programmes began to run out. Power within Tanzania began to shift from the Planning Commission to the Ministry of Finance and the Bank of Tanzania, with moves towards conventional economic stabilization plans and privatization.

But when Tanzania abandoned catching-up strategies in the mid-1980s it had hardly created any indigenous capitalists or even technological capabilities that could sustain the rapid emergence of domestic capitalists. Not surprisingly, its experience with liberalization and opening up was significantly different from the Asian ones. In particular, there was a much weaker acceleration of manufacturing growth driven by national capitalists. The weak development of an African entrepreneurial class is in fact a major distinguishing characteristic of some African countries, and perhaps much more important for understanding relative performance than the resource

constraints and resource curses that are frequently identified, which are obviously also important (Collier 2007).

The absence of a 'national' capitalism matters, because as Wangwe and Arkadie (2000) point out, the relationship between an African political leadership and a 'foreign' capitalism is unlikely to develop the types of business-government relationships that can address the market failures facing entrepreneurs in developing countries. On the contrary, these relationships are likely to be founded on suspicion and businesses are likely to be subjected to occasional populist attacks. Since businesses know this, their strategies of investment and commitment to the economy are also likely to be adjusted accordingly.

The absence of a strong and dynamic class of entrepreneurs is of course a problem in a number of African countries. Remarkably, analysis and policy rarely address the problems that may be preventing the emergence of black African capitalists in Africa. As Bennell (1998: 17) points out, the result may be that many of the policies for achieving market efficiency and improvements in poverty targeting that are advocated for Africa may fail to have a lasting impact. When these issues are addressed, there is a tendency to blame corruption and patrimonialism in Africa for stifling entrepreneurs without recognizing that corruption and patrimonialism were structurally associated with the emergence of capitalism virtually everywhere else in the world (Khan 2002, 2006). This is to some extent because significant market failures have almost always meant that substantial non-market processes were involved in the emergence of capitalism.

Of course corruption and patrimonialism are not *sufficient* for the emergence of capitalism either; otherwise much of Africa would have made a significant transition by now. A variety of institutional and political conditions have assisted these transitions in different countries, depending on their initial conditions and political contexts (Khan 2004, 2005). But simply trying to reduce corruption and contain neo-patrimonialism will have limited effects if the market failures and the absence of capabilities preventing the emergence of dynamic capitalists in Africa are not directly addressed. Ujamaa was not trying to create African capitalists; on the contrary it was trying to ensure that they did *not* emerge. Nor did Ujamaa last long enough to enable unintended primitive accumulation by Africans to take place that *may* have assisted the emergence of an African capitalism. But Ujamaa did have significant achievements and these should not be overlooked. As ex-president Mkapa points out (Mkapa 2008), the main achievement of Ujamaa was the development of a modern Tanzanian state and the crafting together of national unity in a potentially fragmented and divided polity.

Market-enhancing reforms and the growth takeoff

The reform process that began in the mid-1980s was deepened over time, particularly under President Benjamin Mkapa when he was elected in 1996. Privatizations of the 410 parastatals that had been set up under Ujamaa began in 1993. By the mid-2000s significant market-enhancing reforms had been implemented in Tanzania. The financial sector was opened up and the two largest state-owned banks were privatized. By 2003, more than 380 of the 410 parastatals in manufacturing and commercial activities were privatized. Trade reforms were introduced to reduce tariffs. (AFRODAD 2007; Utz 2008: 19-20). From around 2000, the growth of GDP also

accelerated, with a significant improvement in the growth of per capita GDP. Post-reform Tanzania emerged as one of the rapidly growing economies of the world. However, a closer look at the structure of this growth in Table 23 points to a number of distinctive features.

Table 23 Sectoral Sources of Growth in Tanzania 1990-2005

	<u>Average Annual Growth Rate</u>			<u>Average Contribution to Growth</u>		
	1990-94	1995-99	2000-05	1990-94	1995-99	2000-05
Agriculture	3.1	3.6	4.8	1.5	1.8	2.3
Industry	2.0	5.4	9.0	0.3	0.9	1.6
Mining and Quarrying	11.8	14.8	15.2	0.1	0.2	0.4
Manufacturing	0.4	4.6	7.3	0.0	0.4	0.6
Electricity and Water	4.0	5.7	4.4	0.1	0.1	0.1
Construction	2.2	3.5	10.3	0.1	0.2	0.5
Services	1.9	3.8	6.1	0.7	1.3	2.1
Public Administration	1.9	1.6	4.1	0.2	0.1	0.3
GDP	2.5	4.0	6.0	2.5	4.0	6.0

Source: Utz (2008: Table 1.2)

The highest growth sectors in 2000-05 were mining and quarrying and construction. In mining, the growth was the effect of a rapid expansion of gold mining as lucrative concessions were granted to mining companies. Mining is still a small sector of the economy, accounting for 3-4 per cent of GDP in the early 2000s (Khan and Gray 2006: 62). So is construction. The small size of these sectors in overall GDP meant that these sectors together only accounted for 0.9 per cent of the 6.0 per cent GDP growth rate, but the acceleration in these sectors accounted for a significant part of the change in the growth rate.

Tanzania has the second largest gold reserves in Africa, after South Africa. Initial changes in mining laws in 1987 and 1992 set royalties at 3% of income and set normal corporation tax levels. Despite the very generous levels of royalties, there were limited foreign investments initially. Then in 1998 there was a further revision of laws enabling license holders to use mining rights as collateral without further ministerial approval. This facilitated the participation of foreign financial institutions in Tanzanian mining and led to a significant increase in investment in the mining sector. By 2000, FDI coming into Tanzania had grown from virtually zero in the early 1990s to more than \$500 million, of which 30 per cent went to mining, 31 per cent to manufacturing and 14 per cent to trade and tourism (Utz 2008: 33). However, the generous royalty levels were maintained in the 1998 Mining Act. While there was a 30 per cent corporation tax, generous capital deductions meant that little tax was paid (Khan and Gray 2006: 60-1). The contribution of mining to gross national product is therefore likely to be significantly lower than its contribution to gross domestic product.

The second sector with dramatic growth rates during this period was construction, with increases in government investment in infrastructure as well as private residential and business construction. Public spending on construction, together with the growth in public administration (which includes health and education) has been significantly assisted in Tanzania by the growth of aid. Together, the growth in construction activities and the growth in public administration account for another 0.8

per cent of the 6.0 per cent growth in GDP during 2000-05. In comparison, the growth in the manufacturing sector contributed 0.6 per cent of this total growth.

Table 24 Aid to Tanzania 1990-2006

	1990	1995	2000	2005	2006
Aid as % of Gross National Income	28.6	16.9	11.4	12.0	14.5
Aid as % of Imports of Goods and Services	69.9	38.1	45.7	33.6	34.6

Source: World Bank (2008).

Table 24 shows the significance of aid in the Tanzanian economy. Although its significance has tended to decline in recent years, aid is around 15 per cent of national income and equivalent to around a third of the total import bill of the country. Budget support as a vehicle for aid delivery has also meant that at least 20 per cent of the budget comes directly from aid. These flows have ensured that government spending in health, education and public administration have grown rapidly and this directly (arithmetically) contributed to the acceleration in GDP growth. The long-term effects could also be positive but that would depend on the quality of health and education delivered. As Utz (2008: 36) shows, government spending had a critical role in sustaining high levels of growth. From 2000 to 2005, of the overall growth rate of GDP of 6.8 per cent per annum, increased government spending contributed no less than 3.8 percentage points.

The growth takeoff in Tanzania therefore relied on two sets of accidental rents. First, there were governance responses to the potential of developing mining and this attracted foreign mining companies to drive an important and growing component of growth. Second, aid donors with their new interest in Africa and budget support provided air rents that created large domestic demand growth and arithmetically boosted growth by increasing expenditure on health and education. Here too, Tanzania benefited by being able to respond quickly with governance adaptations that satisfied donors.

In the main productive sectors of agriculture and manufacturing the picture is somewhat different. Some acceleration of manufacturing growth did take place, again based largely on foreign investors buying up parastatals or investing in low technology manufacturing. But the question is whether the new policies have led to sustained improvements in growth in these sectors. The growth in manufacturing and utilities was achieved through privatizations of parastatals, with sales often to Asian, South African, Malaysian and other investors. These sales did result in productivity improvements in many cases, and increases in output (AFRODAD 2007). But foreign investors are unlikely to invest in sectors where long periods of learning are required particularly because they are unlikely to develop long-term relationships with government that may explicitly or implicitly create compensatory incentives to encourage these investments. The share of industry as a whole in GDP in Tanzania remains relatively small, growing from 16 per cent of GDP in 1990 to 20 per cent of GDP in 2005. And most of this growth was attributable to the growth of mining, with manufacturing showing a more modest increase (Utz 2008: 22). In 2001, manufacturing still accounted for only 4.5 per cent of commodity exports (Levin and Mhamba 2007: 6-7).

The problems that manufacturing faces in Tanzania are no different to other poor countries. Financing investments in new sectors requires investments in upskilling labour and is subject to market failures in capital markets and markets for knowledge and labour as discussed in Section 4. The general importance of skills and financing is corroborated by surveys of Tanzanian manufacturing enterprises (Chandra, et al. 2008). However, skills development is not just a function of formal education, but also of learning-by-doing, which in turn has to be financed by sources of financing that achieve an acceptable balance of risks and returns for entrepreneurs and financiers. In the case of Bangladesh, where a supply of potential entrepreneurs with sufficient capital had been created by primitive accumulation, the adoption of even very simple garments technologies on a significant scale required investments in skills that became possible because of temporary rents created by MFA. In Africa, AGOA and EBA have created opportunities for African garment and textile exporters but they are competing with already established Asian garment producers in poor countries who also have unrestricted access to these markets or access at very low levels of duty. More substantial and directed sectoral assistance to African producers may be required that is both time bound and subject to specific governance requirements to achieve growth-enhancing outcomes. But even more fundamentally, policies may be required to accelerate the evolution of a potential class of African investors who probably do not yet exist in countries like Tanzania.

Measures of total factor productivity are problematic in Tanzania given the poor data on capital stock. However, Utz (2008: Table 1.4) carries out calculations using a number of different assumptions about base year capital stock. The conclusion is that it is plausible that total factor productivity grew at between 0.7 and 1.24 per cent per annum between 1995 and 2005. But there is little evidence of significant improvements in technology in agriculture and industry. Rather these findings are, as Utz points out, consistent with improvements in capacity utilization in manufacturing as a result of privatizations and rapid increases in (aid-financed) government spending.

Agriculture also presents significant challenges. Primary sector exports accounted for 33 per cent of exports in 2001 (Levin and Mhamba 2007: 6), with coffee, cashews and fishing constituting the largest share. Cotton too is a potentially promising sector. However, average wages in agriculture were only around 15 per cent of those in manufacturing, suggesting very high levels of poverty and very low productivity in agriculture (Chandra, et al. 2008: 145). Cotton yields per hectare in Tanzania were low even by African standards, about two-thirds of those in Zimbabwe and less than half that in Benin or Mali (Baffles 2002: Table 1). Significant improvements in seed quality and distribution can be achieved through gradual work with distributors. Some improvements can be made relatively easily through better distribution of higher quality seeds. Other improvements in agriculture will have to address the vexed question of land rights and land consolidation to achieve scale economies, and the capacity to make investments in irrigation and inputs. These reforms may actually be much more time consuming to achieve relative to governance arrangements that could accelerate manufacturing investments to rapidly create higher paid manufacturing sector jobs.

The case of Tanzania is particularly interesting because the governance and reform agenda in the country has been strongly influenced by a market-enhancing perspective

coming from international development partners. To some extent these reforms have clearly been very successful. The reform in mining laws gave a lion's share of mining rents to foreign investors, arguably to attract investment into Tanzania when it was not an established FDI destination. The government's willingness to address transparency issues and accept PFM reforms allowed the country to receive significant aid inflows including budget support, which contributed strongly to public expenditure driven growth.

In the future, however, a different set of governance capabilities may become critical. The capacity of the state to change rent-sharing arrangements in mining, to increase that national claim on mining rents and then re-deploy these resource rents for domestic development will be a critical capacity to develop. Another condition for a developmental transition would be the evolution of relationships between the Tanzanian state and domestic entrepreneurs, perhaps initially Asian but eventually black African. The initial evidence from privatizations and casual observation of the business sector in Tanzania suggests that black African entrepreneurs are still relatively rare.

For reasons discussed earlier, the development of a dynamic relationship between domestic capitalism and the state requires the emergence of a significant black African capitalist class not just in Tanzania but across Africa. The processes through which domestic capitalists emerged in our other growth economies have not progressed as far in Tanzania and this is a challenge for sustaining growth in this economy. Furthermore, the experience of our other growth economies, while complex, suggests that the investment climate depends critically on how business-government relationships develop to solve significant market failures, and not just on the protection of basic investor rights and the provision of basic infrastructure.

11. Brief Conclusions

The ways in which growth emerged in our five economies has been the subject of this paper. Rather than laboriously repeating what has already been said, and keeping in mind that this is the first of four papers on related subjects, we will instead refer the reader to the figures that summarize the argument. The rents, governance capabilities and policies that drove growth and created specific vulnerabilities for each of our five economies are summarized in a set of figures that the reader can rapidly refer to. Thailand's case is summarized in Figure 12 on page 37, Maharashtra in Figure 14 on page 67, West Bengal in Figure 15 on page 76, Bangladesh in Figure 16 on page 82 and finally, Tanzania is summarized in Figure 17 on page 93.

In each case, we have argued that the growth stories in these second tier economies have been related to the ways in which market failures have been addressed in the past to develop specific entrepreneurial and technological capabilities and the continuation of growth has depended on specific business-government relationships that have determined the sectoral and technological directions in which growth has progressed. In most cases, the rents associated with specific business-government relationships were not consciously created or managed, and in some cases rents drove patterns of growth that almost entirely by-passed entrepreneurial and technological development. No further generalization has been attempted here. In subsequent papers we will focus on the analytical lessons that can be drawn.

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