6

Institutional Governance in Welfare States

Economists working on economic development have paid increasing attention to institutional and governance issues in recent years. Two themes in particular from that literature are relevant to the present enquiry:

- The distinction usefully made by Khan (2007) between 'market-enhancing' and 'growth-enhancing' governance arrangements;
- The importance of critical past events in a world of path-dependence, emphasised recently by Acemoglu *et al.* (2007).

Both of these lines of thinking represent departures from the orthodox 'modernisation' model, which associated institutional quality positively with level and growth of income per capita, and asserted a causal link back the other way from institutions to growth.

Khan suggests that the 'new Washington consensus' (as described by Kremer, (2004: 222) has used the wrong set of explanatory variables in its regressions linking institutions and growth, and that the appropriate variables would be ones that measured the extent to which institutional arrangements are supportive of rapid learning, technological innovation and political stability in the face of rapid externally-driven change.

Khan describes the central preoccupations of international agencies such as the World Bank and International Monetary Fund (IMF) in their promotion of institutional reform since the 1980s as the quest for 'market-enhancing governance' which 'focuses on the role of governance in reducing transaction costs to make markets more efficient'. He lists five key governance goals in this policy framework:

- Achieving and maintaining stable property rights;
- Maintaining the rule of law and effective contract enforcement;
- Minimising the risk of expropriation;
- Minimising rent seeking and corruption;
- Achieving the transparent and accountable provision of public goods in line with democratically expressed preferences.

All of these, it will be noted, fall within Adam Smith's minimalist state.

In contrast, 'growth-enhancing governance focuses on the role of governance in enabling catching up by developing countries in a context of high transaction cost developing country markets. In particular, it focuses on the effectiveness of institutions for accelerating the transfer of assets and resources to more productive sectors, and accelerating the absorption and learning of potentially high-productivity technologies' Khan (2007: 4). Khan lists three key institution-building goals in this context:

- Achieving market and non-market transfers of assets and resources to more productive sectors;
- Managing incentives and compulsions for achieving rapid technology acquisition and productivity enhancement;
- Maintaining political stability in a context of rapid social transformation.

Khan's empirical work finds that market-enhancing governance, as measured by the standard Knack-IRIS[5] and Kaufman[6] indices of institutional quality, is statistically unable to distinguish between successful and unsuccessful developing countries.[7] In contrast, he argues, historical inspection of experience with 'growth-promoting strategies' in the 1960s and 1970s strongly suggests that growth-enhancing governance was a necessary condition for the success of those strategies in East Asia, and its absence was the main reason for the failure of the strategies in Latin America and South Asia.

The governance characteristics identified by Khan as growth-inducing include:

- Government agencies must be able to impose discipline in the policy-driven allocation of resources in the same way that competitive markets discipline firms – that is, non-performance leads directly to withdrawal of resources (Khan, 2007: 16). 'Growth-enhancing governance [in success stories] required monitoring resource use and withdrawing resources or support from sectors or firms that proved to be making inadequate progress. … The difficult part of growth-enhancing governance is to implement and enforce difficult decisions about resource withdrawal when performance is poor' (Khan, 2007: 17).
- There is no particular unique set of governance capabilities applicable to all countries; rather, 'the governance capabilities have to be appropriate for ensuring that the growth-enhancing interventions are effectively implemented and enforced' (Khan, 2007: 16).
- Some minimum level of centralisation is required: 'the agencies involved in monitoring and enforcement are sufficiently centralised to be able to internalise all the costs and benefits of implementing the strategy' (Khan, 2007: 17).
- Enforcing difficult decisions 'requires a compatibility of the required governance tasks with the internal power structures of the country. … Growth-enhancing governance is helped if political factions are too weak to protect non-performing industries and sectors. If political factions are strong and there are many of them, its becomes relatively easy for failing firms to buy themselves protection by offering to share a part of their rents with factions that offer to protect them. … [However],

growth-enhancing governance can be moderately effective even in the presence of strong political factions, provided there is a political settlement that allows the political demands of factions to be satisfied through centralised transfers. This can reduce the incentive of factions to capture rents by protecting rent-recipients who are willing to pay. …' (Khan, 2007: 17, 19).

All the above characteristics fit well with the social-corporatist arrangements common in small states. Smallness in and of itself often imposes the centralisation, political settlement and unsustainability of factional resource battles that are the aims of Khan's governance programme.

Where Khan's approach falls short is its implicit closed economy starting point and the resulting focus upon growth in GDP per capita as the overarching aim to which strategies and governance arrangements are oriented. In the open-economy setting, the relevant goals are growth in consumption and in wealth (access to long-term consumption), neither of which bear any necessary close link with domestic production as measured by GDP.

The details of economy-enhancing governance that apply to small states thus differ from Khan's menu in matters of detail, even if some of the central pillars are the same:

- Centralisation of decision-making in a context of a strong consensual political settlement that underpins the legitimacy of the collective agencies that drive and direct resource allocation into high-productivity uses;
- A focus on rapid learning and adaptation to respond to external threats and opportunities;
- Ability to take and implement hard decisions when external resources fall away.[8]
- Solidarity overriding factionalism at times of crisis, providing a resilience of civil society in the face of the sort of shocks that would destabilise politics in larger entities.