Diffusing Best Practices and Creating Capable Institutions

Perspectives on Policies for Poverty Reduction

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Executive Summary

This analysis suggests a number of approaches countries can take to overcome obstacles to development and poverty reduction. It argues that the key to poverty reduction is creating productive jobs where poor people live. Poverty reduction is not about redistributing the benefits of growth, but about bringing growth processes to poor areas. Poor areas can benefit from technical and organizational innovations made elsewhere in the world, and such innovations mean that today countries can create productive jobs faster and in greater quantity than ever before. The puzzle is what helps spread such “best practices.” The paper argues that saving, investment, education, resources, and new technology are all needed, and are all fairly easy to obtain. What is hard to obtain is the institutions that allow these factors of production to be translated into productive job creation.

Some important institutions develop spontaneously, such as basic markets and small-scale trade, and operate even in the most desperate corners of the world, but creating and sustaining large numbers of productive jobs require a complex web of institutions. The rise of modern firms and contemporary forms of government, both institutions that started in the mid-19th century, provided the critical institutional fabric that allowed factors of production to be combined more productively. To be truly productive, firms need to play by certain rules and be able and willing to cooperate. They need to respect property rights and contracts so that they have incentives to invest and cooperate with buyers and suppliers. They also need to respect a variety of regulations that condition their property rights to ensure that products and production processes adhere to society’s expectations about socially and environmentally sound practices. Under such rules, which require government enforcement, firms of different sizes emerge that symbiotically trade and contract with each other.

Firms are the vehicles that spread best practices and productive jobs to areas where poor people live, but firms require certain routines to operate, and those routines may not always be effective or
sustainable. Because policymakers can never be sure which firms will succeed, the institutional environment must be such that new firms can enter markets, that substandard firms are allowed to fail, and that good firms face few barriers to growth. This is the definition of competition, and competition is what selects good firms and drives the spread of best practices and productive jobs.

The institutional fabric of societies, which consists of firms, government, and other types of organizations, needs to combine competition and cooperation under agreed rules—a tricky task full of unavoidable tensions. Because the spread of best practices and more productive jobs upsets old patterns of production, it typically disrupts the lives of some people while improving the lives of others, but in the end raises overall living standards. Most governments try to help the process along not just by establishing the basics of property rights and contract security, but also by providing special support to businesses and small farmers and adopting industrial policies that provide businesses and large farms with some protection from competition and easier access to credit. Politically popular, such policies can be effective in overcoming interest groups' resistance to reform, but their contribution to productivity improvements is limited, particularly in situations where the basics of security of property rights and contracts and businesses' freedom to enter and fail are lacking.

An alternative is broader social protection schemes such as social security systems. When sensibly designed, these allow change to occur while providing individuals with a safety net, but countries need productive jobs before they can fund such systems. A basic level of security, however, can also support greater risk taking and thereby enhance the scope for experimentation and change that will eventually result in more productive jobs. Indeed, productive societies have seen a dramatic rise in the extent of government activity in the economy, mostly because of the emergence of state-sponsored social protection. At the same time, a number of countries, notably the Scandinavian ones, have withdrawn from interfering with firms' productive activity.

The right mix of state activity and how it best interacts with firms are not fully understood. Partial reforms can work, but they can also fail. Some mechanism that permits experiments and selects successful ones is valuable for national, provincial, and local governments. Such competition among jurisdictions and firms is an integral part of dynamic social systems that holds promise for creating wealth and ending poverty.
First, I would like to have work of any kind.

_Eighteen-year-old man, Ecuador_

The quotation is from _Voices of the Poor_, a World Bank survey that captures the perspectives of poor people around the world (Narayan, Chambers, and others 2000, p. 46). Poor people know what they need to escape poverty. As detailed studies using household survey data confirm, changes in labor earnings and employment status are important factors for escaping from poverty (see, for example, Fields and others 2002). Thus, finding a job or establishing a small business is the key.

Just any job or any business will not, however, lead people out of poverty. If poverty reduction were simply a matter of creating jobs, having the state employ everyone would do the trick, as a number of countries around the world have tried to do, notably the communist regimes. The key to poverty reduction is to create productive jobs, and therefore wealth, not just jobs that allow people to scrape by. As an interviewee in Pakistan put it: “The rich have one permanent job; the poor are rich in many jobs” (Narayan, Patel, and others 2000, p. 36). Such jobs and productivity improvements are especially needed where the poor live, which is mostly in rural areas and city peripheries.

The 20th century offered more hope that poverty could be eliminated than any other period in history. Average income per person, adjusted for inflation, quintupled during the century despite unprecedented population growth from about 1.8 billion people to more than 6 billion (De Long 2000). At the end of the century more people lived above the basic poverty line of $1 dollar a day than even a decade earlier (Pfefferman 2000). When using a definition of poverty broader than just income, human development in extremely poor countries such as Mozambique has advanced beyond that in Italy in
the late 19th century (Crafts 2000). For the first time in history increases in income do not appear to lead to a Malthusian increase in population. Worldwide fertility rates peaked in the 1960s and population growth has since started to slow (United Nations 2001).

Yet the absolute number of poor people has not fallen, even though their share in total population continues to decline. Advances are heavily concentrated in Asia, particularly China and India. In Africa, however, poverty rates have increased during the last three decades. In Eastern Europe and the former Soviet Union they increased during the decade prior to the fall of communism and faster still thereafter. Nor have two decades of reform in Latin America prevented poverty rates from rising (figure 1). Whether global inequality rose or declined overall during the last three decades of the 20th century remains hotly disputed (Milanovic 1999; Ravallion 2000; Sala-i-Martin 2002). In any case, roughly 1.2 billion people still live on less than $1 a day and 2.8 billion people subsist on less than $2 a day (World Bank 2002b).

**FIGURE 1**

**SHARE OF THE WORLD’S POPULATION LIVING ON LESS THAN $1 PER DAY, BY REGION, 1970-98**

Sources: Sala-i-Martin (2002); World Bank (2000b).
Worldwide the average income per person is about $6,000 a year, equivalent to that in the United States in 1900, then the richest country in the world. This shows that the world can produce enough for everyone to lead a better life; however, many people have not benefited. Thus the century that gave rise to unprecedented hope also gave rise to anger that many people are still left out. In the words of Nobel Laureate Joseph Stiglitz: “The experience of the past fifty years has demonstrated that development is possible, but not inevitable” (Stiglitz 1998b, p. 5).
2
Ways to Promote Pro-Poor Growth

How can poor people benefit from wealth creation? Today fewer alternative approaches to economic systems are available than at any time since Karl Marx wrote the *Communist Manifesto* in 1848. Some still hope for nonmarket solutions, but they are struggling, as exemplified in a recent speech by João Amaral, a reformist member of the Portuguese Communist Party: “We are not social democrats or market-friendly socialists. Communism means replacing capitalism with something better, even if we do not yet know exactly what that will be” (as quoted in Wise 2002, p. 6). Maybe a completely different economic system will emerge in the future, but for now we have to rely on markets.

The question thus becomes what pro-poor policies mean in market economies. Some policymakers focus on redistributing incomes. For example, the Basic Income European Network recently proposed a guaranteed basic income for everyone (Williams 2002). The massive redistribution required for such a plan on a global scale would necessitate that economic growth were adequate to fund it. It would also require rich countries’ willingness to fund such a plan. Yet the official development aid of all nations amounts to less than $0.15 for each person living on less than $1 a day, and most of that is in the form of debt that countries have to repay. Compare that with what the Republic of Korea (henceforth referred to as Korea) has achieved since the late 1970s: it has generated more income for its citizens from just the manufacturing sector than all the world’s development aid combined (figure 2).

Even doubling the world’s official development aid and transforming all loans into grants would not achieve sustained economic growth in those countries and areas where the poor live. The hope for poor people lies in productivity growth, not in redistribution. Opinion polls in Latin America show that the poorer people are, the more...
they place their hopes on productivity growth rather than on redistribution (figure 3).

Most current debates about pro-poor growth center on ways of providing opportunities to poor people by improving their health and education (World Bank 2002a), offering them access to credit (Morduch 1999; Robinson 2001), connecting them to the global market, helping to create risk insurance schemes, and creating jobs by stimulating overall growth in poor countries and regions (Stern 2001). Deeper understanding of what such interventions can accomplish and how to implement them effectively is required, but the basics are clear: growth processes need to spread to areas where poor people live or to where they can migrate.

1. See World Bank (2002a) for examples of how information and communications technology is being used to connect producers in low-income or remote areas directly to buyers and to provide producers with access to market- and business-related information.
THOSE WHO BELIEVE PRODUCTIVITY IS MORE IMPORTANT THAN REDISTRIBUTION, BY PER CAPITA GDP, LATIN AMERICA, 1998

Percentage of those surveyed

GDP = Gross domestic product.
Drivers of Growth and Job Creation

There is a tendency to see development as the accumulation of something necessary. For a while it was infrastructure...human capital...It has been other things as well. There's obviously truth in those paradigms, but in a deeper sense, societies that succeed in developing are societies where the fairly common individual pursuit of selfish objectives leads to benign social outcomes because of checks and balances in governments, because of enforced private property rights, because of incentives for creativity and entrepreneurship.

_Lawrence Summers (2002)_

Saving, investment, education, natural resources, and new technology are all necessary for growth and relatively easy to obtain. What is needed but is more difficult to obtain is the institutions that allow these factors to be combined and put to productive use.

**Accumulation of Capital and Ideas**

An understanding of pro-poor growth requires an understanding of growth. Growth requires the accumulation of various types of capital: financial, physical, natural, and human. Most important, humankind's accumulated technical and organizational innovations can, in principle, enable poor countries to catch up with richer ones relatively rapidly, but simply making resources and innovations available does not lead to growth (Easterly and Levine 2001; Temple 1999).

**Finance.** During the 1990s poor countries in Sub-Saharan Africa received capital transfers in the form of development aid that averaged some 10 percent of their gross domestic product (GDP) a year, an extremely high level of inflows relative to the size of these economies.
This did not, however, translate into sustained growth. Instead Africa became the region with the highest incidence of capital flight (World Bank 2000a). Estimates reveal that almost 40 percent of private wealth is held outside the region (Collier and Gunning 1999).

**Investment.** Similarly, high investment rates do not automatically translate into high growth rates. The formerly communist countries offer the most dramatic example: investment rates of 30, or even 40, percent of GDP were among the highest in the world prior to the 1990s, but these countries imploded spectacularly. Hong Kong (China) and Singapore achieved similar growth per person, but Hong Kong (China) did so with significantly lower investment levels (Young 1992). The United States still achieves strong growth with investment rates just below 20 percent of GDP.

**Natural Resources.** Minerals, fuels, and other agricultural and non-agricultural commodities remain critical for economies everywhere, but during the 20th century the price of nonfuel commodities fell by four-fifths in real terms, while per capita income grew fivefold (figure 4). Fuel prices have also declined slightly from the high levels reached during the last 30 years largely because of the activities of the Organization of Petroleum Exporting Countries. So despite massive population growth, natural resources are relatively less scarce than would be expected. Nor is possession of resources the key to growth. Botswana, which is rich in diamonds, and Chile, which has abundant copper resources, have benefited from their resource endowments, but the possession of natural resources can also be a curse. For example, the economies of some countries endowed with large oil deposits, such as Nigeria, Saudi Arabia, and Venezuela, are not growing much, or are even shrinking (Gelb and Associates 1988; Sachs and Warner 2001).

**Human Capital.** Even investment in education does not easily translate into superior growth (Pritchett 1996). During 1960–85 educational progress in Africa was much faster than in East Asia but did not result in higher growth. Indeed, overall educational improvements in the developing world during the last 40 years have coincided with declining growth rates. Detailed household surveys also suggest that education levels alone do not explain who escapes from poverty.

**Access to Resources and Capital.** None of this is to say that finance, investment, natural resources, and education do not matter. They do, but
by themselves they are not enough. On the positive side, moving finance into good investment opportunities has become easier; countries have lowered their trade barriers, making capital goods that embody new technologies more readily available; and the education levels needed for income growth in poor countries do not appear to be too difficult to achieve.

Diffusion of Ideas and Growth of Income. Technical and organizational innovations have led to an unprecedented creation of wealth (see box 1). The advantage of innovations is that, unlike physical objects, if they can be communicated, they can be used over and over again (Romer 1993). This characteristic of ideas is what allows poor countries to raise incomes much faster today than ever before.

For the first time in human history, large numbers of people can escape from poverty within a life span. Today people in poorer countries can make use of new technology, new learning, and better ways of doing things that were developed in more advanced economies. They can learn
Before the 18th century, per capita income grew extremely slowly. When populations grew, their growth risked offsetting any progress, just as Malthus argued at the beginning of the Industrial Revolution. It took incomes some 350 years to double in preindustrial Europe, but in the run-up to the Industrial Revolution, per capita incomes started rising much more rapidly. For example, in the 19th century the United Kingdom, then the world’s richest country, was able to double per capita incomes in 65 years, and at that time no other country could rival its performance. By the second half of the 20th century, however, a whole range of countries, including Botswana, Chile, China, Ireland, Japan, Korea, and Thailand, were able to grow for sustained periods at rates that doubled per capita income in about 10 to 15 years.

Source: Cameron (1991); Crafts (2000).

The diffusion of ideas has also become easier. Many more ideas are recorded, and the means for communicating them have become faster, more efficient, and more ubiquitous. Ideas might not move quite as easily as finance, but people can acquire new ideas embodied in imported machines, buy technology licenses, study at home or abroad, and use the Internet. Korea shows that acquiring new technology and ideas from overseas is fairly cheap: it spent less than 1.5 percent of the increase in its GDP during 1973–79 on the technology licenses that underpinned its manufacturing growth (Olson 1996).

2. Note that the static efficiency gains derived from trade liberalization cannot explain the main benefits of openness. Static gains from trade are typically one-off benefits on the order of 2 percent of GDP, or maybe 4 to 6 percent of GDP in the presence of product differentiation or economies of scale. These are important, but not nearly as important as the gains from learning that drive successful growth processes.

3. While innovators can earn a fair amount of money, they rarely receive the full rents from their innovation. For example, Thomas Edison received but a fraction of the benefits that electric light created. Even patent protection, unless extreme, on average affords innovating firms only a normal rate of return on the cost of their inventions.
Impediments and Traps

If the provision of capital does not drive growth, if finance, capital goods, and know-how are not hard to obtain, why is growth difficult for some countries to achieve? One set of arguments concerns a variety of traps or lasting impediments that prevent countries from growing rapidly. They may suffer from being small, landlocked, or plagued by inclement climates (Gallup, Sachs, and Mellinger 1998). They may be enduring ethnic strife or civil war (Collier 2000; Collier and Gunning 1999). They may have policy and institutional rigidities induced by vested interests (Acentoglu and Robinson 2000; Havrylyshyn and Odling-Smee 2000; Hellman 1998). They may suffer from cultural biases or a lack of trust, a critical part of social capital (Collier 1998; Fukuyama 2000).

Whatever the trap, some countries have been able to escape from it. All of today’s industrial countries emerged, eventually, from hopeless situations. At the time of the Thirty-Year War (1618–48) who would have thought that Germany would ever be an economic powerhouse?

Today many countries have escaped from their traps fairly rapidly by historical standards. Consider the following examples:

- **Countries can overcome adverse climatic conditions.** Tropical Singapore is a rich country, and Malaysia and Thailand have also performed well, as did Venezuela during most of the 20th century until the curse of oil set in during the late 1970s. At the other end of the climatic spectrum, the Scandinavian countries boomed during the 20th century, including isolated, inhospitable Iceland.4

- **Remote location need not prevent development.** Landlocked, tiny Botswana has consistently been a star performer in recent decades. Since the late 1980s landlocked Uganda has emerged rapidly from its days of civil war and dictatorship and experienced strong growth in the 1990s. The tiny island of Mauritius has one of Africa’s best performing economies.

- **Recovery from civil strife is possible.** Civil war ended in El Salvador in 1992. Six years later per capita income had increased by 17 percent and the country’s human development index was up 8 percent, all without increasing its debt burden. Indeed, El Salvador became the third country in Latin America to receive an investment-grade bond rating in 1998, even before Mexico.

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4. One hundred years ago Iceland had virtually no free-standing houses and people lived half underground in grass-covered huts.
Countries that languish for decades can turn around. Ireland, which suffered decades of emigration and economic stagnation, overtook the United Kingdom in per capita income in the 1990s driven by productivity growth from foreign investment.

Countries can even overcome deeply entrenched dysfunctional institutions. Several countries, constrained by a formidable set of growth-restraining institutions, policies, and vested interests, turned around within a decade, particularly China and formerly communist countries in Central Europe.

The enrichment of many countries has demonstrated that some may run into traps at higher incomes. Argentina, once among the most advanced countries in the world, has stagnated relative to other countries since the 1930s. Stagnation could also befall Japan. Those communist countries that grew during the early phases of industrialization are the most dramatic illustration of the phenomenon. We do not know how to predict such cases, but apparently after initial success, some countries' development may be arrested for some time.

Overall, while many countries have emerged from traps, many others have not or are getting trapped again. The upshot is that a variety of factors can make development hard for a country, but in principle they can be overcome, often in a fairly short time. What it takes to do so is the issue.

**Capable Institutions as the Key to Development**

One way to reduce poverty is to allow poor people to move to richer countries. Immigrants to the United States produce over 4.5 times more there than in their countries of origin, yet their skill level is the same. They benefit from extra and more advanced physical capital in the United States, but that explains only about a third of the difference (figure 5). The main explanation is the capability of institutions—be they firms or governments—to allow individuals to perform at higher levels of productivity.

Hall and Jones's (1999) review of output in 127 countries indicates that human and physical capital differences account for only a modest amount of the difference (figure 6). The biggest factor remains hard to capture. The study concludes that the remaining productivity residual is driven by differences in the institutional environment. Having large unexplained residuals in statistical studies of growth for particular countries is
Various factors have to come together to raise productivity and incomes. For example, the more open an economy is—and presumably the greater its ability to learn—the more education becomes useful (Krueger and Lindahl 2001; Lopez, Thomas, and Wang 1998). Similarly, the higher the level of domestic education, the more productive foreign investment becomes (Borensztein, De Gregorio, and Lee 1994; World Bank 2001a). All this points to the power of institutions that enhance the division of labor.

Productivity also differs among regions within countries. Consider the coastal and interior provinces in China or the northeast of Brazil compared with Sao Paulo. Even where labor is mobile and goods, services, and capital can move freely, significant productivity differences can
DIFFUSING BEST PRACTICES

FIGURE 6
CONTRIBUTION OF SELECTED FACTORS TO THE
DIFFERENCE IN OUTPUT PER WORKER, 1988
(ratio of the five richest to the five poorest countries)

<table>
<thead>
<tr>
<th>Difference in output per worker</th>
<th>Contribution of capital intensity</th>
<th>Contribution of human capital per worker</th>
<th>Contribution of the institutional environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>31.5</td>
<td>4.5</td>
<td>5.6</td>
<td></td>
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Source: Based on Hall and Jones (1999).

Persist. Putnam’s (1993) study of Italy suggests that long-standing differences between Italy’s north and south reflect differences in trust among people based on enduring patterns of behavior, what the author calls “social capital.” In short, the environment people operate in affects their productivity.

Cities tend to be more productive than other parts of a country. More ideas are generated there, and incomes are higher because cities allow for flexible labor markets, work arrangements, production, and subcontracting methods and permit an easier flows of ideas. Figure 7 illustrates this with reference to new product innovation in the United States.

Clusters of firms as in Silicon Valley (information and communications technology) and in northern Italy (textiles and garments) provide benefits similar to those in cities (Porter 1998). According to executives in Silicon Valley: “People change jobs without changing carpools,” and
“The network in Silicon Valley transcends company loyalties. We treat people fairly and they are loyal to us, but there is an even higher level of loyalty to their network” (Saxenian 1996, pp. 35, 36). Cities are forms of clusters.

Large, multiplant firms, which exhibit some features similar to those of clusters, such as flexible internal labor markets, loyalty to the larger firm, and flexible internal contracting, are more productive than smaller ones (Sutton 2000). In many developing countries foreign firms are more productive than local ones, which suggests one route for importing some types of capabilities.

Most important, firms spread best practices, and therefore wealth, through channels within countries as well as across national boundaries. Studies of cross-border links between firms have attracted more attention than studies of links among firms within countries. Hence some of the discussion in the next paragraph tends to focus on international learning channels; however, the same or similar mechanisms are at work within countries.

One way to improve firm-level performance is for more productive firms to move into new markets through new investments or through
mergers or acquisitions. When this takes place across borders it is referred to as foreign direct investment. Foreign firms and joint ventures with foreign firms typically exhibit higher productivity than local firms in developing countries (Barberis and others 1996; Blomstrom and Sjoholm 1998; Djankov and Murrell 2002; Earle and Estrin 1998; Havrylyshyn and McGettigan 1999). Foreign firms employ mostly local workers and managers, training them on the job in new technical and organizational practices. The superior performance of foreign direct investors tends to provide them with greater market share in their sector. Over time, local competitors may be able to catch up, but initially they tend to lose market share (Aitken and Harrison 1999; Djankov and Murrell 2002). Similar processes are at work within countries: efficient companies from one part of a country move into other regions and improve productivity there.

Subcontractors to foreign investors appear to be helped by their presence. Dealing with demanding foreign investors helps them upgrade their quality and reduce their costs. In varying degrees foreign investors provide active support to their suppliers to improve the suppliers' performance (Batra and Tan 1995, 2000). Contracting also takes place across borders. Export opportunities provide competent domestic firms with the option of upgrading their productivity. As studies of firms from East Asia suggest, firms that target export markets make appropriate investments in training and technology that raise their productivity (figure 8). Demanding customers in high-quality markets are a key force driving performance improvements.

Another important way for new and more productive firms to emerge is for people who have acquired knowledge in one firm to leave that firm and set up their own enterprises. One example is the garment industry in Bangladesh, where locals learned from a Korean company, Daewoo (see box 2). Eventually they set up their own businesses in Bangladesh, which in turn produced more small entrepreneurs. Relatively quickly the garment industry became Bangladesh's leading export industry and by 2001 accounted for almost 75 percent of the country's export earnings. Similarly, India's most efficient machine tool company was set up by four machine tool design engineers who had left the employment of an old and inefficient state-owned firm. The new firm became a major supplier of machine tools by specializing in the production of a narrow product line and by embarking on a competitive pricing policy. The key to the firm's success was its flexible and efficient management (Sutton 2000).
Many successful small companies are founded by former employees of larger companies, where they learned their jobs. Often they learn about opportunities that their previous employers do not recognize or do not wish to exploit. Former employers might have been stuck in routines that were too hard to change or their employers might have been reluctant to embark on new ventures that would have undermined or cannibalized successful product lines (Christensen 1997). The most detailed attempt at studying the phenomenon comes from the United States, where in 1989 a survey of 500 company founders indicated that more than 70 percent of new ventures were set up by employees who got their business ideas when employed by another company (figure 9).

The Adoption of Best Practices and the Creation of Capable Institutions

Critical to reducing poverty or creating wealth is the capability of institutions that allow people to work together and that create productive
DIFFUSING BEST PRACTICES

BOX 2

THE DIFFUSION OF GOOD PRACTICES AND THE GROWTH OF THE GARMENT INDUSTRY IN BANGLADESH

Bangladesh’s garment industry grew from nothing in 1979 to about $5 billion of exports per year by 2003, accounting for slightly more than three-quarters of the country’s annual export earnings. This phenomenal growth was due to the diffusion of good practices from one foreign company to one local enterprise and from the local enterprise to many other local firms. It was also due to a number of policy and administrative improvements that opened up investment opportunities for local entrepreneurs.

In 1979 the Korean company Daewoo and the Bangladeshi enterprise Desh Garments entered into a collaborative agreement. Daewoo did not make any capital investment in Desh, but signed a five-year contract to help Desh purchase machinery and fabric (some of it on credit from Daewoo), to set up Desh’s factory, to market the garments, and to train Desh’s employees at Daewoo’s plant in Korea and at Desh’s facilities in Bangladesh. About 130 Desh employees received intensive training in technical production skills, management, and marketing in Korea. They returned to Bangladesh with this knowledge plus an appreciation of the corporate culture required for success in export markets. Daewoo sent its own technicians to Desh to help set up the machines, oversee quality assurance in production, and train Desh workers who had not been to Korea.

Garment production began at Desh’s plant in 1980 with 450 machines and 500 workers. The following year Desh’s management believed that the company was ready to operate on its own and terminated its contract with Daewoo. In 1980 Desh produced 43,000 shirts worth $56,000. By 1987 sales had risen to 2.3 million shirts worth $5.3 million. The quality of Desh’s garments had also improved significantly. The unit export price increased by 75 percent from $1.30 to $2.30. Between 1980 and 1987 Desh expanded from 450 machines to 750 and its workforce increased to 1,400. Throughout this period Desh was handling its own export marketing and was buying all its raw materials from sources other than Daewoo.

Of the initial batch of 130 employees who had visited Korea in 1980, 115 had left Desh by mid-1981 to start their own garment exporting businesses and began replicating Desh’s success in other factories. By 1985 Bangladesh had 700 manufacturers engaged in garment exports.

jobs in the process. For poverty to be eradicated quickly, these institutions must be open to learning and adapting know-how that already exists and be capable of applying it efficiently. According to Harberger (1998, p. 27):

If, as I believe, the difference in efficiency between U.S. and developing-country firms is typically large, there is much room for quite rapid improvements in the developing countries as they learn how to adopt and adapt already-known techniques from the advanced countries.

The traditional factors of production—natural resources, capital goods, finance, ideas, and reasonably competent labor—are not hard to

---

5. Whether referred to as poverty reduction, wealth creation, or growth, a widespread rise in individual incomes requires productivity improvements and the provision of better products or services, because standards of living improve when people can acquire existing products or services at lower costs or better ones at acceptable costs.
obtain, but because poor people cannot simply move to areas where capable institutions already exist, pro-poor growth involves diffusing best practices and capabilities to areas where poor people live. As Wade (2002, p. 17) notes, “The engine [of development] is the advance of technology and the diffusion of technical capacities of people, firms and governments.”

Countries can learn the mechanics of organizing institutions. For firms, organizational practices can also be imported through foreign direct investment or the movement of firms within countries. The critical local element of good institutions that is hard to import is people’s ability to work well together, that is, their behavior and culture. Even firms cannot transplant cultures. A study of a large firm in Italy with operations in both the north and south of the country shows that workers’ behavior varies significantly in different parts of the country. When workers from the north move south, they start behaving like southern workers and vice versa (figure 10).

**Figure 10**

**Frequency of Worker Misconduct**

*In an Italian Firm, by Region of Birth, 1975–95*

*(ratio of the number of observations for which at least one misconduct episode was recorded to the total number of observations)*

Source: Ichino and Ichino (1997).
4

The Core Institutions of Markets, Firms, and Governments

Trying to stop a market is like trying to stop a river.

Vietnamese proverb

A nation's economic growth and competitive strength rest on more than natural resources, labor and managerial skills, available capital or even the size of internal markets. The wealth of nations during the past hundred years has been based more on the ability of industrial enterprises to adopt and to develop . . . technologies and to devise administrative structures to co-ordinate the . . . processes of production and distribution.

Alfred Chandler (1997, p. 63)

What distinguishes modern government from personal control is its unremitting character. To be governed is to be subjected to the regular pressure of an authority operating to fixed rules . . . In the full sense of the word, it is arguable that nobody was governed before the later 19th century.

Jean Dunbabin (quoted in Finer 1997, p. 70)

Markets are institutions that arise spontaneously even without government intervention. In the most desolate places merchants ply their trade and supply people with goods and services. Lawless places like Somalia demonstrate that trade in almost all goods at world prices can be organized in the absence of government. Even cell phone service with prepaid cards is available in Somalia, as is basic electricity service—for those who can pay. Tiny enterprises and farms operate in all societies (McMillan 2002).
DIFFUSING BEST PRACTICES

Substantial and sustained wealth creation requires a complex division of labor and more complex organizations than arise spontaneously. The rise of modern firms operating in markets shaped by modern governments provides the institutional fabric for factors of production to combine more productively. To be productive, firms need to play by certain rules and be able and willing to cooperate. They need to respect such basic rules as property rights and contracts so that they have incentives to invest and cooperate with buyers and suppliers. To ensure that products and production processes fit society's expectations about socially and environmentally sound practices, firms also need to respect a variety of regulations that condition their property rights. Under such rules, which governments must establish and enforce, a symbiosis emerges with firms of various sizes that compete, trade, and contract with each other.

Experiments and Routines

Firms spread best practices and productive jobs to areas where poor people live, but this diffusion is not straightforward. As discussed earlier, various channels for improving firm-level performance are available that transfer best practices already developed elsewhere; however, not all firms are capable of benefiting from them, even when governments permit new firm entry and when firms are open to new methods of organization and production. Two fundamental reasons account for this. First, all entrepreneurial activity is fraught with uncertainty and therefore requires experimentation. Second, like any other organizations, firms need to create routines to cope with complex tasks. Thus failure is unavoidable for those firms that make the wrong bet or choose unsustainable routines.

Even simple production technologies, such as planting new farm crops, require adaptation to local circumstances. More complex technologies, such as automobile manufacturing, require extensive learning on the job. Korea's Hyundai Corporation undertook 14 months of trials to design its first prototype automobile. It then experimented with 11 prototypes, 2,888 engine design changes, 97 test engines, and more than 200 test transmissions and 150 test vehicles to produce its first commercial car in 1992 (Kim 1997).

In relation to routines, consider the Indian machine tools industry, which shows that the staff of mediocre firms could do much better than the firms they worked in. Management may not have
listened to them, may not have given them a chance, or may have been unable to restructure existing operations. The old companies were stuck in routines that prevented them from improving.

Routines are unavoidable, but different ways of pursuing a productive activity are often available. Even in everyday life people benefit from routines that simplify their tasks, and routines are even more important when aligning work practices in a firm. Routines are not bureaucratic aberrations but are a way of coping with complexity; however, they may fail to deliver.

**Competition**

The main reasons that firms fail are information problems, uncertainty, and limited ability to cope with complexity. So for firms to adopt best practices, mechanisms must be in place that deal reasonably well with the failure of firms. Such mechanisms need to allow physical assets, ideas, people, and funds to be used again in new and better ways when a firm fails. This is where the competition in markets comes in. Competitive markets select firms that pursue particular experiments or routines. They also provide incentives for market participants to improve and to adjust when they are facing failure. In some cases incumbent firms adapt successfully. In others new entrants drive out nonperforming firms.

Over the last 20 years researchers have undertaken considerable work in attempts to reach a better understanding of the way markets work. Most of this work looks at the industrial countries (Caves 1998; Sutton 1997; Tybout 2000), but a significant amount of work has also been carried out in the developing countries. The picture is similar in both industrial and developing countries, with the main difference being that developing economies tend to have a higher proportion of smaller firms than do industrial economies (figure 11).

**Heterogeneity among Firms.** Traditional economic textbooks treat markets as if all firms are efficient, driven by the incentives from the

---

price signals in markets. When demand increases new firms would enter, and when it decreases some incumbents would fail. In reality the picture is quite different. Typically existing firms are not similarly efficient. Instead they are quite heterogeneous, with substantial dispersion in productivity among firms and among sectors. Harberger’s (1998) detailed review of firm-level performance in 44 different manufacturing sectors in Mexico shows that in each sector some firms add value, some barely contribute, and others destroy value. The average productivity of firms in different sectors in India varies substantially and remains significantly below their potential productivity (figure 12).
FIGURE 12
ACTUAL AND EXPECTED LABOR PRODUCTIVITY, INDIA, 1998 and 2010
(indexed to the United States, 1998 = 100)

NOTE: Figures for expected productivity are derived on the assumption that all productivity barriers are removed. Most of the productivity improvements are expected to come from rationalizing the workforce, improving the organization of functions and tasks, and investing in viable assets.

Competition and the Dispersion of Productivity. In general, bringing average practice closer to best practice is enormously valuable for wealth creation. Individual firms often have similar opportunities to learn and improve but fail to do so for the reasons cited earlier. Competition is key to bringing average practice closer to best practice; hence competition is a critical part of the mechanism for diffusing best practice. A number of studies support this for countries such as Brazil, India, Japan, Korea, Russia, and Thailand (Hallward-Driemeier 2001; McKinsey Global Institute 1994, 1998a,b, 1999, 2000, 2001, 2002).
**Entry and Exit Patterns.** The key element of competition is the freedom to enter the market and to fail. Free entry means that substandard enterprises must be able to exit from markets. Where inefficient but politically well-connected firms are sustained through protection by or subsidies from governments or through bailouts by financial institutions, new firms can compete only with difficulty. Under such circumstances obtaining credit is hard, and new firms tend not to enter.

When entry is possible, new firms do not enter only when demand is up, and old firms do not leave only when demand declines. Every year around 5 to 20 percent of all firms enter the market and a similar number of older firms go out of business. Most new firms are small, and some 40 to 60 percent go out of business within five years of entering (Scarpetta and others 2002; figure 13). Data from developing countries suggest that the average new entrant is slightly more productive than the average firm exiting the market. Thus in most economies the turnover of firms helps increase productivity. In part this reflects the success of people who have previously failed. In part it reflects new entrants altogether.

---

**FIGURE 13**

**Plant Turnover and Market Share of Entrants, Selected Countries**

<table>
<thead>
<tr>
<th></th>
<th>One-year-old plants</th>
<th>Five-year-old plants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>5%</td>
<td>15%</td>
</tr>
<tr>
<td>Colombia</td>
<td>10%</td>
<td>40%</td>
</tr>
<tr>
<td>Morocco</td>
<td>15%</td>
<td>60%</td>
</tr>
<tr>
<td>Korea</td>
<td>20%</td>
<td>70%</td>
</tr>
<tr>
<td>Taiwan (China)</td>
<td>30%</td>
<td>80%</td>
</tr>
<tr>
<td>United States</td>
<td>40%</td>
<td>85%</td>
</tr>
</tbody>
</table>

**NOTE:** The plant turnover rate is the average of the entry rate and the exit rate of plants. **SOURCE:** Tybout (2000).
Opportunities for Small Businesses and Farms. Many of the key measures to help small farms and microenterprises are much the same as those aimed at other firms. De Soto has demonstrated both in writing (De Soto 2000) and in his experiments with setting up new small firms that burdensome entry regulations, red tape, and bureaucratic harassment, along with the absence of clear property rights and contract security, make it impossible for many small entrepreneurs to establish themselves, become formal, and grow. This spotlights the importance of programs to reduce entry regulations, reduce bureaucratic harassment, and clarify and formalize property rights (see box 3).

Internal Growth. Productivity growth comes not only from enterprise entry and exit, but also from the growth of existing firms responding to market incentives. Some of the new entrants succeed and the best become large firms (Rajan and Zingales 1998). Productivity growth also comes from large firms branching out and entering new markets, sometimes through mergers with and acquisitions of promising firms. As good firms become large they tend, on average, to have higher productivity than small firms, but small companies that happen to be particularly efficient exhibit the highest growth rates. Firms are productive not because they are a particular size, but because they are good (Aw 2002).

In a new industry small firms play the prime role in innovation and productivity development (see box 4). The good firms continue to improve through internal growth, taking over less well-managed companies or buying up promising small firms that need capital (Ravenscraft and Scherer 1987). Once firms have proven themselves and become large, they remain more productive and last much longer than the average smaller firm. Indeed, many large firms are like collections of small ones. They operate an internal market for corporate control, which can be superior to that of the broader market, and they owe their success to their ability to allocate people, capital, ideas, and assets better than firms operating at arm’s length from each other (Hellwig 2000; Klein 2000). Nothing is guaranteed, however, and large firms may also fail eventually.

Symbiosis of Large and Small Firms. All sectors in all market economies have a mix of many small, fewer medium, and a few large companies. The average size varies with economies of scale between sectors, but firms of many different sizes are found within sectors, not
The total value of the fixed property the poor in developing countries hold but do not legally own is around $9.3 trillion. This is 93 times the amount of official development assistance to developing countries over the past 30 years and 20 times the stock of foreign direct investment in developing countries between 1989 and 1999. Because the ownership of these assets is not formalized, however, people in poor countries cannot use them as collateral to raise cash.

Field research has shown that the reason why businesses stay informal and landowners do not register their property is not only because they have to pay taxes, but because the bureaucracy usually hinders them in their attempts to do so. For example, De Soto and a team of his researchers tried to register a one-man clothing workshop that they had set up outside Lima, Peru. It took 289 days, including many hours of filling out forms, traveling by bus into central Lima, and lining up to see the relevant officials to register their microenterprise. The whole undertaking cost $1,231—31 times Peru’s monthly minimum wage.

In Malawi people build houses on “customary” land, that is, land that the residents have no formal title to but that their families have cultivated for generations. The village chief usually oversees any disputes about boundaries. If a family breaks the tribe’s rules or leaves the property unattended, the chief has the power to take the land away and give it to someone else. The contract may be oral, or it may be written and signed by the chief. The problem is that no bank will accept it as collateral. The land and the property built on it turn out to be what De Soto calls “dead” capital.

All the rich, industrial countries have clear, enforceable, and almost inclusive property rights. Even though better property laws are not the only reason why some countries are better off than others, De Soto finds that they make a significant difference.

Source: De Soto (2000).
In the 1920s and 1930s pilots flew around 100,000 different varieties of airplanes. All over the world enthusiastic inventors were selling airplanes to intrepid pilots and to fledging airlines. Many of the pilots crashed, and many of the airlines became bankrupt. Of the 100,000 types of airplanes, about 100 survived to form the basis of modern aviation. The evolution of the airplane was a strictly Darwinian process in which almost all the varieties of airplane failed, just as almost all species became extinct. Because of the rigorous selection, the few surviving airplanes are reliable, economical, and safe.

Source: Dyson (1998).

Types of intricate networks of firms exist, within large companies, between large and smaller ones, and in clusters of various types.

The way that a firm enters, grows, and exits varies from country to country, an area little studied so far. A recent Organisation for Economic Co-operation and Development (OECD) study (Scarpetta and others 2002) shows that the average new entrant in the United States is less efficient than existing firms, but entry is valuable because it allows people to try out new ideas, and the companies that turn out to be good can easily grow to become larger. Most productivity growth in the United States is therefore due to the internal growth of firms and not to the entry of more efficient firms, but in several European countries the entry of better firms accounts for a large part of productivity growth and internal growth appears to be less effective. This may reflect barriers to growth in those countries, such as labor regulations for firms above small sizes (figure 14). In developing countries extremely small, informal enterprises proliferate and prefer to remain informal because of the burden of regulations and taxes on formal firms.

In the ecology of firms, markets leave ample room for new organizational species to emerge, which could include atomistic small firms, large hierarchical firms, internal firm markets for corporate control, and all sorts of cooperative arrangements among firms. Customer demand provides the main feedback mechanism, as those
firms that meet customer demand most effectively are the ones that survive. The diffusion of best practice is accomplished within this well-functioning ecology, not by any single measure or any single type of firm. Governments shape the ecology and the niches allowed by the way they set property rights, regulations, taxes, and other relevant parameters.
In relation to generating growth or establishing competitiveness, special government support beyond allowing the ecology of firms to work is often justified in the case of market failures that may affect learning processes and access to finance. Learning needs time; hence proponents of protection argue that certain sectors that have the potential for growth might need some kind of temporary protection until they are ready to face the onslaught of full international competition. To some extent learning is also embodied in individuals. When firms spend resources to train individuals, the latter might decide to leave and reap the benefits for themselves, which could make firms overly reluctant to invest in training. In relation to access to finance, financial institutions may be unwilling to lend to small and medium enterprises because they have little track record; are likely to go bankrupt within a few years; and are typically dependent on a single owner or just a few persons, who might be affected by illness or other sudden adverse events.

Large Firms as Institutions for Coping with Market Failure

Special institutional innovations are needed to cope with such market failures. The larger firm itself is precisely such an institution. Indeed, it is the first line of defense against market failure. It is capable of

7. Smaller firms, in particular, can overcome the problem of incentives to train as long as they are able to employ apprentices at extremely low wages, as happens in a number of countries. Many people may then choose to learn at low wages in small firms in the expectation of higher incomes later rather than taking on an initially better paid job elsewhere that will yield a lower lifetime income. Where labor regulations prohibit low wages for apprentices, small firms may not have the right incentives to invest in training.
Building a track record that will satisfy financial institutions, it is less dependent on individuals than smaller firms, it can invest in small subsidiaries while they learn, and it is more likely to retain staff (because of the broader range of employment opportunities and career advancement than in small firms) and benefit from investment in training.

**Collateral and Credit Information Systems**

As a second line of defense, governments can help with access to credit by establishing functioning property rights systems that allow collateral systems to function so that individuals and small firms can obtain access to credit (Fleisig 1995). For example, small enterprises can secure finance through mortgages on the enterprise owner's real estate. Credit information systems that help track the payment records of individuals and small firms are another key mechanism to help small market participants establish their credit and hence obtain access to finance.

**Support Programs for Small and Medium Enterprises and Farmers**

Beyond these basic measures, on which consensus is relatively widespread, governments can establish additional programs to support small and medium firms. Most countries have directed and subsidized credit programs for small urban and rural enterprises and farms. Advisory services for farms and small firms, for example, on new crops or farming techniques or on business management, are also widespread. The most complete review of studies on experience with such schemes worldwide suggests, however, that few schemes have been properly evaluated (Batra and Mahmood 2001). Overall, many are ineffective or are abused, especially subsidized schemes. The key conclusion that emerges from experience is that the schemes with the greatest chance of working well are those that are aligned with basic market principles. For instance, good credit support programs tend to avoid subsidized credit terms, and sound approaches to advisory services tend to emphasize the creation of demand for such services and delivery via market mechanisms. In addition, special support schemes seem to require a sound, basic, overall policy framework for markets where they operate.
Industrial Policy

Special government support for domestic firms of all types has typically been referred to as infant industry protection or industrial policy, even though such support might also affect other sectors, such as services or agriculture. Essentially, industrial policy consists of a mix of policies that create room for domestic firms to learn and to obtain finance so as to improve productivity. In many countries such policies have been a disappointment. The case of the Indian machine tool industry cited earlier provides an example, where a protected industry did not use protection to learn, but was satisfied with substandard performance. Supporters of industrial policy argue that in East Asian economies like Japan and Korea, industrial policy has often helped. Pack (2000) examines productivity performance in Japan and Korea sector by sector and finds that the sectors that benefited from special support contributed only a modest amount to productivity growth (figure 15). Thus overall, even in the two arguably most successful cases of industrial growth, industrial policy has at best been a small factor in their success.

Clearly, to be successful industrial policy needs to expose those firms that are supported to some form of serious competition, for example, by tying continued support to export success in truly competitive markets as in the case of Japan and Korea (Stiglitz 1998a). If government intervention is to help, firms must be open to best practices and exposed to the selection mechanism of competition. Even analysts who question economic orthodoxy and are open to heterodox approaches conclude that “we do not want to leave the impression that we think trade protection is good for economic growth. We know of no credible evidence—at least for the post-1945 period—that suggests that trade restrictions are systematically associated with higher growth rates” (Rodriguez and Rodrik 2000, p. 317).

Politics of Support Schemes

Whatever form of intervention in support of access to finance or learning governments may consider for small and large firms, in urban or rural areas, basic market forces are apparently needed to give these policies a chance to succeed. Perhaps such interventions work in places where otherwise sound institutions and policies are in
FIGURE 15

EFFECT OF INDUSTRIAL POLICY ON THE GROWTH OF TOTAL FACTOR PRODUCTIVITY IN THE MANUFACTURING SECTOR AND ON GDP GROWTH, KOREA 1966–85 AND JAPAN 1960–79

Korea

<table>
<thead>
<tr>
<th>Average annual growth rate (percent)</th>
<th>With industrial policy</th>
<th>Without industrial policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td></td>
<td></td>
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<tr>
<td>6</td>
<td></td>
<td></td>
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<tr>
<td>4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
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<tr>
<td>0</td>
<td></td>
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</table>

Japan

<table>
<thead>
<tr>
<th>Average annual growth rate (percent)</th>
<th>With industrial policy</th>
<th>Without industrial policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td></td>
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<td>2</td>
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<td></td>
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<tr>
<td>0</td>
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</tbody>
</table>

Note: This analysis is based on the assumption that growth in the manufacturing sector accounted for only a third of the growth in GDP in both Korea and Japan. The total factor productivity growth figures relate to the manufacturing sector only and not to the whole economy.


place anyway. Note that in connection with such successful special schemes as export promotion, industrial policy, and the like, the same small group of countries is mentioned again and again, especially Japan, Korea, and Singapore (Keesing and Singer 1990; Rhee, Ross-Larson, and Pursell 1984; Thomas and Nash 1991).

Doubts about their effectiveness have not reduced the attraction of various forms of government support schemes, for example, those for small and medium firms, which are popular all over the world. Other subsidy schemes are also widespread, and the evidence about their effectiveness is neither strong nor weak; however, some, such as special

8. This is the same as aid effectiveness, where aid is successful when policy and institutional development are already on the right track.
fiscal incentives for foreign direct investment or some agricultural sup-
port schemes in major OECD economies, tend to face somewhat more
skepticism. This suggests that the drivers of support schemes actually
have little to do with economic considerations and may mostly be part
of the political give and take of any nation. In particular, the spread of
best practices and more productive jobs upsets old patterns of produc-
tion, typically disrupts the lives of some people while improving the
lives of others, and in the end is the way to raise living standards
broadly. Support schemes may therefore help good policy because they
may moderate the pain of adjustment and help build political backing
for it; however, they may also help entrench vested interests and the
survival of inefficient firms and thereby hold back productivity growth.

**Insurance Schemes**

Thus a major issue for policymaking is how to deal with demands for
special support schemes. On the one hand, political acceptability may
require such schemes. On the other hand, they must be designed in
such a way that they do not undermine the workings of sound mar-
kets and the development of world-class capability in firms. While
the politics of each country probably require somewhat different
approaches, one general principle may be valid. As discussed earlier,
the creation of successful ventures or firms requires taking risks.
Experimentation is needed and failure is unavoidable. People are
more likely to take risks when they know that they have some safety
net to fall back on in case of failure. A sensible social safety net is
therefore good for efficiency and growth, not just for equity and fair-
ness. For example, the concept of limited liability, which limits busi-
ness owners’ losses, has helped promote entrepreneurship. Similarly,
small farmers are more likely to invest in risky ventures when they
have a way of insuring themselves against failure.

Political acceptability and economic efficiency may therefore be
helped by designing forms of insurance appropriate for a particular
economy. For example, industrial economies are likely to be able to
afford large-scale unemployment insurance, while smaller insurance
schemes are practical in poor countries. The latter schemes would
include microfinance programs, which are mostly used not to fund
investment but to help deal with temporary inability to pay for con-
sumption and spread the default risk among small groups of people
(Morduch 1999).
DIFFUSING BEST PRACTICES

The New Swedish Model

The general picture that emerges for desirable government policy might be termed the new Swedish model. Before the 1990s economists often saw Sweden's economic policy as a “third way” that fell somewhere between capitalism and socialism. After the economic crisis of the early 1990s, Sweden and several other Scandinavian countries remodeled themselves by combining the traditional emphasis on social security and safety nets with renewed emphasis on maintaining sound macroeconomic policies and a competitive business environment. The cornerstones of the current model are as follows:

- A set of prudent macroeconomic policies and low inflation (Dollar and Kraay 2000)
- A highly competitive environment for firms, with few barriers to entry and growth and minimum red tape (figure 16)
- A strong social safety net

As countries develop, the complexity and average size of their institutions, be they firms, government agencies, or other forms of organizations, increase. The share of government in total economic activity also increases, not because the government interferes with production decisions and the ecology of firms, but because of the growth of the transfer payments that lie behind the social safety net of industrial societies. The new Swedish model, whether referred to as capitalism with a heart or socialism with a head, appears to be the main avenue ahead.

Partial and Heterodox Reform

The question remains how good governance in society at large arises and what can be done to promote it. A critical point is that we do not know how to engineer good governance. A plausible explanation is that pure chance and luck play a large role in the creation of successful societies (Easterly 2001). In addition, highly incomplete reforms have to be sufficient for growth to take off; otherwise no country would ever have developed. For example, countries like Bangladesh and China have seen progress, admittedly of varying degrees, by pursuing only partial reforms and despite continuing and pervasive governance issues. Many successful countries have pursued policy mixes that appear to be heterodox, like China, India, Japan,
FIGURE 16
COMPARISON OF REGULATION IN SWEDEN WITH OECD AND INTERNATIONAL AVERAGES, 2002

Number of procedures needed to register a business

<table>
<thead>
<tr>
<th></th>
<th>Sweden</th>
<th>OECD average</th>
<th>International average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of days</td>
<td>5</td>
<td>7</td>
<td>10</td>
</tr>
</tbody>
</table>

Number of days it takes to register a business

<table>
<thead>
<tr>
<th></th>
<th>Sweden</th>
<th>OECD average</th>
<th>International average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of days</td>
<td>18</td>
<td>33</td>
<td>58</td>
</tr>
</tbody>
</table>

Index of formalism in court enforcement

<table>
<thead>
<tr>
<th></th>
<th>Sweden</th>
<th>OECD average</th>
<th>International average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index of formalism</td>
<td>2.98</td>
<td>3.08</td>
<td>3.53</td>
</tr>
</tbody>
</table>

NOTE: The index of formalism measures substantive and procedural statutory intervention in judicial cases at lower-level civil trial courts.
Korea, and Vietnam. Others, such as Chile and El Salvador, have successfully pursued relatively orthodox policies, again with varying degrees of success. At the same time partial reform and heterodox policies may be associated with arrested development, as in the case of countries that unsuccessfully pursued import substitution. Likewise a heavy dose of orthodoxy has not by itself helped some countries, for example, in Latin America, to grow rapidly.

**Creative Destruction**

Successful development may also require the destruction of vested interests, that is, some form of revolution (Olson 2000). It can therefore be quite disruptive for some time, with unavoidable winners and losers. Arguably Germany, Japan, Korea, and Taiwan (China) all benefited to some degree from the disruption of war and from policies in part imposed by the United States after World War II. How much disruption is unavoidable and how much is excessive remains unclear.

**Competition among Jurisdictions**

Given the uncertainty about the exact mix of reforms and institutional change that makes for successful development, allowing experimentation with different mixes of institutional and governance reform must surely be valuable. Today’s industrial economies exist because of the Industrial Revolution that started in Europe. Competition among squabbling European states and principalities led to the world’s growth miracle, termed the “European miracle” by historian Edwin Jones (Jones 1987). China, a previously advanced nation, was left behind as central control and the domination of mandarins over merchants arrested development.

Thus a selection mechanism is also important for the development of good governance, namely, competition among nations, or more generally, among various types of jurisdictions: across countries or across states within, for example, federal systems. Both for the firm and for the government, a symbiosis of competition and rules-based cooperation seems to be required for complex societies to emerge and allow their citizens to prosper.
Effective wealth creation requires capable institutions. A complex symbiosis of competition and cooperation on the basis of accepted rules characterizes successful societies. We understand some of the basic measures required to establish such societies—for example, respect for property rights and contracts and freedom for firms of all types to enter markets as well as to fail. Just as we cannot predict exactly which type of firm will succeed, so we cannot predict which type of government policy and institutional mix will be most successful. Competition among jurisdictions is as important to institutional development as that among firms. We have learned some basics about how to facilitate development, but we do not know how to engineer it and have to remain open to experiments. The hope is that we can improve the chances of success of unavoidable experiments by studying the way markets, firms, and governments interact in more detail (World Bank 2001b).
References


REFERENCES


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REFERENCES


REFERENCES


About the Author

Michael Klein is the World Bank-IFC vice president for private sector development and chief economist of the International Finance Corporation.

He is the author of *The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines*. He has published numerous articles on privatization, regulation, and project finance in infrastructure sectors.

Prior to his current position he was the director of the joint Bank-IFC Private Sector Advisory Services from 2000 to 2003. As the chief economist of the Royal Dutch/Shell Group from 1997 to 2000, he advised on worldwide economic developments and industry issues. He joined the World Bank in 1982 as an economist on oil and gas projects, trade and industrial policy, financial sector reform, and macroeconomic analysis. In 1991 he became head of the unit for non-OECD economies at the Economics Department of OECD. In 1993 he rejoined the World Bank and became senior manager, private participation in infrastructure, focusing on issues of market structure, regulation, privatization, and project finance in the telecommunications, transport, energy, and water sectors. Before joining the World Bank, Michael Klein was active in Amnesty International for many years and served on its German board (1977–79) and International Executive Committee (1979–82). He studied in Bonn, New Haven, and Paris and received his doctorate in economics from the University of Bonn, Germany.
Diffusing Best Practices and Creating Capable Institutions

Perspectives on Policies for Poverty Reduction

Michael U. Klein

According to the author, poverty reduction is about bringing economic growth to poor areas. Because poor areas can benefit from technical and organizational innovations made elsewhere in the world, it is possible today to create productive jobs faster and in greater quantity than ever before.

The puzzle is what helps spread such “best practices.” Saving, investment, education, resources, and new technology are all needed—and fairly easy to obtain. What is hard to obtain are the institutions that allow these factors of production to be combined and translated into productive job creation. Firms are the key vehicles that spread best practices and productive jobs to areas where poor people live. Because we can never be sure which firms will be successful, it is necessary that new firms are able to enter markets, that substandard firms are allowed to fail, and that good firms face few barriers to growth. This is the definition of competition, and competition is what selects good firms and thus drives the spread of best practice and productive jobs.

Governments need to provide the framework in which capable firms can emerge. Yet the right mix of government policy and institutional change and how it affects firms are not fully understood. Some selection mechanism that allows for policy experiments and selects successful ones is valuable for national, provincial, and local governments. Thus competition among jurisdictions and firms is an integral part of dynamic social systems that hold promise for creating wealth and ending poverty.

Michael Klein is vice president of Private Sector Development at the World Bank and the International Finance Corporation and the chief economist of IFC.