State Failure in Developing Countries and Strategies of Institutional Reform

Mushtaq H. Khan
Department of Economics, SOAS, University of London.

Abstract: The analysis of state failure and the policy debate have been driven by two very different underlying views of what the state does. The first, which we call the "service-delivery" view says the role of the state is to provide law and order, stable property rights, key public goods and welfarist redistributions. In failing to provide these, state failure contributes to economic under-performance and poverty. State failure of this type is in turn related to an inter-dependent constellation of governance failures including corruption and rent-seeking, distortions in markets and the absence of democracy. All of these need to be addressed to focus the state on its core service-delivery tasks. The second locates the developing country state in the context of "social transformation": the dramatic transition these countries are going through as traditional production systems collapse and a capitalist economy begins to emerge. Dynamic transformation states have heavily intervened in property rights and devised rent-management systems to accelerate the capitalist transition and the acquisition of new technologies. State failure according to this view has been driven by the lack of institutional capacities in these respects, and more importantly, the incompatibility of institutional capacities with pre-existing distributions of power. An examination of the econometric data and historical evidence raises serious doubts as to whether the governance reforms suggested by the first view can improve growth, while the need for reforms identified by the second view are much better supported. This suggests the need for a significant shift in the focus of institutional reform, as well as identifying the importance of political reorganization in poorly performing economies.

Draft of paper for World Bank ABCDE Conference, Oslo 24-26 June 2002.

I am indebted to Alice Sindzingre for going through several drafts and giving valuable criticisms and comments as well as to Stephanie Blankenburg and Machiko Nissanke.

State Failure in Developing Countries and Strategies of Institutional Reform

Mushtaq H. Khan
Department of Economics, SOAS, University of London.

Theoretical and policy debates on the role of the state and therefore on the location of state failure in developing countries have been driven by two very different underlying views of what the state does. A lack of clarity on this underlying difference has been the source of much confusion. We will define the first as the "service delivery" model, which we argue has underpinned the mainstream consensus view on the state, and the second as the "social transformation" model, which looks at the role of the state in the context of the transition to capitalism. The first focuses on a range of services which states should deliver: in particular "law and order", public goods, social security and market regulation; the second looks at the more critical and problematical role the state plays in the transformation of essentially pre-capitalist and pre-industrial societies into dynamic and essentially industrial capitalist ones. The service delivery conception is not entirely wrong as states in developing countries deliver services as well, but the second is a broader conception that subsumes the first. Historically, success in service delivery has depended in most cases on the success of states in pushing social transformation rapidly in the direction of viable capitalist economies. We argue that the more critical area of state failure has been the absence of adequate institutional and political capacity in developing country states to assist and accelerate a dynamic transformation. Without strategies to enhance this role of the state, sustained progress is unlikely on service delivery either. We argue that many of the consensus policies on reforming institutions to improve service delivery are based on a partial reading of theory and evidence. They are at best unlikely to work and at worst could further undermine the state's institutional and political capacity for ensuring a dynamic transformation.

The pivotal role of the state is based on its claim to the monopoly of legitimate violence. It is the only body in society which can legitimately enforce institutions, collect taxes, redistribute income and wealth, represent and enforce social cohesion or resolve conflicts, in all cases using force if necessary. All of these functions are interdependent and they have a role to play in both service delivery and in social transformation. We cannot look at all of these, but fortunately the role of the state in creating and enforcing institutions shows the interdependence between many of these functions. Institutions are the "rules of the game" that set incentives, opportunities and limitations for individuals or organizations. The key institutions enforced by the state include the system of property rights, the interventions that define rents and incentive structures (which include taxes and subsidies), and the higher level political institutions such as democratic or authoritarian decision-making bodies that describe the rules for changing rules. Since variations in this set of institutions can potentially have big effects on the quantity and quality of investment, economists agree in very general terms that state failure can have a significant effect on growth (for instance, Bates 2001, Bardhan 2000, Olson 2000, Stiglitz 1998, Shleifer and Vishny 1998, Lal and Myint 1996, Khan 1995, North 1990, Migdal 1988, North 1981). It follows that adjusting for differences in initial conditions, persistent shortfalls in growth rates compared to comparable countries provides *prima facie* evidence of state failure and its severity. While we will not be directly addressing static redistribution issues, the strong statistical relationship between growth and poverty reduction (Dollar and Kraay 2001, Lal and Myint 1996: 25-44) also implies that state failure is responsible for the poverty of many developing countries.

To help the discussion, we will define state failure in the broadest terms which can loosely incorporate both positions on the role of the state. Based on Ann Krueger's (1990) definition of government failure, we define state failure as consisting of both "errors of omission", when the state fails to do things that could have improved economic performance, and "errors of commission" when the state does things which worsens economic performance. While the identification of state failure implies a judgement that better economic performance could have been achieved, the challenge is to identify the institutions would could achieve this better performance. The service delivery model uses as its benchmark a model of a well-working market economy which we will loosely refer to as the liberal-market consensus, without implying that everyone within this consensus agrees in all respects. The consensus argues that to generate growth, states have to protect stable property rights, defined by strong contract enforcement, low expropriation risk, and low corruption; they have to ensure undistorted markets defined by low rents; and they have to achieve democratic accountability and civil society participation to keep the state in check. The key service delivery capacities of the state are to provide protection for property rights, and to deliver democratically decided-upon public goods efficiently.

The consensus view has rapidly come to enjoy widespread support because many of the reforms it supports, such as democratization, the achievement of greater openness and accountability, pursuing anti-corruption campaigns and so on, are rightly supported by most people as *ends in themselves*. The danger is that the new consensus is based on a partial reading of the theory and evidence and does not address the core issue of transformation. As a result we will argue that if international agencies give the impression that these reforms are *instruments* that can overcome state failure and help achieve economic takeoff, we are likely to face a crisis of expectations very soon. The benchmark of good institutions described by the new consensus does indeed fit aspects of the institutional structure of advanced countries and poorly performing developing countries do indeed fail to approach this benchmark. Nevertheless, we will argue that the reform package which aims to push institutions in developing countries in the direction of a generalized advanced country model is not actually relevant for assisting developing countries in carrying out the *transition* from essentially pre-capitalist societies to dynamic capitalist ones. It is important to point out that the fight for a deepening of democracy or against corruption are legitimate in their own right. Our concern is only whether these reforms can either be meaningfully implemented or make an *economic* dent in the growth paths of poorly performing countries.

Theory and evidence can be interpreted to suggest a different and much more demanding agenda of reform to combat state failure. Development is an ugly and conflict-ridden process, not just because of corruption and the lack of democracy but primarily because social structures are rapidly changing, new classes are emerging and new wealth is being accumulated at historically unprecedented rates. This social and economic transformation happened in advanced countries over centuries. A shock of a similar magnitude has hit developing countries telescoped over a period of decades and (perhaps partly as a result), the transition to capitalism has been much more patchy. Old production systems have collapsed often well before new ones can take over, social conflicts are intense, and stable and productive political constituencies on which viable democracies can be based are often absent. At the same time, political and economic expectations are higher than at any time in the past. The real question facing developing countries is whether these processes are likely to lead to a viable and dynamic capitalism as it appears to have done in a few high-growth economies, or whether it will lead only to the theft of resources by unproductive classes and a descent into anarchy. The institutional reforms identified in the consensus view are almost totally irrelevant for ensuring that this dramatic period of transition is directed in the direction we want. By referring to some of the data, the historical evidence and the theory which can be brought into play to interpret it, we hope to inject a note of caution into the interpretation of this consensus by policy-makers. The consequences of yet another round of multilateral-led reform in developing countries running out of steam do not need to be spelt out.

We will argue that getting developing economies through this transformation successfully has historically required stronger and more interventionist state capacities than are envisaged in the liberal-market consensus. First, states in high-growth economies participated in the transformation of their economies and societies by assisting in the creation of new productive classes and ensuring that they succeeded in acquiring technology and entrepreneurial capacity. This involved using a range of policies *including active interventions in property rights and the management of growth-enhancing rents* (Rodrik 2002, Khan and Jomo 2000, Woo-Cumings 1999, Lall and Teubal 1998, Aoki, Kim and Okuno-Fujiwara 1997, Rodrik 1995, Page 1994, Chang 1994, Wade 1990, Amsden 1989). The policy conclusion which follows is that policy-makers have to focus on these transformation capacities to enable states to push the "capitalist transition" if economic underperformance is to be addressed.

But secondly, it is clear that recounting the transforming role of state intervention in the high-growth economies does not provide directly relevant lessons either, because most developing country states failed to achieve similar goals despite frequent attempts. Here much of the developmental state literature is also weak in locating where state failure resides. An important aspect of state failure during the transformation is the failure to enforce *any* institutions, a problem that Myrdal had pointed out long ago (1968: 895-6). We argue that the distribution and disposition of political power in society is a key determinant of enforcement success, and the emergence of high-growth states is therefore as much a task of political as it is of institutional engineering to ensure that states are able to enforce painful and socially contested decisions. This explains why institutions that work well in one context may fail badly in another. We argue that the evidence supports the claim that *the most persistent types of state failure occur when institutions fail because of an inappropriate match between internal political settlements and the institutions and interventions through which states attempt to accelerate transformation and growth* (Rodrik 2002, Khan 1995). There has to be a policy recognition that in most cases, political conditions are not conducive for states to acquire and exercise transformation capacities. In these cases, policy-makers have to be concerned with how the disposition and organization of political power needs to change over time. It is unfortunately a misconception that democracy is sufficient to consolidate productive groups and undermine unproductive ones. While direct intervention in the political organization of developing countries is outside the remit of international agencies or researchers, the opening up of a debate about how growth-promoting political coalitions can be constructed is not. On the contrary, by focusing on a set of narrow service-delivery institutional reforms, international agencies are doing little to prevent the consolidation of unproductive groups in many of the poorest economies. These concerns suggest both that the consensus reforms should not be uncritically pushed and points to areas where policy-oriented research should focus. In the next section we look at the theory and evidence underpinning reforms based on the service-delivery model. In the subsequent section we look at the theory and evidence supporting the need to focus on the capacities of the state which ensure dynamic transformations. The last section concludes with a look at the implications.

The Service-Delivery State

The standard textbook list of service-delivery functions of the state are well-known. These include the provision of law and order, the correction of market failures and particularly the provision of essential public goods, and limited welfarist redistributions. Underpinning the service-delivery conception of the state are a set of well-developed theories of how a liberal-market economy works. We will briefly outline three theoretical component and the inter-connections between them that are relevant for our discussion. These have combined to produce the liberal-market consensus underpinning the service-delivery view of the state[1].

Efficient markets are rent-free and have stable property rights. The standard theory of efficiency in competitive markets has been deepened by institutional analysis showing that stable and well-defined property rights are a precondition for efficient exchange, and they also create incentives for long-term investment (Bates 2001, North 1990). In contrast, rents in markets provide *prima facie* evidence of restrictions on competition and if this is achieved through interventions in property rights, they also undermine confidence in the future. Rents are incomes that individuals can earn that are higher than in their next-best opportunity and so rents exist if those in the next-best activities are prevented from getting access to particular resources or opportunities. This could be because of protected rights over information, monopoly rights to supply particular markets, rights over subsidies, or even rights over a valuable natural resource. Of all the different types of rents, monopoly profits and special interest subsidies are typically used as examples to argue that efficiency requires rent-free markets. We will see later that the new information economics critiques this model of the market, but the simpler view still dominates the liberal-market consensus on the state. In term of service-delivery, both errors of commission, such as the creation of monopolies, and errors of omission such as the failure to provide infrastructure, can be explained in terms of (successful) attempts to capture such rents.

Rent-seeking creates rents and destabilizes property rights. The persistence of damaging rents is in turn explained by models that look at the incentives for rent-seeking, developed from the now classic work of Krueger (1974) and Posner (1975). Rent-seeking consists of activities such as lobbying and corruption to persuade states to create rents, while at the same time wasting resources in unproductive persuading activities. The literature on rent-seeking has been growing (Khan 2000b), and has been extended by a more recent subset of literature addressing the causes and effects of corruption (Andvig and others 2000, Bardhan 1997). Corruption is a form of illegal rent-seeking where the rent-seeker uses bribes to influence public officials. One of the most damaging effects of rent-seeking and corruption is to destabilize property rights, since the creation or re-allocation of rents always requires appropriate changes in rights.

The absence of democracy and a weak bureaucracy allows rent-seeking to continue. Finally, to explain why this damaging rent-seeking continues even when the majority is hurt by it, the consensus identifies a number of factors. First, the absence of democracy increases the chances of small groups being able to continue with their socially damaging rent-seeking (Olson 2000, 1997, North 1990). Secondly, low bureaucratic salaries, a politically appointed (hence transient) bureaucracy and a weak judiciary can all reduce the expected cost to public officials of accepting bribes, making rent-seeking more likely (World Bank 1997).

[1] While the post-Washington consensus defined by Stiglitz makes powerful criticisms of the Washington consensus, we argue that on reforming the state there is a broader consensus that includes both.

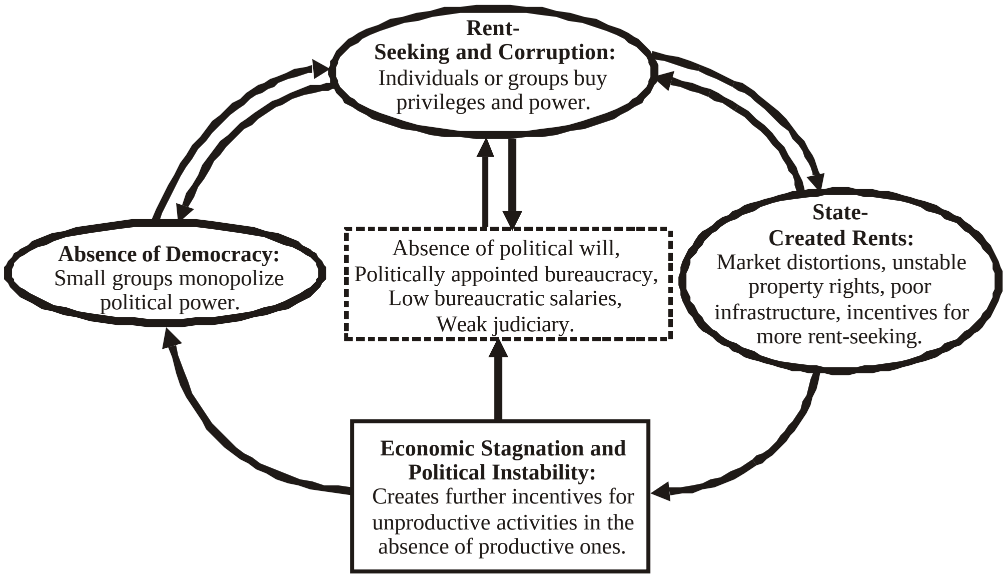

Figure 1 State Failure: The Liberal-Market Consensus

Figure 1 shows how these three core components can interact to lock developing countries into persistent state failure defined as poor service-delivery in key areas such as the protection of stable property rights and infrastructure provision, which in turn affect growth. Causality runs in both directions between most of the factors identified. Thus the absence of democracy not only allows rent-seeking to continue, rent-seeking reinforces the power of special interest groups. In turn rent-seeking not only creates rents, the presence of rents induces further rent-seeking. Weak bureaucratic capacity and low salaries not only allow corruption, corruption makes it difficult to organize the political will to reform the bureaucracy and can make the judiciary corrupt as well. This interdependence means that societies can get locked into undemocratic, high-corruption, and high-distortion equilibria (Bardhan 1997, Murphy, Shleifer and Vishny 1993, Andvig and Moene 1990).

The policy implication of the consensus model is that a number of *parallel* governance reforms are required to deal with state failure. Whereas in the past the focus would primarily have been on *economic reforms* to make markets competitive and rent-free, it is now argued that these policies will not be sustained without simultaneous *political reforms* and *institutional reforms.* Political reforms are understood as moves towards democracy and sometimes decentralization, together with an encouragement of civil society participation. Institutional reforms include moves to “rightsize” the state by focusing on service delivery, raise bureaucratic salaries, improve recruitment, and make the judiciary more independent. Fighting corruption overlaps with all of these reforms with additional specific efforts.

Correcting state failure, it is argued, requires moves on all these fronts simultaneously. These are preconditions for more specific improvements in the capacity of states to deliver public goods and stabilize property rights (World Bank 1997, Asian Development Bank 2000).

The Evidence.

The most significant support for the consensus view comes from a formidable array of econometric exercises (for instance, Hall and Jones 1999, Kauffman, Kraay and Zoido-Lobatón 1999, Johnson, Kaufman and Zoido-Lobatón 1998, Clague and others 1997, World Bank 1997, Knack and Keefer 1997, 1995, Barro 1996, Mauro 1995). These studies find that governance variables such as corruption, the stability of property rights, or democracy are correlated with developmental outcomes such as per capita incomes, the growth of per capita incomes, investment rates or direct indicators of poverty such as child mortality rates. But has the eagerness to establish that all good things go together coloured the measurement and interpretation of the evidence? Some of the data problems are well-known and cautionary statements are added in most of the studies, but taken together the data problems suggest that a much higher degree of care is required in interpreting the results.

The indices measuring governance quality are subjective by nature. Corruption, democracy, the stability of property rights and even the degree of policy-induced "distortion" are measured by indices based on perceptions, or judgements by "competent" observers. Polls are subject to the problem of scaling across countries while competent observers can have preconceptions of what they expect to see. Corruption, instability and distortions can appear to be less serious in high-growth countries even to competent observers, simply because things are working well. Finally, corruption, property right instability and distortions can vary widely in type and seriousness across sectors *within* an economy. In constructing a composite index, prior expectations can bias the choice of evidence and their weights.

Time series data is usually lacking for tests of causality. To see how governance may affect growth, we need both high and low-growth countries to test hypotheses. Most of the high-growth Asian economies began growing sometime in the sixties, seventies or early eighties. But governance indicators are only available from the mid-eighties onwards and the fuller data sets are only available for the nineties or later. Since high growth is expected to improve governance indicators, to test the causal significance of governance variables, we need to have governance indices for high-growth countries *before* they began their takeoff. Because such indicators are lacking, we are often explaining growth in the high-growth countries using their ex-post governance indicators or instrumental variables correlated with them.

There are insufficient observations of state success for satisfactory econometric results. Only a tiny handful of countries were successful developers over the last forty or fifty years. In any statistical exercise, these countries are swamped in terms of numbers of observations by advanced and developing countries with poor to moderate performance and information from the small number of successful developers gets lost as outliers. The problem is that this is the most interesting group of countries for learning how to develop. Incidentally, though small in number, they are not small in terms of population as they include Asian giants like China, but econometric studies do not normally weight observations by population size. The problem of insufficient observations will become clear later.

The high-growth developers are particularly important because even though governance indices are not available for periods *prior* to their takeoffs, their indices remain quite low for a considerable period *after* growth took off. For instance, in terms of the average of the Knack and Keefer (1995) indices of institutional quality based on quality of bureaucracy, rule of law, expropriation risk and contract repudiation by government, the Asian high-growth economies *even in the mid-eighties* come out only a little better than many poorly performing countries. Rodrik (1997: 15-17) points out that while growth *within* East Asian countries was correlated with the index, only Japan, Taiwan and Singapore have high scores and none were remotely poor by then. Indonesia scored the same as Burma, Congo or Ghana while South Korea, Malaysia and Thailand were at the same level as the Ivory Coast. Nor were most high-growth developers democratic when they began growing, or for a considerable period afterwards. As for corruption, Table 1 shows the *Transparency International* corruption index for the 54 countries for which the earliest index is available, for the period 1980-90. While the median growth rates of the East Asian developers were far higher than the other two groups, their corruption scores are not significantly lower than other developing countries. It is possible that if we had governance indices for periods *before* growth took off in the high-growth countries, the differences may have been even less.

Table 1 Growth and Corruption in 54 Countries 1980-90

	1. Developing Countries (24 Observations)	2. High-Growth Developers (6 Observations)	3. Advanced Countries (24 Observations)
Median GDP Growth Rate 1980-90 (Range)	**1.9** (-0.4 - 6.3)	**7.8** (5.2 - 9.7)	**2.8** (1.8 - 7.1)
Median Corruption Index 1980-85 (Range)	**3.46** (0.67 - 7.35)	**4.53** (0.2 - 6.29)	**8.14** (4.2 - 8.41)

The Transparency International Corruption Index ranges from 0 for highest to 10 for lowest corruption.

Interpreting the cross-country evidence. The governance data discussed above has the general pattern shown in Figure 2. Nevertheless, a positive coefficient is estimated for governance variables in regression exercises, which is not surprising given the bulk of observations in clusters 1 and 3 and the very few observations in cluster 2. Taking into account the discussion above, we can make a number of observations.

i) There is *no* historical example of any country that *first* improved governance to advanced country levels to achieve advanced country per capita incomes, growth rates or other characteristics. Reading this as a possibility from the regression line is misleading. The route to advanced country status may be very different as suggested in the diagram.

ii) Even if improvements in these governance indicators in poor countries results in *some* improvement in growth, the regression line does not show how they could achieve the "catching-up" growth rates achieved by the high-growth developers. Catching-up requires significantly *higher* growth rates than those achieved by the advanced countries.

iii) The growth rates in high-growth developers were associated with governance indicators that were *insignificantly* or only *moderately* better than developing country averages. This holds even without any adjustment for the fact that we do not have *ex ante* governance indicators for these countries. Unfortunately, because these countries were few in number, they have little effect on the regression line. If there were more high-growth countries, we would very likely have observed an inverse U relationship as indeed is observed in the case of democracy (Barro 1996). The non-linearity suggests something else was happening in the high-growth economies that we have not identified. It is not enough to say that countervailing factors such as high investment rates or high efficiency of investment operated in the high-growth economies since the institutional argument is that good governance has an economic effect precisely by enhancing investment and its efficiency. It should be said that not all econometric work supports the new consensus models. Notable among these are Treisman (2000) who finds that the effects of democracy and decentralization on corruption are very weak. Burkhart and Lewis-Beck (1994) find that rises in per capita incomes precede the emergence of democracy and not the other way around. But the contrarian results are relatively rare and refer mostly to political institutions such as democracy or decentralization.

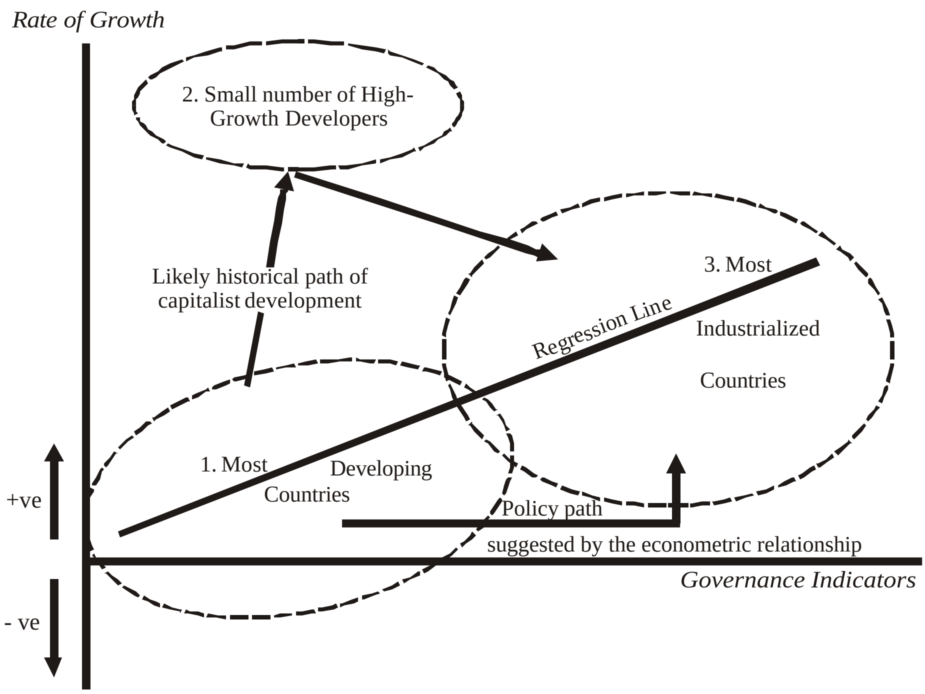

Figure 2 Governance and Development: Interpreting the Evidence

Our reservations do not imply that institutional and political reforms do not matter for growth. Nor is it necessary to reject the possibility that the reforms suggested could sometimes have moderately positive effects in some poorly performing countries. Rather the question is whether the consensus view and the statistical tests supporting it have identified the reforms that are necessary and sufficient for poorly performing developing countries to significantly improve their growth.

The Social Transformation State

States in developing countries play a much more critical role than the service-delivery model suggests. Developing societies are going through unprecedented social and economic changes in which the economic power and violence potential of the state is inevitably deployed for better or for worse. As rising expectations and social mobilisations destroy the political and economic viability of traditional societies, staying still is not an option. Far from being a service provider, the state is an instrument in the hands of contending classes, groups and political entrepreneurs each attempting to capture resources and steer the transformation in specific directions. State institutions and policies are always the outcome of conflict and negotiation between contending forces. But in advanced capitalist countries where there is already a dominant capitalist sector, democratic politics usually oscillates around a relatively narrow range of options that seek to conserve the dynamism of the capitalist sector and differ only at the margin in terms of distribution. This reflects two economic facts. First, much of the resources for running the political system comes from the capitalist sector. Second, and more importantly, the dominance of the capitalist sector means that the immediate welfare of most people, even if they are not capitalists, depends on the health of the capitalist sector. Neither of these restrictions operate to the same extent during the transition to capitalism where the capitalist sector is by definition not dominant. The absence of a dominating feedback loop from the performance of the capitalist sector to the political process allows a much greater range of variation in policies and institutions, and makes it possible for there to be sustained state failure in ensuring a dynamic transformation (Khan 2002). Our basic contention is that during this transition period, state success or failure is not related in any simple way to the state's neutrality in upholding pre-existing property rights, or its abstention from intervening in the economy or in social conflicts.

To narrow our focus to institutions, we examine potential locations of state failure during the transformation by looking at four dimensions along which states have differed. First, states have differed in terms of the *institutions and policies* observed during the transition. Second, they have differed in terms of *how effectively* these institutions were enforced. Third, there may be differences in *the costs of enforcement*, defined as the costs of creating, operating and enforcing institutions. Finally, *the processes driving institutional change* have differed across states. Institutions have changed in efficient directions in some cases but not others. This connects to the first point: if damaging institutions continue to derail the transformation, we want to know why. Figure 3 shows how the growth performance of a state can be attributed to these factors. Observed growth is high if the state supports institutions that are growth-enhancing, (or that change rapidly in this direction), if enforcement is effective, and the costs of enforcement are low. We discuss each of these dimensions of state performance in turn:

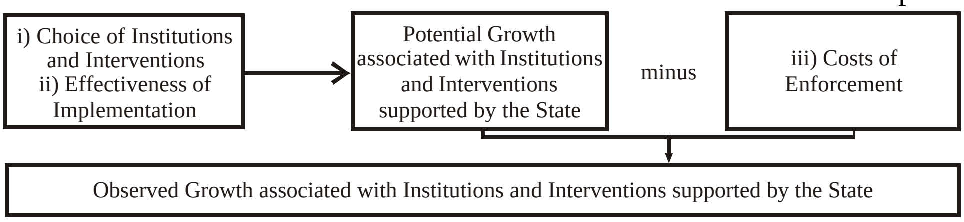

Figure 3 Factors Determining State Success or Failure

Institutional Structure, State Interventions and the Social Transformation.
We have seen that the liberal-market consensus argues that the institutional structure for maximizing growth is one which ensures there are no rents in markets, where the state maintains stable property rights, and limits the transfers it carries out. The main task for the state is to concentrate on the delivery of democratically agreed upon public goods and to have a tax system that is efficient in raising resources for these tasks. While public good delivery is very important, evidence from developing countries casts doubt on the adequacy of these positions. The state's ability to carry out relatively massive interventions in property rights systems has been critical in dynamic social transformations in many high-growth economies, as has been the creation and management of growth-generating rents. States have also carried out significant transfers which contributed to political stability and thereby made the emerging institutional structure politically viable. We discuss these in turn.

Dynamic states have the capacity to alter property rights in the interest of growth. Consensus theorists have frequently pointed out the instability of property rights in poorly performing countries. But in dynamic countries, the rapid emergence of new classes of capitalists has typically also entailed relatively long periods of instability of pre-existing rights. In fact, the standard theory of property rights does not actually say that well-defined property rights are always efficient. Coase, Posner and the founders of the modern theory of property rights pointed out that well-defined rights would help efficient re-allocations only if transaction costs were low. But by definition dynamic transformations involve potentially large re-allocations of rights to accelerate the development of the capitalist sector at a time when pre-existing market institutions are weak. The transaction costs of purely market re-allocation is likely to be high enough in such contexts to rule out rapid transformation. It follows that states exercising the right of *eminent domain* and re-allocating rights from above with compensations determined bureaucratically, or even without any compensation, could in theory significantly improve efficiency and growth. They could also make things a lot worse, so generalizations in either direction are likely to be falsified by particular cases.

The creation, transfer and destruction of property rights with the support of the state can involve many different mechanisms. It can involve legal and illegal transfers of resources across individuals and classes with state support, it can involve straightforward nationalizations and privatizations, or it can involve more subtle fiscal and price interventions that accelerate the transfer of rights to new classes. State-supported changes in the property rights structure which go beyond what would have happened through bilateral "market" negotiations can lead to enormous social waste in some cases when predatory classes or state leaders grab resources to consume or bank abroad. But dynamic capitalists have also emerged through these processes, not only in developing countries but also in the currently advanced countries if we go back long enough in history. The outcomes depend not on the stability of prior property rights structures but on who is capturing resources and the institutional structure imposing discipline.

When a dynamic capitalism emerges, the new property rights system can rapidly stabilize either because the interests of new capitalists and the state converge or because emerging capitalists can spend enough to control or influence the state. If we look at property right stability in high-growth economies once their growth has stabilized, we can get the misleading impression that property right stability was the *cause* of growth. This is where historical evidence is important. This shows that virtually all high-growth states undertook dramatic re-allocations of property rights in the early stages of their takeoffs when such re-allocations were judged to be in the economic or political interests of the state. The stability which distinguishes high-growth states is not a stability of property rights but rather a more subtle stability of commitment to growth, which means that dynamic entrepreneurs could have stable expectations that *if* they remained dynamic, they were unlikely to be touched.

Before the economic takeoff in South Korea and Taiwan, their states carried out rapid and far-reaching land reforms, in South Korea between 1949 and 1950 and in Taiwan between 1949 and 1953. All agricultural land above a very low ceiling was compulsorily acquired by the state at a price much below the market price and distributed to tenants at this artificially low price. By any account, such enforced transfers are not consistent with well-defined property rights. In Thailand transfers of public and natural resources to emerging capitalists happened in a more decentralized way through "primitive accumulation" organized by emerging capitalists who controlled local money politics and the state (Pasuk and Baker 1997). Not surprisingly, Thailand in the eighties was characterized as one of the most corrupt countries in the world and yet managed to grow rapidly for a couple of decades. Failed transformation states are also characterized by regular seizures of land and resources by the politically connected from the weak and the politically unconnected, but in these cases, the grabbers are not operating under a broader institutional system which induces or forces them to become productive capitalists.

Lal and Myint (1996: 85-99) argue that the most important role of South Korean industrial policy may have been to transfer massive amounts of wealth to an emerging capitalist class more rapidly than might have happened in a market, while maintaining sufficient discipline to ensure that this process was not entirely captured by inefficient groups. In fact, the ability of the South Korean state to re-allocate rights also contributed significantly to the effective implementation of its industrial policy regime. The conditional subsidy scheme for learning technologies could have had high social costs if as a result many plants had to be scrapped. But in practice, not only subsidies, but plants too were re-allocated across industrial groups when failure appeared likely. The state was involved in frequent corporate restructurings that re-allocated plants, using its financial muscle in the banking sector to get its way (Lee 1991: 454, Chang 1994). Often this power was misused, as when in 1985 the Kukje group, the country's sixth largest conglomerate of the time, was brought down because it offered insufficient paybacks to the regime (*Far Eastern Economic Review* April 21 1988, Fields 1995: 58). The ability of the government to push the big conglomerates around inevitably declined over time, so that when in 1990 President Roh ordered forty-nine chaebol to sell their real estate holdings that he believed were speculative, he found it very difficult to get compliance (Fields 1995: 58-9). The growing political independence of the chaebol and the growing technological complexity of the South Korean economy were clearly related to the decline of the Korean industrial policy system in the nineties (Khan 2000b: 95-8). But by then Korea was already an industrialized economy. The important observation is that when the South Korean economy took off, it would be difficult to argue that the chaebol enjoyed well-defined property rights.

In contemporary China property rights in many of the most dynamic sectors are not well-defined, and through a different set of institutions, this is again assisting the capture of resources by emerging dynamic entrepreneurs (Rodrik 2002, Qian 2002). China's dynamic Township and Village Enterprises (TVEs) account for at least 40 percent of industrial employment and exports, but observers have been puzzled at the vagueness of property rights over assets in these enterprises (Bowles and Dong 1999). Although notionally owned by townships or villages, they are *de facto* controlled by dynamic managers who own a very small share of the residual. This is puzzling to those who believe that much clearer ownership is required for dynamic management. The answer to the puzzle may be that these proto-capitalists are confident that the state will formalize their *de facto* ownership in the long run, provided they generate growth. In the meantime this arrangement keeps social contestation low and prevents the upheavals that a straightforward privatization may have unleashed (Qian 2002). It is the political coalition backing growth that is new in China after the eighties. The state's ability to restructure property rights in line with its changing objectives is not, and has been demonstrated time and again since 1949. Contemporary China scores somewhat higher than the average developing country in "rule of law" indices but these are primarily based on risk-perceptions of mainly joint-venture companies in export zones. These indices are misleading because while it is true that export-oriented companies in China are fairly safe from expropriation, other holders of rights are not. It would be more instructive to look at the state's ability to re-allocate rights over land and indeed its ability to control internal population movements that allowed it to set up such massive export zones in the first place. Such a degree of power is not always desirable. As an example of a controversial state-driven re-allocation of rights, consider the Three Gorges Dam project. Nearly two million people are to receive compulsory compensation on a scale and timing decided by the state and many others who are displaced will probably never be compensated. There are questions about the technical viability of the project and its cost-benefit ratio, but it is an example of how the Chinese state can re-allocate property rights if it believes a project will further national development. In contrast, property rights are actually much better defined in many developing countries such as India where projects much smaller than the Three Gorges have been successfully blocked in the courts for years. Again, whether this is in the social interest or not depends on the specific projects, but it would be wrong to argue that property rights are well-defined in China and that this has driven its growth.

Dynamic states have the capacity to manage growth-enhancing rents and destroy growth-reducing rents. The emergence of proto-capitalists is not sufficient to ensure that they have the capacity to compete. This raises the important question of rent-management. In a critique of the standard model of market competition, Stiglitz (1996) argues that a wide range of information rents are critical for the working of an efficient market system. These rents create the incentives for information to be generated and properly used. Thus even a well-established market economy would need institutions to regulate these rents and ensure that markets continue to work efficiently. No less important are the Schumpeterian rents that are essential for driving innovation in market economies. In developing economies the problem is even more acute. Emerging capitalists often lack technological capacities and even entrepreneurial capacities to compete in world markets. Learning to use advanced technologies involves high risk and the private return can be lower than the social return. At the same time, high returns are possible from many types of unproductive activities. In such contexts, state-created "learning rents" have often accelerated technology acquisition and the development of entrepreneurial skills, thereby enabling capitalist market economies to develop (Lall and Teubal 1998, Aoki, Kim & Okuno-Fujiwara 1997, Rodrik 1995, Page 1994, World Bank 1993, Wade 1990, Amsden 1989).

However, effective regulation is essential for these rents to have a positive effect. Schumpeterian rents or learning rents can in theory have limited or even negative effects if they last for too long *or* for not long enough, suggesting an inverted U relationship between learning and the period of protection of learning rents (Khan 2000a: 40-53). The optimal period of protection is not technically determined, and learning is most rapid when transformation states have the pragmatic capacity to observe performance and the much more difficult political capacity to re-allocate support when necessary. Incidentally, a similar inverted U relationship between innovation and the degree of competition is also found in advanced countries like the UK, suggesting that very competitive markets are not always desirable (Aghion and others 2002).

In contrast, the damaging effects of growth-reducing rents are well-known. Growth-reducing rents also have to be removed through competition policy and regulation. But both theory and evidence suggests that the creation of dynamic capitalist economies requires more than just institutional structures and policies which ensure that rents do not emerge. Rapid entrepreneurial growth and technology acquisition requires a more demanding set of institutions with the regulatory capacity to make distinctions between different kinds of rents and with the political capacity to manage these rents to generate growth and rapid transformation. Blocked and stagnating transformations are characterized by states that lack these institutional and political capacities (Khan 2000b).

Dynamic states can organize ring-fenced transfers to maintain political stability. In developing countries, no less than in advanced ones, maintaining political stability often requires significant state-organized transfers. Massive social dislocations also make social instability a much more serious problem in developing countries. Official budgetary transfers are a small fraction of the overall system of hidden, patron-client transfers that are routinely deployed to maintain stability in these contexts. In theory, transfers can have relatively low deadweight costs. In reality, transfers often cause serious economic damage if the only way in which fragmented groups can capture resources is by creating or capturing a large number of uncoordinated value-reducing rents. When high-growth states like Malaysia needed to organize significant transfers to maintain political stability they were able to centrally organize and ring-fence these transfers. Distributive coalitions were prevented from trying to capture additional rents through inferior public good provision or by capturing subsidies for industrial learners. To the extent that this can be achieved, a system of significant transfers can be compatible with rapid growth (Jomo and Gomez 2000). Where it cannot, as in the Indian subcontinent, fragmented rent-capture can contribute to poor public good provision and the protection of inefficient sectors (Khan 2000a, b, Bardhan 1988).

	Property Rights	Rents/Competition Policy	Service Delivery
Dynamic Transformation State	Protection, creation and transfers of property rights for *productive* groups. Destruction or loss of property rights of *unproductive* groups.	Regulatory and industrial policy to manage *growth-enhancing* rents. Regulatory and competition policy to remove *growth-reducingrents*.	Efficient provision of infrastructure by ring-fenced institutions. Ring-fenced transfers to maintain political stability.
Stagnating or Failed Transformation State	Protection, creation and transfers of property rights for *unproductive* groups. Destruction or loss of property rights of *productive* groups.	Protection of *growth-reducing* rents.	Service delivery systems captured by privileged groups. Open-ended transfers to maintain political stability.

Figure 4 Institutions and Interventions in Transformation States

These observations suggest that the creation of high-growth conditions is a more demanding process than is suggested by the standard model. Historically, takeoffs in high-growth countries have not been preceded by the prior achievement of property right stability and the removal of rents. Rather, as Figure 4 summarizes, high-growth transformation states intervened in property rights to accelerate the emergence of productive capitalist classes, they created and managed rents to accelerate technology acquisition and promote entrepreneurial capacity and they maintained political stability through transfers often on a large scale. They also efficiently delivered public goods as the standard theory demands.

Even when many of these theoretical and historical observations are recognized, economists remain reluctant to trust the state, with good reason, particularly in developing countries. Thus after developing some powerful critiques of the liberal-market model, Stiglitz (1998) argues that governments should be prevented from restricting competition or intervening in areas where there are special interests, in other words, from creating rents. This policy caution is clearly based on a scepticism about the capacity of the state to create and manage growth-promoting rents, a scepticism that is entirely justified if we look at the vast majority of poorly-performing states. But as his own work on financial institutions points out (Hellman, Murdock and Stiglitz 1997), state-created rents played an important role in explaining the success, and not just the vulnerability, of the Asian high-growth economies.

It is entirely right to say that East Asian institutions and transformation strategies are not relevant for failing states that clearly lack critical capacities. But we can also conclude that attempting to create liberal market economies in these countries without understanding why their states failed to manage property rights transitions or learning rents in the past is also likely to fail given the importance of regulating rents even in competitive market economies. And of course, attempting to construct liberal market economies in countries where a viable capitalist class has not yet emerged or learnt to use modern technologies may fail anyway. However imperfect and partial the process, there may be no alternative to directly tackling the weak transformation capacities of most developing country states. This takes us to an examination of some of the other dimensions of state failure during the transformation.

The Effectiveness of Institutional Enforcement.

In advanced economies, the state's monopoly of legitimate violence has become a metaphor describing the state's ability to enforce institutions. The reality behind this metaphor can be seen in developing countries where states often do not have this monopoly and find it difficult to enforce any institution (Bates 2001). This is clearly related to the intense social contestation thrown up by the process of transformation itself. But the effectiveness of enforcement is not uniformly poor and variations in this dimension account for much of the differences in institutional performance. The effectiveness of enforcement is a measure of the degree to which agents with notional residual control rights in an institutional structure can *actually* enforce their decisions. Residual control rights are rights to determine resource allocations that are not otherwise controlled by law or assigned to others by contract. If the owner of a property right cannot in fact sell the right, or make hire and fire decisions freely, or if an industrial policy planner with residual control rights over the allocation of subsidies cannot in fact re-allocate them, the extent to which they cannot is a measure of the ineffectiveness of enforcement. Developing country states in the sixties and seventies did not just fail to effectively enforce industrial policy regimes. Most of them failed to enforce *any* growth-generating institution, including property rights for potentially productive users (North 1990). How can this systematic failure be explained?

The failure to enforce is often presented as a problem of credible commitment on the part of the state. Since the state has no higher enforcer, in principle it can subvert property rights *ex post* to appropriate the investments of others (Bates 2001, Bardhan 2000, Stiglitz 1998). If this was the major source of enforcement failure, it would be necessary to have democratic or other constraints on the state which made it difficult for state leaders to change their *ex ante* commitments easily. But we have already seen in the context of both property rights and rent-management that high growth during the capitalist transition has required a great deal of *ex post flexibility* on the part of the state (a term suggested by Okuno-Fujiwara 1997). As a result, historically a much more demanding commitment has been required from high-growth states. *Instead of just having to commit not to intervene in stable property rights and undistorted markets, high-growth states have to commit to disrupt property rights and create rents but in ways which promote growth.*

Effective enforcement requires both institutional capacity and a compatibility of institutions with the interests of powerful social groups. When the state is engaged in rent-management and property rights interventions, enforcement is more difficult both from the perspective of institutional capacity (because the state has to have the capacity to do positive things) but also because social resistance and rent-seeking is likely to be more intense. Obviously institutional capacity appropriate for the management and enforcement of particular interventions is important. It is not possible to enforce a property rights system without a properly staffed court system; or an industrial policy system without a competent financial and economic bureaucracy. At the same time, institutional capacity is insufficient without an *effective political capacity* to overcome the resistance of powerful social groups who are opposed to the enforcement of particular institutions.

These two factors are closely intertwined because the political failure to enforce can often rapidly lead to a loss of morale and personnel and persuade remaining public officials to share unproductive rents as a second-best strategy. One of the worrying trends in many developing countries has been the *worsening* institutional capacity of the state and the quality of public officials. On the other hand, the achievement of enforcement capacity can often make previously predatory leaders commit themselves to dynamic transformation strategies which offer them higher personal payoffs. Consider the case of Chiang Kai Shek before and after 1949. Case studies of high-growth transformation states suggest that enforcement capacity has been based on a range of political strategies including the neutralization of unproductive groups, the creation of political organizations of productive groups to counter the power of unproductive groups, or even the accommodation of some unproductive groups through less damaging transfers.

In South Korea, the enforcement of its industrial policy regime “from above” relied on the absence of well-organized factions that could protect inefficient industrial interests. The fragmentation of organized middle class political factions by Japanese colonialism and of traditional landed elites by far-reaching land reforms meant that recipients of subsidies could not easily buy protection from organized factional politics. The state in turn had no interest in accepting payoffs from the inefficient because it was better served by enforcing the industrial policy regime and capturing even bigger payoffs (Chibber 1999, Woo-Cumings 1997, Kohli 1994, Amsden 1989). In Thailand in the eighties, industrial policy was less important but here growth was driven by the intense primitive accumulation organized by a more dispersed class of emerging capitalists. The latter aggressively captured valuable natural and public resources. They were able to effectively enforce their captured rights because unlike most developing countries, Thai capitalists directly controlled many of the factions involved in competitive politics and could buy themselves access to state power. At the same time, intense competition between capitalist factions prevented the state from being captured for long by any potentially monopolistic faction. Thus in Thailand, the enforcement of emerging capitalist property rights "from below" reflected the relative power of politically organized productive groups (Doner and Ramsay 2000, Rock 2000, Pasuk and Baker 1997). We observe yet another pattern in Malaysia, where growth in the eighties was driven by the ability of the state to attract multinational investors and effectively protect their rights. Its ability to do this was based on a unique internal ethno-political arrangement that bought off those who would otherwise have contested the state's policies. Thus in the case of Malaysia, the compatibility between institutional enforcement and political forces was brought about by the organization of politics by the state in a way that allowed it to buy off potential opposition through a form of highly centralized clientelism (Jomo and Gomez 2000). Thus while growth-promoting institutions varied across countries, enforcement was effective in all high-growth countries because the institutions enforced by the state were compatible with or could not be opposed by powerful organized interests within these societies (Khan 2000b).

In contrast, in cases of ineffective enforcement, we frequently observe an inability of the state to suppress or accommodate interests opposed to enforcement. Pakistan's industrial policy regime of the sixties failed, even though the quality of its planning personnel was then moderately good and its military leadership was committed to export-led growth. Control over enforcement was, as in South Korea, formally centralized in the President's office. Yet institutional enforcement failed because unproductive subsidy-recipients discovered that they could easily purchase protection in a society with many fragmented but powerful political organizations (Khan 1999). Industrial policy was not compatible with this distribution of social power. Subsequent liberalization and privatization did attack some aspects of the rent-capture which had become entrenched under statist strategies (Bhaskar and Khan 1995). But the South Asian countries also discovered during the eighties that their states could not properly enforce productive property rights either and were unable to make a significant dent on growth-reducing rent-seeking by unproductive groups (Bardhan 1988).

These observations suggest that policy to improve enforcement in developing countries is not likely to succeed if it simply focuses on the institutional capacity of enforcement institutions such as anti-corruption bureaus or judiciaries. We need to construct a compatible package of institutional reform *and* political restructuring of organized power which may allow better enforcement of a dynamic transformation strategy in the future. Here the notion of *feasibility* is very important as Qian (2002) suggests in the case of China. We can consider ambitious transformation strategies as in South Korea, which promise very high growth if properly enforced, but if compatible political arrangements are unfeasible, such a strategy will fail. Fortunately, there are alternative transformation strategies, as the cases of Thailand, Malaysia and other high-growth developers show, but even these require very specific internal political settlements. No country in the future is likely to be an exact replica of any of the high-growth economies of the past in terms of the mix of policies, institutions and political settlements.

Nevertheless, the lesson is that in poorly performing countries, much more deliberate steps have to be taken to construct compatible packages of institutions and political settlements to achieve even second-best transformation success.

The Costs of Enforcement.

One of the objectives of recent reform proposals is to reduce the loss of resources due to rent-seeking, and in particular due to corruption. Clearly, the larger the enforcement costs, the lower observed growth is likely to be. The enforcement cost is the aggregate rent-seeking cost of running particular institutions. But what determines the magnitude of enforcement costs and how far do differences in these costs explain differences in state performance? These costs include the costs of lobbying, the resources spent in economic and political corruption, the costs of all types of "political" activity from maintaining patron-client networks to contributions to political parties, the policing costs of the state, indeed all expenditures and activities regardless of their legality or morality, that aim to protect or change institutions. Clearly the elements of rent-seeking most relevant for a particular case will depend on the institution, the country and its stage of development. Given that a very wide range of activities count as rent-seeking and given that every right, rent and intervention is valuable for someone, the overall rent-seeking cost is likely to be high in every economy (Samuels and Mercuro 1984). This is confirmed by crude estimates of overall transaction costs in advanced economies (North and Wallis 1987) and by observations of widespread rent-seeking in all developing countries including the high-growth ones (Khan 2000b).

The costs of enforcement should not be confused with the effectiveness of enforcement though the two are closely related. The effectiveness of enforcement may be low if the *ex ante* cost of enforcement is high. However, we have to be careful not to read off from *ex post* observations of costs of enforcement either the degree to which enforcement is effective or indeed the type of institutions that are being enforced. For instance, two comparable societies may each be attempting to enforce decentralized property rights and both may be observed to face the same aggregate enforcement costs. However, differences in the organizational power of the groups contesting these rights may be such that for the same enforcement cost, effective enforcement is much better in one than the other. Similarly, two comparable societies may be attempting to enforce different institutions, say a decentralized property rights system in one and a hierarchical industrial policy system in the other. Even if both face the same aggregate enforcement costs, this does not tell us how growth-enhancing their institutions are, nor how effectively they are enforced. All three clearly matter.

Enforcement costs also depend on the compatibility of institutions with the distribution of organizational power. It has been argued that institutional structure can significantly reduce enforcement costs. North (1990: 107-117) argues that democracy reduces the cost of compensating losers, reducing the overall enforcement cost of creating efficient institutions. In contrast, supporters of developmental states argue that insulated authoritarian states suffer low rent-seeking costs because rent-seekers know that the likelihood of changing executive decisions is small (Chang 1994: 38-44). But the evidence suggests that the costs of enforcement also depend on the compatibility of institutions with the distribution of power. If insulated states in East Asia enjoyed lower enforcement costs, this was at least partly because key institutions faced relatively atomized opposition. In contrast, attempts to construct insulated states in South Asia to enforce similar institutions had the opposite effect. In Pakistan and Bangladesh, military governments managed to reduce enforcement costs for industrial policy systems only temporarily before unleashing massive contestation by well-organized opposition groups. The overall enforcement cost of institutions during military regimes in South Asia was, as a result, very high (Khan 2000b: 107-13). But democracy was also associated with high enforcement costs in South Asia, with relatively small privileged groups engaging in intense rent-seeking (Rudolph and Rudolph 1987, Bardhan 1984). Thus once again, the organization of political factions is an important determinant of institutional performance, this time determining the magnitude of enforcement costs.

However, while enforcement costs do vary somewhat, they are nevertheless generally high in all countries. In advanced countries even though corruption is relatively low, enforcement costs are not, because much of it is legalized in the form of lobbying, political contributions, consultancy fees, expense accounts, tax-supported formal enforcement structures and so on. In developing countries, corruption is uniformly high, as the corruption indices show in Table 1, as is rent-seeking in general. This suggests that enforcement costs probably vary across a relatively narrow range, with the exception of failed states collapsing into anarchy or civil war. The relatively narrow range of variation in enforcement costs is also what we would expect in transformation societies since they have comparable levels of rents and transfers in aggregate, even though they differ greatly in the types of these rents and transfers.

The Location of State Failure.

Figure 5 summarizes the evidence we have discussed so far. Developing countries differ more in the rents and rights effectively maintained by state institutions than in their enforcement costs, locating most developing countries within the shaded area running from east to west at the centre of Figure 5. Failed and failing transformation states are located largely in the top left-hand quadrant which is associated with the lowest growth though some may have moderate growth by being in the top right-hand quadrant. In contrast, high-growth transformation states are located in the bottom right-hand high-growth quadrant.

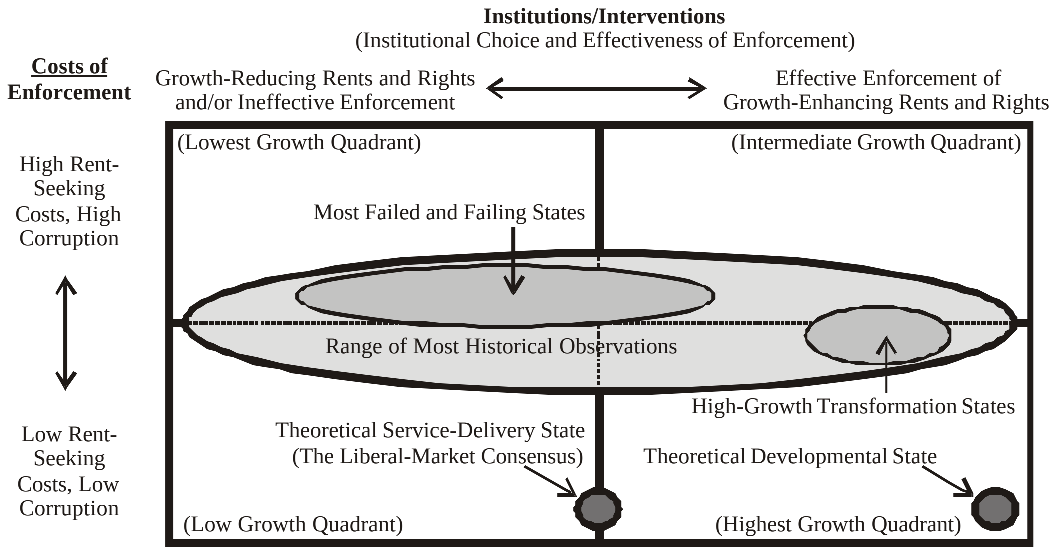

Figure 5 Social Transformations and the Location of State Failure

Implications for policy. The diagram allows us to compare the range of real-world observations during transformation processes with the theoretical service-delivery state that creates neither growth-enhancing nor growth-reducing rents and enjoys low enforcement costs; as well as with the theoretical developmental state which intervenes effectively at low cost. Neither model, and in particular the service-delivery one, suggests viable directions of reform for poorly performing developing countries. The service-delivery model suggests that if policy can move poorly performing countries *southwards* towards the position of the liberal-market state, all good things will go together. But by assuming that all rents are bad and that a viable structure of property rights would exist in the absence of intervention, the service-delivery model assumes away the problem of transformation in its entirety. The developmental state model supports much greater interventions, but it too assumes that enforcement costs can be lowered, this time through state insulation. But more seriously, it does not explain why all developing countries do not migrate to the attractive developmental state position. In contrast, our comparison of failed and failing states with the high-growth transformation states suggests that the necessary direction of reform should be to construct feasible packages of institutional and political-organizational reforms that will allow poorly-performing countries to move *rightwards* in Figure 5 to the greatest extent possible.

The Non-linearity in the consensus governance-growth relationship. The location of countries in Figure 5 can explain why high-growth states do not score significantly better than the developing country average in terms of conventional governance indicators. Most indicators of good governance such as corruption or expropriation risk are primarily (imperfect) measures of perceived enforcement costs. The theoretical expectation in the liberal-market model is that high enforcement costs and bad interventions or policies *go together*. Corruption or expropriation risk is high *because* there are growth-reducing interventions. If this was always the case, there would be a linear relationship between governance indices and growth. In fact, because many rents and even property right interventions are growth-enhancing, particularly during the transition to capitalism, and such interventions provoke high enforcement costs, there is no necessary correlation between most governance indicators and performance. The correlation that is picked up only reflects the fact that most developing countries happen to lack dynamic transformation capacities, so that "poor governance" appears to correlate with poor growth. The huge jump in growth in the high-growth economies in Figure 2 associated with insignificantly better governance suggests that the institution-growth relationship in the consensus approach is mis-specified and the missing variables are those that measure dynamic transformation capacity.

Institutional Transition.

Finally we turn to a dimension of variation which touches on all the ones we have already looked at. Why did some countries do so much better in changing institutions and political arrangements to allow the effective enforcement of growth-enhancing institutions? Was their success due to the "political will" or wisdom of their leaders, the institutions through which they organized change, or the distribution of power between groups and factions in these countries? Clearly all of these and other factors could have played some role, but what were the "binding" constraints, the factors that were necessary for growth-enhancing transitions to take place but were difficult to organize in most countries?

Political will and political institutions. Political will is the least likely explanation of sustained differences in performance, not because it is not necessary but rather because it is not as scarce as is often thought. Committed reformers failed in many countries in the absence of accommodating social conditions. Political institutions too do not provide a sufficient explanation of transition success. The case for democracy as an institution which facilitates efficient transition was made by North (1990) who argued that democracy would best accelerate the creation of efficient institutions by providing an efficient way of organizing transfers to compensate losers. This is a theoretical possibility but almost none of the significant path changes in high-growth developers over the last century took place through formally democratic institutions. Nor did countries with formal democracy such as India do very well in organizing growth-enhancing institutional change. In contrast, Olson (1982) pointed out that democracies are likely to be dominated by special-interest groups that have an advantage in organizing rent-seeking compared to the rest of society, a perspective that was developed in Bardhan's (1984) work on rent-seeking in India. Democracy is an end in itself, but historically it has been neither necessary nor sufficient for ensuring growth-enhancing institutional change.

The role of social power in explaining transitions. When developing countries get mired in low-growth or stagnant transformation processes, the failure is widely perceived and understood in these countries, not just by policy-makers and politicians but by the wider society as well. So why does state failure persist? Any investigation of why growth-enhancing institutions cannot be introduced or enforced leads very quickly to the identification of powerful interests opposed to change who can impose unacceptable costs on others or the state if it came to a fight. Groups that are opposed to an institution because it leaves them worse off can either try to stop its creation or they can subvert it after it has been formally introduced. In this sense, the problem of transition is no different from that of enforcement except that the former concerns the formal introduction of institutions and the latter their real operation. Not surprisingly, the distribution of power between social factions and classes provides a very good historical explanation of the pace and direction of institutional change in many countries (Brenner 1985, 1976, Bardhan 2000).

The importance of building constituencies to support state reform processes is widely recognized in the service-delivery approach to the state as well (for instance in World Bank 1997). However, what is involved in the two approaches is quite different. In the liberal-market consensus, state failure is related to rent-capture by unproductive groups who play no role in the dynamism of the market economy. All of society could potentially be mobilized against them if only democracy, civil society participation and other desirable political institutions could be deepened. In contrast, the transformation perspective provides less comforting prescriptions. Both productive and unproductive groups are involved in rent and resource-capture. Indeed one can transform into the other depending on the relationship with the state and the state's ability to effectively enforce growth-enhancing institutions. A more complex analysis is required here of the compatibility of the distribution of power between competing groups and factions with the effective enforcement of particular growth-enhancing institutions. This involves making case by case judgements, which multilateral agencies dislike. It is more surprising that research on these issues is still not very well developed. At least this could help productive forces within developing countries to organize in the future.

Reforming the State: The Challenge for Policy

The service-delivery and transformation state perspectives provide strikingly different explanations of the causes of state failure and the focus of reform. We argue that the transformation state approach explains state failure in a way that fits better with historical observations. It also allows us to make sense of the anomalous evidence on the governance-growth relationship based on governance indices. A number of policy issues are raised by our discussion, and new questions are thrown up for research and policy discussion.

There is at least a need for caution in the claims that are being made for governance reforms of the types that follow from the service-delivery model and the underlying liberal-market consensus. There is no historical evidence that these reforms were a precondition for growth, nor that they can be meaningfully implemented in transformation economies. There is some support for this reform agenda in developing countries as an end in itself. But competing factions have also found anti-corruption slogans, for instance, useful in factional political conflicts. What is worrying is that there is little evidence that new productive coalitions have formed around these reforms. This is not surprising given that the service-delivery model does not address the key property rights, rent-management, and accumulation issues facing emerging capitalists in their relationship with the state. Much more seriously, there is a real danger that disillusionment in developing countries will grow even further if, as is likely, no significant economic progress is achieved in the end as a result. It is reasonable to ask if multilateral agencies are spending public resources properly in pushing major reforms on the basis of questionable evidence linking these reforms to growth improvements.

In contrast, the transformation state perspective identifies critical state capacities for managing and regulating rents and for organizing changes in property rights systems. The experience of the high-growth economies suggests that if growth and sustained poverty reduction are the objectives, these capacities have to become the focus of institutional and political reform. Engagement in a political restructuring of the organization of power within countries is formally outside the remit of multilateral agencies but they could begin by concentrating on the simplest and least contentious regulatory capacities. Central banks and securities markets have received a lot of attention, but basic state capacities in areas such as encouraging technology acquisition or attracting multinationals and inducing them to adopt technology transfer schemes have not.

More than that, we have argued that there are a range of capacities to do with rent-regulation and property rights transformation where useful lessons could be learnt by looking at the experiences of high-growth economies and the political settlements that underpinned the enforcement success of dynamic strategies. The effectiveness of institutional capacities depends on their compatibility with the underlying distribution of power. We argued that in many of the cases of state failure in developing countries, institutional capacity building has to proceed in parallel with political interventions that aim to restructure the distribution of political and organizational power. The challenge is to suggest *feasible* reforms for particular countries, taking into account pre-existing political settlements, prior capitalist development and the technological capacities of capitalists. It is well to explicitly recognize that institutional reform is deeply political. The proper role of international agencies should be to transfer knowledge of the experiences of successful transformations, offer support in enhancing dynamic transformation capacities and encourage the construction of productive coalitions to support these reforms, even if the implementation of politics must remain an internal matter for developing countries. In turn the challenge for research is to proceed further with the analysis of how the distribution and disposition of organizational power has helped or hindered different transformation strategies, and how this information can be used to suggest feasible institutional and political reform strategies for countries that have done less well.

REFERENCES

Aghion, Philippe, Nicholas Bloom, Richard Blundell, Rachel Griffith and Peter Howitt. 2002. *Competition and Innovation: An Inverted U Relationship.* The Institute for Fiscal Studies Working Paper WP02/04.

Amsden, Alice. 1989. *Asia's Next Giant: South Korea and Late Industrialization*. Oxford: Oxford University Press.

Andvig, Jens and Kalle Moene. 1990. How Corruption may Corrupt, *Journal of Economic Behaviour and Organization* 3 (1): 63-76.

Andvig, Jens Chr., Odd-Helge Fjeldstad, Inge Amundsen, Tone Sissener, Tina Søreide. 2000. *Research on Corruption: A Policy Oriented Survey*. Report Commissioned by NORAD: Chr. Michelsen Institute and Norwegian Institute of International Affairs.

Aoki, Masahiko, Hyung-Ki Kim and Masahiro Okuno-Fujiwara, eds. 1997. *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Oxford: Clarendon Press.

Asian Development Bank. 2000. *Promoting Good Governance: ADB's Medium-Term Agenda and Action Plan.* Manila: Asian Development Bank.

Bardhan, Pranab. 2000. The Nature of Institutional Impediments to Economic Development, in Olson, Mancur and Satu Kähkönen, eds. *A Not-so-Dismal Science: A Broader View of Economies and Societies.* Oxford: Oxford University Press.

Bardhan, Pranab. 1997. Corruption and Development: A Review of Issues, *Journal of*

Economic Literature 35 (3): 1320-1346.

Bardhan, Pranab. 1988. Dominant Proprietary Classes and India's Democracy, in Atul Kohli ed. *India's Democracy: An Analysis of Changing State-Society Relations*. New Jersey: Princeton University Press.

Bardhan, Pranab. 1984. *The Political Economy of Development in India*. Oxford: Basil Blackwell.

Barro, Robert. 1996. Democracy and Growth, *Journal of Economic Growth* 1(1): 1-27.

Bates, Robert H. 2001. *Prosperity and Violence: The Political Economy of Development.* New York: W.W. Norton.

Bhaskar, V. and Mushtaq H. Khan. 1995. Privatization and Employment: A Study of the Jute Industry in Bangladesh, *American Economic Review* 85 (1): 267-272.

Bowles, Paul and Xiao-Yuan Dong. 1999. Enterprise Ownership, Enterprise Organization, and Worker Attitudes in Chinese Rural Industry: Some New Evidence, *Cambridge Journal of Economics* 23 (1): 1-20.

Brenner, Robert. 1976. Agrarian Class Structure and Economic Development in Pre-Industrial Europe, *Past and Present* 70.

Brenner, Robert. 1985. The Agrarian Roots of European Capitalism, in Aston, T.H. and Philpin, C.H.E. eds., *The Brenner Debate: Agrarian Class Structure and Economic Development in Pre-Industrial Europe*. Cambridge: Cambridge University Press.

Burkhart, Ross and Michael Lewis-Beck. 1994. Comparative Democracy: The Economic Development Thesis, *American Political Science Review* 88: 903- 910.

Chang, Ha-Joon. 1994. *The Political Economy of Industrial Policy.* London: Macmillan.

Chibber, Vivek. 1999. Building a Developmental State: The Korean Case Reconsidered, *Politics and Society*, 27 (3): 309-46.

Clague, Christopher, Philip Keefer, Stephen Knack and Mancur Olson. 1997. Democracy, Autocracy and the Institutions Supportive of Economic Growth, in Clague, Christopher ed., *Institutions and Economic Development: Growth and Governance in Less-Developed and Post-Socialist Countries.* Baltimore: The Johns Hopkins University Press.

Dollar, David and Aart Kraay. 2001. Growth is Good for the Poor, draft paper, http://www.worldbank.org/research/growth/pdfiles/GIGFTP3.pdf.

Doner, Richard F. and Ansil Ramsay. 2000. Rent-seeking and Economic Development in Thailand, in Mushtaq H. Khan and K.S. Jomo, eds., *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press.

Fields, Karl J. 1995. *Enterprise and the State in Korea and Taiwan.* Ithaca: Cornell University Press.

Hall, Robert and Charles Jones. 1999. Why Do Some Countries Produce So Much More Output Per Worker Than Others? *Quarterly Journal of Economics* 114: 83-116.

Hellman, Thomas, Kevin Murdock and Joseph Stiglitz. 1997. Financial Restraints: Toward a New Paradigm, in Masahiko Aoki, Hyung-Ki Kim and Masahiro Okuno-Fujiwara, eds., *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Oxford: Clarendon Press.

Johnson, Simon, Daniel Kaufmann and Pablo Zoido-Lobatón. 1998. Regulatory Discretion and the Unofficial Economy, *American Economic Review* 88(2): 387-392.

Jomo, K.S. and Edmund T. Gomez. 2000. The Malaysian Development Dilemma, in Mushtaq H. Khan and K.S. Jomo, eds., *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press.

Kauffman, Daniel and Aart Kraay and Pablo Zoido-Lobatón. 1999. *Governance Matters*. World Bank Policy Working Paper No. 2196.

Khan, Mushtaq H. 2002. Fundamental Tensions in the Democratic Compromise, *New Political Economy* 7 (2): 275-277.

Khan, Mushtaq H. 2000a. Rents, Efficiency and Growth, in Mushtaq H. Khan and K.S. Jomo, eds., *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press.

Khan, Mushtaq H. 2000b. Rent-seeking as Process, in Mushtaq H. Khan and K.S. Jomo, eds., *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press.

Khan, Mushtaq H. 1999. *The Political Economy of Industrial Policy in Pakistan 1947-1971*. University of London: SOAS Department of Economics Working Paper No. 98.

Khan, Mushtaq H. 1995. State Failure in Weak States: A Critique of New Institutionalist Explanations, in John Harriss, Janet Hunter and Colin M. Lewis, eds., *The New Institutional Economics and Third World Development.* London: Routledge.

Khan, Mushtaq H. and K.S. Jomo eds. 2000. *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press.

Knack, Stephen and Philip Keefer. 1997. Why Don't Poor Countries Catch Up? A Cross-National Test of an Institutional Explanation, *Economic Inquiry* 35:590-602.

Knack, Stephen and Philip Keefer. 1995. Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures, *Economics and Politic*s. 7(3): 207-227.

Kohli, Atul. 1994. Where Do High Growth Political Economies Come From? The Japanese Lineage of Korea's "Developmental State", *World Development* 22 (9): 1269-1293.

Krueger, Ann. 1990. Government Failures in Development, *Journal of Economic Perspectives* 4 (3): 9-23.

Krueger, Ann. 1974. The Political Economy of the Rent-Seeking Society, *American Economic Review* 64 (3): 291-303.

Lal, Deepak and Hla Myint. 1996. *The Political Economy of Poverty, Equity, and Growth: A Comparative Study*. Oxford: Clarendon Press.

Lall, Sanjaya and Morris Teubal. 1998. "Market-Stimulating" Technology Policies in Developing Countries: a Framework with Examples from East Asia, *World Development*, 26 (8): 1369-1385.

Lee, Suk-Chae. 1991. The Heavy and Chemical Industries Promotion Plan, in Cho, Lee-Jay and Yoon Hyung Kim eds., *Economic Development in the Republic of Korea: A Policy Perspective*. Hawaii: East West Center.

Mauro, Paolo. 1995. Corruption and Growth, *Quarterly Journal of Economics* 110 (3): 681-712.

Migdal, Joel S. 1988. *Strong Societies and Weak States: State-Society Relations and State Capabilities in the Third World.* Princeton: Princeton University Press.

Murphy, Kevin M., Andrei Shleifer and Robert W. Vishny. 1993. Why is Rent Seeking So Costly to Growth? *American Economic Review Papers and Proceedings,* 82 (3): 409-14.

Myrdal, Gunnar. 1968. *Asian Drama*. Three Volumes. New York: Pantheon.

North, Douglass C. 1990. *Institutions, Institutional Change and Economic Performance.* Cambridge: Cambridge University Press.

North, Douglass C. 1981. *Structure and Change in Economic History*. New York: W.W. Norton.

North, Douglass C. and J. Wallis. 1987. Measuring the Transaction Sector in the American Economy 1870-1970, in S. L. Engerman and R. E. Gallman eds. *Long-Term Factors in American Economic Growth.* Chicago: Chicago University Press.

Okuno-Fujiwara, Masahiro. 1997. Toward a Comparative Institutional Analysis of the Government-Business Relationship, in Masahiko Aoki, Hyung-Ki Kim and Masahiro Okuno-Fujiwara, eds., *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis.* Oxford: Clarendon Press.

Olson, Mancur. 2000. Dictatorship, Democracy and Development, in Mancur Olson Satu Kähkönen eds., *A Not-so-Dismal Science: A Broader View of Economies and Societies.* Oxford: Oxford University Press.

Olson, Mancur. 1997. The New Institutional Economics: The Collective Choice Approach to Economic Development, in Christopher Clague ed., *Institutions and Economic Development.* Baltimore: Johns Hopkins University Press.

Olson, Mancur. 1982. *The Rise and Decline of Nations.* London: Yale University Press.

Page, John. 1994. The East Asian Miracle: Four Lessons for Development Policy, in Stanley Fischer and J. Rotemberg eds., NBER Macroeconomics Annual. Cambridge MA: National Bureau of Economic Research.

Pasuk Phongpaichit and Chris Baker. 1997. *Thailand: Economy and Polity.* Oxford: Oxford University Press.

Posner, Richard A. 1975. The Social Costs of Monopoly and Regulation, *Journal of Political Economy*, 83 (4): 807-27.

Qian, Yingyi. 2002. How Reform Worked in China.
http://ksghome.harvard.edu/~.drodrik.academic.ksg/Growth%20volume/Qian-China.pdf

Rock, Michael T. 2000. Thailand's Old Bureaucratic Polity and its New Semi-Democracy, in Mushtaq H. Khan and K.S. Jomo, eds., *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*. Cambridge: Cambridge University Press.

Rodrik, Dani. 2002. Institutions, Integration, and Geography: In Search Of The Deep Determinants Of Economic Growth.
http://ksghome.harvard.edu/~.drodrik.academic.ksg/growthintro.pdf.

Rodrik, Dani. 1997. TFPG Controversies, Institutions and Economic Performance in East Asia. *National Bureau of Economic Research Working Paper* Working Paper 5914.

Rodrik, Dani. 1995. Getting Interventions Right: How South Korea and Taiwan Grew Rich, *Economic Policy* 20.

Rudolph, Lloyd I. And Susanne H. Rudolph. 1987. *In Pursuit of Lakshmi: The Political Economy of the Indian State.* Chicago: The University of Chicago Press.

Samuels, Warren J. and Nicholas Mercuro. 1984. A Critique of Rent-Seeking Theory, in David C. Colander ed. *Neoclassical Political Economy: The Analysis of Rent-Seeking and DUP Activities.* Cambridge MA: Ballinger Publishing Company.

Shleifer, Andrei and Robert W. Vishny. 1998. *The Grabbing Hand: Government Pathologies and their Cures*. Cambridge, Massachusetts: Harvard University Press.

Stiglitz, Joseph. 1998. Redefining the Role of the State: *What* should it do? *How* should it do it? And *How* should these decisions be made? *Paper presented on the Tenth Anniversary of the MITI Research Institute.*
http://www.worldbank.organize/html/extdr/extme/jssp031798.htm.

Stiglitz, Joseph. 1996. *Whither Socialism?* Cambridge Massachusetts: MIT Press.

Treisman, Daniel. 2000. The Causes of Corruption: A Cross National Study, *Journal of Public Economics* 76: 399-457.

Wade, Robert. 1990. *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization.* Princeton: Princeton University Press.

Woo-Cumings, Meredith. 1999. ed. *The Developmental State.* Ithaca: Cornell University Press.

Woo-Cumings, Meredith. 1997. The Political Economy of Growth in East Asia: A Perspective on the State, Market, and Ideology, in Masahiko Aoki, Hyung-Ki Kim and Masahiro Okuno-Fujiwara, eds., *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Oxford: Clarendon Press.

World Bank 1997. *World Development Report 1997: The State in a Changing World.*

Washington DC: World Bank.

World Bank 1993. *The East Asian Miracle: Economic Growth and Public Policy*. Oxford: Oxford University Press.