5. STATE FAILURE IN WEAK STATES:
A Critique of New Institutionalist Explanations.

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This chapter examines the implications of the New Institutional Economics (NIE) for analyzing state failure in developing countries. The NIE approach aims to identify the institutional causes of state failure. In their chapters Bates and Toye have argued that the economic consequences of particular institutions depend on the social and political context in which they are placed. The question is whether the results of the NIE analysis can be grafted on to data about political differences across countries or whether recognizing political differences requires abandoning the NIE approach.

It will be argued that the performance ranking of institutions is specific to the inherited political power of classes or groups subject to the institution. By ignoring this, NIE authors have come up with competing rankings. *Explaining* institutional performance requires an analysis of the implications of the inherited balance of power or ‘political settlement’. *Responding* to institutional failures requires not just an understanding of the balance of power but also requires us to take political positions. This is not only because there are a multiplicity of potential improvements with different class and group implications. It is also because all solutions to institutional failure involve ‘political costs’ or ‘transition costs’. It is necessary to be explicit about these costs and recognize that their incidence is not equal or inevitable. In attempting to sanitize the analysis of state failure by removing political judgements and political positions, NIE may have clouded rather than clarified this issue.

The first section defines institutions and state failure and distinguishes between two types of state failure which have been addressed within the NIE approach. The second and third sections discuss the two types of state failure and examine the NIE approach to each type of failure. The final section draws some conclusions.

TWO VARIANTS OF STATE FAILURE

An institution is defined as the set of formal and informal rules which constrain and govern the interaction of agents subject to that institution (Schotter 1981: 11, North 1990: 3 and Knight 1992: 2). The formal institutional structure includes conventional property rights but also any other enforceable constraints such as taxes and subsidies. State regulation in general creates or attenuates property rights and is therefore part of the formal institutional structure. The state is also the body responsible for the enforcement and protection of all formal property rights. Both formal institutions and informal or voluntary ones affect economic outcomes because they condition the opportunities and incentives of agents. Institutional failure refers to some judgement about the potential improvement in performance if institutions could be restructured.

This chapter is primarily concerned with formal institutions. The state is closely associated with the protection and maintenance of formal institutions and the processes through which they are changed. This is reflected in the close relationship between the literature on state (or government) failure and institutional failure. In the following analysis, the terms state failure and institutional failure are interchangeably used to *describe* the economic performance of formal institutions. State failure is therefore a descriptive term involving only a judgement about the potential benefits of alternative institutions. It does not necessarily imply that the state *decides* which institutions to protect and how. The state or parts of it can under some circumstances act autonomously, in others it simply responds to pressures from competing classes and groups.

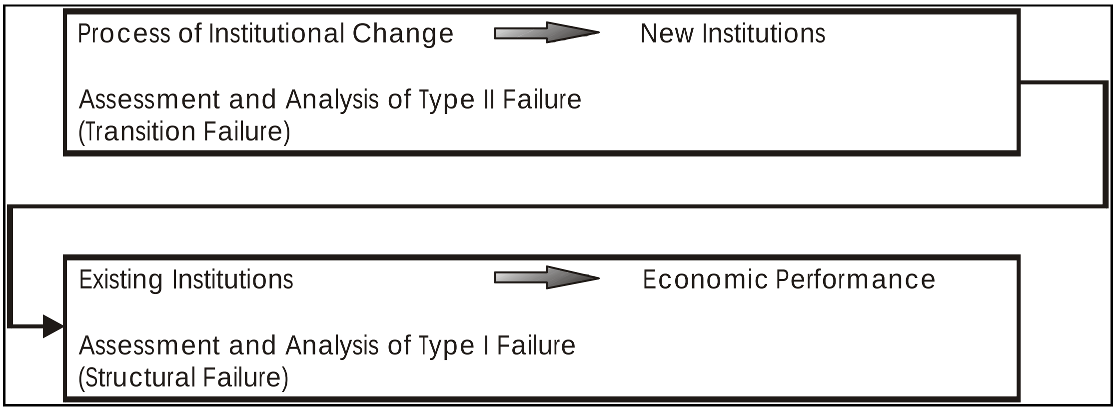

Figure 5.1 Type I and Type II State Failure

Two types of institutional and state failure can be distinguished in the NIE contributions. The distinction is between the performance of the existing set of institutions and the efficiency of the process through which institutions are changed. Type I state failure in Figure 5.1 refers to a comparison of the *outcome* generated by the existing structure of constraints on economic agents with the outcome generated by a hypothetical alternative structure of constraints. Thus Type I failure is referred to as structural failure. Outcomes may be compared in terms of a chosen criterion such as utility, net output or growth. The most general objective is to maximize the level of net benefits for society. *Type I state failure or structural failure occurs if a particular formal institutional structure results in lower net benefits for society compared to an alternative structure.* The lost net benefit indicates the magnitude of Type I failure. The better set of institutions could be theoretically identified or empirically observed. NIE uses transaction cost and rent-seeking analysis to compare net benefits under alternative sets of institutions to analyze the possibility and magnitude of Type I failure.

Type II failures refer to failures in the *process* through which institutions change relative to alternative processes. Type II failures are therefore failures of transition. If Type I failure exists we want to compare alternative paths to a better structure. The existing process may be less satisfactory than an alternative specified by theory or observation and indeed the existing process of change may be increasing the magnitude of Type I failure. If an alternative process could have carried out a transition to a better structure or carried it out faster, the *cumulative* difference in net benefits over a period of time gives a measure of Type II failure. *Type II state failure or transition failure occurs when the process for changing the structure of institutions attains a lower cumulative set of net benefits for society compared to an alternative process over a given period*. For Type II failure, NIE relies on 'higher level' transaction costs such as Douglass North's political transaction costs (North 1990) or the costs of organizing collective action to analyze the institutional determinants of processes of change.

TYPE I STATE FAILURES

The NIE analysis of Type I or structural failure draws on the analysis of rent-seeking and extends it using an analysis of transaction costs. It aims to analyze the contribution of different institutions to economic performance. This understanding aims to aid the identification of the institutions responsible for structural failure across countries. This section examines the consequences of the NIE attempt. Different NIE analysts have identified very different institutions as being critical for success or failure. We argue that these contrary rankings can be explained by making explicit the political balances of power required to make different institutions work efficiently.

Rent-seeking models (Krueger 1974, Posner 1975, Buchanan 1980, Bhagwati 1982) emerged in trade theory and the New Political Economy (which is critically reviewed in Toye 1993). Proponents of such models argued that the cost of state intervention was more than the traditional deadweight welfare losses associated with the divergence of prices from marginal costs. This is because state-created rents create incentives for agents to leave productive activities for so-called unproductive ones to try and acquire credentials which give access to the rents. The withdrawal of resources from productive uses continues till the expected marginal return to a factor from productive and unproductive activities is equalized. The cost of rent-seeking is the use of productive resources in unproductive activities. Type I state failure is associated here with state intervention. Moves towards laissez faire are predicted to reduce the incidence of rent-seeking and hence Type I failure.

Transaction cost analysis derived from the seminal work of Coase (1937). Transaction costs are the costs of agreeing on a contract (including measuring all the attributes relevant for the exchange) and the costs of enforcing the contract (including the costs of detecting infringement, policing and punishing) (Matthews 1986: 906, North 1990: 27, Eggertsson 1990: 14). Coase's insight that transaction costs differ across institutions underlies the NIE analysis of Type I failure. Type I failure is attributed to high transaction cost institutions.

Transaction costs are detrimental for social net benefits because they prevent gainful transactions from occurring which might otherwise have taken place. The failure to exhaust gainful transactions is, of course, market failure. Consequently, transaction costs are simply a way of describing the causes of market failure. If finding the best technologies, organizing the process of production, finding markets, arranging insurance and writing credible and fully enforceable contracts for all of these were costless, every society would be on the notional production frontier. Since all such costs must be transaction costs, the gap between the neoclassical production function and reality can always and tautologically be attributed to transaction costs. To proceed beyond the conventional analysis, the transaction cost approach has to identify an attainable set of alternative institutions with lower transaction costs.

How are these institutions identified by NIE? In what respects does the transaction cost approach extend the rent-seeking framework? Varian (1989) showed that if rent-seeking only resulted in pure transfers there would be no social cost in the conventional sense. The social cost derives from the effects of rent-seeking on the vector of net products. If rent-seeking results in a lower-valued vector of net products with unchanged endowments this is equivalent to production inside the production frontier. This in turn can be described as an increase in the transaction cost of organizing production and exchange. Thus rent-seeking results in Type I failure by increasing transaction costs. Since rent-seeking is only one of the sources of transaction costs, the transaction cost framework can be used to show why the rent-seeking argument may be one-sided in its simple versions.

First, all property rights confer privileges on their possessors. Compared to the alternative where an individual did not have a particular right, these privileges have the character of rents (Roemer 1982, 1988). Rent-seeking type activities can, therefore, be expected to be associated with any structure of rights as people would spend resources trying to change or maintain them (Samuels and Mercuro 1984). Compared to a situation where such contests did not take place, any right structure has rent-seeking costs due to contestation. Type I failure however, only exists if lower rent-seeking costs are *attainable*. Comparing the real world with a contest-free laissez faire which is unattainable is irrelevant. The relevant transaction cost difference between intervention and non-intervention may be much smaller than suggested by rent-seeking theory.

Second, intervention can *save* transaction costs by changing incentives or enabling coordination and monitoring. What matters therefore is the net effect on transaction costs. For instance, if infant industry protection allows cheaper coordination of technology acquisition, the net effect on transaction costs after rent-seeking may still be favourable. If so, intervention with rent-seeking may have lower overall transaction costs than laissez faire with lower rent-seeking.

Although one-sided, the rent-seeking analysis showed that there may be real social costs as a result of contests over property rights. But by concentrating on and overstating the costs it ignored the improvements in net benefits which changes in institutions (or rights) could bring. The transaction cost framework enables this point to be made, although the precise social cost of contests over rights in different contexts is still imperfectly understood. In the early models it was assumed that the social cost was exactly equal to the size of the rents being contested. This was soon shown to be based on assumptions about the political institutions governing rent-contestation (Congleton 1980). Two complementary approaches emerged in the NIE literature to preserve the mapping from institutions to Type I failures. Both attempts ultimately fail.

The first of the two approaches incorporates the effects of formal *political* institutions. It argues that by looking at the effects of formal economic and political institutions jointly we can preserve the mapping from institutions to economic outcomes. Examples of such analyses are Congleton (1980), Rogerson (1982) and Chang (1994). The problem is that in each case it is easy to imagine alternative situations where the results suggested are overturned.

Congleton compares rent-seeking expenditures under majority voting with those under a dictatorship. He finds that if legislators in a majority vote setting can be cheaply bribed, there is less rent-seeking expenditure than under a dictatorship. He points out, however, that if legislators demand high minimum bribes, a dictatorship is cheaper (Congleton 1980: 177). Rogerson compares political institutions which limit access to rents to a small group with political institutions which allow unrestricted access. He finds that limited access might lower rent-seeking transfers. This result too can be overturned if the excluded have the power to heavily contest their exclusion. In Chang (1994) the costs of contestation can be reduced if the state is less vulnerable (p. 38-40) and if the rent-seeking process is less competitive (p. 41-44). However, as he points out, an invulnerable state can sometimes result in large social costs and restricted access to rents at one level can simply lead to rent-seeking spilling over to other levels. It appears that the costs of contestation cannot be deduced from the formal political rules under which the protagonists operate.

The second approach, associated in particular with North (1990 and in this book) is to introduce politics through an analysis of informal institutions while retaining the analysis of formal political institutions. Informal institutions are the norms and conventions which also constrain agents but are not enforceable by third parties. They are important for the functioning of formal institutions because they determine the intensity of contests and therefore determine how cheaply and effectively existing rights can be enforced. Thus a formal institution (such as private property) is likely to have very different consequences if important informal norms (such as the commitment to honour contracts) are absent. The conclusion is that it is not enough to create the formal institutions which lower transaction costs, we also have to create the political conditions which sustain the appropriate informal institutions. This argument is very similar to the previous one, except now it is a combination of formal and informal institutions which determine Type I failure.

In North's (1990) analysis, the best formal economic institutions are well defined private property rights. These formal institutions work best with particular informal institutions which support trust in (and therefore reduce contests over) private property rights. The analysis identifies the best economic institutions and then deduces the best informal institutions necessary to support them. For North (Ch. 2, this volume), the importance of the polity is in ensuring that the required informal institutions come into being.

The critical assumption is that the choice of the best formal institutions is independent of the polity. If the best formal institutions are indeterminate, so are the best supporting informal institutions. For instance, if lifetime employment can be the best institution for some contexts, the best cultural norms would be appropriately different. If the ranking of formal institutions depended on characteristics of the polity, this would undermine the NIE project of attributing performance to institutions and require an analysis of the relative performance of institutions under well-specified political conditions.

The strongest support for such a critique paradoxically comes from the work of institutional economists themselves. North's analysis of institutions is supported by a comparison of the British-North American path with the Spanish-Latin American one (1990: 112-117). In contrast, the evidence from the East Asian NICs has been interpreted by a number of observers as supporting the case for intervention particularly for technology acquisition (Wade 1990, Amsden 1989).

Using the NIE analysis, Chang (1994) argues that state intervention in South Korea *reduced* transaction costs by enabling the coordination of technology acquisition at a lower cost. These analysts thus reverse North's institutional ranking by suggesting that attenuated private rights might perform better than well-defined ones.

The evidence suggests that the political balance of power conditions both the problems institutions have to solve and the costs of solving them in particular ways. The Industrial Revolution in Britain and early North American industrialization occurred in fairly similar societies. Political power was relatively dispersed and technical opportunities required relatively small investments. Well-defined property rights and the market resulted in growth. These institutions can therefore be *described* as having low transaction costs. In contrast, South Korea and Taiwan in the 1960s were societies where political power was effectively centralized and both faced the opportunity of catching up by coordinating technology acquisition. In these countries centralized coordination proved effective and interventionist institutions can be *described* as having low transaction costs. The NIE explanation is misleading because in neither case does this describe anything intrinsic to the institution but only its performance in a particular context.

Looking at the experiences of less successful countries demonstrates why this is critically important. Pakistan in the 1960s, for instance, had an interventionist state quite similar in its modernizing motivation to the one in South Korea. It also had political exclusion under a military regime. Its economic performance was initially promising but not good enough to satisfy all demands and the experiment ended with civil war and the dismemberment of the country in 1971. In Pakistan, as in many other developing countries, although political power was formally centralized, effective political power remained dispersed and was used to challenge formal political and economic rights. Here a strategy which required the centre to coordinate the interests of political organizations rapidly became prohibitively conflictual (Khan 1989).

Both rent-seeking analysis and the subsequent transaction cost models are in effect correcting implicit assumptions in conventional models regarding the social costs of contestation over different sets of rights. However, the net effects of an institution depend not just on the institution and the production technologies it coordinates but also and critically on the balance of power between the classes and groups affected by that institution, that is, on the *political settlement*. North is quite right in pointing out that the informal institutions which can be supported in an economy depend on the polity. However the same is true for formal institutions. The contestation over particular institutions can vary across polities. If so, an institution which is theoretically superior in a model which keeps these costs constant may not be superior when we allow for differences in the political settlement.

One consequence of recognizing differences in the political settlement is that it is possible to explain why performance rankings of institutions in one political settlement may not be transportable to another. The related but more serious problem is to devise a methodology which will allow us to isolate important questions about institutions and to develop analytical models which can address the performance of institutions in specific settlements. The NIE methodology summarized in Figure 5.2 assumes that it is possible to separate the transaction costs associated with an institutional structure into the 'institution effect' of each institution and a residual 'political effect' to be attributed to the political settlement. Instead it is more likely that the balance of power determines the net benefits particular institutions or structures can deliver by determining the contestation costs of maintaining the institution.

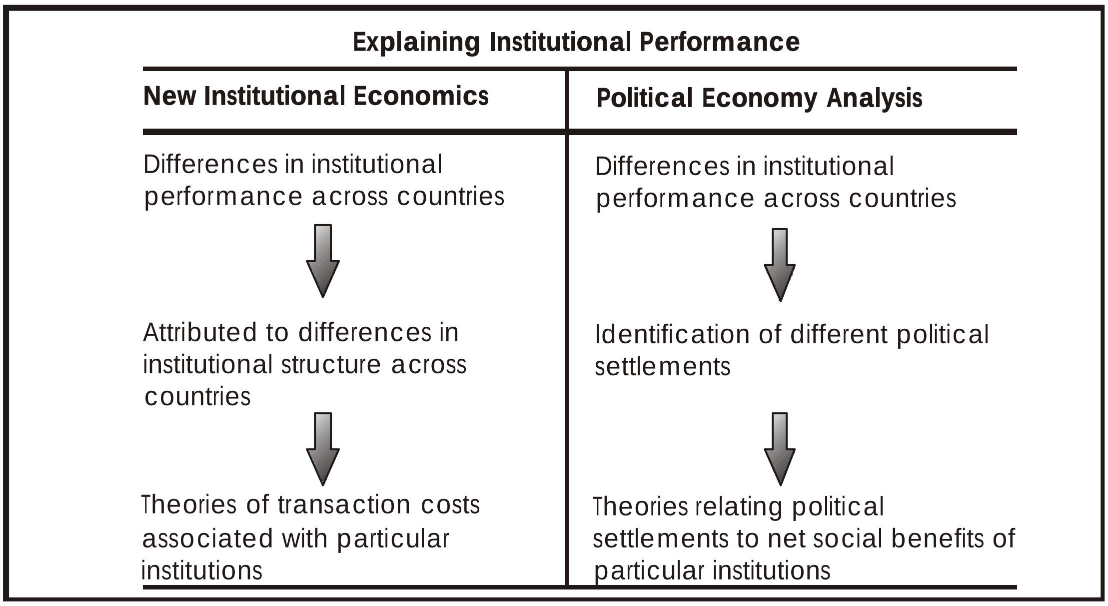

Figure 5.2 NIE versus political economy methodologies

If so, a more appropriate methodology would be to begin by trying to identify important aspects of the political settlement in the country where Type I performance is being assessed. Information about the political settlement can come from historical and sociological sources. It can also be based on comparing institutional performance in the country with others which attempted similar institutional changes. If performance differed substantially, this would alert us to the relative power of classes or groups adversely affected by the institution in the two countries. The alternative methodology is also summarized in Figure 5.2. Here the analysis of the relative economic effects of institutions is concerned with the effects of a specific political settlement on the net social benefits associated with alternative institutions.

The implications in terms of policy assessments are quite substantial. Comparing Pakistan with South Korea does more than simply point to conclusions about the transaction costs associated with particular institutional arrangements. Instead a comparative exercise and a reading of history facilitates an understanding of differences in the balance of power between the groups relevant for each set of institutions across these countries. A comparison of industrial policy in Pakistan and South Korea in the 1960s suggests that the former had much stronger clientelist linkages between middle and lower-middle class groups and the state. These linkages prevented the Pakistan state from making centralized decisions except at a much higher cost in terms of lost net benefits compared to South Korea (Khan 1989).

Industrial policy would be 'responsible' for Type I failure in Pakistan if it is possible to identify alternative institutional arrangements which would imply higher net social benefits *given the balance of political power* in that country in the 1960s. The Pakistan variant of industrial policy, like the South Korean one, was based on the state deciding the industrial activity of a small number of large conglomerates. There are a great number of alternatives which may have reduced the costs of contestation emanating from a large, well-organized but excluded middle class. For instance, the Taiwanese strategy allowed small capitalists to compete vigorously in a relatively free market while technology acquisition was organized by the public sector (Whitley 1992 compares the sociological differences with the South Korean strategy). This may have absorbed many more members of the middle-class into capitalist roles. The role of multinationals is also interesting because it may allow a clientelist state to prevent contestation in critical areas. The Malaysian strategy of limiting most of its clientelism to sectors where important technology decisions were not involved is instructive. Other more radical institutional alternatives could also be considered. Thus industrial policy may have been responsible for structural failure in Pakistan even though it played a dynamic role in South Korea. Why did the Pakistan state follow such a strategy? Was it a weak state? These questions are addressed in the next section.

TYPE II STATE FAILURES

Why should the executive branch of any state not introduce growth-increasing rights? After all, even a predatory state could benefit from growth. The failure to change institutions to improve social net benefits is Type II state failure or transition failure. Explanations of Type II failure can be classified under three heads. The first looks at the objectives of the political leadership and in particular their time horizon compared to that of society. The second concentrates on errors of calculation and the correctness of the models of the world used by agents including the political leadership. The third and potentially most interesting approach looks at the costs of change. The NIE contribution here has been to model these costs as a variant of transaction costs (as in *political* transaction costs, North 1990). The remainder of this section will concentrate on the implications of applying transaction costs to the analysis of change and briefly indicate why the other two approaches are of limited interest.

If policy makers desire lower growth than society, this is a failure of political representation. Problems emerge when an attempt is made to identify systematic reasons why political leaders may not want growth. One explanation is in terms of the time horizon of leaders. This is implicit in the revenue-maximizing state discussed in North (1981). Such a state is not interested in introducing output maximizing property rights if this lowers short-run tax revenues. Casual observation suggests that predatory leaders do not always have short time horizons. Marcos in the Philippines or Ershad in Bangladesh behaved till the very end as if they expected to last forever. Moreover, even if some predators have high discount rates, is this an exogenous variable? For instance, the Kuomintang in China in the 1940s could only be described as predatory (Moore 1991: 187-201). The very same Kuomintang in Taiwan in the 1950s established a developmental state (Wade 1990). It is unlikely that there was an exogenous change in the time preference of Chiang Kai Shek and his party between these two dates. It is more likely that the behaviour of the KMT in China followed from an inability to impose their programme on the population. Type II failure has to be explained by something other than the time preferences of the leadership.

The problems with the knowledge-based arguments are quite similar. Wrong models of the world and imperfect knowledge have been identified as a cause of stagnation (North 1990: 8). For instance, policy-makers may have introduced tariffs to protect domestic industry but, by taxing their raw material imports as well, the net effect may be to disadvantage domestic industry. However, if knowledge was the source of Type II state failure, why does it persist? It would be hard to argue that leaders of less successful countries have lagged behind in *wanting* to learn policies and ideologies from more successful countries. Nor is there any evidence that they persistently make a greater number of mistakes. But less dynamic countries *do* find it more difficult to correct mistakes once made. Failure may have more to do with the costs of changing institutions rather than imperfect knowledge or inadequate vision.

Even if there were substantial differences in the models used by leaders, there are good methodological reasons for focusing on the costs of change in analyzing Type II failure. The relative importance of subjective and objective factors in explaining the performance of the state is an old issue in social science. In the case of firms which share the same environment, the differences in the subjective creativity of entrepreneurs (Schumpeter's entrepreneurial vision) may be fairly important in explaining their relative performance. In comparing the relative performance of states, the objective differences in their environments are likely to be far more substantial. The environment refers not just to technological possibilities but also to political settlements. Subjective differences between leaders may still be important but may in this case be *relatively* less important. Good analysis should therefore begin by asking how objective factors might determine Type II failure.

The third set of explanations focuses on the objective political differences between societies. If growth-enhancing institutions do not emerge there must be resistance to change. The NIE approach is to model institutional change as a series of voluntary contracts. It is therefore exactly analogous to the neoclassical model of market exchange. In the latter transaction costs may prevent all the gains from trade from being exhausted. In exactly the same way, the costs of organizing institutional change may prevent all socially beneficial institutional changes from being implemented. Institutional change involves losers, and if it is to be freely negotiated, the losers must be compensated. In the NIE literature, the compensations are referred to as side-payments (Libecap 1989) or participation bribes (Dow 1993). Political transaction costs are the costs of *organizing* the side-payments which allow institutions to be changed through a process of voluntary contracts (North 1990: 49-51). Type II failure is then explained by high levels of political transaction costs:

> The efficiency of the political market is the key to this issue. If political transaction costs are low and the political actors have accurate models to guide them, then efficient property rights will result. (North 1990: 52)

The critique of the NIE approach to the costs of change applied in this chapter makes two related points: (a) If all institutional changes were voluntarily negotiated with compensating side-payments, all Type II failures would be due to failures of knowledge alone. The costs of change then become irrelevant as an explanation of Type II failure. However, (b) most important institutional changes are *politically* resisted by the losers because compensation is either not offered or, if offered, is not accepted. The intensity and extent of resistance is the real 'cost of change' faced by its initiators, namely, the *transition cost*. This is a cost of change but it is not the political transaction cost. The transition cost is the political cost faced by initiators of new institutions. It depends on the change attempted, the gainers and losers from that change and the balance of power in that society. Thus, it can be concluded that the NIE approach does not in fact explain Type II failure. It is possible to have Type II success with high political transaction costs. It is equally possible to have Type II failure with low political transaction costs.

First, it is necessary to establish why political transaction costs are not relevant for the transacted institutional changes analyzed by NIE. Suppose voluntary contracts were the only available procedure for organizing institutional change. Then the only *attainable* institutions would be those which could be created through voluntary negotiations between individuals. If agents had full information they would always contract into the best attainable institutions given their costs and preferences. Attainable institutions would only be 'lost' if the political transaction costs were higher than they need be. Is there any reason why political transaction costs should be higher than attainable?

Like ordinary transaction costs, political transaction costs are specific to institutions, in this case political institutions. Consequently, individuals could contract to create new political institutions to lower political transaction costs if *they* were attainable. With full information, this too should automatically happen whenever there are potential gains in net benefits from such a change. For North, democratic institutions may not have zero political transaction costs (1990: 51) but they are the most favourable institutional structure approximating that condition (1990: 109). For others in the NIE tradition, the costs of negotiating can be lowered by *restricting* political access (Rogerson 1982, Chang 1994: 38-40). In either case, an explanation has to be found which shows why individuals do not negotiate the creation of *political* institutions with the lowest political transaction costs.

It may be that such political changes are blocked by even higher level transaction costs ('constitutional transaction costs'?). These may include the costs of making credible commitments of compensation to those disadvantaged by the proposed political changes or the costs of monitoring new types of free-riding behaviour once the new institutions are created. Either these constitutional transaction costs are unavoidable and prohibitive in which case political institutions cannot be changed to reduce political transaction costs. In this case we have no Type II failure. Or political transaction costs *can* be lowered. In this case political transaction costs are indeed responsible for Type II failure but this should be transitory. As soon as agents are informed of the possibility of reducing political transaction costs they should freely negotiate the institutional changes which would remove the Type II failure.

With full information, the best institutional world attainable through individual contracting (apart from transitory blips) can be realised (Dahlman 1979). Consequently, political transaction costs can only explain Type II failure during the transitory blips when agents have not caught up with new knowledge. Only persistent failures of knowledge can result in political transaction costs being persistently higher than necessary. In that case this explanation collapses into the lack of information explanation discussed earlier.

But in fact important real world institutional changes are rarely accompanied by the compensation of losers. Human history may not be a history of class struggle alone but it is certainly not a history of negotiated institutional change. Modelling institutional change 'as if' it were a negotiated process with compensation allows the importation of sophisticated tools developed in the neoclassical analysis of market exchanges but makes the analysis seriously deficient. Real world institutional change involves path-changes. These are discontinuous breaks in the paths that would have been negotiated through compensation. Even relatively minor institutional changes such as changes in tax rates are typically not negotiated through compensating side-payments. The NIE in contrast is 'explaining' path-dependence which involves negotiated transitions along a defined path which may have many branches.

The costs of change become relevant with path changing. The relevant costs of change are not the transaction costs of organizing side-payments. By definition, if side-payments are not on offer, the cost of organizing them is not relevant. The relevant costs of change are what we shall call transition costs. *Transition costs measure the political costs which potential losers from a proposed institutional change can impose on the proponents*. Proponents of change can rank potential projects in terms of the political opposition they are likely to face. This ranking reveals their assessment of the transition costs of projects. The ranking may turn out to be wrong and have to be revised over time. But at any given time, the transition cost ranking indicates which if any of the projects are politically feasible given the tolerance level of the proponents to absorb transition costs.

Unlike political transaction costs which are an economic cost, transition costs cannot be measured using an economic numeraire. The political costs they measure are the "costs" inflicted on a specified group by political events such as physical violence or defeats in elections. Some of these costs may have an economic counterpart in damage to property or losses to production but even here what matters is the ranking of composite bundles of costs associated with each strategy. One important determinant of the transition costs political contenders can inflict on one another is the balance of power described by the political settlement. Given the transition cost ranking of each group, the feasibility of particular projects depends on the critical level of transition costs the group can absorb. The ability to absorb transition costs and change rights in turn changes the political settlement since the relative political power of classes depends to some extent on their formal economic and political rights.

	HIGH POLITICAL TRANSACTION COSTS	LOW POLITICAL TRANSACTION COSTS
HIGH TRANSITION COSTS FOR GROUP PROPOSING GROWTH	SLOW TRANSITION Pakistan 1960s	SLOW TRANSITION South Asian Democracies
LOW TRANSITION COSTS FOR GROUP PROPOSING GROWTH	RAPID TRANSITION East Asian NICs China 1980s	RAPID TRANSITION US and UK 19th century

Figure 5.3 Political transaction costs versus transition costs

Although transition costs are not directly related to political transaction costs, organizing cooperation within a class or group with similar interests does depend on the costs of organizing side-payments. In turn, the ability of the contending groups to organize collectively is one factor determining the political costs they can impose on others. The relationship between transaction costs and transition costs is shown in Figure 5.3.

High transition costs for classes proposing growth-enhancing institutional changes is shown in the top row in Figure 5.3. Transitions will be slow regardless of the political transaction costs of negotiating change. Implicitly the balance of power is in favour of groups who would be hurt by the growth strategy proposed. Here low political transaction costs may paradoxically allow cheaper organization of resistance by the dominant group. The stagnation in the top right hand cell may be deeper than in the top left hand cell! This would be the case, for instance, if institutional changes proposed by an emergent industrial class are being successfully resisted by clientelist groups which stand to lose from these changes. In such a context, political arrangements with low costs of negotiating collective action (such as an efficient democracy) may help the dominant clientelist groups further (Khan 1989).

On the other hand, if the political settlement favours classes who are initiating growth-enhancing institutional changes, they will face low transition costs along the bottom row in Figure 5.3. Once again, the effects of political transaction costs are indeterminate. Low costs of negotiating political transfers may further help the already dominant class to coordinate their strategies and to suppress political opposition. The emergence of Parliament as a committee of enclosing landlords may have played just such a role in seventeenth century England (Moore 1991: 19). However, if universal suffrage is the only democratic option, an emerging capitalist class may prefer *high* political transaction costs. With more efficient political institutions, they may find it easier to coordinate their own actions but they may also have to compensate losers much more. The experience of the East Asian NICs and China in the 1980s demonstrates this. The Chinese experience also shows that well-defined property rights may not be necessary for Type I success. If the initial allocation hindered capitalist development, with an appropriate political balance of power, weakly-defined rights may simply indicate rapid transition and Type II success.

Type II failure or transition failure can happen for two sorts of reasons. Given the political settlement, it may be that some beneficial changes with acceptable transition costs are lost because of problems of knowledge or vision or avoidable political transaction costs. These factors result in a failure to negotiate improvements which could have been contractually attained. NIE explanations of Type II failure address this aspect of the transition problem. A second possible reason for Type II failure is that transition costs for a *specific* class or group results in potential institutional changes not being selected. This much more important possibility is the one which needs to be seriously addressed.

The identification of Type II failure due to high transition costs could in turn be based on a number of comparisons with different political implications. First, it should be possible to compare the existing *institutional structure* with an alternative (with lower Type I failure) *holding the political settlement constant*. Type II failure exists if the existing process of institutional change does not lead to the emergence of this alternative structure. Second, a comparison might be made between the existing *political settlement* and an alternative (with lower Type I failure) *holding the existing structure of institutions constant*. Type II failure follows in this case from the state and the classes associated with existing institutions not being able to change the political settlement in the appropriate way. Finally, it may be possible to compare existing performance with an alternative with different institutions *and* a different political settlement. Type II failure in this case follows from not being able to change both institutions and the settlement in appropriate ways.

While it is relatively simple in each case to *describe* the location of Type II failure, by focusing on one location rather than the large number of alternatives, the analyst is making a political judgement about the transition which is desirable. This is a political judgement because there is no arithmetic to compare alternative sets of potential net benefits with transition costs which vary in their intensity and incidence and which are ordinal rankings specific to particular groups. Nevertheless such judgements have to be made. It is then necessary to be explicit about the political values and notions of justice informing the particular choices being suggested.

Differences in political implications can be seen by referring to the example of structural failure in Pakistan in the 1960s. The first type of comparison would locate transition failure in the inability of alternative sets of capitalists (small capitalists or multinationals for instance) to establish alternative institutions more appropriate to the political settlement. The focus here would be on the inability of these groups to absorb the transition costs involved or to reduce the ability of existing groups to inflict these costs. The policy implication would be to mobilize and strengthen these groups for such a contest. Alternatively, a comparison could be made between the political settlement in Pakistan and an alternative which would allow industrial policy of this type to work. Transition failure here would be attributed to the inability of the military regime to change the political settlement by absorbing the transition costs involved or reducing them through political deals. The Ayub Khan regime in Pakistan did in fact attempt such a transition through a process of suppression and selective incorporation of clientelist groups. The experiment was abandoned after the uprising of 1969-71 and a civil war in which possibly a million people died. If the state is still judged to have been a 'weak state' the subsequent policy implications are clear. Finally, a comparison with an alternative set of institutions with a different political settlement could result in radical conclusions and the identification of alternative political programmes.

The analysis of transition failure is therefore quite separate from the political judgements involved in selecting a particular strategy of transition. The great danger with the NIE approach is that by ignoring transition costs it presents what are essentially transitions as processes which can be managed judiciously by states which have the right models or the right 'vision' (Chang and Rowthorn 1993). States, when they are involved in processes of transition, are attempting some transitions rather than others. The justification for this must be based on a politics which should be made explicit. Moreover, transitions which had low transition costs in one context may not in another. The difference between South Korea and Pakistan had little to do with the quality of their leaders and their conflict management skills. The real difference was in the balance of power in these societies in the 1960s. A political assessment of the transition costs which were inflicted by the Pakistan experiment of the 1960s suggests that other strategies of transition must have been preferable even if Pakistan had managed as a result to achieve the South Korean rate of growth.

CONCLUSIONS

The aim of the NIE is to analyze the economic implications of institutions and to suggest policy. It has been argued that a mapping from institutions to economic performance cannot be sustained either theoretically or with reference to history. This conclusion holds even if the institutional specification includes political and informal institutions. An analysis of the political settlement is required for assessing the contribution of specific institutions to Type I failure. It is even possible for the ranking of institutions in terms of their economic performance to be reversed under different political settlements. The alternative research methodology suggested is to analyse the implications of institutional structures under specified political settlements.

The analysis of transition or Type II failure is even more seriously affected by the absence of a political analysis. The NIE analysis is either correct and trivial or incorrect and misleading. It would be correct if real world institutional changes were voluntarily negotiated between contracting parties. It would nevertheless be trivial because in such a world all transition failures would be due to information lags. In fact, institutional change does not involve compensation and the NIE analysis turns out to be seriously misleading. The relevant cost of institutional change is a political cost, the transition cost. The transition cost is closely dependent on the political settlement. Transitions which were possible with low transition costs in one context may be unacceptably costly in another. But this is not all. To select between strategies which have different intensities and distributions of transition costs requires a political judgement about the acceptable incidence of transition costs. Finally, it is worth remembering that a ‘mistake’ in the assessment of the transition costs involved in implementing particular programmes of institutional change can ultimately result in civil war and large scale loss of lives. The false sense of objectivity in the NIE analysis could not be more serious.

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