



## State Failure in Developing Countries and Institutional Reform Strategies

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Two radically different theoretical views on the role of the state in economic development have driven policy debates on the location of state failure and the priorities of institutional reform in developing countries. A lack of clarity on this underlying difference has been the source of much confusion. I shall refer to the dominant view, which has underpinned the mainstream consensus on the state, as the service delivery model, and the second view, which looks at the role of the state in the context of the transition to capitalism, as the social transformation model.

The service delivery model focuses on a range of services that states should deliver, in particular, public goods such as law and order, social security, and market regulation, and relies on competitive markets to deliver all other goods and services. The social transformation model looks at the more critical and problematic role the state plays in the transformation of essentially precapitalist and pre-industrial societies into dynamic and essentially industrial, capitalist ones. While states do deliver services, the service delivery model of the state is misleading for poorly performing developing country states undergoing reform. Historically, success in service delivery has generally depended on states' success in pushing social transformation rapidly in the direction of viable capitalist economies. The critical area of state failure has been the absence of adequate institutional and political capacity in developing country states to assist in and accelerate a dynamic transformation. Without strategies to enhance this role of the state, sustained progress on service delivery is also unlikely. 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.

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The state's pivotal role is based on its claim to the monopoly of legitimate violence. The state is the only body in society that can legitimately enforce institutions, collect taxes, redistribute income and wealth, and represent and enforce social cohesion or resolve conflicts, in all cases using force if necessary. All these functions are interdependent and have a role to play in both service delivery and social transformation. This paper cannot look at all these areas, 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 the state enforces 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 decisionmaking bodies that set the rules for changing rules. Because variations in this set of institutions can potentially have large effects on the quantity and quality of investment, economists agree in general terms that state failure can have a significant effect on growth (see, for instance, Bardhan 2000; Bates 2001; Khan 1995; Lal and Myint 1996; Migdal 1988; North 1981, 1990; Olson 2000; Shleifer and Vishny 1998; Stiglitz 1998b). Therefore adjusting for differences in initial conditions, persistent shortfalls in growth rates compared with similar countries provide initial evidence of state failure and its severity. While this paper does not directly address static redistribution issues, the strong statistical relationship between growth and poverty reduction (Dollar and Kraay 2001; Lal and Myint 1996) also implies that state failure is responsible for poverty in many developing countries. While redistribution can play an important role in any poverty reduction strategy, this paper focuses on the necessary conditions for enabling any economic growth strategy. This is important in a broad discussion of poverty, because growth is a necessary component of poverty reduction in any poor country.

This paper defines state failure in the broadest terms that can loosely incorporate both positions on the role of the state. Based on Krueger's (1990) definition of government failure, state failure is defined here as consisting of both errors of omission, that is, when the state fails to do things that could have improved economic performance, and errors of commission, which is when the state does things that worsen economic performance. While the identification of state failure implies a judgment that better economic performance could have been achieved, the challenge is also to identify the institutions that could achieve this better performance. The service delivery model uses as its benchmark a model of a well-working market economy, loosely referred to here 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 functions of the state are to protect property rights and to deliver democratically decided upon public goods efficiently. It follows that reform should aim to help developing countries attain the appropriate state capacities.

The consensus view has rapidly come to enjoy widespread support because many of the reforms it endorses, such as the pursuit of democratization, the achievement of greater openness and accountability, and the pursuit of anticorruption campaigns, are rightly supported by most people as ends in themselves. However, the new consensus is based on a partial reading of the theory and evidence, and does not address the core issue of social transformation that is a necessary component of any strategy to accelerate growth. As a result, if international agencies give the impression that these reforms are instruments that can overcome state failure and help achieve economic takeoff, a crisis of expectations is likely to occur 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, the reform package that aims to push institutions in developing countries in the direction of a generalized advanced country model is not relevant for helping developing countries carry out the transition from essentially precapitalist societies to dynamic, capitalist ones. The social campaigns to deepen democracy or prevent corruption are legitimate in their own right. The concern here is only whether these reforms can contribute to a serious shift in the growth paths of poorly performing countries.

Theory and evidence can be interpreted to suggest a different and much more demanding reform agenda to combat state failure in developing countries. Development is an ugly and conflict-ridden process, not primarily because of corruption and the lack of democracy, but because social structures are rapidly changing, new classes are emerging, and new wealth is being accumulated at historically unprecedented rates. In the advanced countries, this social and economic transformation took place over centuries. A shock of a similar magnitude has hit the developing countries, but telescoped into 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 they appear to have done in a few high-growth economies, or whether they will lead merely to the theft of resources by unproductive classes and a descent into anarchy. The institutional reforms identified in the consensus view do not directly address these fundamental challenges facing developing countries during the period of transformation or identify the state capacities required to accelerate the transition in the direction of viable capitalism. Instead it targets some of the symptoms of the transformation period—the prevalence of corruption and the weakness of democracy—and attempts to construct institutions that may not be the most relevant for addressing the problems of transformation that characterize this period. These attempts can prove to be largely irrelevant, but they can also make matters worse by further weakening state capacities, raising unattainable popular expectations, or even by simply diverting attention from more pressing problems. By referring to some of the data, the historical evidence, and the theory

that can be brought into play to interpret it, this paper injects a note of caution into the interpretation of this consensus by policymakers. The consequences of yet another round of multilateral-led reform in developing countries running out of steam do not need to be spelled out.

In contrast with the reforms suggested by the liberal market consensus, getting developing economies through this transformation successfully has historically required stronger and more interventionist state capacities. To begin with, states in high-growth countries participated in the transformation of their economies and societies by helping to create a new capitalist class and ensuring that it succeeded in acquiring technology and entrepreneurial capacity. This involved using a range of policies, including active interventions in property rights and management of growth-enhancing rents (Amsden 1989; Aoki, Kim, and Okuno-Fujiwara 1997; Chang 1994; Khan and Jomo 2000; Lall and Teubal 1998; Page 1994; Rodrik 1995, forthcoming; Wade 1990; Woo-Cumings 1999). The conclusion is that policymakers have to focus on these transformation capacities to enable states to push the capitalist transition if they are to address economic underperformance.

In addition, simply describing 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 on developing countries is also weak in locating the sources of state failure in pushing social transformations. An important aspect of state failure during the transformation is the failure to enforce any institutions, a problem Myrdal (1968) pointed out more than 30 years ago. This paper argues that the distribution and disposition of political power in society is a key determinant of enforcement success, and that the emergence of high-growth states is therefore as much a task of political engineering 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. 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 (defined as the distribution of organizational and political power between competing groups and classes) and the institutions and interventions through which states attempt to accelerate transformation and growth (Khan 1995; Rodrik forthcoming).

Policies must recognize that in most cases, political conditions are not conducive for states to acquire and exercise transformation capacities. In such cases, policymakers have to be concerned with how the disposition and organization of political power need to change over time. An unfortunate misconception is 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, opening up debate about how growth-promoting political coalitions can be constructed is not. On the contrary, by focusing on a set of narrow institutional reforms pertaining to service delivery, international agencies are doing little to prevent the consolidation of unproductive groups in many of the poorest economies.

These concerns suggest that the consensus reforms should not be uncritically supported and indicate other areas where policy-oriented research should focus. The next section looks at the theory and evidence underpinning reforms based on the service delivery model. The following section examines the theory and evidence supporting the need to focus on the capacities of the state that ensure dynamic transformations. The paper concludes with a look at the implications.

## The Service Delivery State

The standard textbook list of the state's service delivery functions is well known. These functions include providing law and order, correcting market failures, and, in particular, providing essential public goods and limited welfarist redistributions. Underpinning the service delivery concept of the state is a set of well-developed theories of how a liberal market economy works. The model has three theoretical components that have combined to produce the liberal market consensus underpinning the service delivery view of the state. (While the post-Washington consensus defined by Stiglitz [1998a] strongly criticizes the Washington consensus on the role of the state, both are part of the liberal market consensus in terms of the key policy conclusions discussed below.)

The first component of the model is that efficient markets are rent free and have stable property rights. The standard theory of efficiency in competitive markets has been deepened by new institutional analysis that argues that stable and well-defined property rights are a precondition for efficient exchange and 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 what they can earn in their next-best opportunity, and so rents exist if those in the next-best activities are prevented from acquiring 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. The new information economics critiques this model of the market, but the simpler view still dominates the liberal market consensus on the state. In terms of service delivery, both errors of commission, such as the creation of monopolies, and errors of omission, such as the failure to provide good infrastructure, can be explained in terms of successful attempts to capture such rents.

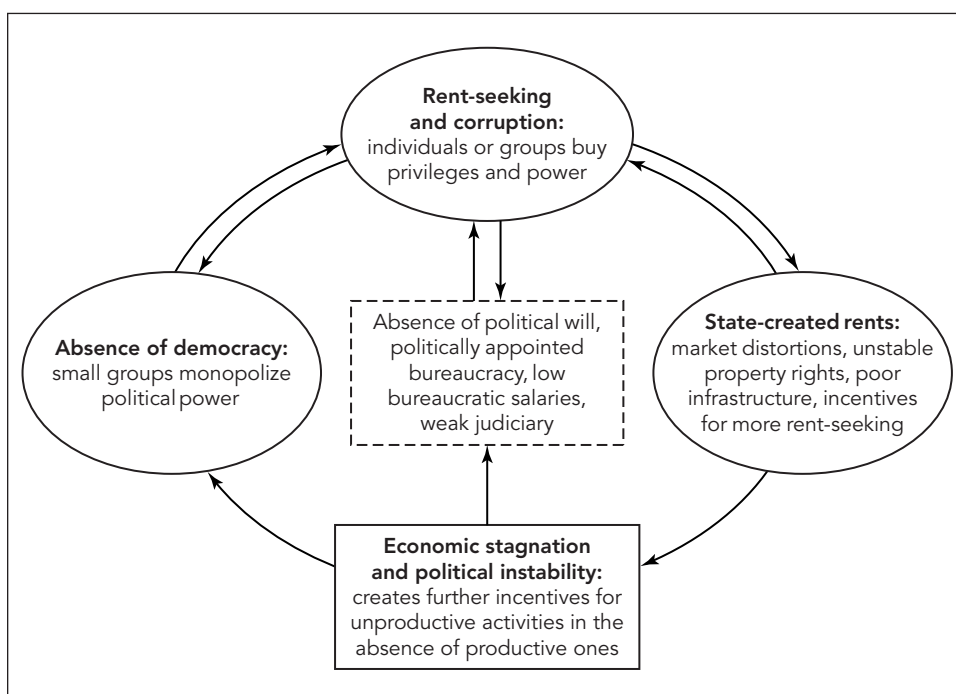
The second component of the model is that rent-seeking creates rents and destabilizes property rights. The persistence of damaging rents and the associated property right instability is thus explained by the incentives for rent-seeking (Krueger 1974; Posner 1975). Rent-seeking consists of such activities as lobbying and corruption that seek to persuade states to create rents. The literature on rent-seeking has been growing (reviewed in 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 illegal rent-seeking whereby the rent-seeker uses bribes to influence public officials. One of the most damaging effects of rent-seeking is the destabilization of property rights, because the creation or reallocation of rents always requires appropriate changes in rights.

The third component of the model is that the absence of democracy and a weak bureaucracy allow rent-seeking to continue. To explain why 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 that small groups can continue with their socially damaging rent-seeking (Olson 2000, 1997; North 1990). Second, low bureaucratic salaries, a politically appointed (hence “short-termist”) bureaucracy, and a weak judiciary can all reduce the expected cost to public officials of accepting bribes, thereby making rent-seeking more likely (World Bank 1997).

Figure 1 shows how these three core components of the liberal market consensus interact to explain how developing countries can become locked into persistent state failure, defined as poor service delivery in such key areas as the protection of stable property rights and the provision of infrastructure, 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, but rent-seeking reinforces the power of special interest groups. In turn rent-seeking not only creates rents, but the presence of rents induces further rent-seeking. Weak bureaucratic capacity and

**FIGURE 1. State Failure: The Liberal-Market Consensus**



Source: Author.

low salaries not only allow corruption, but corruption makes obtaining the political will to reform the bureaucracy difficult and can make the judiciary corrupt as well. This interdependence means that societies can become locked into undemocratic, highly corrupt, and highly distorted equilibriums (Andvig and Moene 1990; Bardhan 1997; Murphy, Shleifer, and Vishny 1993).

The policy implication of the consensus model is that a number of parallel good 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, the liberal market consensus now argues that these policies will not be sustained without simultaneous political and institutional reforms. Political reforms are understood as moves toward democracy and sometimes decentralization, together with encouraging civil society participation, all with the aim of limiting the state's freedom to create arbitrary rents. Institutional reforms include moves to "right size" the state by focusing on service delivery, reducing the state's institutional capacity to create rents, raising bureaucratic salaries, improving civil service recruitment procedures, and making the judiciary more independent. Fighting corruption overlaps with all these reforms and ensures that the incentives to create rents are further reduced. Correcting state failure, according to the liberal market consensus, requires moves on all these fronts simultaneously, because they are preconditions for specific improvements in states' capacity to deliver such services as critical public goods and stable property rights (Asian Development Bank 2000; World Bank 1997).

## The Evidence

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

To begin with, the indexes measuring governance quality are subjective by nature. Corruption, democracy, stability of property rights, and even degree of policy-induced distortion are measured by indexes based on perceptions or on judgments by "competent" observers. Polls are subject to the problem of scaling across countries, while competent observers can have preconceived ideas about 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 its weights.

In addition, we do not have satisfactory time-series data for periods that are long enough to test for causality using the same group of countries. To see how governance might affect growth, we need both high- and low-growth countries to test our hypotheses. Most of the high-growth Asian economies began growing sometime in the 1960s, 1970s, or early 1980s, but governance indicators are only available from the mid-1980s onward, and the fuller data sets are only available for the 1990s or later. As high growth is expected to improve governance indicators, to test the causal significance of governance variables we need to have governance indexes for high-growth countries before they began their takeoff. Because such indicators are lacking, growth in the high-growth countries is often misleadingly explained using their *ex post* governance indicators achieved after their growth has taken off or instrumental variables correlated with them.

Finally, insufficient observations of successful transformation countries are available for satisfactory econometric results. Only a handful of countries were successful developers over the last 40 or 50 years. Even if we had *ex ante* governance indicators for these countries, in any statistical exercise they are vastly outnumbered by poorly performing developing countries with poor governance indicators on the one hand, and by moderately performing advanced countries with good governance indicators on the other. Thus the characteristics of the critical group of successful transformers are lost as outliers. As a result, the regressions pick up statistical correlations or patterns rather than causality. Incidentally, though small in number, the successful transformers have not been small in terms of population as they include Asian giants like China, but econometric studies do not normally weight observations by population size. This alone might have reversed at least some of the econometric results, even without true *ex ante* governance indicators being available.

The high-growth developers are particularly important, because even though governance indexes are not available for periods prior to their takeoffs, their governance indexes remain quite poor for a considerable period after their growth took off. For instance, even in the mid-1980s, the averages of the Knack and Keefer (1995) indexes of institutional quality based on quality of bureaucracy, rule of law, expropriation risk, and contract repudiation by the government for the Asian high-growth economies were only a little better than those for many poorly performing countries. Rodrik (1997) points out that while growth within East Asian economies was correlated with the index, only Japan, Singapore, and Taiwan (China) had high scores and none were remotely poor by then. Indonesia scored the same as the Republic of the Congo, Ghana, and Myanmar, while the Republic of Korea, Malaysia, and Thailand were at the same level as Côte d'Ivoire. Nor were most high-growth developers democratic when they began growing or for a considerable period thereafter.

As concerns corruption, table 1 shows the Transparency International corruption index for the 54 countries for which the earliest index is available for the period 1980–85 and growth rates for these countries for 1980–90. While the median growth rates of the East Asian developers were far higher than those of the other two groups, their corruption scores were not significantly better than those of other developing



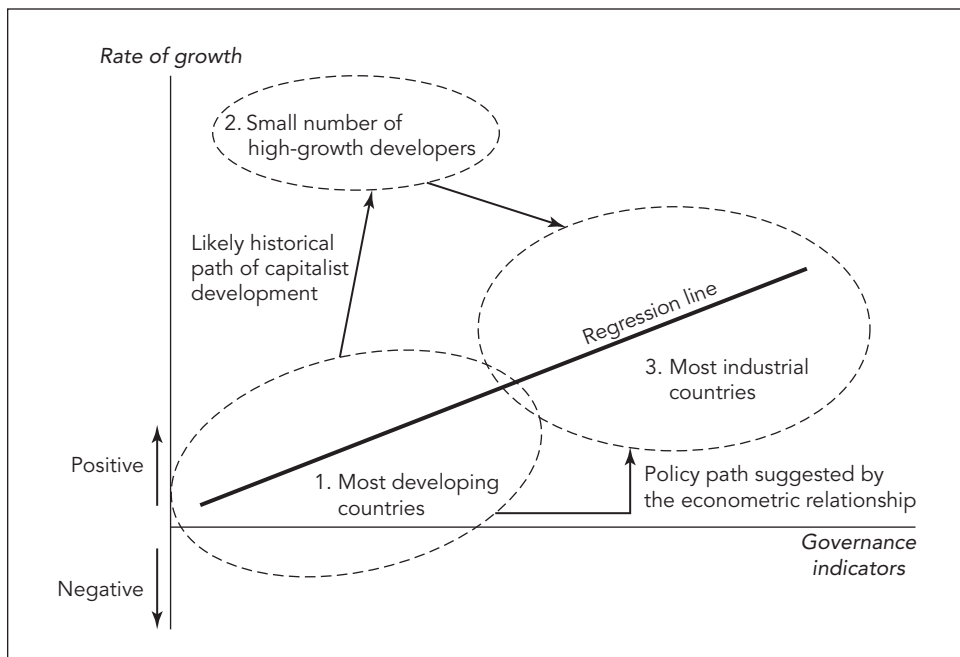
**TABLE 1. Growth and Corruption, 54 Countries, 1980–90**

Item	Developing countries (24 observations)	High-growth developers (6 observations)	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)	3.5 (0.7–7.4)	4.5 (0.2–6.3)	8.1 (4.2–8.4)

GDP Gross domestic product.

Note: The Transparency International corruption index ranges from 0 for the most corrupt countries to 10 for the least corrupt: High-growth developers were separated from the other country groups on the basis of long-term growth rates.

Sources: Transparency International and Göttingen University (2002); World Bank (1999, table 11).

**FIGURE 2. Interpreting the Evidence on Governance and Development**

Source: Author.

countries. If governance indexes were available for the periods before growth took off in the high-growth countries, the differences may have been even smaller.

The governance data conform to the general pattern shown in figure 2. Such data provide the typical positive coefficient estimated for governance variables in regression exercises simply because of the numbers of observations in clusters 1 and 3 and

the few observations in cluster 2. Taking the earlier discussion into account, two main observations challenge the causality suggested by such a regression exercise.

First, no examples exist of any country that initially improved its governance to advanced country levels to achieve equivalent per capita incomes, growth rates, or other characteristics. Reading this as a possibility from the regression line is misleading. As figure 2 suggests, the route to advanced country status may be quite different.

Second, the growth rates in high-growth developers were associated with governance indicators that were insignificantly or only moderately better than developing country averages. By the 1980s, some of the high-growth countries had been rapidly growing for a few decades, and their relatively high per capita incomes would have allowed governance improvements to happen anyway. In other words, we would expect their *ex ante* governance indicators to be somewhat worse than the indicators we have for the 1980s, but even using the corruption indexes for the 1980s, the high-growth economies do not have significantly lower corruption. However, this fails to have any effect on the regression simply because the high-growth countries were so few in number. If there were more high-growth countries, we would probably have observed an inverse U relationship as observed in the case of democracy (Barro 1996). The nonlinearity of the data suggests that something else was happening in the high-growth economies that has not been identified or that the main direction of causality has been misunderstood. Saying that countervailing factors, such as high investment rates or high efficiency of investment, operated in the high-growth economies is not enough, because the institutional argument is that good governance has an economic effect precisely by enhancing investment and its efficiency.

In this context note that not all econometric work supports the new consensus models. In particular, Treisman (2000) finds that the effects of democracy and decentralization on corruption are weak, while Burkhart and Lewis-Beck (1994) find that rises in per capita incomes precede the emergence of democracy and not the other way around. However, in the published literature, contrarian results are relatively rare.

These observations do not imply that governance reforms are unimportant. As governance is what states do, and as the state plays a critical role in pushing social transformations, I believe that governance reforms are even more important than the good governance framework suggests. However, the state capacities identified as being critical have little to do with the good governance characteristics derived from an abstraction of the liberal-democratic state observed in advanced capitalist countries. Rather, far from being a precondition for rapid growth, a more consistent interpretation of the historical evidence is that it shows that good governance—in the sense of less corruption and deeper democracy—is typically an outcome of successful economic development.

The correlation exercises are also misleading in a fundamental respect. The claim that if all else remains the same, then higher levels of corruption will lead to poorer economic performance is simply an arithmetic observation that we do not need to question. The point is whether corruption can be reduced sufficiently in failing states to contribute to an economic takeoff. To begin to approach the levels of development of the advanced countries, developing economies have to grow not just at advanced country rates, but much faster. Even if the regression line in figure 2 accurately

identified the causality from corruption to growth, reducing corruption to advanced country levels would only allow group 3 countries to grow at group 1 rates. The historic challenge is to approach group 2 growth rates, but the good governance framework does not address this question.

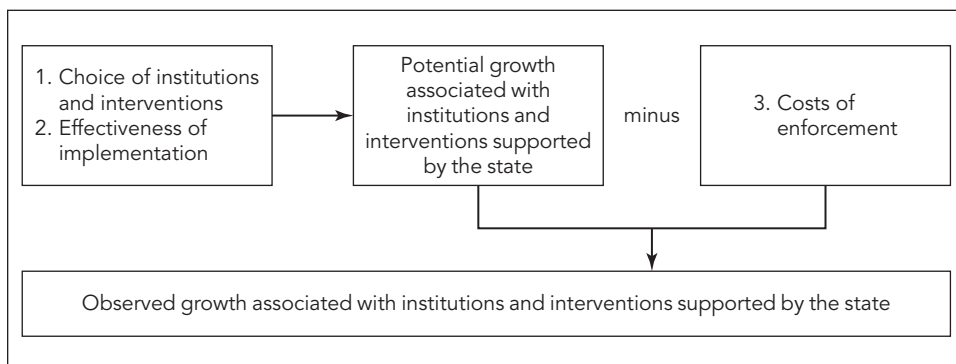
I am not saying that corruption is costless, let alone that it is in any sense functional, nor that democracy is not a fundamental right that people in developing countries strive for. The issue here concerns the degree to which sustainable reductions in corruption or improvements in democracy can be attained before broadly based economic prosperity has been achieved, and even more important, whether these reforms are likely to accelerate economic growth sufficiently to make any impact on poverty (Khan 2002a).

### **The Social Transformation State**

States in developing countries play a much more critical role than the service delivery model suggests. Developing societies are undergoing unprecedented social and economic changes in which states inevitably deploy economic power and violence potential for better or for worse. As rising expectations and social mobilization 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 that already have a dominant capitalist sector, democratic politics usually oscillates around a relatively narrow range of options that seeks to conserve the dynamism of the capitalist sector, and parties usually differ only at the margin in terms of distribution. This reflects two economic facts. First, many of the resources for running the political system come from the capitalist sector, which therefore has considerable influence on policymaking. Second, and more important, 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, when the capitalist sector is, by definition, not dominant. The absence of a dominating feedback loop from the performance of the capitalist sector to the policymaking process in developing countries allows a much greater range of variation in policies and institutions, and makes it possible for sustained state failure to persist when it comes to organizing a dynamic capitalist transformation (Khan 2002b). During this transition period, state success or failure is not related in any simple way to the state's neutrality in upholding preexisting property rights or its abstention from intervening in the economy or in social conflicts. If these were indeed important preconditions, a minimalist service delivery state tightly constrained by good governance reforms would begin to make sense as a policy goal.

In connection with the potential locations of state failure during the transformation, states have differed along four dimensions. First, transformation states have

**FIGURE 3. Factors Determining State Success or Failure**

Source: Author.

differed in terms of their institutions and policies. Second, they have differed in terms of how effectively they enforced these institutions. Third, they have differed in relation to the costs of enforcement, defined as the costs of creating, operating, and enforcing institutions. Finally, they have differed in the processes driving institutional change. Institutions have changed in efficient directions in some cases, but not others. This relates back to the first dimension: if damaging institutions continue to exist, slowing down the transformation, why do they not change? In a dynamic setting, errors of omission do not really differ from errors of commission.

Figure 3 shows how a state's growth performance can be attributed to the first three dimensions. Growth requires not only that the state supports institutions that drive the capitalist transformation, but also requires effective enforcement of these institutions and relatively low costs of enforcement. If growth is systematically low, then the fourth factor, the process of institutional change, will have to be considered.

### *Institutions and Policies during Social Transformations*

The liberal market consensus argues that the institutional structure for maximizing growth is one that ensures the absence of rents. The main task for the state is supposed to be the delivery of democratically agreed on public goods. While service delivery is important, evidence from developing countries casts doubt on its adequacy for ensuring rapid social transformation. Indeed, the state's ability to carry out relatively massive interventions in property rights systems and to create and manage growth-generating rents has been critical in high-growth economies. States have also carried out significant transfers that have contributed to political stability and thereby made the emerging institutional structure politically viable.

### *Dynamic States Can Alter Property Rights in the Interests 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 preexisting rights. This is not surprising. All developing countries are characterized

by large precapitalist sectors that have become unviable and that do not produce enough of a surplus to pay for the protection of their rights. Some of these rights begin to be transferred to more efficient users through the market, but in every developing country a significant part of these necessary transfers takes place through nonmarket mechanisms. These include politically mediated transfers of assets (land reform, transfers through the fiscal mechanism), indirect politically mediated transfers (licensing of land use, manipulation of relative prices), and illegal and quasi-legal activities (land grabbing, staking claims on common property). The scale of nonmarket transfers at this stage can be explained first by the absence of a preexisting and already efficient capitalist sector that can purchase these rights through the market mechanism. Second, the transaction costs of strictly legal exchanges are typically high at this stage, because constructing a generalized institutional structure that can ensure low transaction costs for all market participants is itself an expensive proposition that is difficult to implement until the economy collectively produces a sufficient surplus to pay for it. While nonmarket transfers play a necessary role at this stage, these transfers of assets can and do contribute to the perception that property rights are unstable and contested in developing countries.

If and when a dynamic capitalism emerges through these processes, the new property rights system can rapidly stabilize, because dynamic emerging capitalists can soon spend enough to control or influence the state to protect their rights. Thus a look at property rights stability in high-growth economies once their growth has stabilized can give the misleading impression that property rights stability was the cause of growth. This is where historical evidence is important. Even superficial historical observations show that virtually all high-growth countries undertook or allowed dramatic reallocations of property rights in the early stages of their takeoffs. The stability that distinguishes high-growth countries is not a stability of property rights, but rather a more subtle commitment to growth and to transfer and protect rights in ways that promote growth.

For instance, before the economic takeoff in Korea and Taiwan (China), their states carried out rapid and far-reaching land reforms, in Korea between 1949 and 1950 and in Taiwan (China) between 1949 and 1953. The state compulsorily acquired all agricultural land above a low landholding ceiling at a price well below the market price and distributed it 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 common property resources to emerging capitalists took place 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, in the 1980s Thailand was characterized as one of the most corrupt countries in the world, and yet managed to grow rapidly for decades. Failed transformation states are also characterized by regular seizures of land and resources by the politically connected from the weak and unconnected, but in these cases the grabbers are not operating under a broader institutional system that induces or forces them to become productive capitalists.

Lal and Myint (1996) point out that the most important role of the publicly-owned banking system in the context of Korea’s industrial policy was to transfer

massive amounts of wealth to an emerging capitalist class much 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. Indeed, the ability of the Korean state to reallocate rights through nonmarket mechanisms contributed significantly to the effective implementation of its industrial policy regime. Its conditional subsidy scheme, which essentially subsidized technology acquisition by emerging capitalists, could have had high social costs if many subsidized plants failed to acquire new technologies rapidly, and became bankrupt. However, the Korean state demonstrated its ability to reallocate entire plants across industrial groups before failure had set in, using its financial muscle in the banking sector to get its way (Chang 1994; Lee 1991). By not having to respect the limitations of property rights, civil courts, and procedures, the Korean state could credibly threaten inefficient capitalists with the loss of their assets if they did not meet state export targets, and the state was able to implement these threats with little opposition from the courts or from the losers themselves. In other words, far from weakly defined rights holding back Korea's development, they allowed the implementation of a hothouse strategy for acquiring technology.

This power was often misused, for example, in 1985 when the Kukje group, the country's sixth largest conglomerate at the time, was brought down because it offered insufficient paybacks to the regime (*Far Eastern Economic Review* April 21, 1988; Fields 1995). The government's ability to push the *chaebol* (big conglomerates) around clearly reflected the latter's weak property rights. This political ability on the part of the state inevitably declined over time, so that in 1990, when President Roh Tae-Woo ordered 49 *chaebol* to sell real estate holdings that he believed were speculative, he found that obtaining compliance was extremely difficult (Fields 1995). The growing political independence of the *chaebol* and the increasing technological complexity of the Korean economy were clearly related to the decline of the Korean industrial policy system in the 1990s (Khan 2000b), but by then Korea was already an industrialized economy. The important observation is that when the Korean economy took off, the *chaebol* did not enjoy well-defined property rights in the conventional sense.

In contemporary China, property rights in many of the most dynamic sectors are also not well defined, and even though China's institutions are very different from those of Korea, they are once again assisting the capture of resources by emerging dynamic entrepreneurs (Qian 2002; Rodrik forthcoming). China's dynamic township and village enterprises account for at least 40 percent of industrial employment and exports, but observers have been puzzled about the vagueness of property rights in relation to these enterprises' assets (Bowles and Dong 1999). Although notionally owned by townships or villages, they are actually controlled by dynamic managers who own a small share of the residual. This is puzzling to those who believe that much clearer ownership of the residuals is required for dynamic management. The answer may be that the very vagueness of rights in China is allowing an effective transfer of rights over public assets to an emerging class of entrepreneurs, and that these proto-capitalists are confident that the state will formalize their de facto ownership in the long run provided they remain efficient. In the meantime, this arrangement keeps social contestation low and prevents the upheavals that straightforward

privatization might have unleashed (Qian 2002). It is the political coalition backing growth that was new in China after the 1980s. 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 indexes, but these are based primarily on risk perceptions by joint venture companies in export zones. These indexes are misleading, because while export-oriented companies in China are fairly safe from expropriation, other holders of rights are not. A more instructive approach would be to look at the state's ability to reallocate rights over land, and indeed its ability to control internal population movements that allowed it to set up massive export zones in the first place. Such a degree of power is, of course, not always desirable. As an example of a controversial, state-driven reallocation of rights, consider the Three Gorges Dam project. Nearly 2 million people are to receive compulsory compensation on a scale and at a time decided by the state, and many others who are displaced will probably never be compensated. Setting aside questions about the project's technical viability and cost-benefit ratio, it is an example of how the Chinese state can reallocate property rights if it believes that a project will further national development. In contrast, property rights are much better defined in many developing countries such as India, where projects much smaller than the Three Gorges Dam 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 arguing that property rights are well defined in China and that this has driven its growth would be wrong.

### *Dynamic States Can Manage Growth-Enhancing Rents and Destroy Growth-Reducing Rents*

The mere emergence of proto-capitalists is not sufficient to ensure that they have the capacity to compete. Historically, developing and maintaining competitiveness has required interventionist and regulatory capacities on the part of the state to create, as well as to remove, different types of rents. In an important 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 information rents create the incentives for information to be generated and properly used. A well-established and advanced market economy would need institutions to regulate these information rents, to ensure that information was not cornered in such a way that these rents became monopoly rents, and to make sure that markets continue to work efficiently. No less important are Schumpeterian rents that are essential for driving innovation in market economies. These too require regulation to ensure that Schumpeterian innovators do not become effective monopolists over time. In developing economies, the rent management 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, many types of unproductive activities can yield high returns. In such contexts, state-created "learning rents" have often accelerated the acquisition of technology and the development of

entrepreneurial skills, thereby enabling capitalist market economies to develop. Thus analysis reveals the existence of a range of positive or growth-enhancing rents in developing countries, such as information rents, Schumpeterian rents, natural resource rents, and learning rents (for more on growth-enhancing and growth-reducing rents, see Amsden 1989; Aoki, Kim, and Okuno-Fujiwara 1997; Khan 2000a; Lall and Teubal 1998; Page 1994; Rodrik 1995; Wade 1990; World Bank 1993).

However, in the case of almost all growth-enhancing rents, 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). 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 reallocate rents when necessary. Incidentally, a similar inverted U relationship between innovation and the degree of competition is also found in advanced countries like the United Kingdom, suggesting that extremely competitive markets are not always desirable (Aghion and others 2002).

In contrast, the damaging effects of such growth-reducing rents as monopoly rents are well known. Growth-reducing rents also have to be removed through competition policy and regulation, but both theory and evidence suggest that the creation of dynamic capitalist economies requires much more than institutional structures and policies that ensure that no rents emerge. Because many rents are critical for rapid entrepreneurial growth and technology acquisition while other rents are extremely damaging, rapid growth requires a more demanding set of institutions with the regulatory capacity to distinguish between different kinds of rents and with the political capacity to create, destroy, or manage rents to generate growth and rapid transformation. The rents that need to be managed can vary widely across developing countries depending on their initial endowments, their level of development and the technologies being used or adapted, and their internal political settlements. As a result, the rent management institutions and the political arrangements that have allowed them to be effective have varied considerably across successful developers. Nevertheless, all successful developers had states that actively intervened in markets to create and manage rents and property rights (Aoki, Kim, and Okuno-Fujiwara 1997; Khan and Jomo 2000). In all successful countries, states manipulated changes in property rights to accelerate the emergence of proto-capitalists and managed rents to accelerate the acquisition of technology by these proto-capitalists while ensuring that inefficiency was not sustained or increased. At the same time, transformations in states that lacked these institutional and political capacities were blocked or took place much more slowly (Khan 2000b).

The World Bank and other agencies that support the good governance and service delivery agenda have often recognized the highly interventionist and rent-creating role of the state among the successful developers (for instance, World Bank 1993), but they have immediately followed this observation with the argument that these countries were few in number and had exceptional state capacities. In the absence of such state capacities, they argue, focusing the state on core service delivery and



relying on good governance reforms is better. My response to this is twofold. First, while successful developers are indeed few in number and their state capacities were exceptional, however exceptional they were, no examples exist of failed or failing states that adopted good governance policies and then enjoyed a sustained and successful capitalist transformation to achieve prosperity. Second, it therefore follows that however exceptional the capacities of the successful developers, we have to learn the lessons of how best to develop state capacities in the direction of these countries if performance is to be improved in the less satisfactory cases. As no single model of interventions is common across all the high-growth countries, what we are learning are general principles that then have to be translated into specific institutions given the political realities and initial conditions of different countries.

*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 that cannot be contested by further rent-seeking can have relatively low deadweight costs. In reality, transfers can actually cause serious economic damage if fragmented groups can capture resources 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, which means that further rent-seeking over the type and allocation of transfers was virtually ruled out. Distributive coalitions were prevented from trying to capture additional rents by capturing public good provision systems or subsidies for industrial learners. To the extent that a state can achieve this, a system of significant transfers can be compatible with rapid growth (Jomo and Gomez 2000). Where it cannot, as in India, fragmented rent capture can contribute to the poor provision of public goods and the protection of inefficiency (Khan 2000a,b; Bardhan 1988).

These observations suggest that the creation of high-growth conditions is a much more demanding process than the standard model suggests. Even a cursory examination of the evidence suggests that takeoffs in high-growth countries were not preceded by the achievement of property rights stability and the removal of rents. Rather, as table 2 summarizes, high-growth transformation states intervened in property rights to accelerate the emergence of productive capitalist classes; created and managed rents to accelerate technology acquisition and promote entrepreneurial capacity; and maintained political stability through transfers, often on a large scale. They also delivered public goods efficiently as the standard theory demands, but that is not surprising, because with growing prosperity bureaucrats could be properly paid, and increasing fiscal resources meant that states could meet generalized, as opposed to particularistic, demands.

**TABLE 2. Institutions and Interventions in Transformation States**

Type of transformation	Property rights	Rent and competition policy	Service delivery
Dynamic transformation state	Protection, creation, and transfers of property rights for <i>productive</i> groups	Regulatory and industrial policy to manage <i>growth-enhancing</i> rents	Efficient provision of infrastructure by ring-fenced institutions
	Destruction or loss of property rights of <i>unproductive</i> groups	Regulatory and competition policy to remove <i>growth-reducing</i> rents	Ring-fenced transfers to maintain political stability
Stagnating or failed transformation state	Protection, creation, and transfers of property rights for <i>unproductive</i> groups	Protection of <i>growth-reducing</i> rents	Service delivery systems captured by privileged groups
	Destruction or loss of property rights of <i>productive</i> groups		Open-ended transfers to maintain political stability

Source: Author.

Even when they recognize many of these theoretical and historical observations, economists remain reluctant to trust the state, and with good reason, particularly in developing countries. Thus after developing some powerful critiques of the liberal market model, Stiglitz (1998b) argues that governments should be prevented from restricting competition or intervening in areas where there are special interests, or in other words, from creating rents. This policy caution is clearly based on a skepticism about the capacity of the state to create and manage growth-promoting rents, a skepticism that is entirely justified given the vast majority of poorly performing states. But as their 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. Thus Stiglitz, like the World Bank, is implicitly saying that while high-growth economies had the capacity to create and manage vital rents, most states cannot be trusted to do this.

Saying that East Asian institutions and transformation strategies are not directly relevant to failing states that clearly lack critical capacities is entirely correct. However, the evidence of equally limited success in implementing good governance reforms and creating liberal market economies in countries with failing states suggests that the problem may be that even a competitive market economy may require substantial regulatory capacities. What is more, attempting to construct liberal market economies in countries where a viable capitalist class has not yet emerged or learned to use modern technologies is likely to fail anyway. However imperfect and partial the process of enhancing these interventionist capacities, directly tackling the weak transformation capacities of developing country states may be the only option.

### *Effectiveness of Institutional Enforcement*

In advanced economies, the state's monopoly of legitimate violence has become a metaphor for describing the state's ability to enforce institutions. In developing countries, states often do not have this monopoly and find enforcing any institution difficult (Bates 2001). 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 actually sell the right or make hiring and firing decisions freely, or if an industrial policy planner with residual control rights over the allocation of subsidies cannot actually reallocate them, the extent to which they cannot do so is a measure of the ineffectiveness of enforcement. In the 1960s and 1970s, developing country states did not just fail to enforce dynamic transformation regimes effectively, they failed to enforce even the existing structure of rights (North 1990). How can this systematic failure be explained?

The conventional explanation is that this was a problem of credible commitment on the part of the state. Because the state has no higher enforcer, in principle it can subvert property rights *ex post* to appropriate the investments of others (Bardhan 2000; Bates 2001; Stiglitz 1998b). If this was the major source of enforcement failure in developing countries, having democratic or other constraints on the state that made it difficult for state leaders to change their *ex ante* commitments easily would be necessary. But as already noted in the context of both property rights transfers and rent management, growth during the capitalist transition has required a great deal of *ex post* flexibility (a term suggested by Okuno-Fujiwara 1997) on the state's part. Far from protecting the property rights inherited from the precapitalist past, dynamic transformation states in say China or Korea have been the agency through which massive property rights transfers were organized and the necessary rents created, maintained, and changed as required. As a result, history suggests a much more demanding commitment on the part of the high-growth states. Instead of committing ahead of time not to intervene in property rights and markets, high-growth states have to commit to disrupting property rights and creating rents, but in ways that promote growth. Of course, commitment here is another metaphor, because in reality the state is not an agent that can commit or not commit to do anything. Rather its ability to enforce critical rights and rents depends on the interests and organization of powerful groups in society and the balance of power between them.

Effective enforcement requires both institutional capacity and institutions compatible with the interests of powerful social groups. When the state is engaged in managing rents and intervening in property rights to promote a capitalist transformation, enforcement is more difficult than in an advanced capitalist economy, both from the perspective of institutional capacity (because the state has to have the capacity to do positive things), and because social resistance and rent-seeking are likely to be more intense. Obviously institutional capacity is important: enforcing or transforming a property rights system is impossible without the appropriate bureaucratic capacity. At the same time, however, institutional capacity is insufficient without

effective political capacity to overcome the resistance of powerful social groups who are opposed to particular property rights transformations or the implications of particular rent-management strategies.

Institutional and political factors are closely intertwined, because the political failure to enforce productive rights and rents can often rapidly lead to a loss of morale and personnel in the bureaucracy and persuade the 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. By contrast, the achievement of better enforcement capacity can often make previously predatory leaders commit themselves to dynamic transformation strategies that can offer them higher personal payoffs if they can be enforced. Consider the case of Chiang Kai Shek before and after 1949. In pre-1949 China, the relative weakness of the Kuomintang and its failure to control competing warlords led the Chiang Kai Shek regime to follow highly predatory policies, but in post-1949 Taiwan (China), the same party and leader organized an exemplary developing state, largely because the balance of power between state and society in Taiwan (China) allowed the state to engage in effective enforcement of transformation strategies. Case studies of high-growth transformation states suggest that improving 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 (Khan 2000b; Wade 1990; Woo-Cumings 1999).

In 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. This power structure ensured that the state could allocate rights and rents to whomever it liked, and this in turn ensured that the state had no interest in accepting payoffs from the inefficient, because it was better served by promoting the efficient and thereby captured even bigger payoffs (Amsden 1989; Chibber 1999; Kohli 1994; Woo-Cumings 1997).

In Thailand in the 1980s, industrial policy was less important, but the intense primitive accumulation organized by a more dispersed class of emerging capitalists drove growth. The latter aggressively captured valuable common property and public resources. They were able to enforce their captured rights effectively, because unlike in 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 any potentially monopolistic faction from capturing the state for long. Thus the enforcement of emerging capitalist property rights from below reflected the capture of political factions by emerging capitalists (Doner and Ramsay 2000; Pasuk and Baker 1997; Rock 2000).

Yet another pattern is discernable in Malaysia, where the state's ability to attract multinational investors by credibly promising to protect their rights drove growth in the 1980s. Its ability to do this was based on a unique, internal, ethno-political arrangement that created massive, but ring-fenced, transfer rents that bought off those who would otherwise have contested the state's policies. Thus the compatibility between institutional enforcement and political forces was brought about by the state's organization of politics in a way that allowed it to buy off potential opposition through a form of highly centralized clientelism (Jomo and Gomez 2000). This assured investors, including multinationals, that internal distributive conflicts would not spill over to affect them.

Thus while the growth-promoting transformation interventions varied across countries, enforcement was effective in all the high-growth countries, because the institutions of social transformation enforced by the state were compatible with, or could not be opposed by, powerful, organized interests within these societies (Khan 2000b).

In contrast, an inability by the state to suppress or accommodate interests opposed to transformation is frequently observed in cases of ineffective enforcement. Pakistan's industrial policy regime of the 1960s failed, even though the quality of its planning personnel was moderately good and its military leadership was committed to export-led growth. Control over enforcement was, as in 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). Centralized industrial policy was not compatible with this fragmented distribution of social power. While subsequent liberalization and privatization did attack some aspects of the rent capture that had become entrenched under statist strategies in South Asian countries (Bhaskar and Khan 1995), during the liberalization of the 1980s, these countries also discovered that their states could not properly enforce any property rights and were unable to make a significant dent in growth-reducing rent-seeking by unproductive groups (Bardhan 1988). Thus enforcement capacity of any variety has a political dimension, and in most developing countries this is the critical dimension where state failure is frequently located.

These observations suggest that policy to improve enforcement in developing countries is unlikely to succeed if it simply focuses on the institutional capacity of enforcement institutions, such as anticorruption bureaus or judiciaries. A compatible package of institutional reform and political restructuring of organized power is needed that may allow better enforcement of a dynamic transformation strategy in the future. Here the notion of feasibility is important, as Qian (2002) suggests in the case of China. Ambitious transformation strategies as used in Korea that promise high growth if properly enforced are only potential options; if compatible political arrangements are unfeasible, such strategies will fail. Fortunately, alternative transformation strategies do exist, as the cases of Malaysia, Thailand, and other high-growth developers show, but even these require specific internal political settlements to ensure their enforcement. No country 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 poorly performing countries have to take much more deliberate steps than conventional policy advice suggests to construct compatible packages of institutions and political settlements to achieve even second-best transformation success. A starting point must be a much better understanding of the experience of transformation in the dynamic transformation economies.

### *Costs of Enforcement*

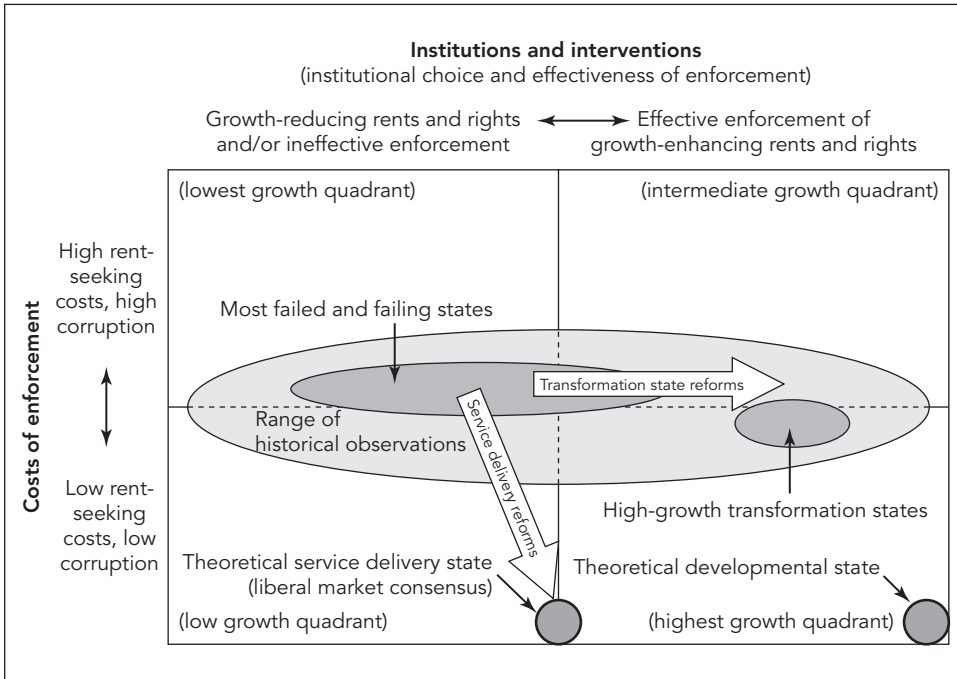
The effectiveness of enforcement should not be confused with the costs of enforcement. Enforcement costs include the costs of policing, regulating, and lobbying; the resources spent on economic and political corruption; and the costs of all types of political activity, from maintaining patron-client networks to contributions to political parties. Indeed, enforcement costs include all expenditures and activities, regardless of their legality or morality, that aim to protect or change rights or rents. Thus enforcement costs are nothing but rent-seeking costs defined in the broadest possible way. In theory, lower enforcement costs are obviously better for the economy, but in practice, enforcement costs are likely to be significant even in countries with effective enforcement of transformation strategies.

Clearly the elements of rent-seeking most relevant to a particular case will depend on the institution and on the country and its stage of development, but given that every right, rent, and intervention is valuable for someone, the overall costs of rent-seeking are likely to be high in every economy, regardless of its success or failure (Samuels and Mercurio 1984). Crude estimates of overall transaction costs in advanced economies confirm this (North and Wallis 1987), as do observations of widespread rent-seeking in all developing countries, including the high-growth ones (Khan 2000b). Every act of attempted enforcement has a cost regardless of the type of intervention, the right or the rent that is being enforced, and the success of the enforcement. Thus as a simplification, the intervention and the effectiveness of its enforcement can be viewed as determining the gross or potential output, with the deduction of the cost of enforcement giving the net or actual output (see figure 3). This is a simplification, because enforcement costs are not really a deduction from output, but represent costs that prevent economic activity in the first place. Nevertheless, this simplification helps us understand why the share of enforcement costs in gross domestic product is likely to be high even in efficient and dynamic transformation economies. If the degree of intervention and rent creation is high, then the aggregate enforcement costs as a share of gross domestic product will also be high. What is different about the successful transformation economy is simply the types of interventions and the effectiveness of enforcement.

### *The Location of State Failure*

Figure 4 summarizes the discussion so far. Societies can differ both in terms of the rents and rights they effectively enforce and their enforcement costs. Nonperforming states score badly on both counts. The service delivery and good governance model assumes that the solution is to eliminate all rents as a way of reducing enforcement

FIGURE 4. Social Transformations and the Location of State Failure



Source: Author.

costs, using strengthened property rights and anticorruption strategies as a way to reduce the state's capacity to create rents. Such reforms attempt to achieve an unattainable goal that has no convincing historical precedents. Instead successful transformation states have intervened heavily in property rights and rents, and while their aggregate rent-seeking and enforcement costs have been high, the internal disposition of political power has allowed them to effectively enforce critical changes in rights and rents essential for a capitalist transformation. If lessons from history are to be learnt, the reforms suggested (see figure 4) are entirely different. Instead of trying to reduce enforcement costs by stabilizing property rights and reducing rents, reformers should focus on identifying in each case the critical state capacities needed to enable the interventions in rights and rents necessary for accelerating a capitalist transformation. Enforcement costs are likely to remain high under such a strategy, including perhaps illegal enforcement costs such as corruption. In many cases progress along these lines will also require a discussion on how issues of political and organizational power need to be addressed, something that has received little attention so far.

The argument presented here explains 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. In reality, because many rents and property rights interventions are growth enhancing, particularly during the transition to capitalism,

and because such interventions are likely to provoke high enforcement costs, it is not surprising that we find at best a weak correlation between most governance indicators and developing country performance. The correlation that is picked up between governance and economic performance only reflects the fact that most developing countries lack dynamic transformation capacities, so that high enforcement costs and poor governance as defined in the service delivery sense appear to correlate with poor growth. The huge jump in growth in the high-growth economies with insignificantly better governance indicators (figure 2) suggests that the relationship between governance and growth in the consensus approach is mis-specified and that the missing variables are those that measure the state's dynamic transformation capacity.

From a policy point of view, this analysis suggests why an uncritical application of the good governance and service delivery framework may potentially do more harm than good. Everything else remaining the same, lower enforcement costs, in particular, lower levels of corruption, are always preferable to higher enforcement costs. This is simply arithmetic in terms of the logic outlined in figure 3. Hence it is not surprising that when countries with similar economic policies and levels of development are compared, or when these factors are fully controlled for, economic performance is better when corruption is lower (Rodrik 1997; Wei 2000).

Lowering any cost is always beneficial, and this result is important, but not particularly profound. Not only that, the result can be misleading, because enforcement costs can be associated with completely different state interventions in property rights and rents during the transformation period and beyond. If reformers attempt to reduce corruption by reducing the state's capacity to intervene in general (in the direction of the service delivery reforms shown in figure 4), they may reduce corruption marginally in the short run, but they may also fatally damage the possibility of creating a developmental transformation state. This is because destroying a state's capacity to create bad rents through downsizing, decentralizing, subcontracting to nongovernmental organizations, and attracting the best talents away from the state all rapidly add up to a state that is incapable of creating, maintaining, or regulating any growth-enhancing rents either. Without such a capacity, the possibility of dramatic growth, and therefore of a sustainable and lasting impact on corruption and democracy, is also fatally delayed. Thus while anticorruption and democracy are vital goals, a critical first step is to focus on developing state capacity for a capitalist transformation in the direction of the very different reform path shown as the dynamic transformation path in figure 4.

### *Transforming the State*

Finally, if the state is not already a dynamic transformation state, the state itself has to be transformed. Are the critical variables here political will and political institutions or the organization of social power?

#### *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 often thought.



Committed reformers with considerable political will have often failed in many countries because accommodating social conditions were absent. Nor do political institutions provide a sufficient explanation of transition success. North (1990) made the case for democracy as an institution that facilitates efficient transitions, arguing 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 well in organizing growth-enhancing institutional change. In contrast, Olson (1982) points out that special interest groups that have an advantage in organizing rent-seeking compared with the rest of society are likely to dominate democracies, a perspective 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.

### *Social Power*

When developing countries become mired in low growth or in stagnant transformation processes, the failure is widely perceived and understood in these countries, not just by policymakers and politicians, but by society at large as well. Any investigation of why the state cannot introduce growth-enhancing strategies leads quickly to the identification of powerful interests opposed to change who can impose unacceptable costs on others or on the state. 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 concerns their real operation. Not surprisingly, the distribution of power between social factions and classes provides a good historical explanation of the pace and direction of institutional change in many countries (Bardhan 2000; Brenner 1976, 1985).

The service delivery approach to the state also recognizes the importance of building constituencies to support state reform processes (see, for instance, 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. Society as a whole 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, and the enforcement of growth-enhancing changes can also be strongly contested and be of much greater benefit to minorities in the first instance.

### **The Challenge for Policy**

The discussion presented here raises a number of policy issues and throws up new questions for research and policy discussion. To begin with, developing country reformers and their policy advisers need to question the claims being made for

governance reforms of the types that follow from the service delivery model and the underlying liberal market good governance consensus. There is no historical evidence to indicate that these reforms were a precondition for growth or that they can be effectively implemented in transformation economies. But there is obviously support for this reform agenda in developing countries, where anticorruption and democracy are legitimately pursued as ends in themselves. However, competing political factions have also found anticorruption slogans useful, for instance, in factional political conflicts. What is worrying is the lack of evidence that emerging capitalist coalitions have coalesced around these reforms as genuine demands, except in the same opportunistic and factional way, but this should not be 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, a real danger exists that disillusionment will grow even further in the developing countries if, as is likely, no significant economic progress is achieved in the end. A reasonable question is whether the multilateral agencies are spending public resources properly in pushing major reforms on the basis of dubious 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 much attention, but transformation capacities are broader regulatory capacities that states require during this period, and these have not, in general, been widely recognized. One problem for the transformation approach is that the critical capacities that need to be focused on will vary from country to country as discussed, but this is a reality that has to be accepted. At a general level, the transformation approach would focus on institutional and political capacities that would be required for creating capitalists, transforming property rights in their favor, providing them with conditional support for acquiring and learning the appropriate technology, negotiating trade and technology deals in international agreements to protect national capitalists, attracting multinationals and inducing them to transfer technology to domestic capitalists through subcontracting and licensing, and so on. To assume that all this will happen spontaneously through the market is making an enormous, theoretical leap of faith that the historical evidence does not justify. Most damaging of all, because of its concentration on reducing the costs of intervention, a focus on the service delivery model can actually weaken states' interventionist capacities, because the simplest way of reducing the cost of enforcing interventions is to reduce the scope of interventions.

Finally, the effectiveness of institutional capacities depends on their compatibility with the underlying distribution of power. In many 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 preexisting political settlements, prior capitalist development, and capitalists' technological capacities. Institutional reform is deeply political and should be explicitly recognized as such. 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 interventions in 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 not done well.

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