

## Chapter 2. Rent-Seeking as Process

Mushtaq H. Khan

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

So far in our analysis of rents, we have looked only at the implications of the rents themselves and not at the implications of the processes through which rents are created or maintained. In fact, since rents are, by definition, beneficial for the recipients, they are likely to spend resources to create, maintain, or transfer particular rents. *Rent-seeking is the expenditure of resources and effort in creating, maintaining, or transferring rents*. These expenditures can be legal, as with most forms of lobbying, queuing, or contributions to political parties. But they can also be illegal, as in the case of bribes, illegal political contributions, expenditures on private mafias, and so on. The processes are of tremendous significance because the resources they use up are a *social cost*, and they determine the *types* of rents which are created and maintained in a particular society.

Conventional rent-seeking theory, however, assumes that rent-seeking only results in the creation or protection of *monopoly* rents, and in addition, it makes restrictive assumptions about how the rent-seeking cost is determined. Nevertheless, the contribution of this theory was to tell us that the cost of rent-seeking was an additional cost of maintaining a monopoly. However, the conventional rent-seeking framework has to be radically extended if it is to be relevant for the real world. Institutional economics and political economy both suggest directions in which the rent-seeking framework can be extended. First, we have seen that rents and the economic rights underpinning them are closely related. Rent-seeking is, therefore, closely related to processes of institutional change through which economic rights are altered. Institutional economics tells us that the outcomes of institutional change are far from straightforward, and can depend on a number of variables, including the incentives set by pre-existing institutions. Secondly, attempts to change the structure of rents can also unleash distributive conflicts. Political economy tells us that political variables, and in particular, the distribution of political power, can determine which individuals or groups are likely to win distributive contests. Thus, a more general approach to rent-seeking can incorporate political and institutional variables to explain first, how much effort is actually expended in rent-seeking, and secondly, the types of rights and rents which are created as a result.

The modern interest in rent-seeking emerged from a few seminal articles written in the seventies (in particular, Krueger 1974; Posner 1975) which argued that the costs involved in *seeking* monopoly rents were much larger than the relatively small deadweight welfare losses associated with the monopoly rents themselves. Their purpose was to alert liberal economists that the social cost of monopolies artificially maintained by the state was much larger than conventional theory had established, since there was an additional rent-seeking cost associated with monopolies. While these early papers were limited in their assumptions, both about the types of rents and the types of rent-seeking, they offered a potentially fruitful way of thinking about

processes of economic, political and institutional transformation in an integrated framework. However, much of the rent-seeking literature has remained limited in its assumptions and the development of an integrated approach has not made much progress.

One problem in most of the rent-seeking literature has been that it has concentrated almost exclusively on the social costs of the resources *used up* in rent-seeking and very little on the different types of rents which rent-seeking has *created* in different contexts. This is partly because the analysis of the cost or ‘input’ side of the rent-seeking story is relatively simple compared to an analysis of the ‘rent-outcomes’, equivalent to the ‘output’ of rent-seeking, which are the different types of rents which can be created, maintained or transferred as a result. Nevertheless, we will argue that the overall effects of rent-seeking depend on both the cost incurred and the rent created.

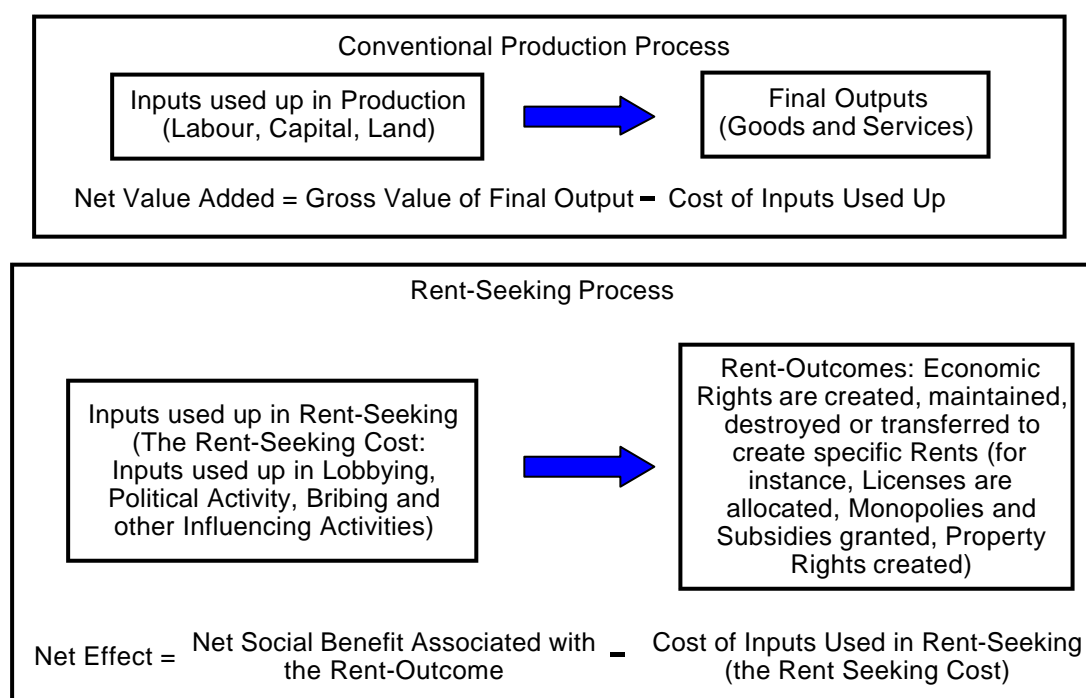
This chapter extends the rent-seeking approach by systematically dealing with both the inputs and the ‘rent-outcomes’ of rent-seeking. The economic implications of the rent-outcomes can vary because any of the rents discussed in Chapter 1 could be sought or protected through a rent-seeking process. The rent-seeking cost, as conventionally defined, is the ‘input’ cost of the process, which can also vary significantly. We are particularly interested in political and institutional variables as determinants both of the input cost of rent-seeking and also of the rent-outcomes or ‘outputs’ produced by the rent-seeking. This is important because political variables, in particular, have generally received little attention in rent-seeking models developed by economists. On the other hand, political scientists have looked at the effects of power and institutions in processes of institutional change, but largely in isolation from the work of economists on rents. We argue that the insights of both disciplines can be fruitfully integrated.

An integrated approach can also show the importance of *evolution and change*. Rent-seeking processes which were growth-enhancing in one period can cease to be so later on, or vice versa. This is because the determinants of the input costs and the types of rents created are themselves changing. We use evidence from South Korea, Malaysia, the Indian subcontinent and Thailand to illustrate how a number of variables can explain the different outcomes associated with rent-seeking across countries and over time.

The core argument of this chapter is that rent-seeking has to be seen as a process whose overall effect depends on its two related components. The first is the net social cost or benefit associated with the *rents* which are the *outcome* of the rent-seeking process. The very different net social benefits which can be associated with some important types of rents were discussed in the last chapter. The second is the *rent-seeking cost*, which is the social cost of the activities which aim to create, maintain or re-allocate these rents. On the one hand, the analysis of the social desirability of different rents, as carried out in the last chapter, is misleading on its own because each of these rents will call forth associated rent-seeking expenditures. On the other hand, an analysis of the rent-seeking cost on its own is also misleading, since the same rent-seeking cost can be associated with the creation, maintenance or transfer of many

different types of rent-generating rights.

There is a close analogy with the inputs and outputs in conventional production. In everyday production processes, the *net value added* is what matters. This depends not just on the total cost incurred but also on the value of the output produced. Production can be profitable even with very large costs if highly valued products are produced. Conversely, production may be unviable even when costs are low, if what is produced is of no value. In exactly the same way it would be misleading to look at the rent-seeking cost without asking what type of rent was created as a result. Figure 2.1 shows this. The *net effect* of any rent-seeking process depends on both the rent-seeking cost, which is equivalent to the cost of inputs used up in this process, and the value of the rights and rents produced as the outcome, which is equivalent to the value of the “output” in this case. Unfortunately, much of the analysis of rent-seeking which has influenced policy-making has typically ignored differences in the value of the outcomes of rent-seeking and has concentrated exclusively on the rent-seeking cost. The conventional analysis of the rent-seeking cost has also been very simplistic, failing to address why the rent-seeking cost can vary significantly from case to case.



**Figure 2.1 Rent-Seeking Compared to a Conventional Production Process**

Section 2.1 discusses the distinction between the inputs and rent-outcomes of rent-seeking and their role in explaining the differential performance of countries. We argue that rent-seeking has to be looked at as a process, and that focussing only on the input costs of rent-seeking fails to explain the historical evidence and is misleading for policy.

Section 2.2 looks at the type of evidence which an integrated rent-seeking framework must address. We look at the types of rents which existed in the industrial sectors in the Indian subcontinent, South Korea, Malaysia and Thailand during the seventies and

eighties, the changes happening over the nineties, and the evidence about rent-seeking costs. This evidence suggests that differences in rent-seeking costs (the input costs) were probably *less* important in explaining differential performance compared to differences in the types of rents created as the outcomes of rent-seeking.

Section 2.3 looks at another aspect of the empirical evidence. Knowing the types of rents and the rent-seeking costs is not enough, we also want to know *who* was engaged in rent-seeking. The organization and relative power of classes and groups varies greatly across countries. Since a significant part of rent-seeking in developing countries is organized through patron-client networks, looking at how they were organized provides insights into the social and political aspects of the rent-seeking process. We argue this has important implications for the *economics* of rent-seeking.

Section 2.4 examines the *input* side of the rent-seeking process and the determinants of the rent-seeking cost. We begin with the conventional rent-seeking analysis which says that the rent-seeking cost is equal to the size of the rent being sought. This simple model is where much of rent-seeking theory stops. However, even if we focus on the input cost of rent-seeking, much more needs to be said. We see that the conventional model only identifies the rent-seeking *expenditure* and not the rent-seeking *cost*. Furthermore, we see that the organization of state institutions and the distribution of political power can significantly increase or decrease the input cost of rent-seeking.

Section 2.5 examines the factors which may explain why rent-seeking can produce very different *rent-outcomes* in the form of different types of rents. Some rents add value for society, others do the reverse. Why does rent-seeking sometimes produce one type of rent and sometimes another? This section goes beyond the traditional rent-seeking literature to look at what we can learn from institutional economics and political economy. We distinguish between three different rent-seeking scenarios and identify the conditions under which value-enhancing rents will be created in each. In the first, individuals seek rents through private negotiations in which the state plays no part. In the second, individuals spend resources trying to influence the state to create the rents they want. And in the third, the state takes the initiative in creating rents. In each case, a different set of conditions is required to ensure that the rents created promote growth and efficiency. These conditions can be classified into a number of political and institutional conditions, and once again, the political variables emerge as substantially important. We then ask if this list of theoretical conditions helps to explain the different overall effects of rent-seeking observed in our countries. We argue that by including political and institutional variables in our explanatory framework we can make a start in understanding some of these differences. Section 2.6 concludes. We argue that our extended framework can provide a better explanation of difference in the net effects of rent-seeking and can serve as the starting point for policy debates about the future direction of reform.

## 2.1 Inputs and Rent-Outcomes in the Rent-seeking Process

While rent-seekers are only interested in the rents which they can capture for themselves, the social value of these rents can vary widely. The social value of any rent is our shorthand for describing the net social benefit over time associated with the



Before the analysis of rent-seeking was developed, the market model of neoclassical economics explained differences in performance solely in terms of market inefficiencies. Not only was there no recognition of rent-seeking costs, the range of rents recognized was also rather narrow. Some positively valued rents were recognized, such as natural resource rents, but most rents, like monopoly rents, signalled small negative net social benefits. Differences in performance between countries were therefore explained in terms of a small area of variation due to differences in government policy in the region marked “conventional market models” at the bottom of Figure 2.2. Not surprisingly, these models could not satisfactorily explain the large differences in the performance of countries.

The first generation of rent-seeking models addressed this problem by arguing that even if only mildly damaging rents exist, the net effect is crippling because of high rent-seeking costs (Krueger 1974; Posner 1975; Buchanan 1980; Tullock 1980a; see also Mueller 1989: 229-46 for a review). These models combined high rent-seeking costs with monopoly rents, locating the net effects of rent-seeking in the box marked “conventional rent-seeking models” at the top of Figure 2.2 in quadrant II. These models explained differences in performance by arguing that interventionist countries were located in this rent-seeking box while free-market economies were located in the right-hand corner of the “conventional market model” box.

The high rent-seeking cost in the early rent-seeking models was soon challenged in second generation models which relaxed some of their assumptions. It was shown that under different institutional structures, the rent-seeking cost could be much lower, despite intervention (for instance, Congleton 1980; Rogerson 1982; reviewed in Mueller 1989). The rent-seeking cost could thus vary along a much wider range and the existence of rents was not sufficient to imply large rent-seeking costs. However, rent-seeking models still did not consider the full range of rents which could be the outcome of rent-seeking.

The assumption that rent-seeking always results in the creation of value-reducing rents was dropped in a few of the early models of rent-seeking (for instance, Bhagwati 1982). Bhagwati considers a model where rent-seeking results in the *destruction* of value-reducing rents. Although this is equivalent to the creation of value-enhancing rights, Bhagwati did not directly consider the latter possibility. Nevertheless, his model showed that society can be better off after rent-seeking. The insight that rent-seeking can produce an *outcome* of socially beneficial rents and rights first began to emerge in the institutional economics literature where rent-seeking was seen as a process through which the structure of rights in society can change (see, for instance, North 1990).

Greater interest in differences in rent-outcomes also began to emerge with the re-evaluation of the success stories of East Asia during their high growth period, which suggested that these countries were not really free-market at all. To a greater or lesser degree, East Asian states had allocated subsidies in socially beneficial ways (Amsden 1989: 145-7; Kim & Ma 1997). This evidence, together with developments within neoclassical theory on the role of rents in generating innovation or in inducing better

monitoring suggested that some rents could be associated with substantial value-enhancement for society (Stiglitz 1996; Aoki, Murdock, & Okuno-Fujiwara 1997). But if rent-seeking costs were high, the benefit of creating socially valuable rents would be cancelled out. Models of developmental states therefore drew on the analysis of rent-seeking to argue that institutions in these countries had kept the rent-seeking cost low as well (for instance, Kim & Ma 1997: 128-30, Chang 1994: 38-45). They described a combination of rents and rent-seeking costs in the East Asian countries which would have located them near the bottom right-hand corner of Figure 2.2, in the box marked “developmental state models” in quadrant IV. Differences in performance were explained by arguing that the East Asian countries were in this region while the typical developing country was in the region identified by conventional rent-seeking models in quadrant II.

Paradoxically, both neoclassical and developmental state models stressed low rent-seeking costs in dynamic economies. We argue that focussing on the rent-seeking cost to this extent misrepresents the real location of differences between dynamic and stagnant economies. The evidence we will discuss suggests that Asian economies were located in the narrow shaded region at the centre of Figure 2.2 marked “Likely range of net effects in reality”. The differences in rent-seeking costs across our countries were relatively small. On the other hand, the types of rents which they sustained *were* significantly different. Differences in rents can have very substantial implications for performance, and a rent-seeking approach which incorporates these differences can have significant explanatory power. A failed strategy of learning with large, inefficient rents has massively negative implications over time which can dwarf the welfare costs of monopolies. On the other hand, rents associated with successful learning, innovation or monitoring can have very large positive effects and play a critical developmental role.

This shifts attention from the high rent-seeking costs in poor performers (which may still be quite high) to their *failure to create and maintain socially valuable rents*. This is important because while both are failures of rent-seeking, the determinants of the two failures are different and may suggest different policy responses. Our perspective on the relative importance of these two components of the rent-seeking process is consistent with the evidence of substantial rent-seeking activities, and in particular of corruption, in the successful East Asian industrializers right through their high growth period. Their success seems to have been based *not* on an unusually low level of rent-seeking, but rather on the creation of value-enhancing rents through their rent-seeking.

The two components of the rent-seeking process are, in fact, closely interlinked. Figure 2.3 shows the inter-dependence of conventional production and rent-seeking processes. The existing structure of economic rights (including property rights) is shown at the top of the diagram. This determines the incentives governing resource allocation between different types of production and rent-seeking activities. The allocation of inputs in *production* results in “final outputs” of goods and services and an associated net social benefit. This is the “conventional” production process and is shown in the horizontal box with the horizontal arrow. Parallel to the allocation of inputs in production, inputs are also being allocated to rent-seeking activities which

seek to create, maintain or transfer the rights on which rents are based. The rent-seeking process is shown in the square box with the vertical arrow. The rent-outcome of rent-seeking is either the reproduction of the existing structure of rights or the creation of a new one. This is the starting point for a new round of activity.

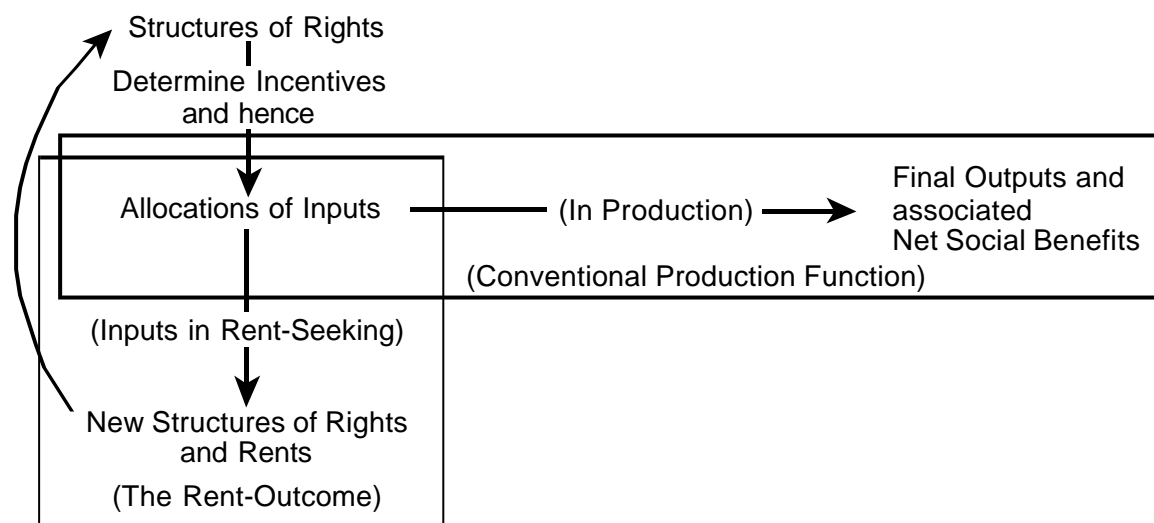


Figure 2.3 The Interface of Conventional Production and Rent-Seeking

“Rent-seeking” in Figure 2.3 could describe the narrow activities which seek to create monopoly rights but it could also describe activities which create new property rights, as in primitive accumulation, or activities which seek to transfer rights, as in subsidies to infant industries. This means that we could potentially describe a wide range of political economy questions and processes of institutional change within an integrated framework of rent-seeking (Samuels and Mercurio 1984). Finally, Figure 2.3 can help to clarify how rent-seeking affects the net social benefits associated with final outputs (at the right-hand edge of Figure 2.3) through two possible routes which correspond to the rent-seeking cost and the rent-outcome effects.

**The Rent-Seeking Cost.** The first effect of rent-seeking is the loss of final output when inputs are transferred downwards (in Figure 2.3) into rent-seeking rather than horizontally into production. The input cost of rent-seeking (or the rent-seeking cost) associated with a specific rent is the value of net social benefits lost as a result of the withdrawal of these inputs from the production of final outputs, *holding the structure of economic rights constant*. Stating it in this way makes it obvious why looking only at the rent-seeking cost on its own is unrealistic. If the specific rent-seeking cost we are looking at had not been incurred, the structure of rights on which existing production is based may also have been different with further effects on final output.

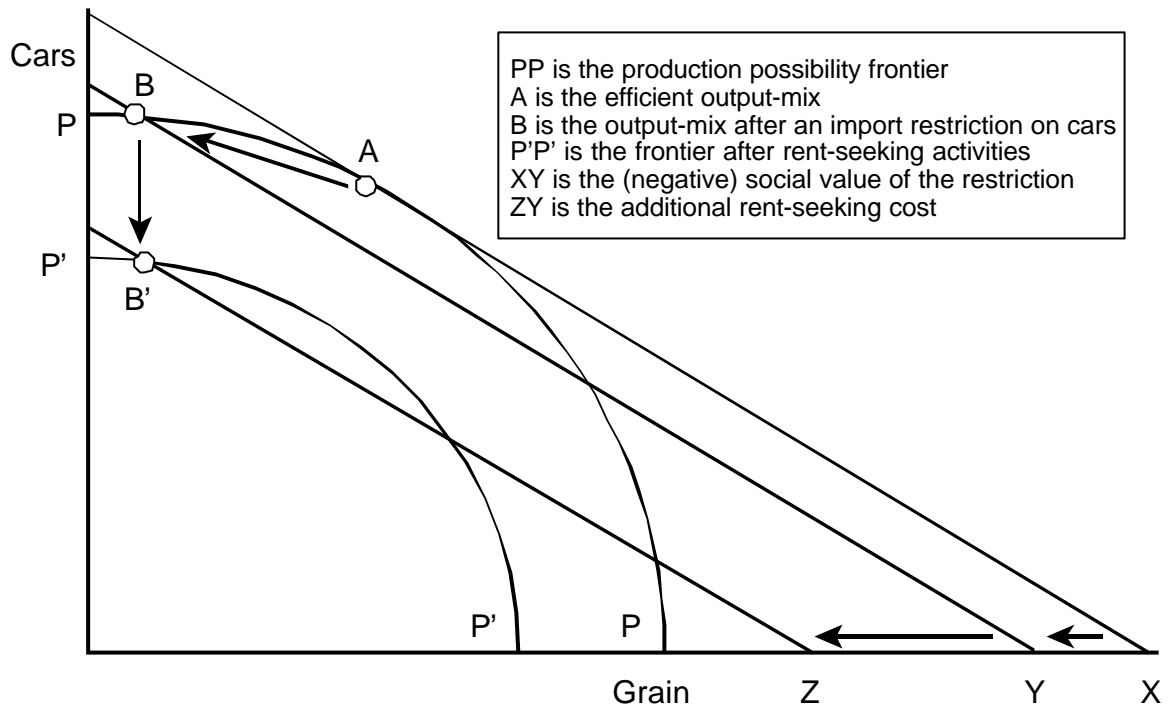
**The Value of the Rent-Outcome.** The second effect of rent-seeking is the creation, maintenance or destruction of some sets of rents. This, in turn has an effect on the final net social benefit achieved. We saw in Chapter 1 that changes in the structure of rights and rents can have positive or negative effects on net social benefits. The difference between the net social benefit *with* the rights created by a specific type of rent-seeking, and the net social benefit which would have obtained *without* these rights, gives us the value of the rent-outcome, *holding the rent-seeking cost constant*.



This is essentially the net social benefit attributable to specific rents keeping the associated input withdrawal due to the rent-seeking constant. The analysis of Chapter 1 was implicitly doing this. There we had been implicitly holding the rent-seeking cost constant by ignoring it! Again, this is unrealistic, because each rent has a specific rent-seeking cost, and a different rent would have a different cost. While each of the two effects is unrealistic on its own, by combining the two, we get very close to the true net effect of a specific rent-seeking process.

Note that any analysis of rent-seeking costs and rent-outcomes only makes sense if we are asking questions about a specific part of the rent-seeking process. The more narrowly we can define the rents being considered, the more precise the rent-seeking analysis. Thus at the most specific level, we could look at the rent-seeking process associated with the creation or re-allocation of very specific rights such as a particular type of import license. At the broadest level of application, we could look at a limited range of rent-seeking in clearly defined sectors, such as the rent-seeking associated with policies supporting industrialization in developing countries. This is the level at which much of the rent-seeking analysis in this book is carried out. However, it makes no sense to ask what the *total* rent-seeking cost in a society is, or what the structure of rights would be in the absence of *all* rent-seeking. That is a bit like asking what the world would look like in the absence of all friction. None of the structures or activities which we know may be viable in the absence of all friction, and similarly, no institutions and rights might survive if *all* rent-seeking expenditures really disappeared. On the other hand, it does make sense to ask whether there are incremental effects when friction increases in particular areas. Similarly, we can try to identify the incremental effects on net social benefits if particular rents change as the outcome of specific rent-seeking processes, and what the associated rent-seeking costs are.

**The Two Effects in Production Function Diagrams.** Some readers may find a diagrammatic representation of the two effects in production functions useful, but others may skip the rest of this section. Figure 2.4 looks at rent-seeking in the conventional rent-seeking model where rent-seeking sustains a monopolistic rent, say based on import controls which protect a domestic producer. The production possibility frontier PP for cars and grain shows the combinations of goods the country can produce domestically, using all available resources entirely in production. The international prices for cars and grain are shown by the slope of the straight price lines.



**Figure 2.4 The Net Effect of Rent-Seeking with Value-Reducing Rents**

The value of the monopoly right (which is the rent-outcome in this case) is measured as follows. According to standard economic theory, the efficient position for the economy given world prices is the point A where the price line is tangential to the production frontier. This mix of cars and grain gives the country its highest value of final output. The import restriction raises domestic prices for cars (not shown in the diagram) and moves domestic production to a point such as B. More cars are produced locally, but a lot less grain, and society is worse off. Since inputs are held constant, the value of lost final output at world prices (which are assumed to be optimal prices) is the lost net social benefit. To compare the value of output at B with that at A, we run the world price line through B and compare its level with the level of the price line through A. In Figure 2.4, the lost output is valued at XY when measured in grain at world prices. XY is exactly equivalent to the deadweight welfare loss with monopoly restrictions measured by the small triangle CDE in Figure 1.3. This is the (negative) value of the monopoly right.

The early rent-seeking theorists argued that XY underestimates the social cost of the monopoly. At B, car producers are earning rents because of the high domestic price of cars. Producers who do not enjoy these rents can be expected to attempt to capture similar rents by spending resources trying to persuade state officials to create new restrictions. Similarly, those who enjoy the restriction may be expected to spend resources to ensure that their rents are preserved. These rent-seeking expenditures use up resources which could otherwise have been used to produce cars and grain. The loss of these inputs from production to rent-seeking results in a shrinkage of the production possibility frontier from PP to P'P'. Once this happens, with the same restrictions, the economy produces at a point such as B'. The location of the new

position has no necessary relationship with B, except that it is on a lower production possibility frontier.

We can now put a notional input cost on the rent-seeking. Comparing the value of output at B', which is the final output *after* inputs have been lost to rent-seeking, with the value of final output at B *without* the input withdrawal gives us the rent-seeking cost. Measured in grain at international prices, the rent-seeking cost is ZY. The net effect of the rent-seeking process is thus XZ. Of this XY is the value of the rent created by the rent-seeking (the rent-outcome) which is typically ignored in the standard rent-seeking analysis because it is relatively small and because economists already know about it. The rent-seeking cost, ZY, is subtracted from this (increasing the negative benefit for society) to give XZ, the net effect of the rent-seeking process. Note that the sequence of events in this exposition is a notional one. The input withdrawal due to rent-seeking activities and the monopoly rent created through this rent-seeking are typically simultaneous events.

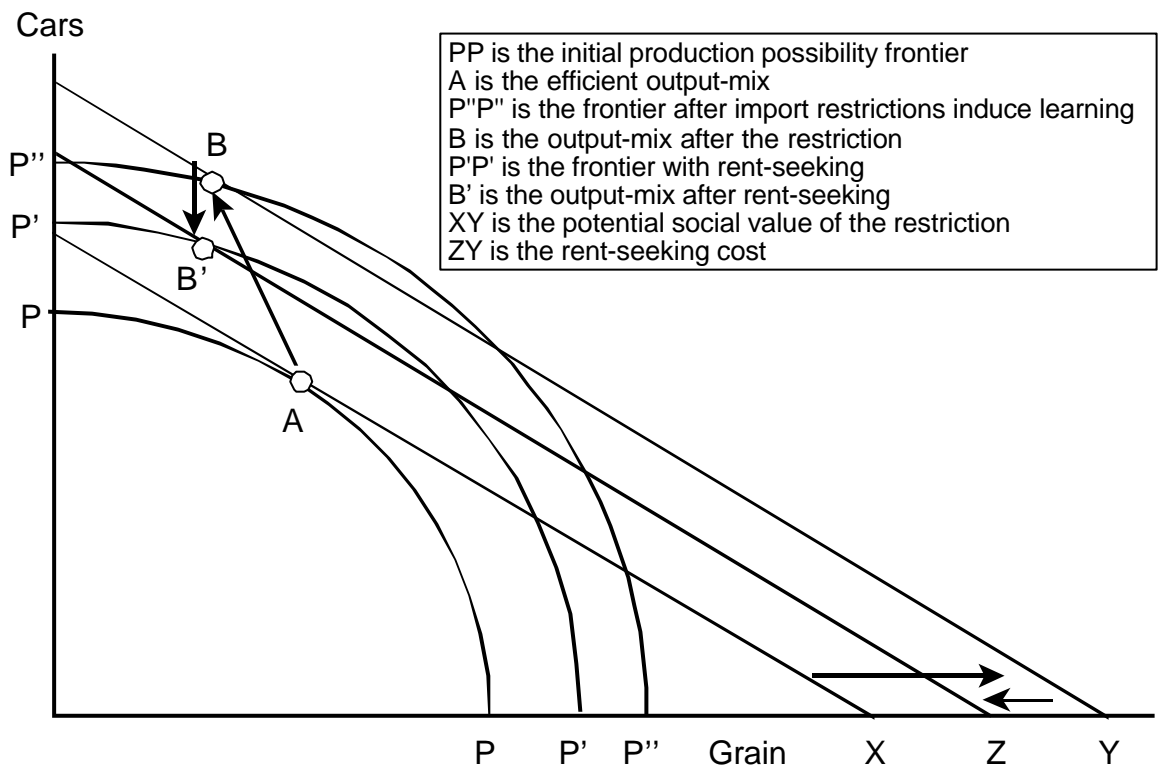


Figure 2. 5 The Net Effects of Rent-Seeking with Value-Enhancing Rents

The importance of distinguishing between the inputs and rent-outcomes of rent-seeking can be seen by considering an example where rent-seeking is associated with the creation of socially *beneficial* rents. In the last example, the restriction induced greater car production but had no effect on technology. Figure 2.5 shows a case where the restriction induces “learning” by the car producer. If the state is able to ensure that the rent earned by the domestic producer is for a limited period and subject to learning taking place, the result may be a movement outward of the domestic production function. This is equivalent to the successful learning case discussed in Chapter 1. *If*

the subsidy is successful in inducing learning, the rent creation would result in a movement outward of the production possibility curve in the first instance.

Our starting point is once again point A on the initial production possibility frontier PP. The effect of the learning induced by the rent is to move the production possibility curve out to P''P''. As a result, the economy could potentially move to point B. This part of the story is based on the analysis of Chapter 1 and ignores any rent-seeking which may be associated with the management of this rent. Rent-seeking expenditures may have an effect which is equivalent to a lowering of the production possibility frontier such that it reaches only P'P' instead of P''P''. Actual production is at a point such as B' rather than B because of this rent-seeking cost.

The overall effect is therefore composed of a rent-seeking cost ZY, which is negative as before, and a potential social benefit of XY due to the induced learning, which in this case is positive. In this case, the net effect of the rent-seeking process is a net *benefit* of XZ given by XY-ZY. Splitting the move from A to B' into two parts is analytically convenient but in fact, once again, the two moves happen simultaneously. In the general case, where either value-enhancing or value-reducing rights may be created, the evaluation of both components of the rent-seeking process is clearly important.

## 2.2 Rent-seeking: The Evidence

Table 2.1 shows GDP and industrial growth rates for several Asian economies over their three decades of high growth culminating in the financial crisis of 1997-8. We are not suggesting that all of the difference in performance can be explained in terms of any single model. Nevertheless, it is useful to ask whether differences in processes of rent-seeking could account for at least part of their differences in performance. To answer this question, we draw on the existing literature to summarize some of the evidence on rent-seeking in the industrial sectors in the Indian subcontinent, Malaysia, South Korea and Thailand, and ask whether the input or rent-outcome dimensions of rent-seeking can explain performance differentials.

**Table 2.1 GDP and Industrial Growth Rates and Corruption Indicators in some Asian Countries**

	(Industrial Growth Rates in Brackets)					
	BANGLADESH	INDIA	PAKISTAN	SOUTH KOREA	MALAYSIA	THAILAND
1970-80	2.3 (5.2)	3.4 (4.5)	4.9 (6.1)	9.6 (15.2)	7.9 -	7.1 (9.5)
1980-90	4.3 (4.9)	5.8 (7.1)	6.3 (7.3)	9.5 (12.1)	5.2 (7.2)	7.6 (9.9)
1990-97	4.5 (6.8)	5.9 (7.1)	4.4 (5.5)	7.2 (7.5)	8.7 (11.2)	7.5 (10.3)
1998 <sup>e</sup>	-	5.0	5.4	-5.0	-6.0	-7.0
1999 <sup>p</sup>	-	5.2	4.3	-1.0	-2.0	0.5
	Subjective Corruption Indices					
1980-83	4.0	5.3	4.0	5.7	6.0	1.5
1996	2.3	2.6	1.0	5.0	5.3	3.3

Sources: World Bank (1994; 1998/9). 1998 growth figures are estimates and 1999 figures are predictions: Asian Development Bank. Corruption Indices from Mauro (1995); Bardhan (1997). A corruption index of 10 indicates minimum corruption, 0 indicates maximum corruption.

**Rent-Seeking Costs.** In terms of final outputs, the relatively poor performance of the Indian subcontinent compared to the East Asian countries is shown by the relative growth rates of GDP and industrial output in Table 2.1. To what extent can this be explained by differences in the input cost of rent-seeking across countries? In the past, following Krueger (1974), rent-seeking theorists have attempted to calculate the input cost of rent-seeking as a percentage of GDP. The input cost is difficult to compute directly because rent-seeking expenditures can take a variety of forms, including expenditures on corruption, lobbying and political contributions. For reasons which will become clear after Section 2.4 where we discuss the theoretical determinants of the input costs of rent-seeking, we do not believe that these costs can be *indirectly* deduced by measuring the total rents in the economy, the method followed by Krueger and her followers. Instead, we will argue that a precise measure of the rent-seeking cost as a share of GDP is not absolutely necessary. We will rely on statistical, journalistic and academic evidence to give the reader a feel for the substantial amount of rent-seeking expenditures in *all* these countries to argue that *differences* in these expenditures are not likely to be of a sufficient magnitude to explain the substantial differences in performance.

The evidence on corruption in Table 2.1 refers largely to the industrial sector where foreign business was mostly involved. It suggests that these countries all suffered significantly from corruption in the key period of the seventies and eighties. The *Business International* index for corruption in 1980-83 (on a scale from 0 for maximum corruption to 10 for no corruption) was 5.25 for India, 5.7 for South Korea

and 6 for Malaysia (Mauro 1995). Given the crudity of these subjective indices, these differences are not very significant. Thailand, on the other hand, had a very high corruption index of 1.5 for this period, suggesting a combination of large and widespread bribes faced by prospective businessmen, and yet it was a high-growth economy prior to 1997.

According to this index, by the mid-nineties corruption had increased in most of these countries. The only exception was Thailand which was the most corrupt country in the group in the eighties, but by the nineties was less corrupt than the South Asian countries. Yet despite this improvement, Thailand led the East Asian countries into the financial crisis of 1997. At the same time, the most significant *increase* in corruption in the nineties was in the South Asian countries, but paradoxically they suffered hardly at all from the financial crisis of 1997. To the extent that the corruption index is trustworthy, it corroborates other evidence which suggests that the 1997 financial crisis had specific causes which should not be confused with our long-run assessment of the implications of corruption and rent-seeking in these countries.

The publication of subjective indices of corruption should not lead us to ignore other types of rent-seeking expenditures, in particular expenditures on lobbying and on political “contributions”. In all these countries, the role of the state was substantial even though the types of intervention were different. Lobbying and “shoe-leather” costs in overcoming red-tape affected them all, though here too, there were some differences. The Indian subcontinent has long been recognized as having some of the most oppressive red-tape in Asia (see Little, Skitovsky and Scott 1970). But there were significant red-tape and lobbying costs in the other countries as well, though they are difficult to rank. Finally, contributions to political factions were an important rent-seeking cost in all these countries and will be further discussed in our next section.

Looking at each of our countries in turn, the Indian evidence suggests that rent-seeking expenditures had a rising trend over the sixties and seventies, as the intensity of rent-seeking contests increased (Bardhan 1984; Ahluwalia 1985). Expenditures on political factions were a significant component which grew from the mid-sixties onwards, a trend which is further discussed in our next section. Liberalization, which began in earnest in the late eighties, does not seem to have resulted in a reduction in the most blatant forms of rent-seeking expenditures in India (Harriss-White 1996). Liberalization probably *did* result in a reduction in the burning of shoe-leather required to work around the labyrinthine industrial licensing system. On the other hand, it had ambiguous effects on corruption and on political contributions, which may actually have increased. As far as subjective perceptions of corruption go, Table 2.1 suggests that there was a significant *increase* in corruption in the Indian subcontinent in the nineties following liberalization.

While corruption probably did increase over this period, there was also a much greater public *perception* of corruption, fuelled by legal proceedings against highly placed politicians. Rajiv Gandhi was accused in the late eighties of covering up kickbacks to his party from Bofors of Sweden which was granted a contract to supply arms to the Indian army. In late 1995, thirty or so politicians, including several cabinet ministers

of the succeeding Rao government, were implicated in a corruption scandal involving 20 million US dollars over a period of two years. Although the sum involved was small, the case became politically important as an indicator of widespread kickbacks from businessmen to political faction leaders. Following Prime Minister Rao's fall from office in 1996, he too was charged with corruption and arrested. Soon afterwards, a number of lesser Indian politicians were implicated in corruption scandals, including, most notably, the Chief Minister of Bihar, Laloo Prasad Yadav, who was forced to resign in mid-1997.

In South Korea, the evidence suggests that corruption was high throughout the high growth period following the Park Chung Hee coup of 1961 (Kong 1996). Although there has been a tendency amongst some rent-seeking analysts to portray the South Korean state as relatively clean, observers of South Korean industrial policy have pointed out the coexistence of efficiency with corruption (Amsden 1989: 15, 73). Hard evidence of the scale of corruption in South Korea has begun to emerge only recently, particularly with the admission in 1995 by ex-President Roh Tae Woo of his personal accumulation of around 650 million US dollars during his five year period in office (Khan 1996a; 1996b). Like Prime Minister Rao in India, President Roh of South Korea was eventually arrested on charges of corruption, and almost all the large *chaebol* were publicly named as having been involved in kickbacks to the regime. Again, the subjective perception of corruption in Table 2.1 suggests a *worsening* of corruption in South Korea in the nineties, when liberalization began in earnest. Nevertheless, the perception of international businessmen was that corruption had worsened much more significantly in the Indian subcontinent. However, the difference in the degree of corruption in these countries was *less* significant in the eighties when the performance differential between them was *most* significant. Moreover, in the nineties, when India suffered a catastrophic increase in corruption, South Korea and the East Asian NICs suffered most severely from the financial crisis.

The efficiency of the South Korean industrial policy regime meant that little attention has been given in the literature to the costs of lobbying in South Korea. But we do know that industry associations had to spend a lot of time in consultations with government. This was clearly a rent-seeking input, but in contrast to India and many other developing countries, the outcome of the lobbying in South Korea was, on the whole, productive. Nevertheless, lobbying in South Korea must have involved real and substantial input costs. In addition, there were also contributions to political parties and factions, but they were incorporated in the payoffs going to the top man as a result of the centralization of the political establishment in this period. Thus, payoffs going to President Roh from the *chaebol* were partly used to fund his own political campaign, partly to fund the campaigns of his opponents (Kim Dae Jung, his arch-rival admitted that he received part of the money!) and even to provide performance related kickbacks to bureaucrats.

The Malaysian evidence suggests that corruption was substantial throughout its period of high growth in the seventies (Jomo 1986: 243-72). However, compared to the other countries, Malaysia receives a relatively clean report from international business in its subjective corruption index. We will suggest a possible explanation for this in our next section. While journalistic evidence of cases of corruption involving top

politicians has not come to the fore as much as in India and South Korea, scandals involving kickbacks from major construction projects such as dams have attracted international attention because they involved western governments and companies. In the eighties, evidence of political contributions from business to political factions increased, as factions within the ruling party developed contacts and kickback arrangements, particularly with Chinese business (Jomo and Gomez, this volume). Liberalization probably contributed to the worsening of corruption in the nineties, as indicated by the subjective corruption index in Table 2.1. Lobbying by business is less widely discussed in Malaysia, perhaps because the state was, for a time, less accessible for domestic capitalists compared to India or South Korea. Political contributions were also centralized during this period, as we will see in our next section, which kept them moderate compared to the Indian subcontinent.

In Thailand, the high degree of corruption of political leaders has been well known for some time. In 1973, when Prime Minister Thanom Kittikachorn fell, the subsequent government was actually able to seize assets equivalent to 140 million US dollars (Phongpaichit & Baker 1997: 287). If anything, the magnitude of the bribes collected by the top leaders has gone up over time despite a long history of new governments attacking the corrupt politicians of the previous regime. In addition, corruption has become more democratic over time, with a growing number of political factions participating in “money politics”. The distinctive feature of Thailand from the seventies onwards was that a large number of these factions were controlled by emerging capitalists, a feature which we will see in Section 2.3 was of some significance (see also Sidel 1996). While the corruption figures in Table 2.1 suggest some decline in the corruption faced by foreign business over time, the political evidence which we will later discuss suggests that “money politics” and expenditures on political factions increased significantly since the mid-seventies.

While rent-seeking was widespread in all these countries, this does not mean that the expenditures on rent-seeking in absolute terms or as a share of GDP or industrial value added were the same. A subjective assessment of the balance of evidence suggests that over the seventies and eighties, relative rent-seeking expenditures were greatest in the Indian subcontinent and Thailand, less so in Malaysia, and least in South Korea. However, since even Malaysia and South Korea had very interventionist states over this period, with substantial corruption and political contributions, the differences in the share of rent-seeking expenditures in GDP are likely to have been relatively small.

How large would differences in rent-seeking costs have to be, to explain a significant part of the differences in performance? In Table 2.1, we see that in the seventies, the difference in industrial growth rates between India and South Korea was around ten per cent per annum, falling to five per cent in the eighties. No one suggests that this can be entirely due to differences in rent-seeking costs, but it is instructive to ask how large these differences would have to be to explain such performance differentials. The incremental capital-output ratio in Indian industry was around 8 in the seventies and 14 in the eighties (Chakravarty 1987: 105). Thus for Indian industry to have grown 10 per cent faster in the seventies, it would have had to invest 80 per cent more of industrial value added in the seventies; and for it to have grown 5 per cent faster in



the eighties, it would have had to invest 70 per cent more of its industrial value added. Thus, to explain the growth differential in terms of rent-seeking costs, we would have to argue that rent-seeking in Indian industry absorbed 70 to 80 per cent of its industrial value added which would otherwise have been invested *on top of the share lost to rent-seeking in South Korea*. From the qualitative evidence we have looked at so far, this amount of *additional* rent-seeking in India is not credible. This is another way of saying that the productivity of investment matters. The productivity of investment is not entirely independent of the rent-seeking process, since differences in the *types* of rents have important implications for the productivity of investments.

**Rent-outcomes.** The outcomes of rent-seeking have varied much more significantly across our countries. The industrial policy structure which emerged in South Korea in the early sixties is now well known (Amsden 1989; Chang 1994; Kim & Ma 1997). Rents for learning were created using state subsidies. But in South Korea, effective performance monitoring ensured that subsidy-recipients did in fact move up the technology ladder and the learning rents (see Chapter 1) were significantly value-enhancing. In contrast, in the Indian subcontinent, industrial policy in the sixties also aimed to promote strategic sectors but the results were less impressive. Licensing of production sought to use entry barriers to create rents for infant industries and to encourage the adoption of new technologies. However, performance monitoring was much weaker, in fact virtually non-existent, and the rights which created rents were not, or could not be, reallocated when performance lagged (Ahluwalia 1985). A significant part of Indian rent-creation was of value-reducing redistributive rents for competing factions based on caste, community, language and party which are discussed further in our next section. These differences in rent-outcomes can potentially explain substantial differences in growth rates.

By the eighties, important changes began to emerge in both countries. Both India and South Korea embarked on liberalization strategies in the mid-eighties, which marked an important shift in the types of rights and rents which both economies had been supporting in the past. In India, the immediate effects of liberalization were positive given the poor performance of previous statist policies. In contrast, in South Korea, liberalization, particularly of the financial sector, marked a break with previously successful industrial policy (Chang, Park and Yoo 1998). It is arguable that industrial policy of the old type was no longer feasible given technological and social developments in South Korea. We will come back to this debate later. What is clear is the South Korean industrial performance declined in the liberalization phase as learning rents and the industrial policy structure were progressively abandoned.

The Malaysian story in the seventies and eighties is different from both the South Korean and Indian ones. The most distinctive feature here was the creation of redistributive rents for ethnic Malays based primarily on transfers from the Chinese-Malaysian business sector. Transfers on this scale should have had negative incentive effects, but in fact, despite some dampening of confidence, Chinese-Malaysian capitalists continued to drive the domestic industrial sector (Jomo and Gomez, this volume). In addition, the public enterprises set up to create jobs for Malays were often reasonably competent recipients of learning rents, though monitoring of subsidies was substantially weaker than in South Korea. Finally, an important component of

Malaysian rent-seeking was the insulation of multinationals from domestic redistribution. The confidence of multinationals explains the large inflow of capital and technology in the seventies, and again since the late eighties, till the financial crisis of 1997 temporarily halted this process.

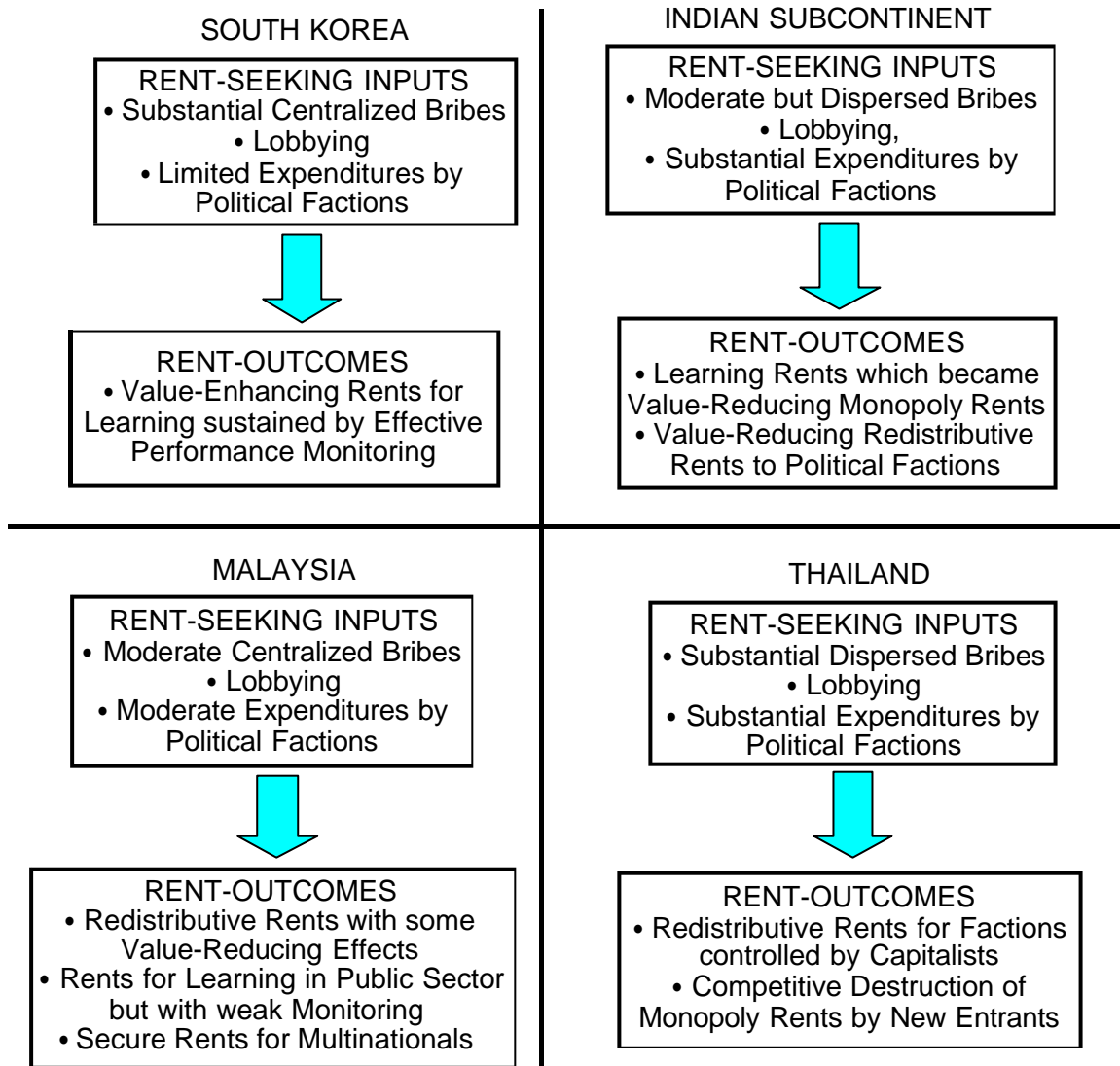


Figure 2.6 Rent-Seeking Processes in Asian Industry in the Seventies and Eighties

The Thai rent-outcomes were different again. Thai rent-seeking resulted in redistributive transfers to capitalists, but unlike South Korea, here these transfers mainly supported primitive accumulation rather than being learning rents. More significantly, the rent-seeking in Thailand was very competitive and repeatedly resulted in entry into rent-earning industrial sectors by excluded capitalists (Doner & Ramsay; Rock, this volume). Fortunately for Thailand, the relatively basic technology in most of its industrial sectors did not require learning and monitoring rents for their adoption or efficient operation. As a result, rapid entry and rent dissipation of monopoly rents turned out to be value-enhancing. On the other hand, the unplanned

and almost anarchic nature of Thai rent-seeking undoubtedly had a role to play in explaining the gradual adoption of unsustainable capital account policies which precipitated the 1997 financial crisis.

Based on our discussion so far, Figure 2.6 summarizes some aspects of the inputs and rent-outcomes of rent-seeking in these countries, focussing on the industrial sector in the high growth period of the seventies and eighties. Differences between our countries in terms of rent-outcomes were significant. We saw in Chapter 1 that these differences may be associated with very large differences in growth rates and thus explain a significant part of their differences in performance. In comparison, differences in the scale of their rent-seeking expenditures appear to be less significant. This does not mean that differences in rent-seeking costs were not important, but it does mean that policy and analytical attention has to be re-oriented.

### **2.3 Patron-client Networks and the Organization of Rent-seeking**

So far we have looked at the types of rents and the associated rent-seeking costs in our countries. We now look at what we know about *who* was engaged in rent-seeking and how this rent-seeking was organized. In developing countries, a significant part of the rent-seeking cost is spent within patron-client networks and the rents produced as a result are also often distributed within these networks. A study of the resource flows within these networks is thus a very useful way of mapping differences in the organization of rent-seeking across countries. On the one hand, a large part of the total *inputs* used in rent-seeking are often spent within these networks. Some of these expenditures are legal, such as election expenditures or payments to party officials, but large parts are illegal or quasi-legal, such as payoffs to mafia bosses, payoffs to members of factions to retain their allegiance, illegal election expenditures, and so on. Collectively, these inputs maintain the organizational power of patrons, which is often critical for winning rent-seeking contests. At the same time, a large part of the rents which are the *outcomes* of rent-seeking are likely to be created for key members or constituencies within these networks. Thus, there is likely to be a “circular flow” whereby part of the income from rents created for patrons as rent-outcomes in one period provide the resources for inputs of rent-seeking expenditures on clients in the next period. This sustains their organizational power and allows further rounds of rent-seeking. These flows of resources therefore give us very useful information about differences in the organization of rent-seeking across countries.

This section looks at patterns of resource flows in our target countries based on a reading of their economic and political histories. We focus on those features of patron-client relationships in each country which are particularly relevant for our subsequent comparative analysis of rent-seeking. From the perspective of our subsequent analysis, we will be particularly interested in the distribution of organizational power within these countries. A comparative approach is very important because it directs our attention at an abstract level to what is *different* between countries. Looking only at one country often prevents such an understanding because to some degree all types of organizations and types of rent-seeking can be found in every country. What is important is that the relative importance of different processes can be significantly different and the comparative approach allows us to

focus on what is distinctive in each country. We focus on the industrial sectors in our countries over the sixties, seventies and eighties. We also touch on the likely changes in flows within networks and in the underlying distribution of power in the nineties, to see how the organization of rent-seeking was changing over time.

**The Indian Subcontinent.** Despite important differences between India, Pakistan and Bangladesh, there are many similarities in the predominant ways in which rents are sought in these countries. They each have a very large number of factional groups which compete for redistributive rents. And in each case, members of the “intermediate” or “middle” classes play a key organizational and leadership role within these factions. The intermediate classes are, in the main, the educated sections of the population, both employed and unemployed, and the richer peasants whose sons and daughters provide new entrants into the educated classes through the universities and colleges. While capitalists and landlords may, as individuals, control significant resources, they are too few in number to control the political process by themselves. In contrast, the middle and lower middle classes have the *organizational* power to dominate politics.

The composition of the group of classes providing political and organizational leadership varies across regions in the subcontinent. But, by and large, the groups which dominate organizational politics are neither capitalists nor landlords in the conventional sense, nor are they from working class or poor peasant backgrounds. While their social origins vary, they typically occupy an “intermediate” position in society. Some Indian political economists have singled out professionals (white collar workers) as playing a distinctive role in Indian rent-seeking. For instance, Bardhan (1984) identifies professionals as one of the three classes forming the coalition of dominant classes in India, together with capitalists and landlords. Professionals are a subset of the intermediate classes; they have high levels of education and therefore have more privileged positions in the job market. But professionals are not the only members of the intermediate classes. Less well-educated lower middle class groups such as unemployed college graduates, the urban petty-bourgeoisie and richer peasants in the villages have substantial organizational power and play a key role in the competition for redistributive rents. We include all these groups in our category of the “intermediate” classes.

The roots of the role played by the intermediate classes goes back at least to British colonial times, if not earlier. The British in India were so few in number that they could only have ruled with the complicity of Indian classes and groups which had the power to challenge them. These groups included, in the first instance, landed elites and later members of the emerging “middle class”, both of which became key players in the colonial polity. The strategy of the colonial state was to exploit divisions among these groups and indeed to create new divisions. The object of this exercise was to ensure that claims and counterclaims over resources were finely balanced so that the state had to deal with a small number of malcontents at any one time. On the other hand, because redistributions were based on organizational power, there were big potential gains for factions with organizational power. Given the weakness of the productive classes, organizational power involved the construction of cross-class alliances led by political entrepreneurs from the intermediate classes. As a result,

linguistic, religious and caste organizations proliferated. The lion's share of the redistributive rents were, of course, captured by the political entrepreneurs but to mobilize large numbers, at least some of the rents had to be distributed down the factional networks.

Subsequent economic and political developments further strengthened the intermediate classes. The deepening of democratic aspirations and demographic growth strengthened these groups both numerically and politically. Most political scientists agree that factional politics intensified in India after the mid-sixties (see, for instance, Rudolph & Rudolph 1987). A similar intensification also happened in Pakistan and later Bangladesh at about the same time despite the presence of military governments in the sixties and again in the late seventies and early eighties (Khan 1989). As the intermediate classes grew in strength, the numbers of factions and competing ideological identities also increased. New ethnic, religious and caste groups entered the political arena. This pattern of politics has not enriched the vast majority of the populations of these countries, but *has* enabled successive layers of emerging middle class groups to get access to rents on the basis of their ability to organize the much more numerous groups below them.

One of the distinctive features of rent-seeking in the Indian subcontinent is that the number of competing factions has always been large, and moreover, since the sixties, has been rapidly growing. An important consequence of this was that for anyone with resources to spare, organizational power in the form of “unemployed” factions could be cheaply purchased. This explains why emerging industrial capitalists (and in the countryside, rich landlords) have found it so easy to contribute to factions which could provide them with additional political muscle. This in turn has allowed capitalists and others to seek and protect redistributive rents. The excess supply of organizational power and the fragmented nature of factions helps to explain the dense structure of interlinked economic and political exchanges within patron-client networks in the Indian subcontinent. This interlocking of economic and political exchanges in Indian corruption was identified by (amongst others) Wade (1984; 1985; 1989).

Figure 2.7 shows the complexity of the flows of resources between the state, capitalists and political organizers in the Indian subcontinent which we will later compare with our other countries. In these diagrams, bureaucrats (B) and politicians (P) are shown as two parallel hierarchies within the state. For simplicity, Figure 2.7 only distinguishes between two social groups, capitalists (C) and non-capitalists (N), the latter being led in the main by the intermediate classes discussed earlier. However, successful non-capitalist organizers can often become political leaders or even capitalists over time.

The cross-cutting patron-client resource flows in the Indian subcontinent can be described as *fragmented clientelism*. There are a large number of competing patrons supporting non-capitalist clients (the arrows from P to N). These flows are, in the first instance, resources which political entrepreneurs spend as rent-seeking *inputs* to buy organizational power. The quid pro quo for these patrons is a reverse flow of political and organizational support from clients. Since this is not an economic flow, it is not

shown in Figure 2.7, but the organizational power which patrons mobilize in this way plays a critical role in the rent-seeking process in these countries. When this type of rent-seeking is successful, redistributive transfer rents for factions are created as an *outcome* shown by flows of resources typically funded by transfers from the state. These rents can benefit different constituencies and are shown in the diagram as a number of flows: from B to N (when transfer rents are created for non-capitalist constituencies), from B to C, (when transfer rents are created for capitalists), and from B to P, (when political leaders directly gain control over budgets which they can allocate to their constituencies).

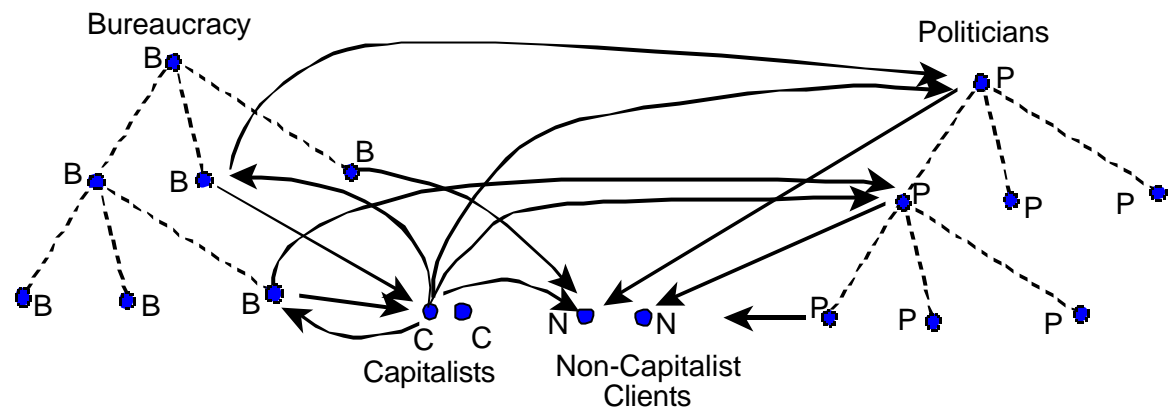


Figure 2. 7 Resource Flows in Patron-Client Networks: The Indian Subcontinent

This fragmented clientelism has important implications for rent-outcomes in industry. Like capitalists in other countries, Indian capitalists have engaged in straightforward rent-seeking. They have spent resources on politicians and bureaucrats (the arrows from C to P and from C to B) in the form of inputs going into lobbying and bribes. When this rent-seeking has been successful, the rent-outcome for capitalists has taken the form of transfers sustaining primitive accumulation, monopoly rents protecting particular producers or ostensible learning rents (all shown by the arrows from B to C).

But apart from this standard type of rent-seeking, capitalists in the Indian subcontinent have also engaged in “political” rent-seeking. Given the excess supply of organizational power, capitalists have spent rent-seeking inputs purchasing political organizers (the arrows from C to N and from C to P), and thus organizational power and “protection”. These inputs gave individual capitalists the political power to protect their rents. The rent-outcome of this type of rent-seeking was the *political* protection of rents which had an important but subtle effect. The purchase of factional political power by capitalists made it difficult for the state to manage rents for learning efficiently. Subsidies had to be granted to capitalists attached to powerful factions and could not be withdrawn once granted. This ensured that rents which were ostensibly learning rents for infant industries were effectively converted into monopoly rents for protected capitalists. Subsidies for poorly performing industries and sectors persisted despite common knowledge of their performance failures (Khan 1989). Although the Philippines has a very different social history, with the oligarchs

rather than the intermediate classes playing leadership roles, Hutchcroft's analysis of patron-client flows in the Philippines (this volume) has interesting parallels with India's fragmented clientelism.

The experiment with liberalization in the Indian subcontinent in the eighties and nineties has to be seen in this context. By reducing the amount of subsidy up for grabs, the supporters of liberalization hoped to drive out redistributive factions, and eventually the blocking effect these played in processes of structural change. The likely outcome of this strategy is still in the balance. There is no evidence yet that redistributive politics has been effectively curtailed. Much of the early success of liberalization has been due to a boom in the demand for consumer durables rather than a decline in redistributive politics. It is only if the latter is achieved that liberalization would change the pattern of rent-seeking in India in the long run (Harriss-White 1996; Khan 1996a). The limited evidence on corruption suggests that redistributive demands may actually have increased driven by more intense conflicts over resources (see the corruption indices in Table 2.1).

**South Korea.** South Korea during the sixties and seventies presents a very different configuration of patron-client flows. In contrast to the complexity of the flows we see in the subcontinent, the predominant patron-client flows in South Korea were more coordinated. The South Korean state enjoyed much greater political power relative to its constituents and its executive leadership could deal with political contestants in a much more centralized way. At the same time, non-capitalist political organizers seem to have been much weaker compared to the Indian subcontinent. This allowed patrons located within the South Korean state to enjoy a higher degree of autonomy from competing demands in society (Jones & Sakong 1980; Mason et. al. 1980; Amsden 1989; Kim 1994: 59-70; Kong 1996; Kim & Ma 1997). In Figure 2.8 we exclude non-capitalist political organizers entirely, not because they were completely absent, but because they did not play a decisive role in the process of rent creation and allocation at this time.

Figure 2.8 shows the most important flows associated with rent-seeking in South Korea during its industrial policy phase (Amsden 1989; Khan 1989; Chang 1994; Kim & Ma 1997). The most important rent-outcome during this period was the transfer of resources from the state's bureaucratic apparatus (B) to emerging capitalists (C). Initially, these transfers were simply transfer rents supporting primitive accumulation, for instance, when abandoned Japanese assets were "privatized". Later, these transfers took the form of learning rents for emerging capitalists. South Korea was one of the most successful countries attempting to catch up using rents for learning in the sixties and seventies. At the same time, substantial rent-seeking costs on the input side were associated with these transfers. We now know that there were substantial rent-seeking *inputs* in the form of kickbacks from the favoured industrial groups (C) to the political leadership (P) and through them to bureaucrats (B) as well (Kong 1996; Khan 1996a; 1996b). These revelations emerged during the corruption cases of the nineties, but they referred to the sharing of bribes between top politicians and bureaucrats in the seventies and eighties.

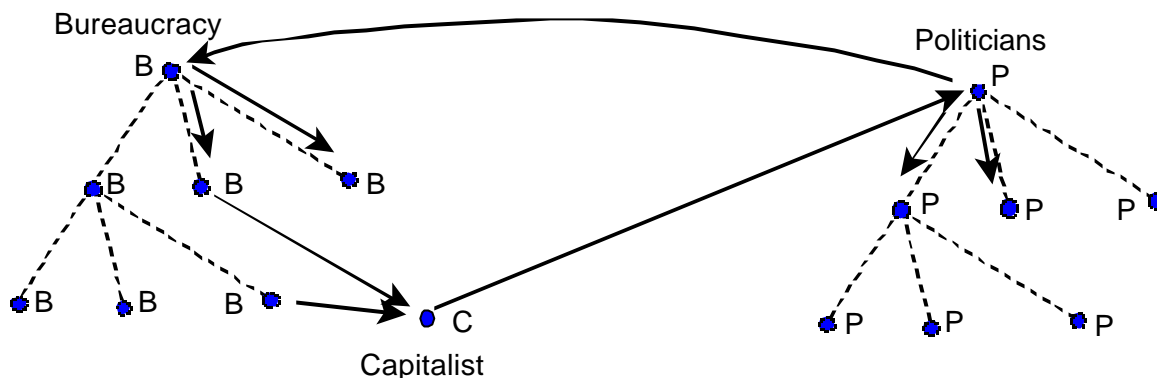


Figure 2. 8 Resource Flows in Patron-Client Networks: South Korea in the Seventies

The key difference of the South Korean rent-seeking process from that in the Indian subcontinent was the absence of decentralized centres of organizational and political power which had the ability to effectively demand or protect redistributive rents. This had important consequences for *rent-outcomes* in that transfers organized as learning rents could generate growth because the central leadership of the state could use a carrot-and-stick strategy to induce learning but not allow feather-bedding. The distribution of organizational power in South Korea prevented individuals unrelated to industrial policy from offering to protect the rents of emerging capitalists independently of the interests and calculations of the political leadership (Woo-Cumings 1997).

The absence of a large number of redistributive groups led by a powerful intermediate class can in turn be traced to Korea's social history and the nature of the Japanese colonial impact (Kohli 1994). The Japanese, unlike the British, did not rule through the creation of supporters and administrators within the local population. Instead, they relied to a much greater extent on Japanese colonial administrators. This had much to do with Japan's geographical proximity and its demographic dominance over its colonies, as well as perhaps to differences in colonial ideology. The British in India could not have fielded the same number of troops and administrators relative to the domestic population. Consequently, its colonial strategy was significantly different. In contrast, the Japanese colonial state could carry out far-reaching social changes from above, often with great harshness. Japanese land reforms and confiscations destroyed the power base of the landed elite. It transferred between a quarter and a third of arable land to Japanese entrepreneurs and corporations (Kohli 1994: 1277-9). But at the same time, considerable investments in industry and agriculture created employment opportunities in the productive sector, rapidly changing the structure of the economy.

In contrast to the British in their far-flung colonies, the Japanese goal in its neighbouring colonies seems not to have been to extract a few resources and maintain a captive market at the lowest cost. Instead, they aimed to convert Korea into a productive base for Japan and eventually to absorb it totally (Kohli 1994: 1272-4). Accommodating landlords, urban professionals and middle classes formed no part of



this plan, and the organizational power and legitimacy of intermediate groups never developed to the same extent. To say that South Korean industrial policy eventually benefited from this social history is not to deny the importance of the leadership role of Park Chung-Hee, nor the importance of the institutions under which rents for learning were administered during the industrial policy phase. However, similar institutional attempts to discipline recipients of learning rents failed in other countries, such as Pakistan in the sixties, which did not have this social history (see, for instance, Khan 1999).

The pattern of South Korean rent flows shown in Figure 2.8 did change over time. Rapid economic development eventually created a large middle class which, by the mid-eighties, became increasingly unwilling to accept the high-handed way in which resources were being allocated by the state. Not surprisingly, by the early nineties, revelations of corruption increased dramatically, even though much of this referred to the efficient rent-creation period of the sixties and seventies. The evidence suggests that the pattern of corruption was also changing by the nineties. Evidence of value-reducing interlocking between political factions and capitalists along the Indian pattern begins to emerge. Thus, in 1997, the steel company Hanbo went bankrupt amidst allegations that it had continued to receive state support long after its poor economic performance had become well-known. Factions within President Kim Young Sam's party and one of his sons were implicated in supporting these subsidies. In the same year, Kim Young Sam's finance minister seems to have supported a takeover of the automobile operations of the Kia conglomerate by its competitor Samsung, a strategy which many observers felt was motivated by political rather than economic considerations. The minister was closely associated with Samsung, and the company had also invested heavily in President Kim's home town of Pusan. These and other revelations led to a decline of domestic and international confidence in industrial policy well before the financial crisis of 1997.

Chang, Park & Yoo (1998) argue that these examples of efficiency-reducing corruption in South Korea were not typical of industrial policy in that country. They subscribe to the view that the gradual abandonment of industrial policy in the nineties and the shift towards liberalization was a policy decision which was not driven by any change in the viability of old-style industrial policy. They may be right, but it may also be that by the nineties, real changes were taking place in the distribution of political power in South Korea which allowed rent-recipients to form political alliances to protect their rents in ways which had not been possible earlier. The growing technical sophistication of South Korean industry was undoubtedly also making the allocation of learning rents more difficult, since bureaucrats were less and less competent to judge performance. The shift towards liberalization in South Korea may well have been driven, at least in part, by a recognition within the state that efficient rents for learning could no longer be effectively managed. This does not mean that liberalization of the type selected was the only or the best response. Constructing the institutions and political alignments to manage learning rents when political power is fragmented is a challenge for all developing countries. For relatively advanced countries like South Korea, which are operating close to the technical frontier on many (but by no means all) fronts and have exhausted easy learning opportunities, the challenge is more daunting. Here, the challenge is also to

construct new institutions for managing Schumpeterian innovation rents in addition to learning rents.

**Malaysia.** The South-East Asian countries were located somewhere between South Korea and the Indian subcontinent in terms of the relative organizational power of their intermediate classes. They did not experience the draconian colonialism and social engineering which South Korea and Taiwan suffered under the Japanese (Kohli 1994). On the other hand, although their colonial experience was closer to that of the Indian subcontinent, in most cases they had a shorter colonial history and the development and accommodation of the intermediate classes was less advanced. Indeed in the case of Thailand, there had never been direct colonial rule.

As in the Indian subcontinent, post-independence Malaysia faced redistributive demands from its own intermediate classes. However, here, a centralized pattern of resource flows emerged in response to these demands which proved to be compatible with rapid growth. Paradoxically, the ethnic divide in Malaysia between its largely Chinese-Malaysian capitalists and the predominantly Malay population allowed this centralized redistribution to emerge. The political isolation of the Chinese capitalists allowed them to be effectively “taxed” in a centralized way for the benefit of emerging intermediate groups. Moreover, since the bulk of the transfer could be legal, the need for illegal exactions was far less. This is probably an important reason why Malaysia was the least corrupt of the countries in Table 2.1. If, instead of the ethnic argument, a purely welfarist argument for transfers had been used, it would probably not have allowed the same pattern of centralized transfers. Welfarist transfers would have gone to the poorest groups in Malaysia, and not to the politically powerful Malay middle class, and would not serve the political purpose of accommodating the organizationally powerful. The ethnic and religious diversity of intermediate groups in India is one reason why it has been so difficult to construct a similar centralized transfer for the Indian intermediate classes.

The centralized solution to the redistributive problem emerged as an unintended consequence of the 1969 riots and the adoption of the New Economic Policy. The political consolidation which took place after the 1969 riots established UMNO (the United Malays’ National Organization), the Malay party in the ruling coalition, as the dominant political power in the country. The effect was to consolidate potentially competing Malay clientelist groups into a unified structure, and at the same time, to establish their political dominance over the largely Chinese-Malaysian capitalists who would have to pay for the redistributive rents. We could therefore characterize Malay clientelism as *centralized clientelism* compared to the fragmented clientelism afflicting the Indian subcontinent (Khan 1989) or the decentralized, but capitalist-led clientelism in Thailand, discussed below (see also Doner & Ramsay this volume; Sidel 1996).

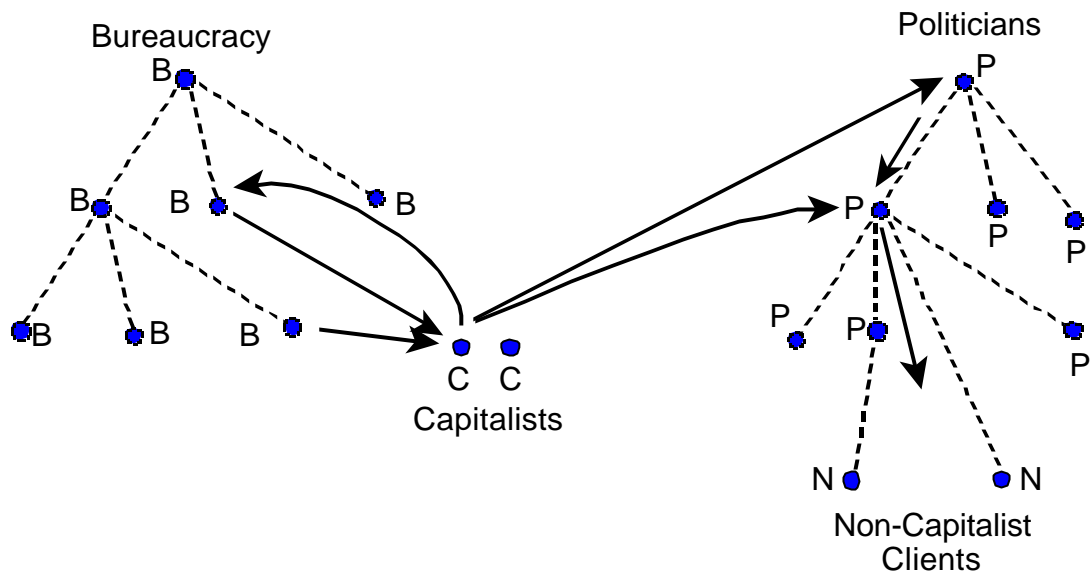


Figure 2. 9 Resource Flows in Patron-Client Networks: Malaysia in the Seventies

The resource flows within patron-client networks in post-1969 Malaysia are shown in Figure 2.9. The most important *rent-outcome* of this rent-seeking system was the redistributive transfer rent going from the mainly ethnic-Chinese capitalists (C) to the central political leadership (P) of the Malay party, UMNO. This included both legal taxes and illegal extractions. Malaysia's rich natural resources also allowed the state to tap significant natural resource rents. Collectively, these resources were used to create further transfer rents for the intermediate classes in a number of forms, including jobs in public sector enterprises and subsidized loans from the banking system (see Jomo and Chin this volume), shown by arrows from (P) to (N). The organizational power of UMNO was, in turn, based on rent-seeking inputs being expended by the party leadership in the form of rent-sharing with lower level clients. Thus the arrows from (P) to (N) were sometimes rent-seeking *inputs* which maintained the organizational power of the ruling party.

A subsidiary type of rent-seeking in Malaysia involved, as its outcome, the transfer of relatively small learning rents to domestic capitalists as assistance for moving into high technology industries and the capture of natural resource rents by companies gaining rights to exploit Malaysia's rich natural resources. These rent flows are shown by the arrows from (B) to (C). The implicit transfers which the state organized for Malaysia's capitalists were typically not the large, explicit rents for learning (as in South Korea) but they were nevertheless of economic significance (Jomo 1986; Jomo & Edwards 1993). To sustain these rights, capitalists also spent further resources as rent-seeking inputs, in lobbying or bribing state officials at various levels (flows from C to P and from C to B).

Compared to the Indian subcontinent, the distinctiveness of the Malaysian rent system was that the redistributive transfer from the Chinese capitalists was centralized and, initially at least, direct links between particular capitalists and political factions in the

Indian manner did not exist. By satisfying the demands of the organizationally powerful through a centralized redistributive transfer, this strategy separated them, for a time, from capitalists seeking rents. The demands of the latter could be evaluated on the basis of economic calculations (such as who could offer the highest bribes or the highest growth rates for future taxation and bribes) without individual capitalists being able to deploy political power to the same extent as in the Indian subcontinent.

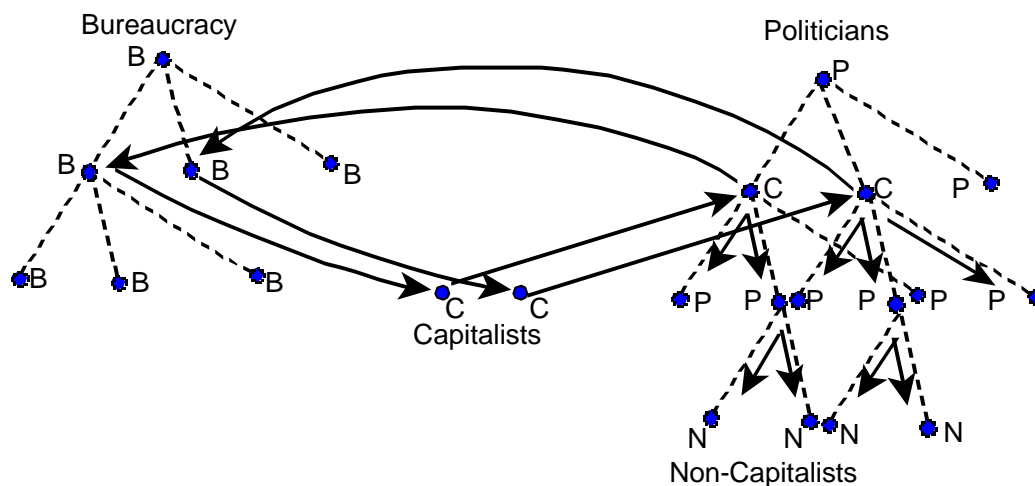
Finally, the political stability which Malaysia achieved as a result, allowed it to attract high-technology investments. The centralized political settlement, together with the fact that large natural resource rents were also available for redistribution, meant that domestic redistributive demands could be met internally. As a result, high technology multinationals were assured that their global Schumpeterian rents would be protected in Malaysia and would not be captured by local political processes. This must have contributed to the willing relocation of many of these firms to a cheap labour haven, by-passing countries like India which also had plenty of skilled labour. Not surprisingly, prior to the financial crisis, multinationals in Malaysia were driving exports and technology acquisition to a greater degree than in most other developing countries (Jomo 1986: 254-6; Jomo and Edwards 1993).

While Malaysia's centralized redistributive system was, for a time, compatible with rapid growth, it was nevertheless less dynamic than the industrial policy system of South Korea in the sixties and seventies. Since the bulk of the redistribution was to the intermediate classes, this limited the resources which could be transferred to capitalists to accelerate primitive accumulation or used as learning rents. Technical progress in Malaysia was therefore based on directly attracting foreign investment rather than inducing domestic learning. Nevertheless, given the domestic political configuration, it is doubtful whether a South Korean industrial policy system would have been feasible. The Malaysian state faced much greater political demands for redistribution, and the centralized system of redistributive rents was an efficient response.

The pattern sketched above has changed to some extent over time. As the Malaysian economy has grown, the political power of competing Malay factions within UMNO has grown as well (Jomo & Gomez, this volume). As decentralized factions developed through the late eighties and nineties, the Malaysian rent-seeking system began to slowly approach the Indian pattern with factions increasingly able to play a role in protecting rents for particular capitalists. The growing factionalization within UMNO was exemplified in the conflict between Prime Minister Mahathir and his erstwhile deputy Anwar Ibrahim. If the Malay intermediate class groups are indeed becoming more fractured, the centralized rent distribution system shown in Figure 2.9 may no longer be feasible. The challenge for Malaysia will be to democratize its polity without allowing competing factions to block efficiency-enhancing changes in the South Asian fashion.

**Thailand.** In Thailand, as in Malaysia, the Chinese played an important role in business and trade. But in contrast to Malaysia, ethnic-Chinese capitalists in Thailand inter-married with the local population and were linguistically integrated. Thailand was also different from all the countries discussed so far in not having experienced

direct colonial rule. Perhaps partly as a result, the Thai middle class of professionals, salaried workers and the petty-bourgeoisie were politically passive even as late as the 1980s (Phongpaichit & Baker 1997: 363). Compared to the Indian subcontinent or Malaysia, redistributive political factions were dominated to a much greater extent by business interests, though there were powerful patrons in the countryside who could mobilize large sections of the rural population. There were ongoing tensions in the Thai polity between a military-bureaucratic group which wanted authoritarian politics to clamp down on clientelism, Bangkok-based capitalists who wanted to take over political factions to achieve their own interests, and rural patrons who wanted to use their organizational power for developing provincial business and trade interests of their own. Despite these tensions, the distinctive feature of Thai clientelism from the seventies onwards was that redistributive rents were, in the main, demanded by groups which wanted to engage in primitive accumulation to develop business interests. While the balance between the Bangkok capitalists, the provincial capitalists and the military shifted over time, by the mid-seventies a stable pattern began to emerge as provincial and Bangkok capitalists began to collectively dominate political factions (Phongpaichit & Baker 1997: 332-354).



**Figure 2.10 Resource Flows in Patron-Client Networks: Thailand in the Seventies**

Figure 2.10 shows the dominant patterns which emerged after the fall of the military in 1973, though there were brief interruptions following military coups in 1976 and 1991. The key arrows are the ones showing rent-seeking *inputs* from capitalists (C) to political factions led by themselves (C), and thence to other politicians (P) and non-capitalist members of factions (N) who provided the organizational power for winning elections. By the seventies, Thai capitalists were running their own political factions to a much greater extent than in other developing countries in Asia (Sidel 1996; Phongpaichit & Baker 1997: Tables 10.1-10.2). This not only gave Thai capitalists places in parliament, but also the political power to bargain for subsidies, franchises and licenses, which were the *rent-outcomes* of their rent-seeking, shown by the arrows from (B) to (C) (see also Doner & Ramsay; Rock, this volume). These rents included monopoly rents, transfer rents supporting primitive accumulation, and learning rents for infant industries.

The distinctive features of the Thai rent-seeking system were first, the relatively low degree of redistributive rent transfers organized by non-capitalist political entrepreneurs. Since the capitalist faction leaders of Thailand did not have the social legitimacy to demand redistributive rents on ethnic, religious or other ideological grounds, Thai transfer rents supported primitive accumulation to a greater degree than in Malaysia or the Indian subcontinent. When redistributive factions are led by non-capitalist intermediate classes, competitive clientelism can lead to the generation of a growing number of ideological or ethnic identities to create redistributive rents, as we see in the Indian subcontinent. However, when competitive factions are led by capitalists, competition between them is more likely to lead to excluded factions trying to enter *existing* high-rent markets, since they cannot so easily create new ideological justifications for redistribution to themselves.

A second feature of the Thai rent-seeking system was the intense competition between these capitalist-controlled factions. The relatively large numbers of capitalists going into the political fray in Thailand reflected the development of trade and commerce in the country. Not having suffered an interruption due to a colonial takeover, small traders, often Chinese, had accumulated slowly over a century, and by the sixties, many of them were substantially wealthy. The vigorous political competition between factions controlled by Thai capitalists prevented the political system from being monopolized for long by any particular faction. Thus, although the rent-seeking input costs in the form of corruption and clientelism were high, long-run economic performance was good because the rent-outcomes of this rent-seeking were rapid primitive accumulation, and a tendency for new capitalists to enter sectors with high monopoly rents. Compared to other developing countries, there was a greater downward pressure on monopoly rents. On the other hand, the management of learning rents was poor, as the allocation of subsidies depended more on political bargaining power than on economic performance.

A key factor which ensured that this rent-seeking system was efficient was the nature of the technology which Thai capitalists were adopting in the seventies and eighties. In sectors such as textiles, logging, food processing and so on, Thailand was adopting technologies which had limited economies of scale, and did not require long periods of learning. In particular, they did not require learning rents for successful adoption. Rents, in this context, were only useful in accelerating primitive accumulation, as soon as that had happened, the competitive bidding down of rents in these sectors was socially desirable. This would not have been the case if useful rents had to be *maintained* and managed, for instance if learning was required or if sophisticated monitoring and regulatory mechanisms needed to be developed. In the long run, as Thailand moves into higher technology sectors, institutional reformers will have to face these issues.

The snapshot pictures of resource flows within patron-client networks in this section provide a starting point for our analysis of rent-seeking. It is important to recognize that these patterns are changing over time and so each pattern is specific to a particular phase of a country's development. Nevertheless, once particular patterns are recognized, we can ask general questions, the answers to which may be relevant for

other contexts as well. In the next two sections we will look at the variables which can explain differences in the input costs of rent-seeking and the differential rent-outcomes in different contexts.

## 2.4 The Input Cost of Rent-seeking

Conventional rent-seeking models have concentrated almost exclusively on the rent-seeking cost which is the input cost of rent-seeking. This is the cost to society of resources being used up in rent-seeking activities. These activities include lobbying, bribing, maintaining political factions and so on, which can potentially absorb a significant share of society's resources. The estimation of the *rent-seeking cost* involves two steps. First the *magnitude of the rent-seeking expenditure* and secondly, the *social cost* of this expenditure have to be estimated. The early rent-seeking models used a number of simplifying assumptions to show that the rent-seeking expenditure was equal to the size of the rent being competed for. If this was true, then for a total rent of \$100, the total expenditure on rent-seeking would be exactly \$100. For the second step, these models simply asserted that this entire expenditure was a social cost. We begin by looking at the early models. We then see how with different political and institutional assumptions, the rent-seeking cost can be much larger or smaller.

**The Rent-Seeking Expenditure: Early Rent-Seeking Models.** We know that individuals will only spend resources on rent-seeking if their expenditures change the *probability* of their winning (or not losing) the rent they are seeking (or which they already possess). *How much* individuals spend in aggregate will depend on how they perceive their probabilities of winning are likely to change as a result of these expenditures. This is where our assumptions about institutions, bargaining power and strategic perceptions become very important. The importance of these assumptions can be seen by considering how the early rent-seeking models worked. Later, we will consider the effects of relaxing these assumptions.

The key, but often only implicit, assumption in the standard Krueger-Posner type of rent-seeking model is that each individual's probability of winning the rent depends on that individual's *proportionate* expenditure on rent-seeking. In other words,  $\Pi_i$ , the probability of individual  $i$  winning the rent (of any value  $R$ ), is given by

$$\Pi_i = \frac{E_i}{\sum E_i}$$

where  $E_i$  is the expenditure of the  $i^{th}$  person on rent-seeking, and  $\sum E_i$  is the rent-seeking expenditure summed over all persons. If the probability of winning was determined in this way, this means that if person  $i$  spends \$10 on rent-seeking when the total expenditure on rent-seeking is \$100,  $i$ 's probability of winning the rent  $R$  is 0.1. *If* this is how the probability of winning is determined, we can then determine how much would be spent on rent-seeking in aggregate. The answer turns out to be exactly  $R$ . This is an important result. It says that *in this case*, if the total rent,  $R$ , is \$1000, the total expenditure on rent-seeking,  $\sum E_i$ , will be \$1000 as well. The reason for this can be seen by looking at the expected gain from "investing" one more dollar in rent-seeking. The expected gain is the probability of that dollar winning the prize

(the rent) times the size of the prize which is  $R$ . In symbols,  $i$ 's expected gain =  $\Pi_i \cdot R$  where  $\Pi_i$  is the probability of  $i$  winning the rent with an expenditure,  $E_i$ , of \$1. For instance, if for the last dollar,  $\Pi_i$  is 0.25 and the prize is a rent of \$1000, the expected gain is \$250. Since the expected gain of \$250 is achieved with an outlay of 1 dollar, person  $i$  is likely to invest the dollar in rent-seeking.

When is he likely to stop investing further sums? As  $i$  (and others like  $i$ ) keep investing in rent-seeking, the value of  $\Sigma E_i$  will keep growing and, as a result, the value of  $\Pi_i$  will keep falling. Eventually, the value of  $\Pi_i$  will fall to the point where  $\Pi_i \cdot R$  ( $i$ 's expected gain) is exactly 1 dollar. Any investment of a further dollar in rent-seeking beyond that point will not be attractive for  $i$  or anyone else. Clearly when  $\Sigma E_i = R$ , given that  $E_i = 1$ ,  $\Pi_i$  will equal  $1/R$ . The expected gain from an expenditure of \$1 will then be  $\Pi_i \cdot R = 1$ . Any further investment will result in  $\Pi_i$  declining further and the expected gain from subsequent investments will be *less* than 1 dollar. Thus, if  $R = 1000$  and a total of 998 dollars have been spent on rent-seeking, a further dollar spent will have a  $1/999$  chance of winning the prize, giving an expected gain of just more than \$1 (1000 times  $1/999$ ) for an expenditure of \$1. The next dollar will have an expected gain of exactly \$1 as total expenditure,  $\Sigma E_i$ , reaches \$1000. Beyond that point further dollars spent have an expected gain of less than \$1 and further rent-seeking expenditures will no longer take place. But by then, the total expenditure on rent-seeking,  $\Sigma E_i$ , will have reached exactly the value of the rent,  $R$ .

This is why early rent-seeking theorists were happy to estimate the rent-seeking cost by simply estimating the value of total rents in the economy, usually by adding up all the monopoly rents and subsidies. Thus in Figure 2.4, the rent-seeking cost which was analytically identified as YZ, could be given a numerical value simply by estimating the monopoly rent or the subsidy in the protected sector (Krueger 1974). Alternatively, if we go back to Figure 1.3 in Chapter 1, the social cost of monopoly was identified as a deadweight welfare loss equal to the small triangle CDE. Now rent-seeking theory was saying there was an additional rent-seeking cost which was equal to the size of the rent, in this case equal to the much bigger rectangle BCDP<sub>2</sub>.

**Rent-seeking Expenditures Versus Rent-seeking Costs.** The theory discussed so far estimates the *expenditure* on rent-seeking,  $\Sigma E_i$ , and assumes that this is an accurate measure of the rent-seeking *cost*. This may not be the case. Not all of the expenditures on rent-seeking are expenditures on inputs, and are therefore not a *cost* for society. If some of the expenditures on rent-seeking are transfers from one person to another, as bribes can be, the transferred resources are potentially available for production and no social cost is involved. Thus, there is a distinction between rent-seeking expenditures on inputs which are *used up*, as opposed to expenditures which simply *transfer* resources across individuals (Tullock 1980b; Browning 1980; Varian 1989).

An example of a rent-seeking expenditure which consumes inputs is lobbying. When an industrialist employs a lobbyist to work for him, the lobbyist consumes inputs while performing a specified activity. These inputs cannot be used subsequently to employ an engineer. On the other hand, an example of a rent-seeking expenditure which simply transfers resources is a bribe from an industrialist to a government official in exchange for a license. Here, no activity has been performed by the



government official which uses up inputs (ignoring the cost of signing pieces of paper which would perhaps have to be signed anyway). The bribe transferred is therefore *potentially* available for the same range of uses as before. The recipient could use the money to organize production or go for a holiday, just as the bribe-giver could have done. As far as society is concerned, inputs have not yet been used up. If all rent-seeking expenditures were transfers rather than expenditures on inputs, there would be no potential loss of inputs for producing final outputs, and therefore, no rent-seeking cost.

However, the fact that inputs remain *potentially* available following a transfer does not mean that the allocation of inputs in production is unchanged. Individuals have different preferences, and the bureaucrat may use his bribe differently from the industrialist. If the industrialist is more likely to invest than the bureaucrat, a bribe may have a social cost in a poor country with an investment constraint. Thus, even if rent-seeking expenditures are transfers, they can still affect the allocation of resources in production. An accurate measure of the rent-seeking cost would have to break down any rent-seeking expenditure into three components. First, part of the total expenditure may be a pure transfer which leaves final output unchanged. This component of rent-seeking expenditures will have zero social cost. Secondly, a part may be a transfer which nevertheless changes allocative decisions in particular ways. Here, the social cost is the difference in value of final output with and without the transfer. This may be difficult to estimate in practice. Third, there may be a component which is a true input withdrawal, and this part of the rent-seeking expenditure is entirely a cost. The practical difficulty of estimating the true social cost of rent-seeking expenditures in this way explains why we usually make the simpler assumption that the rent-seeking cost is at least proportional to the rent-seeking expenditure. If this assumption is justified, higher rent-seeking expenditures should at least imply higher rent-seeking costs. For comparative purposes such an assumption is justified as long as the *composition* of rent-seeking expenditures is roughly the same in the situations being compared. This qualification should be borne in mind, though we do not have any simple way of correcting our estimates when this is not the case.

**The Rent-Seeking Expenditure: Additional Variables.** The claim of the early Krueger-Posner rent-seeking models was that the rent-seeking expenditure is equal to the size of the rent. This, as we have seen, was based on some very special assumptions. We now see that if we take into account other institutional and political variables, the magnitude of rent-seeking expenditures can be more or less than the size of the rent.

*i) Institutional Rules.* A key assumption of the first-generation models was an implicit institutional rule for allocating the rent-generating right. This institutional rule said that when individuals or groups spend resources on rent-seeking their probability of getting the rent is equal to their share of the total rent-seeking expenditure,  $E_i/\Sigma E_i$ . But if the rule for allocating the rent is slightly altered, the final rent-seeking expenditure can be substantially more or less than the size of the rent (Mueller 1989: 229-46).

For instance, if only a small number of individuals are allowed to enter the rent-

seeking game, and the rent-generating right is randomly allocated to one of them, the total expenditure may be very small. This would be the case if the expenditure each person has to make to *enter* the game is small. Thus, if the rule is that the first five people in a queue are allowed to bid \$1 for a rent of \$1000, which is then allocated to one of them by the state, either randomly or according to some autonomously determined rule, the total rent-seeking expenditure will be limited to \$5. This is a simplified version of the argument that insulated, authoritarian or “invulnerable” states which can limit the competition over rents can also limit rent-seeking expenditures (Chang 1994: 38-44; Kim & Ma 1997). This is also what Hutchcroft (this volume) calls “purposive rent allocation” which he contrasts with “competitive rent-seeking”.

However, this institutional argument is incomplete. It is not clear why *secondary* rent-seeking does not take place. Secondary rent-seeking in this case refers to expenditures by excluded groups to change the rent-allocation *rule* itself since this rule excludes many potential rent-seekers from the chance of winning, and also excludes many state officials from collecting bribes which they may otherwise have done. In fact, rules for allocating rents which exclude many rent-seekers *are* often contested. One important variable which determines the outcome is the distribution of political power between insiders and outsiders in the restricted rent-seeking game. If the excluded have the power to contest, it is unlikely that they will be effectively excluded in the long run, and we should expect to see the exclusionary rules being changed. It follows that institutional rules which seek to lower rent-seeking expenditures by limiting the access to rents can only work if those being excluded are not powerful enough to contest their exclusion.

In contrast, we can also think of institutional rules allowing high degrees of competition which may result in much *larger* rent-seeking expenditures than the rent available. One example would be a rule which says that any number of agents can compete, and the right is allocated to the *biggest* spender. Under this institutional rule, the rent-seeking expenditure is indeterminate, and may be much larger than the rent being competed for. For instance, for a rent of \$1000, it is quite possible that under these rules, each of 10 contestants bids \$990, resulting in \$9900 being spent in rent-seeking. However, this rule too is unlikely to be sustained in a repeated game because too many contestants will go bankrupt. Contestants are likely to begin to collude when bidding for the rent, but it is difficult to say much more *a priori*.

In the real world, an institutional rule which is often relevant for allocating rents is the *democratic* rule. This institutional rule says rents are allocated to coalitions of majorities in representative institutions. Analytical comparisons of rent-seeking expenditures under “democracies” and “dictatorships” have attracted great interest. However, it turns out that at a purely analytical level, political institutions have indeterminate effects on rent-seeking. Democratic legislatures could be associated with high or low rent-seeking expenditures depending on other conditions. As an example, Congleton (1980) argued that in democracies, if there is competition in forming coalitions, this is likely to drive bribes down to the minimum effective level for each legislator. The total bribe paid could then be as low as the minimum bribe per legislator for half the legislators plus one.

For instance, suppose the minimum bribe acceptable to each legislator is \$1 and there are three legislators. Suppose also that we start from a position where bribes are high and all three legislators are getting a bribe of \$5, represented by (5,5,5). Since only two votes out of three are needed for a majority, rent-seekers can offer the first two legislators a lower total bribe to form a new coalition which still has the majority required to allocate rents. For instance, they could offer (6,5,0). This in turn can be bettered (from the rent-seeker's point of view) by an offer of (7,0,1) which costs even less but will be accepted by a new majority combination of legislators. This in turn can be bettered by (0,1,1). In each case, rent-seekers buys the required two votes, but for less and less, till the minimum effective bribe is reached. A game-theoretic version of this coordination problem facing corrupt legislators in a democracy is provided by Rasmusen and Ramseyer (1994). The problem with drawing firm conclusions about the rent-seeking expenditure in a democratic legislature is that the result depends on the minimum bribe which legislators will accept, and moreover, the minimum-bribe coalition may not necessarily be stable. Rent-seekers who have lost out have the incentive to offer higher bids to new coalitions of legislators so that bribes can be bid up again. Thus, if legislators are powerful enough to demand high minimum bribes, or if winning coalitions can be repeatedly overthrown by new combinations, it is possible for rent-seeking expenditures to be very high in a democracy. Whether democracies actually result in high or low rent-seeking expenditures clearly cannot be determined from such abstract models.

Another approach to modelling the rent-seeking cost under democracies comes from transaction cost economics. We have seen that the social cost of rent-seeking is not necessarily proportional to the magnitude of the bribes and transfers. Thus, even if democracy lowered the total bribe, this does not necessarily mean that the rent-seeking cost is low. One of the true costs of transfers is the *transaction cost* of organizing them. These are the costs of *negotiating* the size and allocation of the transfer. Negotiating uses up resources (in the simplest sense because haggling uses up time which could have been spent in production). If failed negotiation results in conflict, there are additional costs in the form of strikes or even riots. These are true social costs, which may or may not be directly proportional to the size of the transfers taking place.

North (1990) calls these costs of organizing transfers the *political transaction cost*. He then puts forward a somewhat different argument for democracy on the grounds that democracy reduces political transaction costs to their lowest possible level. The intuition here is that the free flow of information in a democracy would make the process of striking deals easier and faster compared to other systems. But once again, one could argue that whether a democracy ensures the lowest political transaction cost for organizing transfers and bribes depends on the distribution of power. If there are many groups which are evenly matched, they may each hold out for very small gains, in which case the political transaction cost under democracy may be very high. Nevertheless, if North is right, rent-seeking costs will be minimized in democracies. Note that this result directly contradicts the argument which suggests that an invulnerable or autonomous state can ensure low rent-seeking costs. These competing models show that it is possible to construct perfectly logical arguments showing how

quite different institutions may be better for reducing rent-seeking costs. Equally, the *same* institution may be associated with high or low rent-seeking costs depending on other conditions.

The theoretical indeterminacy of the rent-seeking expenditure associated with specific institutional rules is confirmed when we look at our countries and try to relate rent-seeking costs to the degree of democratic competition. By this we mean how far their institutions allowed free elections, a free press and freedom for groups to organize into factions and parties. India was clearly the most democratic of our group of countries. Its constitutional arrangements ensured regular elections, a free press and many competing parties. The only break in its democratic record was the brief period during 1975-77 when Mrs. Gandhi imposed her Emergency.

The other countries are more difficult to rank. In each case, some democratic rights were suspended for some part of the period we are looking at. Rights were suspended for varying periods, and some rights but not others were curtailed, making a clear ranking difficult. Keeping this in mind, we would rank Malaysia next. On the one hand, although party choice was limited, Malaysia had a civilian administration throughout the period we are interested in. As we saw in Section 2.3, the representative structure which emerged after 1969 was responsive to redistributive demands coming from its large intermediate classes. On the other hand, many organizational rights, particularly of labour unions, were curtailed during the Emergency of 1963-66 and some rights remained curtailed thereafter (Jomo 1986: 236). The ethnic dominance of the Malays in the representative structure which emerged after 1969 also made it more difficult for some excluded groups to compete for rents. This justifies ranking Malaysia lower than India.

South Korea, Thailand, Pakistan and Bangladesh are at the other end of the institutional spectrum as they each suspended civilian administrations for varying periods in the sixties, seventies and eighties, followed by controlled transitions to democracy. In South Korea, Park Chung-Hee's coup of 1961 established the authoritarian state which governed South Korea during its industrialization. The state made frequent use of the Korean Central Intelligence Agency to control dissent and periodically used martial law in the early years. It also exploited the popular perception of impending hostilities with North Korea to institutionalize limits to democracy in the Yushin Constitution of 1972. Genuine democratization began only in the eighties (Woo-Cumings 1997). Pakistan and Bangladesh were similar to South Korea in having an authoritarian state in the sixties following Ayub Khan's military takeover in 1958. When the two countries split apart in 1971, gradual moves towards democracy began, but with another military interlude in both countries covering roughly the mid-seventies to the late-eighties.

The fall of the military government in Thailand in 1973 marked the beginning of its slow progress towards greater democratization. However, the military remained suspicious of the "corrupt politicians" who dominated parliament and did all they could to restrict the power of the legislature. Constitutional provisions allowed the Prime Minister and some of his Cabinet to be appointed from outside the legislature, and the military was usually successful in ensuring that its candidates remained at the

apex. When it felt that parliament was stepping outside its bounds, there were short-lived coups in 1976 and again in 1991. Despite this, parliament played a function in the rent-seeking game by allowing capitalist factions to seek redistributive rents in the way described in Section 2.3, and the powers of the legislature gradually increased over time (Phongpaichit & Baker 1997: 290-364).

A loose ranking in terms of the degree of democratic competition in these countries would, therefore, place India first, followed by Malaysia, and then the other four countries, which are difficult to rank further. Fortunately, the precise ranking does not matter very much for what we want to say. If North's (1990) proposition about democracy is true, India should have had the lowest rent-seeking costs (relative to the size of its GDP), followed by Malaysia, and with South Korea, Thailand, Pakistan and Bangladesh with the highest. If on the other hand, the argument in favour of invulnerable states is true, then the ranking in terms of rent-seeking costs should be reversed. On the basis of our earlier discussion, admittedly based on subjective and qualitative data, the actual ranking in terms of rent-seeking costs does not fit either institutional story.

If we look at the seventies, authoritarian South Korea probably did have lower relative rent-seeking expenditures than democratic India (but probably not much lower). On the other hand, authoritarian Pakistan and Bangladesh seem to have had *higher* rent-seeking expenditures than democratic India. (In a similar vein, Hutchcroft in this volume suggests that authoritarian rent allocation also failed to reduce rent-seeking costs in the Philippines under Marcos). Thailand's fairly authoritarian regime over the same period probably led to one of the highest rent-seeking expenditures, and probably higher than the relatively democratic Malaysia. In the eighties, some of these rankings change, but once again, there is no simple story. Depending on which countries and periods we select, we can find support for either hypothesis.

Clearly, there are other variables which could explain the differences in rent-seeking costs in these countries, but the interesting question is whether the effects of particular institutional rules *also* depend on the social context. Chang (1994: 45) points out that restricting political competition under authoritarianism is not a simple issue because the institutions which will successfully restrict competition depend on the political economy of the country. We would go further and argue that the rent-seeking cost is not always reduced by attempting to *reduce* political competition institutionally. While an institutional *restriction* of political competition seems to have worked for a time in South Korea, given the weakness of its excluded rent-seekers, such a strategy has often resulted in *increased* secondary rent-seeking costs in other developing countries.

The comparison of Pakistan and Bangladesh with India in the sixties and seventies is instructive because these countries had very similar social structures. However, their political institutions differed as Pakistan and Bangladesh repeatedly attempted to restrict access to political power, while giving a small number of players access to industrial sector rents. These were precisely the institutional features which are often identified as important in explaining low rent-seeking expenditures in South Korea (Kim & Ma 1997). However, in both Pakistan and Bangladesh, excluded groups led

by the intermediate classes were always successful in vigorously contesting their exclusion whenever exclusion was attempted, and this eventually resulted in much larger secondary rent-seeking expenditures over time (Khan 1989; 1999). Such was the magnitude of this secondary rent-seeking effort that authoritarian regimes in these countries either did not survive for long, or did not remain authoritarian in practice.

These examples suggest that whether democracy or authoritarianism has lower rent-seeking costs will also depend on the degree of fragmentation of society and the strength of redistributive factions. Where social factions are weak and power is centralized, as in South Korea in the sixties and seventies, the institutions of authoritarianism might produce low rent-seeking costs. Where social factions are strong and the effective power of the state to suppress them is weak, democratic institutions may be necessary to achieve the lowest rent-seeking costs, not only for the information reasons suggested by North, but also because they are likely to result in lower levels of conflict from excluded groups, and therefore lower secondary rent-seeking costs. The institutional rule for allocating rent is therefore a useful starting point for analysing rent-seeking expenditures as long as we remember that institutional rules do not exist in a social and political vacuum.

*ii) Sunk Costs and Insider Advantages.* Given an institutional structure, rent-seeking expenditures can depend on the costs and benefits of the different contestants. Insiders in a rent-seeking game may have sunk costs, that is, investments which they have already made which are now of little value in other uses. For instance, investments already made in patron-client networks, on acquiring insider information and even investments in R&D often have this character because they are of little value in other sectors. If outsiders know this, rent-seeking is similar to an entry deterrence game, where the incumbent paradoxically has an advantage due to prior sunk costs. The advantage comes from the fact that the incumbent can credibly threaten to spend resources fighting potential entrants even if that implies big losses for a time, since part of the incumbent's assets have no value elsewhere. Knowing this, potential entrants may decide not to bother to spend resources and the rent-seeking expenditure may be very low (Rogerson 1982).

We may then expect challenges from outsiders to be less frequent when insiders have established themselves for some time in particular sectors. However, this theoretical expectation is not supported by the evidence. Although India's industrial sector was somewhat smaller relative to the economy than that of South Korea's at independence, big capitalists in India were effectively already insiders. Big business houses, such as the Tatas and Birlas, played a key part in the nationalist struggle against British colonialism and subsequently enjoyed substantial influence within the Congress Party. Their views were influential in the construction of the Bombay Plan of 1944 which established the capitalist class as legitimate partners of the state in the construction of post-colonial India. Yet the Indian evidence suggests that the insider status of established capitalists was not sufficient to limit the overall rent-seeking expenditures in the industrial sector. In Malaysia too, the existence of established capitalists did not deter rent-seekers. Here, the established capitalists were Chinese Malaysians, but their insider status did not deter the most important group of rent-seekers, the Malay political elite whose activities entailed inevitable rent-seeking costs (Jomo 1986).

On the other hand, the incumbent rent recipients in South Korea in the sixties and early seventies were paradoxically much less credible as established insiders. The *chaebol* in South Korea had been tainted by their association with the Japanese colonial power and their influence over Park's nationalist regime was correspondingly limited. Consequently, the *chaebol* in the early years did not enjoy the status of established insiders. Of the top ten *chaebol* in 1965, only three remained in the top ten in 1975. Since then, greater stability has emerged in the longevity of the top *chaebol* (Fields 1995: 34-5). Nevertheless, rent-seeking expenditures were probably relatively lower in South Korea in the sixties and seventies compared to India and Malaysia. Thus, the sunk cost advantage of insiders does not seem to correlate well with our perceptions of relative rent-seeking costs in these three countries. This does not mean that the insider effect is not important. But it does suggest that in our countries, countervailing factors, such as the institutional variables discussed earlier and the power variable to be discussed next, may have pulled relative rent-seeking costs in other directions.

*iii) The Distribution of Power.* The outcomes of rent-seeking games often depend on which of the competitors can inflict the biggest costs on others and hold out the longest in expensive contests. These attributes can be described in terms of the distribution of the power to contest, bargain and hold out. The simplest model in which to see the importance of power is in a rent-seeking contest which takes the form of a game of coordination with conflict (the so-called Chicken game). In this 2-person game, both players gain as long as coordination is achieved (in this case, through the creation of a socially-useful right), but the benefits are unequally shared since the right and the associated rents go to one person alone (which is the source of the conflict). The creation of exclusive property rights is an example. A society which creates property rights over resources threatened by free access overuse is collectively better off, but the particular individuals getting the rights gain disproportionately. Each agent is therefore likely to spend on rent-seeking to become the owner of the proposed property right (and of the associated rents), but if everyone engages in rent-seeking, a clear winner may not emerge which may prevent the right from being created at all.

An example of the payoff structure in such a game for two agents, or classes of agents, is shown in Figure 2.11. This shows the payoffs to each agent under each combination of strategies, with A's payoffs being shown first. Note that only the ranking of the payoffs matters and not the absolute numbers. The payoffs reflect the net effect of rent-seeking, that is, they take into account the social value of the rent created as well as the rent-seeking cost. In this example, the social value of the rent associated with the property right is 14 units. The rent-seeking cost is 1 unit for each individual engaging in rent-seeking. The starting point, when the right does not exist is shown in the bottom right hand corner of the box, where both players avoid rent-seeking and get the fallback payoff of 1 unit each. The right is created if *one* of the players engages in rent-seeking. For instance, if A engages in rent-seeking and B does not, the right is created for A. As a result, A gets the lion's share of the added value in the form of a rent. Even after A's rent-seeking expenditure of 1 unit, she gets a final payoff of 10 units, while B gets 5. The *total* social payoff is thus 15 units, compared

to the previous payoff of 2, the difference being the social value of the new right (14 units) less the rent-seeking cost (1 unit). The individual payoffs are reversed if B engages in rent-seeking and A does not, but the total social payoff is unchanged. If A and B both engage in rent-seeking, the social outcome is the worst, since both incur the rent-seeking expenditure of 1 unit *and* the right is not created in this round, since a winner cannot be decided. Their payoffs are now 0 each, giving a total social payoff of zero. Moreover, the rent-seeking is likely to continue in subsequent periods as long as each player has the resources to continue.

		B	
		Engage in Rent-Seeking	Avoid Rent-Seeking
A	Engage in Rent-Seeking	0,0	10,5
	Avoid Rent-Seeking	5,10	1,1

**Figure 2.11 Rent-Seeking Game with Coordination and Conflict**

The equilibrium strategies in this game are indeterminate. If A *believes* that B will engage in rent-seeking, her best strategy is to avoid rent-seeking. It is clearly in B's interest to make A believe this. Conversely, if B *believes* that A will fight, his best strategy is to avoid rent-seeking. Each side therefore wants the other to believe that it will fight. If both believe they have a chance and engage in rent-seeking, the rent-seeking expenditure is greatest *and* the right is not created. This is the worst outcome for society with a payoff of (0,0). If neither believes they have a chance, the rent-seeking expenditure is zero, but in this case society is worse off with a payoff of (1,1) because the useful right is not created. The best outcome obtains if only one of them engages in rent-seeking. The rent-seeking expenditure is then low and a useful rent-outcome is produced. What will actually happen in each round depends on the *reputation* of the agents. This is based on their mutual assessments of their relative power, which makes their threats to fight more or less credible to their opponents (Knight 1992). For instance, if A is very wealthy (and can therefore hold out for many rounds of the game) or has acquired a reputation in the past for fighting, her threat to engage in rent-seeking is likely to be credible. In this case, B may not bother to rent-see and the right may be created for A after the first round. If both agents are evenly matched, there may be many rounds of contestation till reputation or the relative power of one is established, and the right is created for that person. Thus, evenly matched contestants may spend much more on rent-seeking compared to contestants who are very unequal. Thus, paradoxically, an egalitarian society may suffer more from rent-seeking expenditures when possibilities of new rents emerge.



This example shows why institutional rules may be insufficient for determining the magnitude of rent-seeking expenditures. *The same institution may lead to high or low rent-seeking expenditures depending on the expectations of the contestants.* In the example above, political institutions implicitly allow both agents free access to the rent-seeking competition, but their rent-seeking expenditure depends on how they believe the other will act. This belief is likely to be based on the objective relative *power* of the agents. If one is clearly much more powerful in the sense of the ability to engage in contests, the other is more likely to give up. With some amendments, a model similar to the one above may be used to explain the extent of secondary rent-seeking expenditures in the context of insulated state institutions. The rule followed by the insulated state is that insiders get rights over rents while outsiders do not, regardless of their expenditure. However, if outsiders can impose costs on both the state and the insiders by engaging in rent-seeking, their strategy will depend on their perception of how long their opponents can withstand this contest. Only if the state and its insider clients are perceived by outsiders as *powerful* enough to resist their rent-seeking challenge will the rent-seeking expenditure be low.

Thus, low rent-seeking expenditures under insulated states requires that excluded social actors in these societies believe they will not be able to change the exclusionary rules by secondary rent-seeking (Khan 1995). In contrast, if excluded outsiders feel they *can* win, insulated institutions can provoke bouts of massive rent-seeking expenditures. This is why a *political* analysis is important for revealing the actual or perceived power of the different groups engaged in the rent-seeking process. This is clearly an area where the rent-seeking methodology can profitably draw on the work of political scientists and others working on the relative power of groups involved in rent-seeking activities in particular countries.

Our discussion in this section suggests that by looking at a range of variables which may determine rent-seeking expenditures, we can go beyond the early models which claimed that rent-seeking costs would be equal to the size of the rent. These additional variables improve our understanding of why rent-seeking expenditures varied across our countries, even though these differences are unlikely to explain performance differences on their own. Thus, the observation that South Korea and Malaysia suffered lower rent-seeking costs than India may not be wrong, even though the differences were probably less dramatic than is often suggested. In the first two countries, centralized rent allocation resulted in relatively low rent-seeking expenditures not only because of centralized institutions, but also because of a distribution of power in society which allowed these institutions to work at low cost. In South Korea, this was due to the relative weakness of the intermediate classes, in Malaysia because an implicit social contract was constructed which allowed the intermediate classes to be centrally accommodated. In India democratic rules and a fragmented distribution of social power resulted in higher rent-seeking expenditures, but these were probably somewhat lower than in Pakistan and Bangladesh, where centralized institutional allocation was, for a time, attempted in societies with very dispersed distributions of power. Thailand was an intermediate case. Despite the attempts of the military and bureaucracy to maintain centralized allocative rules, the distribution of power between competing factions meant that rent-seeking

expenditures were very large and centralized allocation did not last very long. On the other hand, the dispersion of contestation power was less than in the Indian subcontinent due to the lesser role of the intermediate classes. Rent-seeking expenditures of all types were possibly as large as in India but lower than in Pakistan and Bangladesh as secondary rent-seeking in the form of violent social contestation of state policies was less marked. In each case, while the differences in rent-seeking expenditures contribute to part of an explanation of performance differentials, it should be clear by now that the real differences lay in the rent-outcomes of the rent-seeking process.

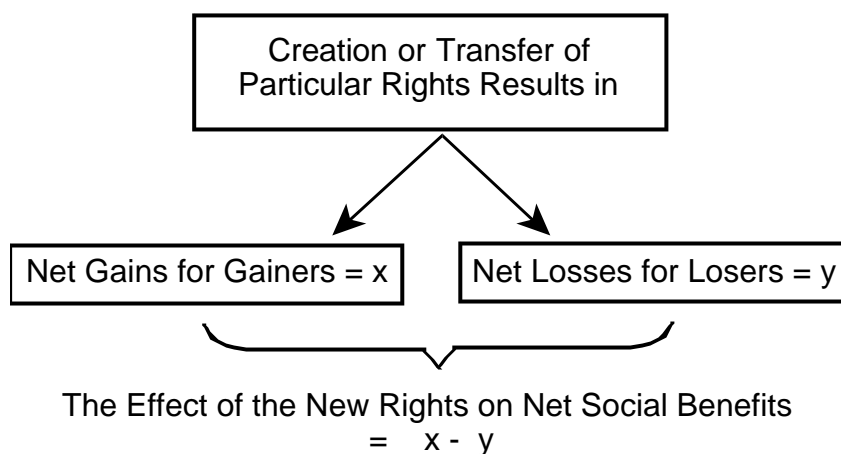
## 2.5 The Rent-Outcomes of Rent-seeking

In Chapter 1 we saw that there were important differences between types of rents, some of the important features of which were summarized in Figure 1.13. While each rent is a source of extra income for its recipients, some rents can clearly be socially beneficial, while others are socially impoverishing. We also saw earlier that there were substantial differences in the *rent-outcomes* of rent-seeking in our countries in terms of the types of rights which were created, maintained or transferred as a result of their rent-seeking (Figure 2.6). Why should rent-seeking result in the creation of value-reducing rents in some cases but value-enhancing rents in others? This question has received relatively little attention in the rent-seeking literature.

To some extent, this is because it is not easy to provide neat answers to this question and economists typically dislike messy stories. Nevertheless, the absence of elegant theory does not mean that the question can be shelved. Indeed, we would argue that not addressing the rent-outcomes of rent-seeking makes much of the rent-seeking analysis worse than useless since conclusions based on the input side of the story alone may be positively misleading. Fortunately, despite the absence of elegant models, we can draw on a broader literature in institutional economics and political economy to discuss some of the conditions under which value-enhancing rents are likely to emerge. Since rights and rents are *evolving* over time, we only need to identify the factors which allow value-enhancing rights and rents to emerge. Figure 2.12 shows that the value of any new right created by rent-seeking can be decomposed into net gains (equal to  $x$ ) for gainers, and net losses (equal to  $y$ ) for losers. Since the net social benefit associated with a specific rent or right is precisely the net gain for the gainers after the losses of the losers have been accounted for, the net social benefit attributable to a particular right is  $(x-y)$ .

Figure 2.12 says that the net social benefit associated with any rent can be decomposed into gains for gainers and losses for losers. This is simply an arithmetic fact, but it may help some readers to see how this decomposition works for the simplest case of the monopoly rents analysed in Figure 1.2 in Chapter 1. When a monopoly rent is created, output falls from  $Q_1$  to  $Q_2$ . The losers are consumers and (previous) producers, while the gainer is the monopolist. The gain,  $x$ , for the monopolist is the monopoly rent, so  $x=BCDP_2$ . The loss for consumers is equal to the shrinkage in the consumer surplus, which is equal to  $P_1FE-P_2FD=P_1P_2DE$ . The loss for producers is equal to the shrinkage in the producer surplus, equal to  $P_1AE-BAC=P_1BCE$ . The total loss of the losers is  $y=P_1P_2DE+P_1BCE$ . The net gain,  $(x-y)$ , is

$BCDP_2 - P_1P_2DE - P_1BCE = -CDE$ , which is the deadweight welfare loss, the (negative) net social benefit associated with the monopoly.



**Figure 2.12 Decomposing the Value of the Rent-Outcomes of Rent-Seeking**

In the case of other rents too, the net social benefit can be decomposed into gains for gainers and losses for losers. In the case of complex rents, such as Schumpeterian rents or learning rents, the eventual net social benefit depends on the conditions which determine these gains and losses (see Figure 1.7). For instance, the gains from learning rents depends on how well the rents are policed and what the recipients have to do in return, which can determine whether the eventual gains for society outweigh its short-term losses. But in every case, socially desirable rights are *created* if, and only if,  $x-y > 0$  for any new rights and rents created. Equally, socially desirable rights are *maintained* if value-reducing changes ( $x-y < 0$ ) are *not* introduced. Thus, the creation and maintenance of desirable rents are closely related.

We want to identify the conditions under which rent-seeking results in the systematic creation of socially valuable rents and rights (where  $x-y > 0$ ), as opposed to socially damaging rights (where  $x-y \leq 0$ ). The complication in trying to look for general conditions is that these conditions can depend on who is seeking the rent and how. At the very least, we have to distinguish between three scenarios. In the first, individuals (or groups) *privately negotiate changes in rights* without involving the state at all. In the second scenario, individuals and groups again take the initiative in seeking rents, but the state ultimately creates, maintains or transfers rights. Here *individuals or groups attempt to influence the state* by spending resources in bribing or lobbying, or by using political pressure. Success now depends on relative influencing abilities, so we have to look at how private players manage to get the state to act in their interest, possibly against the interests of others. In the third scenario, the *state leads initiatives to create and change rights* according to its own objectives. The state is no longer passively responding to influence, but is the primary “rent-seeker”. Here, the agenda of the state leadership matters, but social groups also matter because they can support or resist the state. In reality, rent-seeking is likely to involve elements of more than one of these cases. For instance, the state may simultaneously respond to pressures

from society while trying to follow its own agenda. Nevertheless, the simplified scenarios make it easier to identify the conditions under which value-enhancing rents are likely to emerge.

Figure 2.13 summarizes a number of conditions for each of the three scenarios (labelled A, B and C), which we discuss in turn. Some are necessary conditions, others are necessary in some situations, but not others. It is best to see them as conditions which are *conducive* for the creation and maintenance of value-enhancing rights and rents.

Different Rent-Seeking Scenarios	Conditions Conducive for the Creation of Socially Valuable Rents
A: Rent-Seeking through private negotiation with no role for the state	A-i) Gainers always compensate losers
B: Rent-Seeking by attempting to influence the state	B-i) The spending power of rent-seekers is proportional to their gain or loss B-ii) The political power of rent-seekers is proportional to their gain or loss - if this does not hold, we require at least- B-iii) Political demands for transfers can be met with a stable set of redistributions
C: Rent-seeking led by the state	C-i) State officials are value maximizers who learn rapidly from their mistakes C-ii) The costs of collecting bribes and taxes do not differ across groups C-iii) The state's institutional structure allows all costs and benefits to be internalized C-iv) Losers do not have the power to politically resist the state

**Figure 2.13 Conditions for the Creation of Value-Enhancing Rents**

**A: Rent-Seeking Through Private Negotiation.** In our first scenario, rents are created through private and voluntary negotiations between individuals and groups with the state playing no role at all. Only one condition is required to ensure that *only* value-enhancing rights are created and this is condition (A-i) in Figure 2.13:

**A-i) Gainers always compensate losers.** Since this condition is usually met whenever we assume voluntary negotiation, nothing more is required. If the gainer has to compensate the loser by paying him  $y$ , the net value to the gainer of the proposed rights (ignoring any additional rent-seeking cost) is  $(x-y)$ . Therefore, gainers will only propose these rights if  $x-y > 0$ . The net value of these rights for society (again ignoring the rent-seeking cost) is also  $(x-y)$ . This is why, in this case, rights which reduce value for society will *never* be introduced. For instance, a monopoly would never be created

if the monopolist had to compensate all potential losers before the monopoly could be set up.

In practice, this type of rent-seeking is rare. However, an example would be the creation of voluntary rules governing access to, and use of, a natural resource such as a fishing lake. Such agreements create *de facto* property rights and natural resource rents for the users. These arrangements do in some cases evolve through voluntary negotiation, though in practice, some users are almost always excluded without compensation and the arrangement is therefore never truly voluntarily negotiated. Despite the limited historical evidence for voluntarily negotiated changes through rent-seeking, some institutional economists have constructed long run models of institutional change with the “as if” assumption that losers are compensated (for instance, North 1990). A possible justification for such an assumption might be that losers are unlikely to give up without a fight, and the more they stand to lose, the more likely they are to fight. If the conflict imposes costs on the gainers *equal* to the loss of the losers, it may be convenient to assume that losers are always compensated even if in reality they are not. The net gain to the gainers will, once again, be  $(x - y)$ . However, such models may be misleading precisely because the cost inflicted on gainers in the course of a conflict is often *not* equal to the potential losses of the losers (see also Khan 1995).

There are some important reasons why in the real world important institutional changes, such as the creation of property rights, typically do *not* happen through processes of negotiation and compensation. First, all losers typically do not have the institutional basis to demand or bargain for compensation. In such cases, rent-seeking is by definition not voluntary. For instance, when a manufacturer seeks a monopoly right and consumers do not have the institutional ability to demand compensation, the rent-seeking process is not driven by voluntary negotiation. Secondly, when large differences in power exist between classes of agents, it makes no sense for the strong to compensate the weak. Thirdly, even if they were so minded, their commitment to compensate losers may not be credible. This is because when the gains and losses take place over time, the compensation would also have to be paid over a period of time. But the institutional change, once it takes place, will *ex post* change the bargaining power of the losers, usually making them weaker than they were *ex ante*. The offer of compensation in the future is therefore often not credible. As a result, compensation is frequently not offered, and if offered, is not accepted as credible. This explains why relatively few institutional changes (value-enhancing or otherwise) actually take place through compensation, which in turn raises serious questions about the significance given to this scenario by theorists.

**B: Rent-Seeking By Influencing the State.** In the second scenario, individuals or groups in society still take the initiative in rent-seeking, but now a state exists which enforces rights and contracts. The creation or maintenance of rents now requires the participation of the state. But here the state does not have its own agenda, it simply *responds* to social pressures. Social actors seek rents by competing to influence the state. Influencing the state can involve spending resources in lobbying or bribing, but it can also include political pressure. Influencing can also extend to groups taking over the state apparatus by winning elections or organizing coups. Thus, on the one

hand, rent-seeking through the state involves having the *economic* ability to spend resources to influence the state; on the other, it also involves having the *political* ability to organize effectively, as this is an alternative way in which “influence” can be exercised.

Ensuring value-enhancing outcomes (that is those where  $x-y>0$ ) requires that influence is proportional to the absolute value of gains and losses. For instance, if the creation of a new rent implies that gainers stand to gain \$100 and losers stand to lose \$50, the creation of this value-enhancing rent requires that the gainers should have greater (economic and political) influencing power. This will ensure that the value-enhancing rent is created. Blocking value-reducing changes requires the same conditions, in other words, losers should have more influencing power when the value of their loss is higher than the value gained by gainers. Thus the creation and maintenance of value-enhancing rents is assured if the economic and political power to influence is proportional to the absolute value of the gain or loss. Since political power is usually *not* proportional to potential gains and losses from rent-seeking in most countries, we need at least a third condition to limit the damage from value-reducing rent-seeking. This says that it should be possible to satisfy political demands for transfers with a stable set of redistributive flows. If this condition is not met, the outcome can be even worse. We discuss each of these conditions in turn.

***B-i) The spending power of rent-seekers is proportional to their gain or loss.*** With a neutral state which can be influenced, those who can spend more on lobbying and/or bribing will win, other things being the same. It would seem at first sight that the amount individuals or groups are willing to spend should bear a close relationship to the absolute value of their potential gain or loss. This is, after all, the implicit assumption in the simplest rent-seeking models where rent-seekers spend as long as a cost-benefit calculation suggests positive net returns from such expenditures. If groups can spend in proportion to their potential gains or losses, any proposals for value-enhancing new rights will win because gainers will spend more than losers, and value-reducing changes will be blocked, because losers will spend more than gainers.

Unfortunately, this is not always the case. Condition (B-i) may not hold because groups are not necessarily always able to spend in proportion to their gains and losses. Rent-seeking may then result in value-reducing rents being created *irrespective* of the amount spent on rent-seeking. In other words, a responsive state may not only suffer from large rent-seeking costs (as we saw in our last section), in addition, the rent-outcome of the rent-seeking may now also be value-reducing if (B-i) does not hold. The most commonly-identified reason why condition (B-i) may fail is the *collective action* problem popularized by Olson (1965; 1982). A group which has a larger absolute gain (or loss) may not be able to mobilize more resources if it faces a free-rider problem in collecting contributions from individual members. The severity of the free-rider problem depends on many things, but the size of the affected group is one factor. Even if a large group collectively faces a large gain (or loss), it may fail to raise sufficient resources for lobbying or bribing if there are many free-riders. Small cohesive groups may be able to raise more, even though the absolute value of their gain (or loss) is smaller. A responsive state may then create rents for small, well-organized groups simply because they can spend more, even though these rights are

value-reducing for society.

Condition (B-i) could also fail for a number of other reasons. For instance, there may be an *inter-temporal* problem if gains and losses happen at different times. For instance, *future* gainers and losers may have a lower ability to spend compared to *current* gainers and losers because of market failures which prevent the former from borrowing cheaply on the basis of their future gains or losses. This problem is exacerbated when unborn future generations are affected by current decisions. Under these circumstances, value-reducing rights may be created because of these inter-temporal effects.

The failure of condition (B-i) could explain the existence of inefficient rents in some cases. For instance, inefficient industries may keep getting protection or subsidies because although their gain is smaller than society's collective loss, the small number of gainers in the inefficient industry may be able to spend more on lobbying than a diffuse and large group of losers in the rest of society. Since industrial subsidy recipients are always a relatively small group compared to the rest of society, this may seem like a promising route for explaining inefficient rents in the industrial sector. However, it is not clear that it takes us very far in explaining *differences* among our countries.

First, industrial subsidy recipients in all our countries were a relatively small group. If anything, South Korea's industrial sector was the most concentrated, with a few firms dominating each industrial sub-sector (Amsden 1989). Therefore the numbers argument does not explain why industrial subsidies were efficient in South Korea, since there was as great a likelihood that firms in South Korea should be able to bribe the state to have an easy life. Secondly, there are no obvious reasons why our countries should have differed substantially in terms of groups raising resources for rent-seeking on the basis of future gains and losses. It is true that the South Korean or Malaysian state did plan with a longer time horizon than the Indian state, but it is difficult to attribute this to the greater ease with which future gainers and losers in the first two countries could raise resources to influence the state. Thus while the evidence does show that learning rents had dramatically different net social benefits in different countries, these differences are not adequately explained by the degree to which condition (B-i) held.

***B-ii) The political power of rent-seekers is proportional to their gain or loss.*** Political power is not always proportional to economic power. Political power may be exercised through mechanisms ranging from the ballot box to political demonstrations, riots and civil war. As with raising resources for spending, the exercise of political power can also involve a collective action problem, but this is a different collective action problem from that involved in mobilizing resources. A group which is not able to raise much in the way of resources may be much more successful in mobilizing themselves or other people to come out on the streets. In developing countries in particular, economically superior groups are not always organizationally more powerful. Indeed, organizational as opposed to economic power is important for understanding the basis of clientelist politics in many developing countries. Organizational power can allow political organizers to create

and capture rents even when their economic power is relatively limited (Khan 1989).

Political power is often based on the costs a group can inflict on the state through political processes such as votes, strikes or, ultimately civil war, if its interests are not taken into account. The creation and maintenance of value-enhancing rights is assured if political power is proportional to the absolute value of the gains or losses of different groups. This ensures that for any new rent where  $(x-y)>0$ , gainers who gain  $x$  will have greater political power than the losers who lose  $y$ , and the rent will be created. On the other hand, any rents where  $(x-y)<0$  will be blocked. However, this condition is clearly much more demanding than (B-i). There is no obvious reason why political power should be proportional to the absolute value of the potential gain or loss *unless* political power is ultimately based on the ability to mobilize economic resources. But this link is precisely the one which is often broken in developing countries. The political power of different classes and groups is based on such things as legitimacy, literacy, political organization and so on, which do not always have a close correspondence with economic gains and losses.

If we compare our countries, it is not obvious why groups demanding value-enhancing rights should have been politically stronger in South Korea or Malaysia compared to India. We have already seen that industrial groups did not enjoy a great deal of legitimacy in the early sixties in any of these countries. On the other hand, there *were* differences in the political power of unproductive groups demanding redistributive transfers. We will return to this later. Only in Thailand do we find any evidence of value-enhancing rent-seeking led by the bargaining power of productive groups (see Section 2.3, and also Doner & Ramsay; Rock, this volume). To a much greater extent than in the other countries, Thai capitalists used their financial muscle to buy political factions which then provided bargaining power within and outside parliament. The rather exceptional role of capitalists in Thailand in controlling political factions resulted in a much greater correspondence between political power and calculations of gain and loss through changes in rights and rents (Condition B-ii). This in turn ensured that for a time, rent-seeking through the state produced value-enhancing outcomes in Thailand.

Capitalist-led rent-seeking in Thailand proved to be much more damaging in a period of rapid globalization of financial flows in the early nineties. When virtually limitless supplies of cheap funds became available in global markets, the crude link between the economic productivity of rent-seekers and their political power was fatally broken. If cheap capital is available in large blocks for speculation, speculators in a decentralized and competitive clientelist system can acquire rent-seeking power on the basis of borrowing, and they could drive the rent-seeking process even though it was no longer value-enhancing. In the short run, the speculator's bets can even be self-fulfilling regardless of underlying productivity if other speculators are making similar bets on asset appreciation. The financial and property speculation in Thailand in the mid-nineties certainly suggests that something like this was happening. Paradoxically, therefore, globalization may have contributed to the collapse of condition (B-ii) in Thailand, opening up the possibility of value-reducing rights rapidly emerging through capitalist-led rent-seeking. This possibility means that Thai rent-seeking will have to be much more carefully regulated in the future if its



openness to global markets is to be maintained.

Unlike Thailand, there is little evidence that value-enhancing rent-seeking in our other countries was driven by the greater political power of productive groups. But this does not mean that the distribution of political power was unimportant even in these countries. Political power provided the basis for negotiating redistributive transfer rents. Redistributive rents were least in evidence in South Korea, but in India and Malaysia, intermediate classes were driving value-reducing rent-seeking, which was particularly damaging in India. When redistribution is taking place through the exercise of political power, condition (B-iii) is required for the emergence of value-enhancing rents.

***B-iii) Political demands for transfers can be met with a stable set of redistributions.***

We saw in Chapter 1 that rents based on transfers can have negative efficiency and growth implications. But are some transfer rents worse than others? Since transfers can be the basis of primitive accumulation, they can play an essential role in the transition to capitalism. Here, we will only concentrate on transfers to non-productive groups, in particular to groups led by intermediate classes, who play, as we saw in Section 2.3, an important role in many of these countries. If transfers to these groups are being continually re-negotiated, the result is an unstable set of transfers. Such a continuous renegotiation of transfers is most likely when there are more potential groups demanding redistribution than can be satisfied given the resources available. When this is the case, the negative effects of transfers may be much greater.

One reason is that rent-seeking costs will be high if excluded groups continue to contest (see Section 2.4). However, there are also likely to be effects for rent-outcomes. First, the negative incentive effects on other sectors are likely to be higher if the transfers grow over time to accommodate further groups. A growing and shifting set of transfers will be associated with negative incentive effects which can shrink value-enhancing activities in the rest of the economy. Secondly, there is likely to be a more subtle effect. Remember that unstable transfers most likely reflect an excessive number of groups all of whose demands cannot be met. When this is the case, the unstable pattern of transfers is a reflection of the large number of potential groups with political power. Under such circumstances, it becomes increasingly likely that rent-recipients elsewhere in the economy will develop alliances with dissatisfied groups with political muscle which have not yet been accommodated. These political alliances can then be used to protect value-reducing rents when they are attacked by the state or by groups who suffer damage.

Monopoly rents are more likely to persist under these conditions because their beneficiaries are likely to share these rents with political factions in exchange for their support. Similarly, rents for learning are more likely to become inefficient if their recipients share them with political factions in exchange for their support in protecting these rents when the state tries to withdraw them. We saw in Section 2.3 that while South Korea suffered the least from redistributive transfers, the Indian subcontinent suffered the most. Rent-seeking in the latter was dominated by unstable patterns of redistributive rents which reflected the relative size and organizational power of its intermediate classes. This can provide at least part of an explanation for the

persistence of monopoly rents and of inefficient learning subsidies which effectively became monopoly rents for many industrialists. The failure of condition (B-iii) can thus play a potentially significant role in explaining poor industrial performance in some countries (Khan 1989; 1999).

In contrast in Malaysia, despite the presence of a large intermediate class demanding redistribution, their demands could be met by a stable, centralized set of transfers, and condition (B-iii) was met. The stability and degree of centralization of the pattern of transfers reflected the somewhat weaker position of Malaysia's intermediate classes relative to the state, as well as the much greater availability of resources to redistribute from both domestic natural resources and a relatively well developed capitalist class. This allowed redistributive demands coming from its intermediate classes to be met through a centrally negotiated social contract. We have seen in Section 2.3 that this stable arrangement had desirable effects for rent-outcomes. By accommodating most dissatisfied groups centrally, their political power was not directed to protecting inefficient rents, at least during the early years following the 1969 social contract.

Thailand is an exception since although it was a good performer, its redistributive transfers were neither stable nor uncontested, so that condition (B-iii) did not hold. Thailand was similar to India in this respect. Both countries had decentralized variants of clientelism. However, the difference was that in Thailand, *capitalists* were in control of significant chunks of these redistributive coalitions and used their political power to compete for rents through the political process. Thus Thailand fulfilled condition (B-ii) to a greater extent than any of our countries, and certainly India, even though condition (B-iii) held only weakly if at all.

**C: Rent-Seeking Led by the State.** In our third scenario, the state acts as an agency in its own right in creating, maintaining or transferring rents. The magnitude of the rents which the state can capture for its own purposes is an important consideration in determining its decisions during the rent-seeking process. The important variables determining the types of rents produced now include the motives of decision-makers within the state, the transaction costs they face in collecting payoffs, the organizational structure of the state which determines which costs and benefits are accounted for, and the power of individuals or groups in society to resist changes which hurt them. A different set of conditions are now relevant for value-enhancing rights to emerge.

**C-i) State officials are value-maximizers who learn rapidly from their mistakes.** The intentions of state leaders now clearly matter. This condition is important because state leaders may sometimes have totally non-economic objectives. As an extreme example, they may believe that the goal of state policy should be the acquisition of cultural or racial purity, even if it impoverishes everyone. However even the most insulated societies have not been so insulated that they are untouched by economics. Powerful mechanisms operate, forcing leaders to give economic objectives some importance, even if they did not do so initially. For instance, there may be pressures from domestic groups who aspire to better lifestyles, or military threats from economically advanced neighbours. Nevertheless, the less important economic

rationality is for state officials, the less likely it is that value maximizing rights and rents will be created by autonomously acting states. If value-enhancing rents are to be created, state officials have to be value-maximizers. It does not matter whether they wish to maximize value to extract bribes for themselves or to maximize social welfare. Even if they are only selfish value-maximizers, as long as the other conditions hold, there is a good chance that they will maximize social value simply to extract larger bribes.

However, it is not enough that state officials *want* to be value-maximizers. They must also have the ability to learn from their mistakes. If they do, the long run effects of mistaken beliefs may be minor. On the other hand, if they suffer from long-term cognitive failures, this can cause persistent performance failure. Some institutional economists believe that cognitive failures must play an important part in explaining long run performance differences (North 1995, see Khan 1995 for a critique of this argument).

In comparing the leaderships in our countries, we have to be careful not to fall into the trap of attributing the performance of the economy to the *ex post* quality of its political and bureaucratic leaders. For instance, it may seem plausible to compare the qualities of the bureaucracies in our three countries today and conclude that India suffers from an obstructive and unimaginative leadership. Nevertheless, would we have said this *ex ante*, say in 1950? The early leadership of the Congress Party in India included modernizers like Nehru, who were strongly committed to industrialization and modern technologies. The Indian Civil Service, which the country inherited in 1947, was also a relatively competent bureaucracy by developing country standards.

Although Indian policy-makers in the sixties appeared less keen to capture world markets than their South Korean counterparts, once again, we have to be careful about cause and effect. Chakravarty (1987: 16) argues that in India, state support for export-oriented textile industries was politically difficult since it would have meant supporting one regional group of capitalists against others. Given the ability of powerful excluded groups to organize opposition, this strategy may not have been *politically viable* for the Indian state at that time, even if it had wanted to maximize the growth rate. Indeed, agencies within the Indian state were aware of why their industrial policy was going wrong very early on. For instance, an internal committee of the Indian state, the Dutt Committee, reported as early as in 1969 that industrial policy was failing because the state could not discipline poor performers, and could not reallocate resources rationally.

Since Indian state leaders were clearly aware of what was going wrong, the creation of value-reducing rents and the adoption of welfarist ideologies which justified them may have *reflected* political constraints rather than being independent variables which *caused* poor performance. Equally, the economic takeoff in South Korea and Malaysia were not preceded by wide-ranging changes in the ideologies and objectives of their bureaucracies. Rather, they were associated with political changes which made new policies and institutions possible, which in turn allowed new accumulation strategies. Individuals did matter, but they only succeeded when they could

implement policies because they were consistent with the balance of forces in society. Thus, the apparently value-reducing objectives of bureaucrats and politicians can often be a dependent rather than an independent variable. To the extent that this is the case, we should be careful not to explain differences between countries in terms of the cognitive failures of its leaders.

***C-ii) The costs of collecting bribes or taxes do not differ across groups.*** A selfish value-maximizing state may create value-reducing rights which enrich itself rather than society. This possibility is much reduced if the state has a long time horizon (see Condition C-iv below) and if it does not face *different* costs of collecting bribes or taxes from different groups, which we now discuss. Consider, for instance, a situation where this condition does not hold, such that for a value-reducing rent where  $x-y < 0$ , it is easier to extract bribes from the gainers (who gain a small amount  $x$ ), rather than the losers (who lose a large sum  $y$ ). If the state can extract a bigger bribe from the gainers rather than the losers, the value-reducing right and the associated rent may be created. If on the other hand, there is no difference in the cost of collection, the losers would be able to block the right by being willing to pay more than the gainers to veto the change. Thus, differential transaction costs can lead to the creation of inefficient rents by states (North 1981). Of course, if the state is altruistic anyway, this condition is not necessary. But even if state leaders are selfish, this ensures that value-reducing rents are blocked.

This condition is unlikely to hold in full measure anywhere since the collection of bribes often requires costly investments in building contacts and, paradoxically, in building trust. It is also cheaper to collect a large bribe from a single person engaged in a large project (preferably involving the import of large capital equipment which can be over-invoiced) than collecting many small bribes from a large number of people. This is why corruption often results in the allocation of rights to a few cronies of the regime, even when they are value-reducing for society. If officials could auction all proposals, rights would be allocated to the highest value-adders, and value-reducing proposals would be stopped by the bribes of potential losers. Of course, the transfers involved would have secondary implications for incentives and investment, and in any case a state which publicly declared itself to be open to all offers would soon lose all legitimacy. Nevertheless, if the costs of bribe and tax collection varies significantly across groups, it is more likely that value-reducing rights will be created and maintained.

There is no obvious reason why the transaction costs of collecting bribes and taxes should have varied more significantly in some of our countries compared to others. Individual businessmen in all our countries had close relationships with state officials. In all countries, industrial policies favoured the creation of large capital-intensive plants. Collecting a share of the rent from the relatively few businessmen operating such plants is cheaper in transaction costs. It may be that large plant technologies were favoured precisely because of the transaction cost advantage of extracting bribes from large capitalists. India had the most deliberate strategy of promoting small-scale enterprises, partly because of Nehru's political compromise with Gandhi's petty-bourgeois constituency. Large numbers of smaller firms may have made efficient corruption more difficult in India, but the performance of India's large plants was as

bad or even worse than that of its medium and small plants (Little, Mazumdar & Page 1987).

***C-iii) The state's institutional structure allows all costs and benefits to be internalized.*** For the state to create rents which add to net social benefits, the state's calculation of the costs and benefits associated with the proposed change has to coincide with the actual social costs and benefits. In the language of economists, there should be no externalities: all costs and benefits have to be internalized. There may be many reasons why this may not happen, for instance the differences in collection costs discussed earlier may lead the state to ignore some costs or benefits. Here we will look at a specific factor which can prevent internalization, the institutional structure of the state itself.

If the state is fragmented into a number of agencies each trying to maximize bribes for itself, the outcome may be worse than under a centralized state. This is because the fragmented agencies are not able to look at the bigger picture and internalize all the effects of their separate decisions. An influential model of the negative effects of state fragmentation is Shleifer and Vishny's (1993) model of corruption. They assume that the state only creates value-reducing rights, such as licenses to import restricted items. These restrictions create monopoly rents for license-holders and income for the state in the form of bribes, but they reduce net social benefit. The only question for Shleifer and Vishny is the bribe price which is charged for each right and the *quantity* of restrictive rights which are supplied under different institutional structures. Nevertheless, since the quantity of restrictive rights produced is an aspect of the rent-outcome, their analysis is a useful starting point, though some of their conclusions can change when we look at states creating value-enhancing rents.

Keeping in mind that they assume that the state only creates value-reducing rights, they argue that a *very* fragmented state structure is the best. A totally centralized state with a high degree of coordination is next in terms of desirability. But paradoxically, an intermediate situation with a semi-fragmented state structure and limited coordination is the worst. The optimality of the very fragmented structure follows from their assumption that a no-rent economy without state intervention is the most efficient. If many state agencies compete with each other to sell the output-reducing restrictions (such as licenses to import or produce particular items), the bribe "price" of these permits falls, eventually to zero, and producers can buy as many of the permits as they need. Restrictions effectively disappear, since if anyone can buy at zero price the "exclusive" right to import, effectively anyone can import. An efficient market outcome then emerges. But we have argued that states can also create value-enhancing rents. A totally fragmented state will not be able to create value-enhancing rents either, say through property rights over scarce resources or targeted learning rents. A very fragmented state may therefore not be optimal in a world where value-enhancing rents exist.

An intermediate level of state fragmentation generates the worst outcome in their model. Here, each state agency supplies one of a number of restrictive rights to produce or import, but these are *collectively* required to produce a final product. For instance, the right to import steel and glass are supplied by separate agencies, but

factories need to have both. A prisoner's dilemma problem emerges because each agency takes the quantity of rights supplied by the others as given, while attempting to maximize its own take. Thus the agency supplying permits to import glass takes the existing import of steel as given and sets a price for glass import permits to maximize its bribe. In the same way, the agency supplying steel import permits takes the imports of glass as fixed. They do not realize, particularly if they are playing this game just once, that if each pushes up the price of *its* permit, this will reduce the demand for the *other* permit, which will eventually lower demand for its own permit. The outcome is that the bribe (or price) demanded for each restrictive right is set too high. Compared to the previous case, many fewer permits are sold and overall productive activity is correspondingly lower.

This problem is reduced if the state is totally centralized, and all agencies come under a master agency which jointly sets the price of every permit. The master agency can then maximize the total bribe by coordinating the "price" of each restrictive right. This will typically involve setting the price for *each* permit at a somewhat lower level which takes into account the effect on the demand for other complementary rights. While the master agency is only concerned with maximizing the total bribe, its coordination nevertheless has the nice effect of increasing value for society. This is because the level of each bribe is now lower, more permits are sold compared to the second case, and therefore the level of productive activity in the economy is higher, and closer to the perfectly competitive situation (Shleifer and Vishny 1993). Effectively, each agency is now forced to "internalize" the cost it imposes on other agencies by charging too high a bribe. Thus this institutional structure internalizes more (but not all) of the costs of bribe collection and the resulting outcome is somewhat closer to the social optimum.

This model may seem to explain why South Korea, say, which apparently had more centralized state agencies, also had less damaging forms of corruption than countries in the Indian subcontinent. But on closer inspection, the model has a number of problems. Shleifer and Vishny are talking about the *institutional* structure of agencies. The failure of state agencies to coordinate is more often the result of the dispersed political power of the rent-seekers affected by the state. For instance, it is possible for states with *formally* centralized institutional structures to behave in a fragmented way if, for instance, powerful but dispersed interest groups can prevent coordination by state agencies. Thus, institutional centralization is not *sufficient* for coordination. The Pakistani state in the early sixties, for example, was institutionally as centralized as the South Korean state, but it was far less successful in coordinating agency actions.

Moreover, states whose formal institutional structures appear to be fragmented can sometimes behave in a coordinated way, particularly in repeated games. Shleifer and Vishny's analysis is of a one-shot game, which is particularly inappropriate for modelling state-society interactions. Institutionally fragmented agencies could begin to act in a coordinated way in a repeated game provided the payoffs from coordination are large compared to the payoffs from non-coordination, the time discount of officials is sufficiently low so that they do not ignore the future completely, and most importantly, the agencies are not involved in protracted political conflicts over how the spoils should be shared. Thus, institutional centralization may not even be

*necessary* for coordination to emerge in repeated games. In fact, even in South Korea, the centralization of the state was not absolute. There were different agencies such as the Economic Planning Board, the Ministry of Finance and the President making decisions, but in a repeated game, their decisions were effectively coordinated. The agency structure which concentrated key decisions in a small number of agencies in South Korea offers, at best, a partial explanation of its good coordination. More important was the distribution of power between the key players in its rent-seeking game (see Section 2.3) which allowed coordination to be *effective* and made South Korea significantly different from other institutionally similar competitors.

Finally, the Shleifer and Vishny model takes as its benchmark the neoclassical model of efficient competitive markets with no rents and no intervention. In reality, states can and do create value-enhancing rents as well. The optimal institutional structure of the state, when we allow for this possibility, is more problematic. If sectors and projects are technologically complementary, innovation and learning may be accelerated if the structure of rents is centrally coordinated (Aoki, Murdock & Okuno-Fujiwara 1997: 6). This is because in this case, each project has large external benefits for complementary projects, and net social benefits will be higher if investments in these projects are coordinated. In this case too, centralized states have an advantage in creating value-enhancing rents compared to fragmented states (although very fragmented states are no longer desirable). In fact, South Korea in the sixties followed *this* type of technology trajectory. Its relatively centralized state structure would have helped state officials to internalize more of the external benefits of learning when they were determining the allocation of rents for learning. This is a very different story from the one described by Shleifer and Vishny, even though there is a superficial similarity in the conclusion that centralized states produced more efficient rights by internalizing external effects. In either case, South Korea's state structure satisfied condition (C-iii) and contributed to the internalization of all relevant costs and benefits.

In contrast, if technologies are small-scale, or if projects are substitutes, too much central coordination may be counter-productive. It may lead to large and avoidable losses when “coordinated mistakes” are made, for instance, in the selection of an integrated set of investments which collectively turn out to be wrong. In these cases, since each project has few externalities for other sectors, the economy may benefit from a more fragmented set of institutions through which competing value-enhancing rents are created. This allows greater competition among competing sets of rent-generating projects, which may be more socially beneficial by maximizing entry and minimizing risk. This seems to have been the case in Thailand under its competitive clientelism (Doner & Ramsay, this volume). Thus, given the different technology trajectory which Thailand followed, although its state institutions were more fragmented compared to South Korea, it did not necessarily contravene condition (C-iii) too seriously, since its technologies were relatively small-scale, with few externalities.

A range of state structures may therefore be optimal for creating value-enhancing rights and rents, depending on different technologies and their associated externalities. Condition (C-iii) simply says that the institutional structure should be such that all

external costs and benefits of decisions are accounted for. If complementary *value-reducing* rents are being created, (the Shleifer and Vishny case), a totally fragmented state is best, but a centralized state will minimize the social damage compared to a partially fragmented one. However, when *value-enhancing* rents are being created, a centralized state will be most conducive for value-enhancing outcomes, but only if technologies are large-scale or complementary, with many externalities. In contrast, when technologies have few externalities, there is little benefit in coordinating but there could be large costs if coordinated mistakes occur. In this case, more fragmented states with lesser agency coordination may be better for creating value-enhancing rents.

***C-iv) Losers do not have the power to politically resist the state.*** Our final condition examines the minimal political requirement relevant for this scenario. The state should not face strong *political* resistance from losers. This condition is usually not identified in the literature, but is necessary for the creation of value-enhancing rights when the state is an autonomous actor. However, one consequence of this condition not holding *is* widely recognized, and that is the effect on the time horizon of state leaders. If this time horizon is very short, it is very likely that state leaders will try to extract resources from the economy by increasing their share of rents, even if that results in the size of the pie shrinking. If their time horizon was longer, this would not make sense, since they would be better off getting a constant share of a growing pie. While the time preference of state leaders can sometimes be an independent variable (some leaders are just impatient), it is often actually a reflection of the vulnerability of the leadership. When leaders face very strong opposition from society, perhaps because they lack legitimacy, their response is often to make money fast and get out. In such cases, the time preference of leaders is not an independent variable, but is determined by the political (in)stability of the state.

Here, we will examine a more important implication of political resistance. When states face strong political resistance from those who stand to lose from the creation of particular rents, these rents may obviously not be created, even if they add value for society. Thus, even if  $x > y > 0$ , if losers can *politically* resist by imposing high costs on the state (described as *transition costs* in Khan 1995), the change is unlikely to go through. Condition (C-iv) clearly has close parallels with condition (B-ii), which was relevant when different groups were *influencing* the state. Even if influence is not involved, powerful losers can still stop change. As with condition (B-ii), the failure of this condition can either result in value-enhancing rights *not* being created, or being created at very high rent-seeking cost, which in this case is the *transition cost* which losers can inflict on the state.

The extent to which condition (C-iv) is fulfilled often depends on the relative power of the clients of the state. Where its clients are weak, the state is able to dictate terms. We have elsewhere argued that such a relationship between a state and its clients is a feature of *patrimonial* patron-client networks (Khan 1996a; 1996b). In such a context, the state may be able to override sectional interests to achieve value maximization. In contrast, where its clients are strong, the state cannot easily hurt them. This, in contrast, is a feature of *clientelist* patron-client networks, since now, clients call the shots. Condition (C-iv) fails in clientelist networks and the state may fail to produce



value-enhancing rent-outcomes because powerful clients are able to resist changes.

Our discussion of patterns of redistributive rent flows in Section 2.3 is once again useful because it helps us to identify the underlying distributions of power in our countries. The political isolation of capitalists receiving rents for learning in South Korea made it the country in our sample which most closely fulfilled condition (C-iv). Value-reducing learning rents could be terminated without the losers being able to resist these changes politically. The distribution of political power within South Korea provides the best example of patrimonial patron-client networks in action, certainly during the period of high industrial policy in the sixties, seventies and the first half of the eighties (Figure 2.8 in Section 2.3). In contrast, the flows between patrons and clients in India (Figure 2.7) provides an example of clientelist patron-client networks, where condition (C-iv) broke down most significantly. The state faced significant political resistance whenever it attempted to change the allocation of rights and rents according to any independently defined criteria. Therefore, to the extent that states in these countries were trying to push their own developmental agendas, condition (C-iv) suggests that the state would be most likely to produce value-enhancing rents in South Korea and least likely in India.

Malaysia (Figure 2.9 in Section 2.3) was in an intermediate situation. It did have a powerful clientelist constituency, but it was centralized and did not provide, at least initially, the incentives for value-reducing alliances between threatened capitalist interests and clientelist factions seeking payoffs for their political support. As a result, the political resistance facing the Malaysian state when it tried to change specific rents was higher than in South Korea, but lower than in India. Thailand (Figure 2.10) is an anomalous case because the large numbers of autonomous centres of power in this country could theoretically have resulted in serious political constraints facing the state *if* it had tried to follow an autonomous agenda. But the evidence suggests that the state in Thailand played a more responsive role during its high growth phase, and played a lesser role in taking the *lead* in allocating sectoral and firm-level learning rents to accelerate development. This does not mean that learning rents were not being allocated in Thailand. Indeed they were, as Rock (this volume) argues. However, because Thai rent-seeking was predominantly responsive, as in our Scenario B, its failure to meet all the conditions required for state-led rent-seeking was less damaging. In contrast, in our other countries, the more significant leading role of the state and the weaker role of capitalist-led rent-seeking makes their rent-seeking closer to our Scenario C.

Clearly, states played an autonomous role in all these countries, the difference is only in extent and significance. In all of them, the degree to which conditions (C-i) to (C-iv) held was therefore important. *Differences* in ex-ante leadership qualities (C-i) and in the transaction costs of collecting bribes and taxes (C-ii) were less dramatically in evidence across our countries. There *were* differences in the institutional and organizational structure of the state (C-iii), but in most Asian countries, states were relatively centralized. In some cases, as in the Indian subcontinent and in Thailand, the state behaved in a more fragmented way. This was only partly due to differences in the formal institutional structure, and to a larger extent due to differences in the distribution of bargaining power within these countries which allowed different parts

of the state to be captured by competing factions. This brings us to differences in the political power of potential losers, (C-iv). Drawing on Section 2.3, the evidence suggests that the potential resistance faced by states trying to impose particular rent-outcomes varied greatly.

Country/ Region	Scenario(s) appropriate for modelling dominant rent-seeking processes	Conditions explaining differences in rent-outcomes
Indian Subcontinent	B and C	(B-i)-(B-iii) did not hold (C-i)-(C-iii) partially held (C-iv) did not hold
South Korea	Primarily C	(C-i)-(C-iii) partially held (C-iv) held
Malaysia	B and C	(B-i)-(B-ii) did not hold (B-iii) held (C-i)-(C-iv) partially held
Thailand	Primarily B	(B-i)-(B-ii) held (B-iii) did not hold (C-i)-(C-iii) partially held (C-iv) did not hold

**Figure 2.14 Key Conditions Explaining Differences in Rent-Outcomes**

Figure 2.14 summarizes the discussion in this section by listing the critical differences between our countries. While rent-seeking of the type described in each of our three scenarios was going on in every country, the balance did vary. Figure 2.14 records the preponderant forms in each country based on our discussion. Rent-seeking in South Korea during its high growth phase in the sixties and seventies was very largely led by the state, as in scenario C. Society-led rent-seeking in South Korea at that time was not a significant part of its industrial performance story. Most of the conditions required for value-enhancing rent-seeking held. But the political condition, (C-iv), is particularly important because it differentiated South Korea most significantly from the others. However, by the mid-nineties, this condition for the effective operation of state-led rent-seeking may no longer have held, and in any case South Korea's industrial policy regime began to be substantially dismantled at this time.

India and Malaysia had state-led *and* society-led rent-seeking. The poor performance of India was attributed particularly to the failure of conditions (B-iii) and (C-iv), which are closely related. The absence of a stable set of transfer rents in India was a symptom of a distribution of power which also resulted in strong political resistance to state-led rent changes whenever this hurt powerful constituencies. The failure of these conditions distinguished India from Malaysia. But changes in Malaysia's social and political context meant that by the mid-nineties, the differences with Indian rent-seeking were becoming less marked. It has to be remembered, though, that by then Malaysia was a much richer country and the severity of their developmental problems was no longer comparable.

Finally, Thailand had primarily society-led rent-seeking. This was largely capitalist-led from the seventies, and the fulfilment of conditions (B-i) and (B-ii) contributed to value-enhancing rent-outcomes. The globalization and unprecedented financial flows of the nineties upset the internal balance which kept political power roughly proportionate to economic productivity. Foreign capital inflows gave a rent-seeking advantage to speculative capitalists who were primarily interested in short-term returns from asset price inflation. The shift in policy-making in favour of these groups resulted in a self-fulfilling asset inflation for a time but, inevitably, the bubble finally burst in 1997.

We have drawn on institutional economics and political economy to identify a number of conditions which could explain differences in rent-outcomes in a specific group of countries. A look at other countries or periods may throw up other conditions which are important. We have also seen that the presence or absence of specific conditions is not enough to ensure, or rule out, value-enhancing rent-outcomes. Rather, a *mix* of institutional and political conditions seems to be required, and some of these conditions can compensate for the absence of others. The mix which does work also depends on technologies and global market conditions. These complexities prevent us from constructing simple models of the determinants of rent-outcomes. However, we can identify some conditions which appear to have been important.

This analysis can help to assess the prospects of particular reforms. For instance, the experiences within the Indian subcontinent suggest that if the political settlement cannot be changed, democracy or authoritarianism makes little difference for rent-outcomes. In these countries, constructing a social contract which reduces the blocking effect of clientelist factions must clearly be an important priority. Malaysia suggests one solution to the problem of constructing a social contract which sustained, for a while, value-enhancing rent-outcomes. The South Korean model of the seventies is unlikely to be useful for countries suffering from clientelist political constraints, as the unique political settlement underlying its success is not likely to be reproducible. On the other hand, South Korea may have more to learn from other developing countries as its political settlement begins to approximate the more typical pattern and political resistance to state-led rent creation increases. Thailand appears to be a tantalizing model for many developing countries. Its internal political balance was also unique, but it was one which a number of developing countries may eventually move towards. But the success of the Thai rent system was itself dependent on particular technology and global market conditions. The challenge for the future is to devise institutional structures which can manage rents in the typical developing country polity dominated by strong intermediate classes, where the adoption of some technologies require the management of learning rents, and where the gradual opening up of capital markets introduces new challenges.

## **2.6 Rent-Seeking as Process: Conclusions**

Our analysis of rent-seeking as a process distinguished between the input costs of rent-seeking and the rent-outcomes. While substantial rent-seeking costs were observed in all the countries we looked at, they differed greatly in terms of the rent-

generating rights created as a result of these expenditures. Conventional rent-seeking models misrepresent the rent-seeking problem by presenting only one side of the process, the input side, which eats up resources in rent-seeking costs. We also need to understand why the rent-seeking process created very different rent-outcomes in different countries, as these differences explained much of the differences in the *net effects* of rent-seeking.

There *were* differences in rent-seeking costs across countries, but the institutions which reduced rent-seeking costs varied, depending on political conditions. Thus, authoritarian regimes succeeded in reducing rent-seeking costs in some countries, but in others, they resulted in higher rent-seeking costs than in similar countries with democratic institutions. Similarly, attempts to reduce the competition for rents by reducing the number of players in the rent-seeking game worked in some countries and not others. The success of exclusionary strategies depended on the relative contestation power of the groups included in, or excluded from, the rent-seeking.

To explain differences in rent-outcomes across countries, we drew on political economy and institutional economics. We found that differences in institutional structures often provided an initial explanation for some of these differences. In addition, differences in the political power of competing groups, and differences in their ability to resist change also had considerable explanatory power. This is particularly important as political variables have typically been given little attention in the rent-seeking literature. Furthermore, the rent-seeking process is itself evolving, and there are important differences in the net effects of rent-seeking over time.

Some of these results have obvious implications for policy. First, the stress which is usually put on the magnitudes of rent-seeking expenditures is at best emphasizing half of the problem. The qualitative data suggests that the variance in rent-seeking costs is less significant than the variance in the social value of the rents created by the rent-seeking. Thus, even if rent-seeking costs could be cut back very substantially in poorly performing countries, as long as the rent-outcomes continue to be value-reducing, the impact on performance may be limited. Secondly, improving rent-outcomes appears to be not just a problem of getting the institutions and policies right. The value of the rent-outcomes also depends on the interdependent effects of technologies, institutional strategies and the distribution of bargaining power in society. In some cases, policy can focus on adjusting institutions and technologies to political realities. In other cases, responses which seek to directly change the political reality may be a precondition for achieving better results.

An important conclusion which we draw is that a number of rents, and the rent-seeking which sustained them, played a critical role in the rapid development of capitalism in the East Asian countries. Not only was the creation of rents critical for primitive accumulation and learning, transfer rents were critical for maintaining political stability even though the economic implications of these transfers varied significantly. The role of rents in economic development is worth stressing in the aftermath of the financial crisis of the late nineties. The depth of this crisis led many economists to link the immediate economic woes of the region to the systems of rents and rent-seeking popularly described as crony capitalism. The implicit counterfactual

to “crony” capitalism is a “genuine and impartial” capitalism of free markets, zero rents, fair market-determined returns for everyone, and a minimal state which only maintains a level playing field. However appealing such a mythical capitalism may be, our discussion has been concerned to establish that such a model is not relevant for developing economies, and perhaps not for any economy. The relevant distinction is between rent-seeking systems which are developmental and those which are crippling. The relevant policy question is to understand how one may transform into the other.

The financial crisis *was* related to the nature of rent-seeking in East Asia and some of the inter-connections were explored in our analysis. The immediate cause of the crisis was the role played by speculative capital flows which were inadequately regulated. The regulatory failure could have been due to the over-confidence of policy-makers in high growth economies, but it could also have been exacerbated by rent-seeking pressures from the beneficiaries of rents in financial markets. We have argued that there were good reasons why such pressures could have emerged. The possible role of rent-seeking in bringing about the financial crisis should not, however, take attention away from the many other types of rents and rent-seeking determining the long-run economic performance of these countries.

The long-run relationship between rent-seeking and growth is of much greater interest. If growth requires the management of growth-enhancing rents rather than the abolition of all rents, high growth countries will always have rents and will therefore inevitably have to live with rent-seeking. Globalization and liberalization will not change this fundamental economic problem nor is globalization or liberalization likely to succeed if policy-makers attempt to proceed on the basis of inappropriate no-rent market models. The no-rent model of market development remains compelling *not* because the evidence supports it, but because its policy implications are much simpler to understand. Our analysis suggests that identifying the conditions which have in the past been conducive for growth is a much more challenging task. The conditions which allow value-enhancing rents to emerge and which limit rent-seeking costs vary from country to country because countries do not have the same political conditions, and they do not follow the same technology trajectory. This is where a deeper examination of the historical evidence is important to warn us against falling for seductively simple theories. There is no evidence in Asia, possibly no evidence anywhere, of long-run development taking place on a no-rent basis. Instead, the policy challenge is to construct and reconstruct institutions and politics in developing countries to sustain developmental rents and rent-seeking while attacking value-reducing rents and rent-seeking.

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