

Political Settlements and the Governance of Growth-Enhancing Institutions

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Abstract: It is well known that institutions work very differently across countries because their political contexts are different. It is also understood that this has important implications for the design of governance priorities in different countries. This paper develops an analysis of the ‘political settlement’ to provide an analytical framework for analysing institutions and governance in developing countries.

Central to this analysis is an understanding of the distribution of power. We define this as the relative holding power of different groups and organizations contesting the distribution of resources. Holding power is partly based on income and wealth but also on historically rooted capacities of different groups to organize. A political settlement emerges when the distribution of benefits supported by its institutions is consistent with the distribution of power in society, *and* the economic and political outcomes of these institutions are sustainable over time. In advanced countries, the distribution of power is largely based on the distribution of incomes generated by *formal* institutions and rights. The correspondence between power and formal institutions explains why Weberian states in advanced countries can effectively enforce formal institutions. In contrast, the distribution of power in developing countries draws significantly on organizational abilities based in non-capitalist sectors. In many cases, the historical roots of these capabilities go back to colonial history or earlier. Here, formal institutions alone cannot support distributions of benefits consistent with these distributions of power. *Informal* institutions like patron-client allocative rules, and informal adaptations to the ways in which particular formal institutions work play a critical role in bringing the distribution of benefits supported by the institutional structure into line with the distribution of power. Differences in the political settlement can therefore explain why developing country institutional structures are different *and* similar formal institutions also perform differently. The political settlement also defines the ‘growth-stability trade-off’ facing particular institutional changes: institutional changes cannot be implemented if their implementation pushes political stability below the tolerance limit of that society. An understanding of the political settlement can therefore provide a framework for looking at institutional performance and evolution across countries.

While all developing countries have variants of ‘clientelist’ political settlements, there are significant differences between these clientelist settlements. Differences between countries are examined along two dimensions: the organization of the ruling coalition and its relationship to the emerging productive sector. The analytical framework is applied to the case study countries studied in this series of papers to outline how their political settlements evolved over time in terms of these characteristics. The evolution of their political settlements is shown to be closely related to changes in their formal growth-enhancing institutions and the performance of these institutions. This analysis can therefore help to identify governance changes that can be sufficiently enforced to make a developmental difference in particular countries as well as providing a framework for understanding the paths along which the political settlement is changing in different countries.

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1. Introduction

In a work published in 1995 I used the concept of a ‘political settlement’ to explain why apparently similar institutions can perform very differently in different countries (Khan 1995). This paper builds on and significantly extends that early analysis. It is also part of a series of papers examining the institutional and governance challenges of sustaining growth in developing countries (Khan 2008, 2009a, 2009b). While the other papers focus on particular institutions and governance issues necessary for sustaining growth, this paper provides an analysis of the political economy background in which institutions have to operate, and relates the institutional analysis of our case study countries to an analysis of the evolution of their political settlements. These considerations are vital for the design of governance reform because the latter has to identify the most appropriate growth-enhancing institutions for particular contexts, or alternatively, identify how the context itself may need to change if developmental institutions are being systematically blocked.

A political settlement is often loosely used to describe the ‘social order’ based on political compromises between powerful groups in society that sets the context for institutional and other policies. To capture the key features that make a political settlement sustainable enough to be the subject of analysis, we define it more precisely. *A political settlement is a combination of power and institutions that is mutually compatible and also sustainable in terms of economic and political viability.* Institutions and the distribution of power have to be *compatible* because if powerful groups are not getting an acceptable distribution of benefits from an institutional structure they will strive to change it. But the compatibility also has to be *sustainable* because institutions, both formal and informal, have to achieve the minimum levels of *economic performance and political stability* that are required for the reproduction of particular societies. Even though this may appear to be a very general definition, it allows us to show that there are limits to the types of institutions that can survive in particular contexts, and that substantial differences in institutional performance are both to be expected and can be the subject of rigorous analysis.

A political settlement that reproduces itself over time must have institutions whose benefits are consistent with the distribution of organizational power and which also achieves the minimal levels of political stability and economic performance required to be viable. *If powerful groups are getting a distribution of benefits that is too low given their relative power, these groups will strive through different means including conflict to change institutions till they are satisfied or they give up.* While this conflict is going on the contestation can directly affect political stability or it affects economic performance by affecting the implementation of institutional rules. A serious incompatibility can make the political settlement unviable. But a compatible combination of institutions and power can also be unviable if economic performance is too poor. A political settlement is therefore a dynamic and interdependent set of variables and our first task is to make these interdependencies analytically tractable.

If a political settlement ceases to be viable, discontinuous change can come about in the evolution of institutions or the organization of power. This is to be distinguished from gradual processes of growth, institutional change and political mobilizations that incrementally alter political settlements in all societies. No political settlement is static and all settlements are continuously evolving. But the evolution can sometimes be gradual; at other times stability or economic performance can collapse as a result

of incompatible evolutions of power relationships or institutions and lead to a crisis. In the latter cases, stability and growth are only likely to recover when a new political settlement defined by a different combination of institutions and power emerges, possibly at the end of a period of significant conflict.

Political settlements in developing countries are structurally different from political settlements in advanced countries. Developing countries have small formal productive sectors and the incomes generated from these sectors do not and cannot define the broad distribution of power in these societies. If there are significant sources of power that are not based on formal institutions, the exercise of power in developing countries cannot simply be focused on the protection and operation of formal institutions. This explains why informal institutions structurally operate on a different scale in *all* developing countries. The most important 'informal institutions' are a polite way of describing the significant exercises of informally organized political power to generate distributions of benefits that could not be sustained by the operation of formal institutions alone. This also explains why the goal of a Weberian 'good governance' state is simply not achievable in developing countries as an immediate goal. More importantly, if the goal is to identify the most appropriate institutional reform strategies that can be implemented and deliver results, the Weberian good governance model is not even a good guide to incremental policy priorities.

The political settlements in developing countries are 'clientelist'. They are characterized by the significant exercise of power based on informal organizations, typically patron-client organizations of different types. Some patron-client networks can operate through formal organizations like political parties. Nevertheless, because of the importance of informally organized power, political parties in developing countries operate very differently from those in advanced countries even if they are formally constituted in the same way. At the same time, clientelist political settlements also display significant variations, with different levels of sustainability in terms of political stability and economic performance. The differences *between* clientelist political settlements have many dimensions, but the most important ones are sufficient to explain significant differences in their institutional performance.

Once a political settlement based on a compatible combination of institutions and power emerges, both the institutions and the distribution of power become supportive of each other. As a result, the operation and introduction of further institutional changes has to take this social distribution of power as given. The performance of new institutions and the consequences of institutional evolution can therefore be analysed in terms of how institutions or institutional changes are likely to be resisted in the context of this specific distribution of power. The political settlement can therefore help to explain the performance of *particular* institutions because of specific costs of enforcement and resistance.

In much of the standard institutional analysis, it is assumed that the governance agencies responsible for the enforcement of formal institutions have the power to enforce compliance. In fact, the degree of feasible enforcement, and the costs of enforcement depend on the strength of resistance to the enforcement of particular institutions. The difficulty of enforcing an institution can be measured either by the frequency of violations or the cost of enforcement or both. If frequent violations are occurring or if the cost of enforcement is high, some groups are trying to resist the

implicit distribution of benefits that the institution defines, or are trying to achieve higher benefits for themselves by free riding. Or the violations may be an informal arrangement through which a different distribution of benefits is achieved which makes the institution viable in that context. The extent to which any of these types of violation strategies can continue depends on the relative power of the groups who benefit from violation relative to those who want to enforce that particular institution.

Power has been a difficult concept to pin down in the social sciences and has not been well-integrated into an analysis of institutions. A simple workable concept of power appropriate for the problems we want to address is derived from the analysis of games of cooperation with conflict, also called chicken games. In these games there are multiple equilibria (ways of cutting the pie). Different groups want the equilibrium most favourable to them. The likelihood of a group achieving the distribution it wants depends on its ability to hold out in conflicts. Engaging and holding out in conflicts is costly. This gives us the concept of *holding power*, defined as the capability of an individual or group to engage and survive in conflicts. Unpacking the components determining the holding power of different groups can give us insights into the likelihood of conflict and the way in which power, institutions and economic outcomes may be related.

At a general level, two sets of factors can contribute to a group's holding power and therefore its ability to engage in and win conflicts. The first is the ability to *impose* costs on others, and secondly and no less important, the ability to *absorb* costs inflicted on them. Together, these capabilities help to determine the group most likely to prevail in a conflict. The greater the costs a group can impose on others, the greater the likelihood that other groups will abandon their attempts to get their preferred outcomes. Similarly, a group more able to absorb costs can survive longer in conflicts and is more likely to 'win'. Translating these observations into the context of institutions and governance, the enforcement of a particular institutional rule is likely to be more effective if the distribution of benefits under that institution is not contested by groups with holding power, and conversely its enforcement is likely to be weaker if powerful groups contest its enforcement.

The factors that may explain differences in the underlying ability of different groups to impose or absorb costs are specific to societies. In general, economic strength is important but by no means the only determinant of holding power. Greater wealth or income can allow more expensive strategies and weapons of 'warfare' and allow richer individuals or groups to survive for longer in conflicts. Against this, poorer groups are more likely to be able to absorb pain. Richer individuals and organizations may also have commitments and expectations that may make it difficult for them to absorb the costs of conflict for very long. The net effect of greater economic capability on relative power is therefore likely to differ from case to case. More importantly, non-economic capabilities can play a critical role in determining holding power. The political ability to organize, the numbers of people that can be mobilized, and perceptions of legitimacy are particularly important for understanding the differential abilities of groups to inflict and absorb costs in the course of conflicts. These complexities explain why richer individuals or groups do not always win.

But the combination of economic and political characteristics can only give a rough indication of relative holding power. *Many aspects of power are based on difficult-to-*

observe features of a group such as its determination and its strategies of mobilization. The difficulty of identifying all the sources of power in a particular case is precisely why it is difficult to predict the winner, and this paradoxically explains why so many conflicts actually take place. If observable initial conditions like wealth or observable political capabilities significantly determined holding power, the chances of winning or losing could be more precisely estimated and most conflicts might never begin. Powerful organizations or groups would achieve the distribution that they might have achieved through fighting without having to fight. Those who might have fought them would not engage in conflicts whose outcomes could be fairly well predicted.

Fortunately, we do not have to predict power or the outcomes of conflicts to pursue our analysis. We can begin with a historical observation of the distribution of power in particular countries, and look at how it has evolved using observable characteristics related to the organization of patron-client organizations. This can provide the basis for an analysis of important characteristics of the political settlement. Political stability is achieved with the emergence of a consistent set of beliefs or expectations in society about the relative power of different groups and a distribution of benefits consistent with those beliefs. The beliefs themselves are likely to be consistent across different groups and individuals if they are based on previous historical evidence of the outcomes of conflicts. It is only when a group believes that its ability to win is not reflected in the current distribution of benefits that conflict is likely to break out, and that too only if other groups do not concede.

Conflicts are likely to break out either when a group believes that the underlying distribution of power has changed and the distribution of benefits is not reflecting it, or if changes in distributions of benefits do not reflect the perceived distribution of power. The conflict itself is often the only mechanism for demonstrating and establishing holding power so that subsequent distributions reflect this underlying power. Conflicts end when the relevant groups accept a distribution of benefits as compatible with the distribution of power. In reality, the distribution of political power is continuously changing in a society, particularly in a developing one that is going through rapid social transformations. Consistent expectations about relative holding power may therefore be difficult or impossible to establish. Developing countries are likely to be characterized by ongoing social mobilizations and distributive arrangements have to be flexible in responding to these mobilizations if conflict is to be minimized and the political settlement in a broad sense sustained. These features of developing countries mean that we need to describe political settlements in a dynamic way, and yet we should be able to identify points of discontinuous changes in a political settlement. Organizational activity, drawing on gradual changes in economic and political conditions, can occasionally upset the gradual evolution of a political settlement. Thus, occasionally discontinuous changes in the distribution of power can occur, which can sometimes accelerate and at other times slow down or even halt the evolution of a political settlement in particular directions. It is not our task to predict these changes in the distribution of power, but to observe and track these changes so that the implications for institutional performance can be analysed.

The analysis in the subsequent sections is at two different levels. The levels are interdependent but there is also a logical hierarchy in that the analysis of the lower level cannot be meaningfully conducted till we have an understanding of how the

higher level problem was resolved. The higher level is the emergence of the social order itself, without which society is likely to be in a state of violence or anarchy and economic development is unlikely. The emergence of social order implies a significant decline in violence and the achievement of some minimal level of political stability. A social order must therefore involve not only some degree of centralization of violence capabilities but also a series of institutional and distributive compromises that ensure that the distribution of benefits is in line with the underlying distribution of power. This is essential if powerful groups are to stop fighting. The institutional and distributive arrangements that achieve this social order clearly have to be consistent with the distribution of power between the factions whose conflicts threaten the social order.

As soon as a social order emerges, the distribution of power becomes embedded in institutional arrangements that sustain it. Some of these may be formal institutions, but in a developing country formal institutions are not likely to be able to sustain the distributive requirements of all powerful groups. Inevitably, there will be a substantial variety of informal institutional arrangements, including the organization of informal power in patron-client organizations. These informal organizations can help to achieve a defined political settlement if they generate distributions of benefits that bring the overall distribution of benefits closer into line with the distribution of power. Thus informal institutions both reflect but also ultimately sustain the distribution of power by creating supportive benefits for powerful groups. Therefore, once a political settlement emerges, it reflects a distribution of power and also sustains it at the level of society as a whole. This analysis allows us to develop a typology of political settlements. We argue that developing countries are characterized by *clientelist political settlements*. These are structurally different from *capitalist political settlements* that characterize societies where the formal productive sector (we use the shorthand 'capitalist' to describe this sector) dominates the economy. This analysis also helps to explain why the governance structures that characterize advanced economies are not achievable in developing economies.

At the lower level of analysis, the distributions of power that a political settlement sustains are 'given'. The distribution of power is effectively an exogenous variable for understanding the performance of specific institutions and the constraints facing institutional change in particular directions. In some political settlements, particular formal institutions may work quite well, in other variants the same formal institutions may have poor or even negative effects. Different political settlements in developing countries also define very different 'growth-stability trade-offs' for institutional strategies that attempt to improve the enforcement of particular institutions or incrementally change the institutional structure in particular directions. We identify two sets of characteristics distinguishing different clientelist political settlements that are likely to be important for explaining differences in institutional performance between them. Both are observable characteristics of the structure of patron-client organizations, and therefore they provide a framework for classifying the evolution of political settlements in our case study countries.

The first dimension of difference is in the organization of the ruling coalition: the factions that control political authority and state power in different societies. The ruling coalition of factions faces distributions of power ranged against it both horizontally and vertically. The greater the power of horizontally excluded factions,

the greater the vulnerability of the ruling coalition. This reduces its time horizon which affects the types of economic strategies it will be willing to support through formal and informal institutions. But ruling coalitions also have to organize factions below them to give them the holding power necessary to rule. The power of the ruling coalition vis-à-vis their lower level supporters can also vary. The stronger the lower-level factions, the lower the capacity of the ruling coalition to enforce institutional rules that lower-level factions may contest. A second dimension of variation is in the technological capabilities of productive entrepreneurs in that society and their relationship of power with the ruling coalition. Differences in these two dimensions define important differences in clientelist political settlements that are relevant for understanding the performance of specific institutions and for the growth-stability trade-off facing particular directions of institutional change.

We begin with a quick review of the standard institutional analysis coming from the new institutional economics (NIE). An analysis of the limitations of that framework also allows us to establish the importance of an analysis of political settlements. Subsequent sections then develop our analysis of the political settlement and its application. We then use this framework to look at how the political settlement has evolved in each of our case study countries. Our classification of changes in the political settlements within each country, and comparisons across countries, shows the relevance of this framework for understanding differences in institutional performance and the evolutionary paths of institutional change across countries.

2. Institutions: The Analysis of New Institutional Economics

The analysis of institutions was (re-)introduced into economics by the body of literature collectively referred to as the new institutional economics. Institutions were defined as rules that define the right to do certain things or make decisions of a particular type. Rules for driving on a particular side of a road are simple institutions that define activity that is permissible by defining rights. Property rights are complex rules that specify who can make what decisions with respect to a particular asset, the types of uses that are allowed and ruled out, how the output is subsequently allocated and so on. The contribution of the new institutional economics (NIE) that developed through the work of Douglass North and others was to highlight that institutions mattered because rules were essential to make social interaction possible. The facilitating role of institutions was often described in terms of transaction costs, the argument being that in the absence of rules, the costs of organizing particular types of interaction may be so high that coordination and cooperation may be precluded. Going further, the new institutional economics argued that different sets of rules could have significant implications for the types of social activity that was possible (North and Thomas 1973; North 1981, 1984; Williamson 1985; Matthews 1986; North 1990; Ostrom 1990; Bromley 1991; Knight 1992; Papandreou 1994; North 1995; Olson 1997; Rodrik 1999; Bates 2001; Rodrik 2002; Acemoglu, et al. 2004; Rodrik, et al. 2004; Bardhan 2005).

Institutions as rights or decision-making rules define the types of decisions that can be made, and indirectly, the cost of making decisions. Some institutions are *formal* in the sense that these rights or rules are defined openly and in public by laws and are externally enforced by formal governance agencies. The governance or enforcement agencies for formal institutions are typically 'state' agencies like the police,

prosecutors, regulators, courts and so on, which are typically themselves subject to higher level institutional rules. Our focus in terms of policy is primarily on formal institutions and the governance agencies necessary to make these institutions enforceable to an adequate extent. An important characteristic of formal institutions is that they are typically *impersonal*, meaning that the rules are typically specified without reference to named individuals or organizations and therefore apply to all individuals or organizations with similar general characteristics. In principle, formal institutions do not have to be impersonal. Historically, formal institutions often took the form of charters that were rules specific to named organizations. However, the contemporary political reality even in relatively underdeveloped societies is that formal institutions are typically defined in impersonal terms. This makes the enforcement of formal institutions an important characteristic of the rule-following and impersonal ‘Weberian’ state.

However, the operation of formal institutions can depend on informal institutions, and these interdependencies turn out to be very important. Institutions are *informal* when there are no formal rules written down and enforced by formal (state) enforcement, but there are nevertheless ‘rules’ that are systematic enough to be identified. There are a number of types of informal institutions. First, informal institutions could refer to patterns of behaviour of individuals who are following internalized norms and values. An example would be an internalized norm of respect for property that may restrain individuals from appropriating assets owned by others even if the property rights are not well enforced. This type of informal institution is most often referred to in the NIE in explanations of why particular informal institutions may support the operation of particular formal institutions. For instance, the norm just referred to would significantly lower the cost of enforcement of formal property rights if the norm was widely adhered to.

Informality can also refer to rules that are not formally written down (or cannot be written down for political reasons) but which are nevertheless enforced by third parties who may formally be within the state but whose operations in any case rely on the mobilization of informal power. Examples of informal enforcers would be the mafia or patron-client structures that may operate through a state or independently. The informal rule that job-seekers who come with a recommendation from the local mafia boss should be given the job is an informal institution of this type. We will be particularly interested in important variants of this type of informal institution based on the mobilization of power by informal organizations like patron-client networks.

Finally, some informal institutions simply describe behavioural regularities of individuals or organizations in the game-theoretic sense of ‘equilibrium behaviour’, given the behaviour of other individuals and organizations. These *tacit* institutions are likely to emerge where the problem is simply one of coordination. For instance, if I know you will drive on the left I may drive on my left without any external enforcement. However, even driving is never simply a game of coordination and different types of free riding behaviour are possible, for instance when crossing junctions. In the absence of any third party enforcements efficient driving outcomes may be precluded. We will not focus much on tacit institutions that can emerge without any type of enforcement.

An important characteristic of all informal institutions is that there is no necessity that these rules are generally followed or are applicable to all individuals of the same category. By definition, while most or all formal institutions are impersonal, informal institutions are *never impersonal*. In particular, the second type of informal institution, where rules that are not formally written down are enforced, emerges precisely because it brings differential benefits to some individuals or groups and is therefore deliberately personal in its application. This type of informal institution is widespread in developing countries and indeed explains why the typical developing country does not conform to the Weberian ideal. The systemic reasons that could explain why informal institutions of this type are widespread in developing countries are discussed later.

Institutions are important because social activity requires many individuals to work together using different assets and inputs to produce outputs. This involves many interdependent decisions and agreements. Agreements are required about the ways in which assets and inputs are to be used, production organized, discipline and effort ensured and the net product (or loss) shared out. The critical decision-making rules in a productive network could have been allocated to individuals or groups in many different ways. For instance, in the NIE discussion about setting up a capitalist firm out of a team of co-workers, different individuals or groups of individuals could have become the residual claimant (Alchian and Demsetz 1972). Each way of allocating decision-making rights is likely to result in subtle differences in decision-making costs, as well as significant differences in the distribution of benefits. However, the NIE analysis has focused only on the implications of differences in decision-making costs in evaluating the efficiency of different institutions. This discussion has focused on a narrow definition of transaction costs and asked how specific institutions can reduce transaction costs and thereby increase economic efficiency or growth.

Transaction costs were initially thought of rather narrowly but have gradually become broadly defined. But in applications, transaction costs continue to mean a rather narrow range of decision-making costs. The narrowest interpretation of a transaction cost is literally the cost of exchanging ownership rights in acts of exchange (Eggertsson 1990: 14). In the narrow sense, this includes the cost of finding a person to exchange with, agreeing on a price and agreeing to a contract that covers basic contingencies. But even if we look at this simple act of exchange, it soon becomes clear that exchange cannot happen if the rights that are being exchanged cannot be enforced. A house can only be sold if the deeds give effective ownership and are not themselves contested. This soon extends the concept of transaction cost to include a variety of enforcement costs which determine whether the rights that are being exchanged can actually be defined at a reasonable cost to enable an exchange. Once enforcement costs are included it becomes clear that the concept of transaction costs can be applied to the organization of any type of collective action. For instance, organizing production also involves a series of agreements that have to be enforced at different points. The costs of enforcing these contracts are very similar to the costs of enforcing property rights.

A broader definition of transaction costs in Matthews (1986) says transaction costs are the costs of arranging a 'contract' *ex ante* and monitoring and enforcing it *ex post*. In contrast, production costs are the direct costs of executing the contract. The broader definition allows us to look at a variety of coordination, contestation and enforcement

costs that are involved in making collective arrangements of different types work. There are well-known grey areas in such definitions since many production activities are practically inseparable from monitoring and enforcement activities. For instance, production supervisors may be producing themselves as well as monitoring the effort of others and enforcing high levels of effort. 'Contracting' in this context should not necessarily be seen as entirely voluntary agreements, since what can be contracted depends on the initial rules defining rights. The underlying rights may therefore be heavily contested at one level, while the contracts representing working agreements may appear to be voluntary agreements at another level.

At the broadest level, transaction costs include the costs of constructing the groups involved in the activity, agreeing on the contributions and benefits of different individuals and groups, monitoring the exchange or production process over time to ensure that agreements are upheld, and enforcing and punishing violations of agreements, including breaking up the agreement under specific conditions. Transaction costs can clearly be very significant, and indeed, may be so significant that many potentially desirable activities may not be viable because the agreements are too costly to organize or enforce. This was one of the most important propositions of the new institutional economics (NIE). Specific institutions could reduce some transaction costs but only if the costs of enforcing the institution were also low.

Institutional analysis aimed to identify how institutions could explain economic performance, and also why dysfunctional institutions could continue to persist in some societies. The emerging analysis focused on three different types of variables. Not surprisingly, the *formal institutions* were studied first. Formal institutions can include both the rules that guide the activity of economic organizations, but also political and constitutional rules that define the rules for changing rules. As a first approximation, an analysis focusing only on formal institutions can take us some way towards understanding economic performance and the constraints limiting institutional change. But a focus on formal institutions could not explain why the same formal institutions perform differently across countries, or why formal institutions remain persistently inefficient in some countries but evolve rapidly towards greater efficiency in others.

Secondly, *informal institutions* were looked at as possibly affecting the operation of formal institutions. In the NIE analysis, informal institutions matter because they affect the costs of enforcing formal institutions and they can provide alternative forms of third-party enforcement that could be effective in some contexts. This may explain why the same formal institutions could be associated with very different outcomes in different contexts. But this approach too had its limits because informal institutions are not necessarily exogenous. If informal institutions are inappropriate, why do they remain so? Why do they fail to evolve in some countries in ways that allow the appropriate formal institutions to attain efficiency?

In response to these problems, a further evolution of institutional analysis looked at *non-institutional factors* that could explain differences in institutional performance. For instance, North suggests the importance of *cognitive capabilities* to explain why some societies appear to be slow to adapt poorly working institutions (North 1995). This is a logical extension of the institutional approach but implicitly suggests very problematic sources of differences between societies. Instead, in the approach that we

will develop, we will look at the *organization of power* to explain differences in the costs of enforcing institutions and in the costs of creating new institutions.

A First Approximation: Formal Institutions

The early new institutional economics (NIE) was a reaction to textbook neoclassical models of the market. The latter assume that the decision-making process is costless (zero transaction costs) and therefore institutions are not necessary for solving problems. Property rights do exist in textbook neoclassical models but only to describe the initial endowments of individuals. The main effect of different initial allocations of endowments in neoclassical economics is on distribution. Property rights are not necessary for reducing transaction costs (because transaction costs do not exist) so the initial allocation of property rights has no effect on the efficiency of the system. The zero transaction cost assumption makes it impossible to ask how institutional rules could possibly matter. But of course in reality transaction costs are not just positive, they may account for as much as half of all economic activity even in apparently efficient market economies (North and Wallis 1987).

The contribution of the new institutional economics (NIE) was not just to point out that these decision-making (transaction) costs are significant. A more significant observation was that small differences in the magnitude and incidence of transaction costs could have important economic implications. Differences in the performance of market economies may have a lot to do with the design of institutions that *reduce* specific transaction costs constraining the achievement of particular social objectives, including economic growth. This much would be agreed upon by most economists studying comparative institutions and growth.

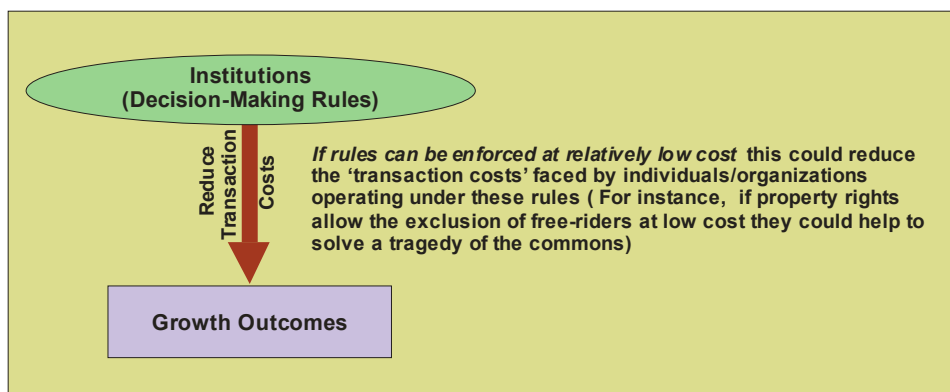


Figure 1 Formal Institutions Explaining Growth in the NIE

Figure 1 summarizes the initial contribution of the NIE. Institutions defined as decision-making rules (or rights) matter because while institutions themselves have a cost of enforcement, they may nevertheless reduce the overall transaction costs faced by organizations operating under these rules. As a first approximation, the initial NIE models suggested that economic efficiency would be higher if the overall transaction costs of the system could be lowered. For instance, clear rights (or rules) giving owners of assets the right to own the profits and the right to make production decisions could reduce the costs of agreeing to and enforcing a number of relevant production decisions (Alchian and Demsetz 1972). In the absence of a prior allocation of returns and decision-making rights to a specific group such as the owners of assets, there may be too many possible ways of enforcing production decisions and sharing

the returns. The absence of a clear and enforceable rule may then involve so much bargaining over how production is to be organized and shared that production may be abandoned altogether.

The NIE focus on aggregate transaction costs was, however, too simplistic. It is possible that a reduction in some transaction costs in the presence of others may be damaging for growth (for instance, if it reduced the organizational costs of those harmed by growth to oppose it more effectively). It is also important to distinguish between overall transaction costs and the transaction cost *per unit of transaction*. Advanced countries pay for a significant part of their aggregate transaction cost in the form of a collective enforcement of property rights and other economic rules as part of the ‘rule of law’. Aggregate transaction costs (when we include the cost of enforcing the rules) may be very high, but collective provision ensures that the cost *per unit of transaction* facing individuals or organizations is relatively low. These complexities have significant implications for understanding developing country problems. Nevertheless, the NIE made an important early contribution by proposing that poor economic performance was related to inappropriate institutions that failed to reduce the costs of coordinating social activity in appropriate ways.

A more fundamental question is why in many countries failing institutions continued to persist and more effective institutions failed to emerge? In developing countries, the experience of more successful countries can provide *prima facie* evidence about economic possibilities. The evidence of actual economic performance compared to the potential should feed back to create pressures for institutional change. If this does not happen, we need to ask why this might be the case. Inefficient or ineffective institutions should in principle be renegotiated through a political process. The early response of the NIE was to look for formal institutional explanations for why this process of negotiation could be blocked. In particular, it tried to identify ‘higher-level’ political institutions that could explain the costs of negotiating new and better lower-level institutions (North 1990).

One variant of this early NIE response is summarized in Figure 2. The relevant higher-level formal institutions are ‘political’ institutions which define the rules for changing rules, and these rules define the ‘political’ transaction costs of organizing changes in lower-level institutions. In principle, it should always be possible to negotiate the introduction of growth-enhancing institutions because the additional output should enable losers to be compensated directly or indirectly, *if the political transaction costs of negotiating the compensations low*. But if political institutions are inefficient and political transaction costs are too high, the cost of organizing beneficial changes in lower-level institutions may preclude a rapid evolution in the direction of greater efficiency. Political transaction costs do not refer to the actual compensations that are negotiated. They refer to the cost of *negotiating* these compensations, including the costs of creating coalitions, the costs of bargaining over appropriate compensations and enforcing the relevant agreements. These political transaction costs can depend on the design of political institutions in the same way that lower level transaction costs are determined by the design of economic institutions.

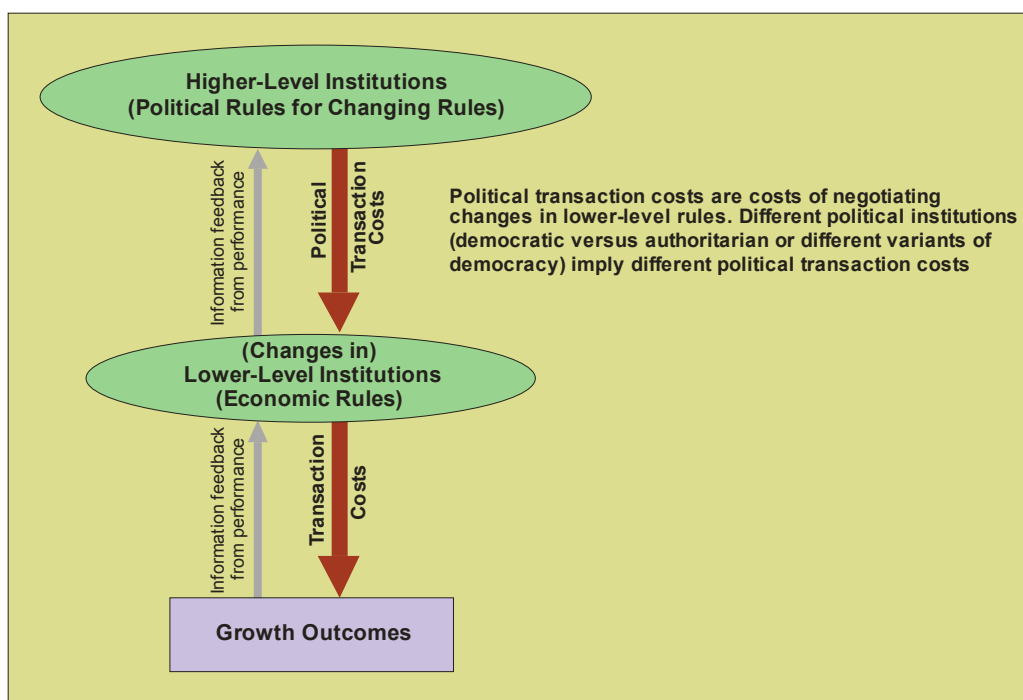


Figure 2 Formal Institutions Explaining Institutional Change in the NIE

Thus, 'inefficient' political institutions may constrain the evolution of efficient institutions, just as inefficient institutions can directly constrain economic output and growth. The obvious problem with this answer is that we have simply pushed the analysis up one level. If political institutions are inefficient *their* persistence also needs to be explained. Clearly, there are limits to how far a purely institutional explanation can take us. Eventually, we have to explain why formal institutions do not emerge or change without referring back to the presence or absence of other formal institutions.

Further Developments: Informal Institutions and Non-Institutional Factors

The puzzling persistence of inefficient institutions in many countries is closely related to two other empirical observations. First, apparently similar formal institutions like property rights appeared to have very different economic effects across countries. Secondly, very different institutions appeared to be successful in solving similar economic problems in different countries. These puzzles could be at least partially explained by the differential success of countries in enforcing particular formal institutions. It is clearly not sufficient to formally announce the introduction of an efficient institution if the conditions for its effective enforcement are missing.

The obvious step for the NIE approach was to examine if differences in enforcement capabilities could be explained in terms of missing or mismatched institutions, both formal and informal. In particular, was it possible that inappropriate informal institutions could explain the high costs of enforcing particular formal institutions? Informal institutions refer to norms, values and cultures that explain particular patterns of behaviour and these may be relevant for explaining differences in the enforcement costs of formal institutions (North 1990, 1995). If individuals and organizations subscribed to an informal value-system that declared that particular

rules (or rights) *ought* to be respected, the cost of enforcing these rules through formal enforcement mechanisms would be lower because challenges would be less frequent.

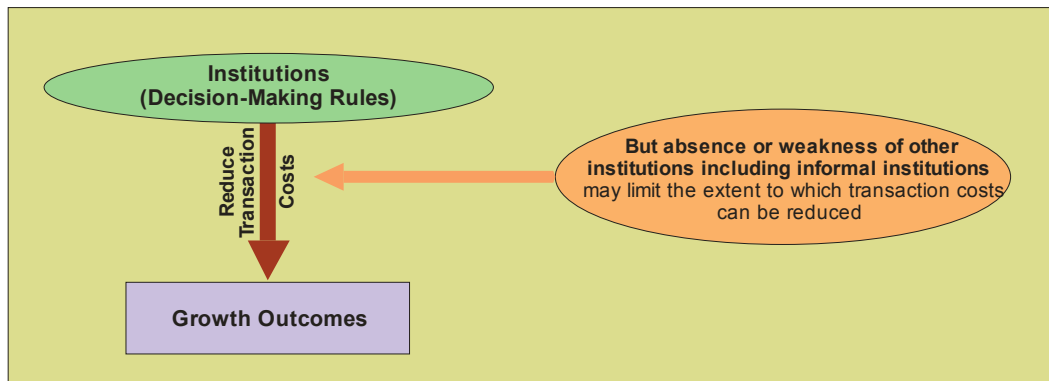


Figure 3 Informal Institutions Constraining Performance in the NIE

These observations resulted in a more complex theorization of the effects of institutions compared to the simple relationship between formal institutions and economic performance in Figure 1 and Figure 2. Developments within the NIE elaborated the possibility that missing institutions and norms could affect institutional outcomes as shown in Figure 3. The poor performance of particular institutions that *should* have performed better according to theory and evidence could now be attributed to a broader set of missing institutional conditions and in particular missing informal norms that raised the costs of enforcement. This approach ultimately put a lot of explanatory weight on missing or inappropriate informal institutions and thereby raised a new set of problems.

If norms can plausibly be dependent variables that adjust to formal institutions, the analysis has to be careful so as not to wrongly identify cognitive capabilities as the constraints on growth when other factors may be responsible for a particular equilibrium between formal and informal institutions. Consider for instance the relatively trivial norm that says people who have arrived earlier in a queue should have priority in getting on to a bus. If this norm is adhered to, some of the cost of enforcing formal rules for accessing buses can be saved. But people are more likely in the first place to internalize queuing behaviour as an informal norm if they know there are formal enforcement capabilities in the background that will punish aggressive behaviour at bus-stops and if they know that the next bus is coming along very shortly. If both of these conditions hold to an appropriate extent, violations of queues would be expensive for the violator, and an informal norm supporting queuing may then be rapidly adopted by almost everybody even if very few people held to this norm in the first place.

The adoption of the norm as an internalized set of constraints would then indeed further reduce the cost of formal enforcement, and the formal enforcement may eventually never have to be called upon. Thus, once equilibrium has been established between a particular set of underlying formal institutions and supporting informal ones, the direction of causality may indeed be from the informal institution reducing the costs of everyday enforcement of the formal institution. However, while the norm clearly becomes very useful and plays a part in sustaining patterns of behaviour at lower cost, the evolution of the informal norm in this and other similar cases may

historically have been largely endogenous and dependent on the enforceability of some formal institutions.

The importance of the historical analysis can be illustrated by a thought experiment about what is likely to happen in a queuing culture if the background enforcement capabilities for constraining aggressive behaviour suddenly collapsed, and/or the bus service deteriorated so that it was not possible to predict when the next bus would come along. If this happened, it is plausible that the queuing norm may be rapidly abandoned and access to buses organized on other principles, such as calibrated demonstrations of aggressiveness. In the absence of a significant increase in formal policing and enforcement, informal norms will adjust to these realities, and so the norm of queuing for buses may disappear rather rapidly. Instead, alternative norms may emerge, for instance a norm that says it is 'normal' for people to demonstrate their importance so that they have priority in getting on to buses. This may actually reduce the chances of fights breaking out by making the new rationing rule compatible with decentralized and informal 'enforcement capabilities'. Clearly, it would be misleading to explain the absence of queues in this example in terms of a missing set of informal queuing norms as the norms in question are themselves (to some extent) dependent variables. Thus, in this example of disequilibrium the direction of causality can reverse, with changes in the enforceability of a formal institution driving changes in supporting informal institutions.

Informal institutions are likely to continuously adapt in this way because if they did not, the individuals whose values were confronting a dissonant reality would soon suffer from cognitive dissonance. For instance, a strong person who may have got on a bus in the new situation by displaying signals of strength would soon begin to suffer if he or she persistently refused to do this. A few people would sooner or later opportunistically break the previous norm and they would benefit by improving their probabilities of getting on the bus. Strong individuals who persisted in standing in ineffective queues would not only suffer economic costs but also rapidly increasing psychological costs. The concept of cognitive dissonance refers to the latter. To avoid this, individuals are likely to develop normative justifications for what they have to do. People who have to demonstrate their social precedence or signal aggression to get on to a bus would be likely to rationalize in normative ways why this behaviour was justified in this context. At least, we should not be surprised if they did.

These methodological warnings are important because it is often possible to read the same empirical evidence in a number of ways in the absence of a historical analysis. For the reasons just discussed, poor formal institutions are likely to coexist with informal norms that have adapted to them. If we do not allow for a reverse causality from formal to informal institutions, we end up with the troubling conclusion that informal institutions and ultimately cognitive capabilities of societies were the problem. This in turn leads to a possible overemphasis of 'culture' and 'values'. Ultimately it takes us to the conclusion that societies may differ significantly in their capabilities to process information as suggested by an emphasis on cognitive capabilities. Cognitive capabilities can be interpreted as a society's 'software' for information processing, in which case these capabilities are closely related to informal institutions. A focus on cognitive capabilities defined in this way raises very similar questions to the discussion of informal institutions: why does this software not change when confronted with evidence? But cognitive capabilities can also be interpreted as

the ‘hardware’ for information processing in the brains of individuals in some societies. Before we enter this domain, we should at least have satisfied ourselves that other more plausible explanations do not suffice.

Apart from the fact that some implications of cultural and cognitive explanations are worrying, there is also historical evidence of dramatic path-changes that are not consistent with cultural and value-based explanations of performance. If we focus solely on the capitalism of the ‘West’, it may be possible to argue that Protestant or Christian cultural values were necessary underpinnings of market capitalist institutions (Platteau 1994a, 1994b). But in the second half of the twentieth century, the lethargic Confucianism that had been blamed for Chinese stagnation till the 1970s began to be associated with the rapid growth of the East. What changed in the values supported by Confucianism between the first and second halves of the twentieth century? Similarly, what could possibly have changed so rapidly in the values and norms of the Taiwan of the 1950s or the South Korea of the 1960s that set them so distinctly apart from their own societies of a decade earlier or the North Korea of the same period? The list of examples that challenge the importance of informal institutions as *norms* is a long one.

The very significant institutional changes that happened in Asia and elsewhere in the second half of the twentieth century were *not* associated with dramatic prior changes in values and cultures, notwithstanding the tragically misnamed ‘cultural revolution’ in China. Rather, the precursor to significant takeoffs, including the Chinese one, was typically a significant *political re-alignment* that changed the internal balances of power in these societies and allowed new institutions to be introduced and enforced. The types of ‘capitalism’ that emerged in the East were different from each other and from the capitalisms that emerged in the West. Perhaps culture could explain *some* of these differences. But informal institutions can offer a more satisfactory explanation of differences in institutional performance if we see informal institutions as informal enforcement mechanisms based on power that are important for delivering benefits to powerful groups who would not immediately benefit from the creation of the modern formal institutions of capitalism.

3. Power and the Political Settlement

Power matters for institutional analysis because the power of different groups to contest, obstruct and oppose rules that are against their interests clearly affects the *enforceability* of institutions. Institutions can only be effective in reducing some relevant transaction costs to the extent that they can actually be enforced at a lower cost than the transaction costs they are supposed to save. For instance, property rights which define who can make specific decisions about the use of a piece of land could reduce the free access problem (the tragedy of the commons) *if* the rule can be enforced at a cost that is low compared to the social loss caused by free riding. Similarly, property rights can enhance the time horizon of investors by establishing a rule giving them ‘ownership’ of future profits, but only to the extent that enforcing the rule is possible at a cost that is low compared to the future profits generated by the additional investments. The NIE explanations summarized in Figure 1 did not address the question of enforcement in depth. What factors determine the extent to which a particular institutional rule can be effectively enforced at a cost low enough to make the relevant social activities feasible?

We can begin to answer this question by recognizing that all institutional rules have a dual character. In theory, an institutional rule, if it could be well enforced, would have a potential effect on efficiency and growth by changing the types of decisions that can be made and the costs of making these decisions. But at the same time, each institutional rule also defines the distribution of the net benefits of making these decisions. A few examples may help to illustrate the general principle summarized in Figure 4.

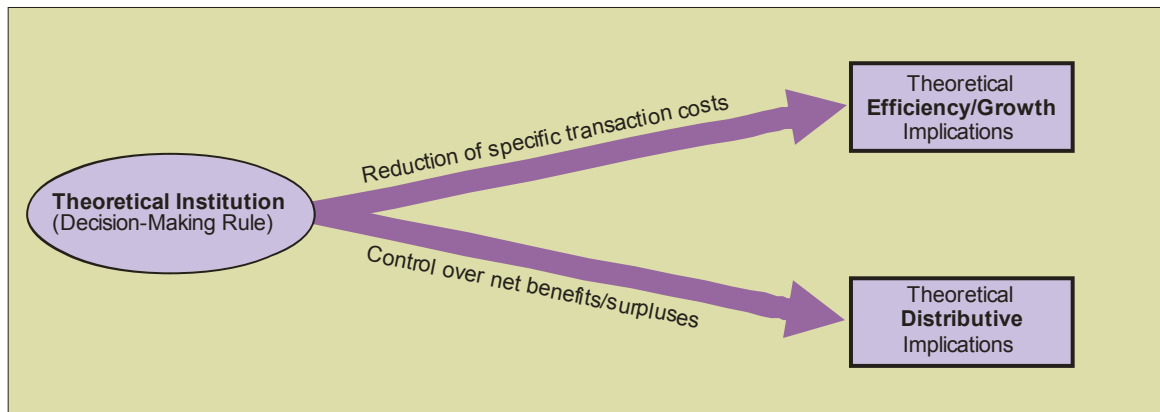


Figure 4 The Dual Effect of Institutions on Growth and Distribution

Consider an asset such as a lake that is subject to free access overuse. The allocation of a property right over the asset that gives a specified person or group of people the right to decide the extent of use will, if enforced, assist in determining an appropriate level of use that sustains the value of the resource over time. The property right (or decision-making rule) can be created and allocated in a number of different ways, including an allocation to a single person or to various subgroups of individuals. With effective enforcement, each would imply specific transaction costs of reaching appropriate decisions about the level of use that was appropriate. But just as important, each institution implies a fundamentally different distribution of net benefits across individuals and groups. Individual ownership gives a specific individual most of the increase in net social benefit, while collective ownership shares the net social benefit across a broader group. In both cases, other potential claimants to the resource are excluded.

The dual effect of institutions helps to explain why they may face high or low enforcement costs in different societies. Given any initial structure of norms and formal enforcement capabilities, the difficulty of enforcement is likely to be (significantly) greater if the distribution of benefits is not consistent with the distribution of power between the groups affected by the institution. Powerful groups are likely to (strongly) resist the enforcement of an institution that is against their interest. ‘Governance agencies’ responsible for enforcement do indeed have different enforcement capabilities that are partly to do with their internal capabilities: the quality of their personnel, the physical infrastructure and resources they have to work with, the incentives they can offer internally and so on. *But the effectiveness of enforcement also depends on the resistance or support coming from powerful groups in society given that any institutional rule has differential costs and benefits for*

different groups. This is why an analysis of the political settlement is important for institutional analysis and for the design of governance reform.

Political Settlements: Two Levels of Analysis

Institutional analysis requires that the context in which institutions are operating has some characteristics of order. Institutional effects are only likely to be regular if the context in which the institutions are operating displays some characteristics that are stable over time. We describe an institutional and political system that has characteristics that are reproducible over time as a *political settlement*. At the highest level, a political settlement is a description of the ‘social order’ that describes how a society solves the problem of violence and achieves a minimum level of political stability and economic performance for it to operate as a society. Of course, in many developing countries suffering from violence a social order is missing. Widespread violence threatens to break out or has already broken out. In these countries the pressing problem is the emergence of a social order. The achievement of a social order or political settlement requires in turn formal and informal institutions (such as property rights or informal rules of redistribution) that create benefits in line with the relative power of powerful groups. If this can be achieved, overt conflict can come to an end, provided that the institutional system manages to achieve at least a minimal economic viability for the system to be able to reproduce.

At a deeper level, a political settlement implies an institutional structure that creates benefits for different classes and groups in line with their relative power. The commonsensical understanding of a political settlement as a stable agreement between elites (or a social order) is therefore only likely to be viable if it is underpinned at a deeper level by a viable combination of institutions and a distribution of power between organizationally powerful groups in that society. A distribution of benefits that is economically unsustainable will collapse. But an institutional structure that attempts to achieve economic viability with a distribution of benefits that is unacceptable to powerful groups will also collapse. By definition, a social order defined by the absence of violence must be based on a consistent set of institutions and power relationships to achieve minimal levels of economic *and* political viability.

Power can be ranked along many possible dimensions. The dimension that is most useful for us is *holding power*. Holding power refers to how long a particular organization can hold out in actual or potential conflicts against other organizations or the state. Holding power is a function of a number of different characteristics of an organization, including its economic capability to sustain itself during conflicts, its capability of inflicting costs on competing organizations, its capability to mobilize supporters to be able to absorb costs and its ability to mobilize prevalent ideologies and symbols of legitimacy to consolidate its mobilization and keep its members committed. As the outcomes of conflicts depend on relative power rather than absolute power, our use of the word power refers to a *distribution* of power.

We define a *political settlement* as *an interdependent combination of a structure of power and institutions at the level of a society that is mutually ‘compatible’ and also ‘sustainable’ in terms of economic and political viability*. If a combination of institutions and power is not viable enough to survive, it is not a political settlement. We define viability in turn as a minimum level of economic and political viability necessary to keep that institutional structure together. Economic viability requires the

political settlement to achieve sufficient economic performance to avoid an economic crisis. Basic economic activities should be at least reproducible if not growing, but the minimum level of economic performance can also differ across societies depending on the expectations of powerful groups. Political viability is more specific to particular societies and requires the level of dissent or violence and conflict to not reach such a level that the core institutional and political arrangements that define the political settlement begin to unravel. How robust a political settlement is depends on how the economy and polity are operating with respect to these minimum viability limits. However, the minimum levels of economic and political viability are not defined in absolute terms but are themselves endogenous to the society.

The minimum level of political stability (or maximum level of conflict) that a society can tolerate before major political mobilizations are triggered can vary significantly across societies and in the same society over time. Nevertheless, at any time there is some minimum level of political stability below which the social order is not sustainable, either because violence suddenly becomes much more widespread and the social order collapses, or because new political mobilizations are induced which establish a new political settlement that is more viable. Similarly, the minimum level of economic performance below which the political settlement is no longer sustainable can vary significantly across societies and over time. Some political settlements can tolerate substantial economic hardship and poverty without collapsing; others are more sensitive to economic performance. The detail is even more complicated because the economic and political tolerance limits can also depend on how economic performance or political stability declines. If the decline in either affects powerful groups first, the viability limits are likely to be reached earlier and significant counter-mobilizations will begin. In contrast if the decline hurts less significant groups, a political settlement can survive despite a significant worsening of economic conditions and/or an increase in violence. The aim of analysis is to identify these political and economic interdependencies within particular political settlements and the implications for institutional and governance reforms in these contexts.

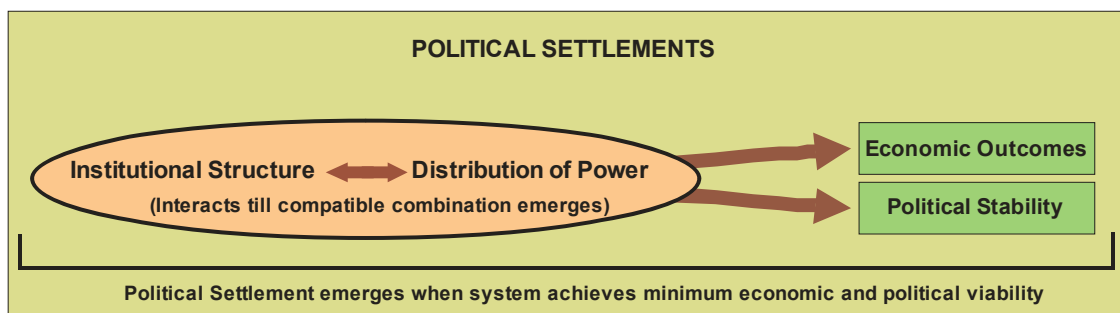


Figure 5 Political Settlements

It is useful to distinguish between two levels at which the interaction of institutions and the distribution of power is analytically significant. The first and higher level of interaction operates at the level of a society as whole to define the political settlement. Figure 5 describes this interaction between institutional structures and distributions of power at the level of society. A compatible system of institutions and a distribution of power is a political settlement if the resultant economic outcomes and levels of political stability are sustainable for that society.

Institutions and the distribution of power are necessarily an interdependent system. First, *institutions affect the distribution of power* because institutions create economic benefits that contribute to the relative holding power of different groups. Secondly, *the distribution of power affects institutions* because powerful groups are likely to drive the evolution of formal and informal institutions to achieve the distributions of benefits that they desire. Both are likely to interact in interdependent ways till a compatible combination of institutions and power emerges. Once a compatible combination emerges, both the institutions and the distribution of power are mutually supportive. In particular, a political settlement is both based on and supportive of a distribution of power. The distribution of power supported by the current political settlement is in turn relevant for understanding the operation of particular institutions that already exist and the evolution of new institutions.

Therefore, a second and lower level of analysis looks at how the distribution of power embedded in a political settlement is relevant for understanding the enforcement and operation of particular institutions and the evolution of particular institutions over time. Once it emerges, a political settlement is likely to be fairly robust in its broad outlines, even though it is inevitably evolving all the time. The configuration of holding power at the level of society is then buttressed by a range of formal and informal institutions that reproduce and sustain this configuration of power by enabling a consistent set of economic benefits to be created and allocated. The constraints set by the existing distribution of holding power are important for the analysis of particular institutions and governance capabilities because at that level the social distribution of power is exogenous for particular institutions. An individual institution is unlikely to change the distribution of power in society, but is likely to be affected by that configuration. If a particular institution, even one that already exists, would have implied an allocation of benefits that is significantly at variance with the distribution of holding power in society described by the political settlement, it is likely to result in high levels of contestation and therefore high enforcement costs, or very partial enforcement.

An important analytical weakness of the NIE analysis of institutions is that it ignores how the political settlement can be a determinant of institutional performance at the level of particular institutions. Attempts to identify the effects of particular institutions on transaction costs without reference to the political settlement have often proved to be misleading because the effect of particular institutions can depend on the distribution of power sustained by the political settlement. Institutions that *could* reduce transaction costs in one political configuration may actually increase transaction costs in a somewhat different political configuration. This can happen because institutions not only define ways of solving particular economic problems; they simultaneously define the distribution of net benefits. If this distribution of benefits is accepted (or cannot be resisted) by the groups affected by the institution, the costs of enforcing the institution (a key component of overall transaction costs) will be low, but not otherwise. In some cases, the opposition to a potentially beneficial institution may be so high or its enforcement so distorted that its presence does more harm than good.

An institution that was beneficial overall in terms of net social benefits may still be strongly contested if the implied distribution of benefits was not compatible with the

interests of powerful groups. It is sometimes assumed in NIE analyses that if net social benefits increase, the opponents of an institution can always be compensated so that the institution can be introduced and society can collectively benefit. This is often an arithmetically valid but practically naive proposition. The transfer of significant benefits from those who directly benefit from an institution to those who are losing out may itself be costly in terms of incentives and a promise to make these transfers formal may not even be credible over time (Khan 1995). More significantly, compensations may not be arithmetically feasible if there are multiple unconnected claimants who believe they deserve a share of the net value added by an institution. Their competing claims may add up to more than the net benefit added by the institution. The institution may then either not be introduced or it may be introduced with informal transfers to some groups who assist in its partial enforcement till enforcement can be gradually improved as a result of changing distributions of power at the social level.

If a significant group refuses to accept the distribution of benefits generated by the institution, it can begin to undermine its enforcement in a variety of ways ranging from attempting to change the rule through legal processes, violating some or all of the rules and accepting the consequences, or by engaging in open conflicts. All these responses imply costs for all those involved. The transaction costs of enforcement are likely to go up depending on the intensity of the resistance and political stability can decline to different extents depending on the strategies of resistance and confrontation that are deployed by different parties. In contrast, if the distribution of benefits supported by the institution is consistent with the overall distribution of power, contestation is likely to be low. Enforcement costs overall will be correspondingly low and the transaction cost improvement achieved by the institution is likely to be in line with the theoretical expectation.

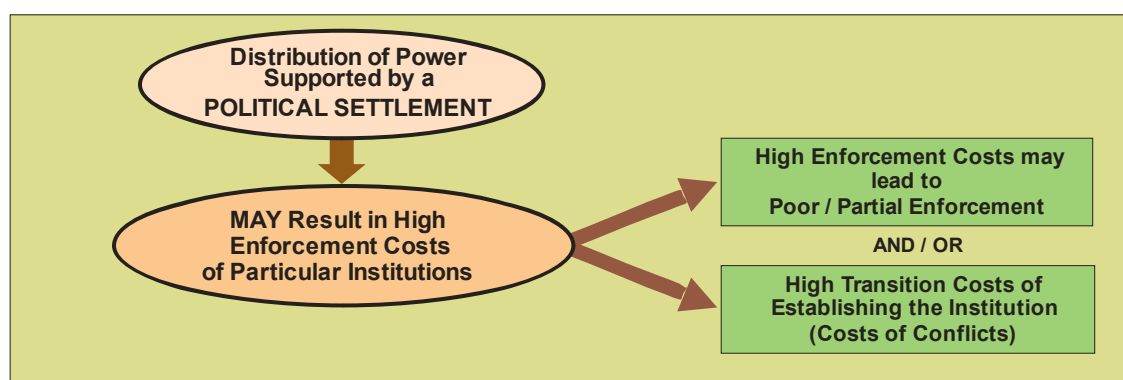


Figure 6 Lower Level Analysis: Effects on Particular Institutions

If powerful groups contest the distribution of benefits implied by a potentially beneficial institution, there could therefore be two types of effects, summarized in Figure 6. One possible effect is that the full enforcement of the institution may not be attempted because the enforcements costs for full enforcement were effectively too high. Partial enforcement may result in more acceptable levels of damage for powerful groups, or it may reflect that powerful groups are capturing some of the benefits from the institution (with likely negative effects on the economic outcomes of

the institution). This is an important reason why apparently similar institutions display such significantly different results in different contexts.

Alternatively, or in addition, the attempt to enforce the institution may also result in conflicts. These inflict ‘transition costs’ on the parties. Transition costs are the costs that parties to a conflict can inflict on each other through ‘political’ acts that can range from strikes and demonstrations to open violence. Because of the many different dimensions of transition costs, we are unlikely to be able to add up all the different transition costs that are involved during a period of conflict. However, we may still be able to rank situations in terms of ‘political stability’ or the ability of the coalition benefiting from the institutional change to sustain itself in power. We will follow this strategy later. Both these implications of contestation imply that an institutional solution that is in theory less efficient but where the distribution of benefits is more compatible with the existing distribution of power may actually provide better incremental economic benefits without a serious deterioration in political stability.

By focusing on how political settlements define the enforcement costs of particular institutions, we can explain why the *same* apparently beneficial institution like industrial policy can produce excellent results in some developing countries and very poor results in others (Khan 1999). Equally, this framework can help to explain why very *different* institutions are observed to be effective in different countries. For instance, the most effective structure of firm appears to be very different across countries depending on pre-existing relationships within each society (Whitley 1992). The institution that is most likely to reduce overall transaction costs depends on the distribution of power in which that institution has to be located. Finally, we can begin to explain why growth-enhancing institutional evolution has more serious effects on political stability in some societies compared to others. If emerging institutions that promote growth are more significantly inconsistent with prior power distributions, the decline in political stability is likely to be more severe.

Our core argument is therefore that the interdependent analysis of power and institutions has to be conducted at two levels. First, as we see in Figure 5 we need to have an understanding of the political settlement at a social level and its evolution over time. Secondly, as described in Figure 6, we need to locate the analysis of particular institutions in a particular country in the context of power defined by its current political settlement. We now look at these two levels of analysis in greater depth.

4. Power and Institutions Defining the Political Settlement

Institutions are clearly not just rules for making decisions; they also define distributions of benefits. In turn, a distribution of benefits helps to sustain the distribution of holding power that supported the institutions providing these benefits. However, here there is a substantial problem which distinguishes developing countries from advanced one. In developing countries, formal institutions cannot adapt sufficiently to provide a distribution of benefits that is compatible with the distribution of holding power in society. A major reason for this is that the productive sector protected by formal rights is small. The distribution of benefits coming from the small productive sector cannot reflect the broad distribution of power in society. Moreover, the productive capabilities of the most powerful political organizers are

typically very limited and so they could not immediately benefit if formal productive rights were immediately assigned to them. Nor is it possible to specify formal rules of redistribution that allocated the net product of productive activities to currently powerful factions and organizations. As a result, the only way in which institutions could support the distribution of power in the typical developing country is through the emergence of appropriate informal institutions.

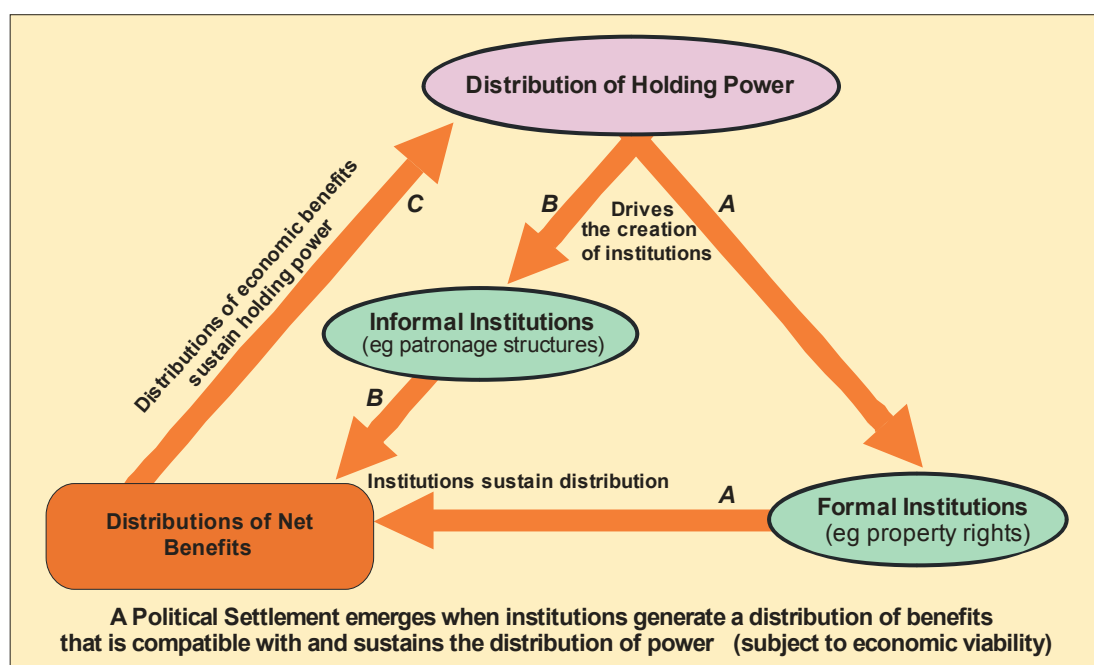


Figure 7 The Interdependence of Power and Institutions

The circular and interdependent relationship between institutions and the distribution of power is shown in Figure 7. Institutions evolve in response to the activity of powerful groups; power in this context referring to both economic and political holding power. The ‘rent-seeking’ activities of powerful groups result in the creation of both formal and informal institutions. The informal institutions that we are primarily interested in are institutions that are based on informal enforcement and which achieve significant distributions of benefits for the organizers of power. In turn, formal and informal institutions sustain distributions of economic benefits for the participants in these institutional arrangements. The creation or modification of institutions in response to power and ultimately the creation of streams of benefits is shown by Arrows A and B. The distributions of benefits in turn support the distribution of power, shown by Arrow C in Figure 7. A political settlement emerges when the distribution of power and the distribution of benefits generated by the institutional structure are compatible in the sense that they support each other and the broad features of the system of power and institutions are identifiably stable. But the survival of these arrangements also requires a second set of requirements about viability: the institutional structure has to achieve minimum economic viability.

A political settlement is stable precisely because the distribution of power is (eventually) sustained by the institutional structure through an appropriate distribution of benefits. It is in this sense that a political settlement describes a sustainable *and* compatible combination of power and institutions. The equilibrium is never perfect,

as power and the distribution of benefits are always changing through economic, political, demographic, organizational and other processes. Nevertheless, stability requires by definition, a rough balance between power and institutions.

The Significance of Informal Institutions in Developing Countries

A significant characteristic of developing countries is that their inherited distributions of power cannot be supported by the incomes generated by formal institutions alone. Informal institutions play a vitally important role in all developing countries because informal institutions are the only feasible mechanism for sustaining economic benefits for powerful groups who would otherwise have lost out. Till informal institutions emerge to sustain the aspirations of these groups, conflict and resistance prevent the achievement of minimum stability. The problem is that powerful groups in developing countries often have few capabilities that could benefit from the protection of property rights and a rule of law.

Even if powerful groups captured productive assets and established property rights over them, they would typically not survive in competitive markets without significant additional assistance and capability building. These are relatively slow processes of productive transformation. In any case most developing countries do not have sufficient formal institutional and governance capabilities to convert political accumulators into productive entrepreneurs. Nor can redistributive flows to powerful groups be enshrined in formal public rules of redistribution such as taxes and subsidies even if appropriate fiscal resources were available. This is because such redistributions to the not-so-poor would be difficult if not impossible to justify in terms of general public principles of welfare. Informal arrangements are therefore used to enable powerful groups to have continued access to incomes through 'political' accumulation. The political settlement in the typical developing country therefore has a significant component of informal institutions as part of its interdependent system of (formal and informal) institutions and power.

Our analysis of a political settlement provides an explanation for the significance of informal institutions in developing countries that is very different from the ones usually provided by institutional economics. The usual explanation for informality in developing countries is that the governance capabilities for enforcing formal institutions are weak, leaving a lot of activity to be guided by informal institutions. Sometimes, the weakness of enforcement is also explained by the presence of unfavourable cultural values that increase the costs of enforcement. These explanations imply that if the governance capabilities for enforcement could be sufficiently strengthened (with appropriate changes in cultures to the extent that this can be achieved) developing countries would become more like advanced countries, with Weberian (impersonal) states enforcing property rights and a rule of law.

In contrast, the analysis of political settlements suggests that informal institutions are likely to remain important in developing countries regardless of attempts to improve formal governance capabilities. The scope of informal institutions in this analysis reflects not the weakness of formal governance capabilities (which are undoubtedly weak) but the distributions of holding power that are far removed from the ones that could be supported by any emerging formal institutions. The 'solution' which maintains political stability at acceptable levels in developing countries is the emergence of significant informal institutions that allow benefits to be captured by

powerful groups. This is reflected in the combination of formal and informal institutions and the distribution of power that constitutes the political settlement in a developing country.

Informal institutional arrangements like resource allocation and accumulation through patron-client networks are examples of arrangements through which powerful groups create economic benefits for themselves during developmental transitions. The informal institutions in this context are mechanisms through which social and political stability is maintained. They help to generate distributions of economic benefits that are more in line with existing distributions of power and in doing so they also sustain these distributions of power. Political settlements across developing countries do of course vary greatly. These variations reflect differences in evolutionary paths from very different class and social structures and colonial strategies. Differences in political movements, party organizations or social movements have also resulted in differences in the ways in which political settlements are constituted in different countries.

An important question is why the distribution of holding power in developing countries is *not* based on the incomes and other formal rights defined by previously existing formal institutions. Why is the distribution of power so significantly out of line with the incomes and rights defined by their own formal institutions? We will discuss this further in a later section on typologies of political settlements. An important part of the answer is that developing countries are *transitional* societies. Their 'pre-capitalist' economic and social systems have collapsed and modern 'capitalist' economies have not emerged. When pre-capitalist political settlements were operative holding power was indeed based to a much greater extent on formal institutions. Of course by describing developing countries as societies in transition we are not suggesting that there is any teleological path that will eventually take them to a productive capitalism.

Nevertheless, the concept of transition is important because the emerging capitalist and market-based formal institutions in the typical developing country are not developed enough or productive enough to make the beneficiaries of these formal rights the dominant power group in these societies. The proposition that the organization of power plays a significant role during periods of crisis when formal institutions are being radically restructured is not controversial. In fact, developing countries are effectively going through long and relatively slow processes of transformation. Their historic 'pre-capitalist' formal institutions have all but collapsed and new formal institutions that are self-sustaining in economic and political terms have not yet emerged.

A further part of the answer is that colonial impacts often made the gap between holding power and formal institutions even bigger. In many developing countries, the pre-capitalist political settlements were collapsing anyway, but the colonial impact accelerated this collapse. In many cases, strategies of colonial rule required the colonial powers to recognize the organizational power of different groups who did not have formal rights but who had to be incorporated sequentially into the system of state benefits to ensure stability. Ironically, anti-colonial struggles were often led by these very groups and the process of successful organization against colonial powers further

enhanced the importance and legitimacy of *organizational* holding power in post-colonial developing countries.

The newly independent countries also witnessed accelerated social mobilizations by previously excluded groups to gain access to redistributive rents. These processes have created a growing gap between the actual holding power of relevant groups and the holding power that could be attributed to formal rights and incomes. Success in political organization, and sometimes the organization of violence, has become the critical determinant of holding power in these contexts. For obvious reasons, the power of these emerging social mobilizations cannot be sustained by benefits created by formal institutions. But these mobilizations can and do use informal mechanisms to capture resources in ways that both reflect and sustain their holding power.

Economic Growth with Informal Institutions

A common perception is that the absence of well-defined formal institutions like a system of property rights constrains the development of poor economies. The underlying theory is plausible but does not help us to understand the dynamics of development in contexts defined by political settlements with a significant structural role for informal institutions. When productive activities emerge in these contexts, they are *not* organized as islands of formal economies in the midst of a sea of informality. Rather, the productive activities emerge out of and are deeply embedded in the mix of formal and informal institutions that characterize the political settlement. A transition to greater formality may gradually happen, but to be consistent with a viable evolution of the political settlement, it will have to happen in line with gradually changing social distributions of power. Otherwise attempts at enforcement will fail, or if enforcement is attempted with violence, the political settlement can collapse into significantly greater instability and violence as groups with significant holding power can be expected to fight back.

Moreover, there are a number of additional features of ‘late development’ which mean that even if well-defined property rights existed, they would be insufficient for ensuring dynamism in contemporary poor countries. This is because a number of significant market failures exist that cannot be adequately addressed simply by strengthening or extending the emerging structure of formal rights. One example is the complexity in the historical definition of land rights. These complexities mean that the problems of acquiring land for industrial development, for instance, are not likely to be addressed simply by defining existing property rights a little better (Khan 2009a). Another important example is the market failure constraining the transfer of technological capabilities to developing countries. Given the difficulty of absorbing and learning modern technologies and the intensity of global competition, a viable and productive economic structure is not likely to emerge just because formal property rights are defined for a few asset-owners, even if they were better defined (Khan 2009b). The achievement of technological capabilities in developing countries requires strategies of technology upgrading and learning. As these significant market failures cannot be easily addressed through existing or potential formal institutions, another driver of informality comes paradoxically from the economic requirements of developing a productive sector with formal rights. Thus, there are both political and economic factors that sustain the informality of institutional characteristics in the typical developing country.

The emerging productive economy thus has a dual challenge. First, it has to deal with weakly protected and inadequately defined formal institutions like property rights as a consequence of political settlements supporting significant informal arrangements. Standard contract-enforcement is therefore more difficult in developing countries because one way in which informal institutions and organizations claim a share of benefits is by making themselves indispensable for contract enforcement of all types. Making inadequately enforced formal institutions work therefore requires access to informal enforcement capabilities and networks of power. Successful entrepreneurs are therefore rarely likely to be far away from informal networks of enforcement. These networks deploy power, including enforcement power, and contract enforcement is one of the many activities through which income is redistributed to powerful groups through informal organizations.

However, the second factor, the presence of significant market failures means that the relationship of the emerging productive economy with informal power is complex and not always one of predator and victim. The emerging productive economy is initially structurally uncompetitive as a result of market failures that would not be sufficiently addressed simply by enforcing property rights and contracts a little better. The dual drivers of informality in the productive sector are summarized in Figure 8.

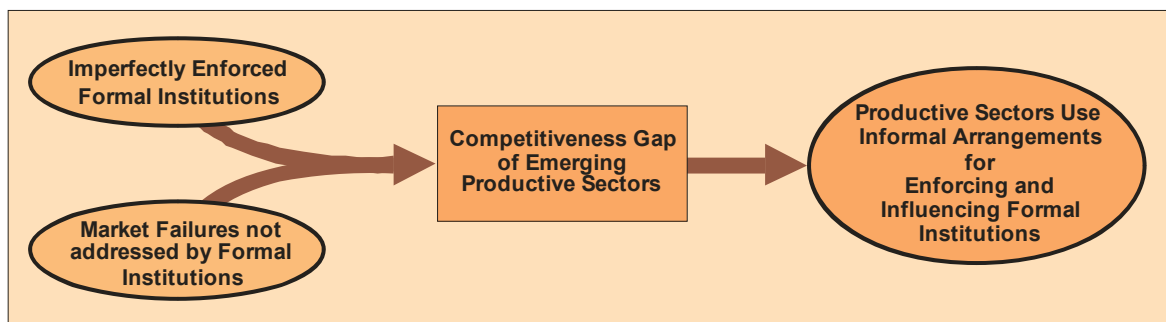


Figure 8 Productive Sectors also depend on Informal Arrangements

The combination of structural constraints facing the development of formal institutions *and* significant market failures not addressed by the formal institutions on offer means that the emerging productive sector in developing countries operates intensively with a variety of informal institutions and informal power influencing the operation of formal institutions. As a result, while emerging sectors that appear to have formal characteristics may demand formalization and good governance, particularly given the dominant discourse in the international context, they are rarely prepared to break out of the informal networks in which they are embedded. A rapid shift to formality is not only unlikely given the political settlement, it would also leave many entrepreneurs exposed to possible rapid collapse given that many have not yet acquired sufficient competitiveness.

Emerging entrepreneurs use their networks within and outside the state to acquire assets like land, to finance their learning strategies and to address other market failures to sustain production. The policies that assist them may sometimes be formal but in many cases, even formal policies were developed and fine-tuned through informal access. Some of these entrepreneurs *may* eventually become independently competitive but only if the combination of formal and informal institutions create an

appropriate combination of opportunities and compulsions for them to not only set up in production, but also to put in the effort to become competitive. As we have outlined in other papers in this series, the formal institutions that worked for the early capitalist developers are no longer sufficient. Yet models of appropriate formal institutions that can deal with these challenges do not exist, certainly not in the economic and governance models of the dominant paradigms of good governance reform. The limited success of the good governance agenda in enlisting the support of the productive sector in developing countries is not surprising.

In principle, some of the market failures in question could be addressed by developing appropriate formal institutions that may work in the context of these political settlements, and that is indeed the challenge of the growth-enhancing institutional agenda. Attempts at catching up with formal institutional support have in the past often resulted in a waste of resources as inefficient entrepreneurs captured these resources without putting in sufficient effort (Khan 2009b). Many of the ambitious formal instruments used in the past, like broad-ranging industrial policies, were inappropriate for the political settlements in which they were attempted. Successful developmental states where ambitious industrial policies did work were fortunate because their political settlements were supportive and their structures of informal power could enforce growth-enhancing conditions. In other settlements, where clients of state policies were powerfully organized and divided into many factions, ambitious industrial policies failed (Khan 1999). Some of the differences between political settlements observed in developing countries will be discussed later. The challenge in countries with less supportive political settlements is to design appropriate formal institutions that can assist technological capability building in less favourable contexts.

Our discussion also suggests why analytical frameworks developed in advanced countries have typically under-played the importance of power. In advanced countries there is (by definition) a well-established and productive economic system based on formal institutions. Formal institutions are dominant in the sense that they are responsible for the bulk of social output and incomes and the bulk of social power flows from the incomes generated by formal institutions. A separate analysis of the sources of power in advanced countries therefore often appears to be superfluous. Distributive conflicts exist and can be relevant for explaining institutional performance, but distributive conflicts are likely to be organized along the lines of incomes generated by formal institutions. Another feature of the ‘capitalist’ political settlement is that the owners of formal capitalist rights normally have the most significant holding power in advanced countries, so the limits of distributive conflicts are set by what is acceptable to the owners of productive rights. In terms of Figure 7, Arrow A is the dominant arrow and Arrow B is virtually non-existent.

In contrast, in developing countries Arrow B in Figure 7 is very important because many powerful groups do not have formal rights and cannot immediately convert themselves into capitalists or otherwise maintain their power on the basis of formal rights. Informal rules and organizations such as patron-client networks are important, but primarily not because of culture, deference or inequalities in the distribution of formal rights (which may all be important). Rather, the essential problem common to *all* developing countries is that these are essentially societies where there is a structural (transitional) mismatch between the scale and productivity of activities

protected by formal institutions and the distribution of power. Informal institutions are used to enable different types of rent capture by organizationally powerful groups and these informally generated economic resources reinforce and sustain their holding power over time. Some of these rents are very damaging in comparison with alternative feasible ways of organizing society. But other rents, including redistributive rents may be essential for maintaining stability and preventing a descent into violence (Khan 2000b; North, et al. 2009). And finally, some rents even in these contexts may be playing a vital role in supporting the development of productive assets and technological capabilities (Khan 2000b, 2000a). Therefore, a perspective which sees all rents and all informality as a problem is not very useful in this context.

Clearly the diverse sources of power and the ways in which power is organized are much more important in developing countries and these differences can explain significant differences in the organization of the political settlement. An analysis of these differences can help to explain why countries have performed differently and can also inform the design of reform strategies that are more likely to be implemented and have positive effects in particular settlements. More controversially, perhaps, an understanding of political settlements can help reformers and political movements in developing countries discuss marginal and feasible changes in the organization of power that can assist their societies to sustain growth or achieve higher growth. We now discuss the mechanisms through which political settlements can constrain the operation of formal institutions in developing countries and then turn to a classification of political settlements.

5. The Political Settlement as a Constraint on Institutional Performance

We now turn from the analysis of a political settlement at the macro-level to the question of how a particular political settlement can affect the operation of particular institutions. At the macro-level, when we look at a society as a whole, it is unlikely that the overall institutional structure can produce a distribution of incomes that is significantly out of line with the distribution of holding power (Knight 1992). Nevertheless, if we drill down to particular institutions, the formal structure of some institutions may imply distributions of benefits that are significantly out of line with the distribution of power of groups involved in operating and contesting that institution. As a consequence, we are likely to see enforcement that may be unusually poor for these institutions, the participation of informal organizations in sharing benefits from particular formal institutions, or sustained low level conflicts at the level of particular institutions.

In addition, at the margin institutions are evolving and new institutions are being advocated by competing groups or by the state to further particular interests or in response to economic and political challenges. Proposed institutional changes do not always fully take into account the likely resistance to the implementation of the institution, and this resistance can determine the performance of these institutions and even whether they can be sustained over time. The partial implementation of formal institutions like property rights or industrial policies can explain significant differences in the development experience of countries.

The resistance of powerful groups can range from legal attempts to reverse institutional changes, non-compliance with rules at different levels of intensity and

ultimately engagement in conflicts in the form of withdrawals of investments, strikes and, in some cases, violence. As we summarized in Figure 6, if powerful groups oppose the implementation of a growth-enhancing institution, two types of results could follow. First, the institution could be partially enforced. Effectively, powerful groups would get a distribution of benefits more acceptable to them, but at the cost of subverting the expected economic outcomes. Secondly, the implementation of the institution could result in some political costs due to conflicts (transition costs) that reduce political stability. These two effects, partial enforcement and political instability, are enduring features of developing countries, and reflect the fact that institutional evolution and resistance are always going on. For a particular institution, resistance can be expected to continue till either the institution is withdrawn or till gradual changes in the underlying distribution of power bring the resistance to an end. In many cases, the reason why useful formal institutions appear to be missing is because their introduction would have resulted in significant resistance. This, rather than oversight or ignorance on the part of that society is often the problem. We discuss partial enforcement and the costs of political instability in turn.

Partial Enforcement

The standard explanations for the poor enforcement of formal institutions in developing countries focus on the weakness of governance agencies and sometimes also on prevailing cultures and norms. The alternative explanation focusing on the distribution of power supported by a political settlement is summarized in Figure 9. Institutions potentially have both efficiency and distribution effects. The standard analysis of institutions in the NIE looks primarily at the efficiency implications of formal institutional designs. This focuses on the incentive implications of institutions or the closely related analysis of the transaction costs of coordination, information collection and monitoring of free-riding behaviour under different institutions. This theoretical analysis can provide a useful starting point for an analysis of how institutions like particular allocations of property rights or types of firms could reduce transaction costs. The superiority of some institutions over others could depend on the economic characteristics of the problem defined by numbers of people who need to be coordinated, the nature of the technology and so on. But this analysis almost entirely ignores distribution and therefore the *political* problems of enforcing the ‘contracts’ implicit in these institutional arrangements. The purely theoretical efficiency effects of formal institutions that are the focus of NIE are shown as Arrow A in Figure 9.

In contrast, the distributive effects of the institution, typically ignored in the standard NIE analysis are shown along Arrow B. These may or may not be compatible with the existing distribution of power (defined by the political settlement) between the groups interested in the institution. This can result in more or less serious mobilizations against particular institutions along Arrow C. For the assessment of particular institutions, the distribution of power determined by the macro-level political settlement is an exogenous variable. If the resistance is significant, the economic costs of enforcing the institution will be high. The overall transaction costs of operating under the institution are therefore only partially defined by the analysis shown by Arrow A. The overall transaction costs also depend on the joint effects of Arrows B and C. If enforcement costs are high the overall efficiency of a theoretically efficient institution will be low, and it may not even be sustainable.

Part of the high enforcement cost may be hidden in informal transfers to organizations that are necessary to partially enforce the institution. The informal redistribution of benefits may have an indirect efficiency effect in terms of lower output. The loss in output is then the enforcement cost. But part of the enforcement costs may be very visible in direct conflicts that result in high enforcement costs and the response to this may be to accept poor enforcement. This effect can be described in a number of equivalent ways. If the enforcement is partial (violations are allowed), the loss in output can be a measure of the enforcement cost, and we can also describe this as an economic transition cost if we assume that these are costs that have to be borne as the system awaits better enforcement. In the broadest sense of transaction costs, all of these different aspects of enforcement costs are also transaction costs.

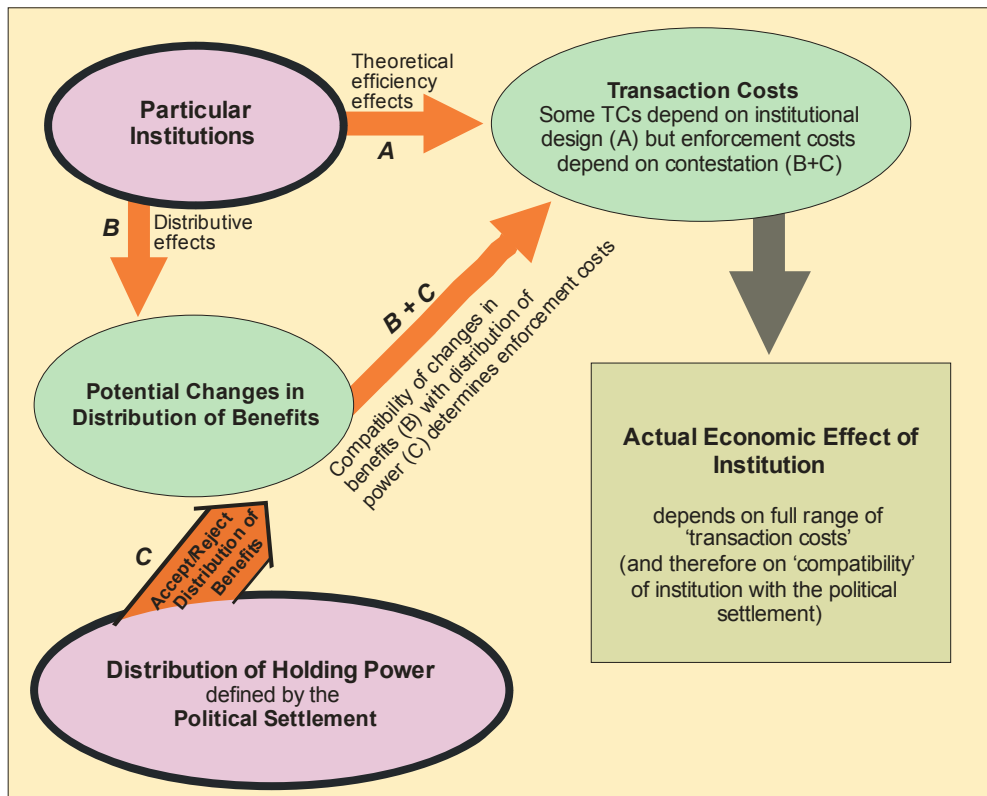


Figure 9 Power as a Constraint on the Operation of Particular Institutions

As an example, consider the simple free access problem where a number of people are using a common resource like a lake for fishing. Overfishing can result in a collapse of the fish stock. The institutional problem is to create incentives for responding to emerging scarcities as well as to create an authority with the power to limit levels of fishing beyond a sustainable level. In theory, the incentives and the authority could be created in a number of different ways that could work equally well. One possibility would be a private property right giving one individual the authority to make decisions about entry into the lake and giving that person ownership of the economic surplus from fishing. Other possibilities include different types of collective ownership. Ignoring transaction costs entirely may suggest that any institutional rule may be equally good. Here, the NIE analysis focusing on the theoretical transaction costs of institutions may suggest that some types of institutions may be better in some contexts. But a consideration of the social context of power and of enforcement costs may overturn the NIE analysis entirely.

Before the NIE came along, different institutional solutions to problems like free access appeared to be equivalent. The NIE analysis pointed out that this may not necessarily be the case because, for instance, an individual owner may face lower costs of making decisions and monitoring, compared to a collective which may have the additional problem of monitoring its own members attempting to free ride on collective decisions. This kind of analysis focuses on the transaction costs relevant for achieving efficiency along Arrow A. An analysis of these transaction costs was the significant contribution of the NIE.

However, this early institutional analysis was incomplete because it ignored the effects of possible conflicts over distributive outcomes shown by our arrows B and C. Returning to our example, individual ownership allocates most of the social gain from controlling overuse to one individual, while the fishing collective allocates the social gain more equally across a larger group of fishermen. Distribution is not just important for understanding the distributive justice of different solutions, but directly for understanding the efficacy with which the institutional rules themselves are likely to be implemented. This is because the institution will have to be implemented in an actually existing social context with a pre-existing distribution of power between the fishermen themselves and maybe other affected groups.

If this distribution of holding power is out of line with the distribution of benefits brought about by the proposed institution, resistance is likely to raise enforcement costs. The critical determinant of enforcement costs is the degree of incompatibility between the distribution of benefits described by Arrow B and the distribution of holding power described by Arrow C. Note that this analysis makes no assessment of the justice of the actual distribution, whether egalitarian or otherwise. That is a separate question that is also important, but institutional arrangements that achieve greater distributive justice will not necessarily be easier to enforce unless the underlying distribution of holding power is appropriate. The important point now is that our assessment of the economic implications of an institution has to take into account enforcement costs.

If the fishermen were initially more or less equal in terms of their 'holding power', an attempt to create private property rights for a single individual would result in significant contestation. The egalitarian distribution of power could be based on formal asset ownership or it could be that local fishermen belong to equally powerful informal networks. The allocation of significant benefits to a single individual in such a context would be out of line with that distribution of power. Contestation could take the form of the excluded fishermen violating the formal property right and continuing to fish as they had before or engaging in other forms of legal or illegal challenge. Instead of an efficiently enforced property right, the likely result would be some combination of partial enforcement and persistent contestation and transition costs.

Given a relatively diffuse distribution of power between the fishermen, collective ownership that shared benefits between all or most of the fishermen may face lower contestation and enforcement costs. As a result, the *overall* transaction costs for collective rights may be lower compared to individual rights, even accounting for the higher costs of reaching agreements and controlling internal free-riding under the formal decision-making rules of collective ownership. In contrast, if the political

settlement supported a very unequal distribution of local power, individual rights are more likely to be more efficient. If a particular individual had significantly greater holding power than others in the locality, an individual right for that individual may be enforceable at low cost. Other fishermen would have little to gain by contesting the property right, and even if they did, the contest would be likely to be over relatively quickly. In this case the individual right would be well-enforced and enforcement and transition costs would be low. The overall transaction costs would then indeed make individual rights the more efficient institution.

The overall effect of institutions on growth and efficiency can therefore depend on the compatibility or otherwise of the distribution of benefits with the distribution of power in that social and historical context. The macro-level analysis of a political settlement can provide insights into how formal and informal institutions sustain the holding power of different groups. This background sets the scene for the analysis of particular institutions. The extended analysis is more likely to explain differences in institutional performance across societies, as well as identifying the institutions most likely to assist growth in particular political settlements.

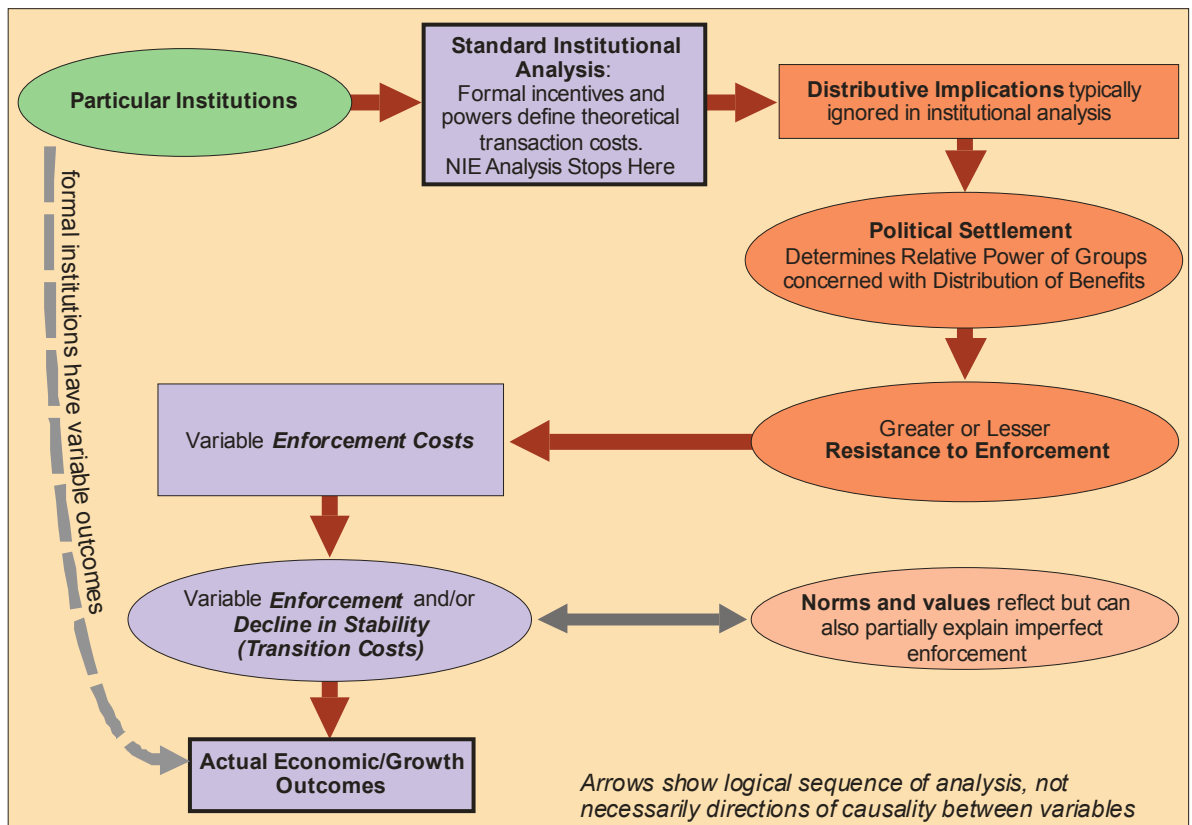


Figure 10 Political Settlements, Partial Enforcement and Institutional Performance

The standard analysis of institutions in NIE therefore needs to be extended to take into account the effects of differences in enforcement costs. Figure 10 summarizes a series of further steps that are required to develop the analysis of particular institutions and their economic outcomes. The NIE analysis of institutions stops with its efficiency analysis of formal rules in the first box in Figure 10. The analysis of formal incentives can suggest that some institutions are theoretically better than others in reducing

relevant transaction costs. However, this analysis is a first step and can be misleading on its own. We need to take into account enforcement costs, for which we need information about the political settlement at the social level. The further steps in the analysis summarize our argument so far. Figure 10 also spells out that resistance to enforcement can manifest itself in two different ways, sometimes simultaneously.

First, the institution may be imperfectly or partially enforced, resulting in poor results. This could happen because violations of rules cannot be consistently or successfully stopped. For instance, an insufficiently powerful individual may not be able to ensure that enforcement agencies enforce a formal property right. In this case, powerful groups exercise their informal power to directly appropriate benefits that should have been differently allocated according to the formal rules. The expected efficiency and growth effects of the formal institution may as a result fail to fully materialize. Partial enforcement could also take the form of formal owners voluntarily offering to share these benefits with powerful informal organizations to achieve better enforcement and protection of their formal rights. For instance, the enforcement of the right may require payments to informal networks. Once again, the rule is subverted compared to the formal rules but in this case the rule may appear to be better enforced. Nevertheless, the fact that benefits have to be informally shared means that once again, effective control over the stream of benefits is diluted and the efficiency and growth effects of the formal institution are negatively affected. Secondly, enforcement in a context of resistance may result in contestation and political costs. These transition costs can have an economic effect, but they often have directly political effects that *are* costs, but costs that cannot be reduced to economic values in a simple way. Partial enforcement and the transition costs of conflicts are jointly determined. We turn now to a discussion of the growth-stability trade-off along which different degrees of enforcement success and political transition costs are jointly determined.

The Growth-Stability Trade-off

The introduction of institutions that are incompatible with the interests of powerful groups can be expected to result in opposition and counter-mobilizations by these groups. The transition costs that powerful coalitions can inflict on those who are proposing the institutional change as well as on the general society have multiple dimensions. We include in our definition of these political transition costs all types of costs that a society can face as a result of organized ‘political’ resistance to the implementation and operation of particular institutions. The transition costs can be ‘measured’ by the degree to which stability declines. If the institution is a growth-enhancing one, we expect to observe a ‘growth-stability trade-off’ whose severity depends on the political settlement, the institution in question and the strategies the ruling coalition are pursuing in attempting to enforce the institution.

As there is always some margin for tolerating a decline in stability, some growth-enhancing institutions are always being introduced and partially enforced in most political settlements even if they are resisted by powerful groups. The severity of the decline in stability when improvements in growth are achieved determines the feasible limits to institutional change along the particular path being followed. Thus, the shape of the ‘growth-stability trade-off curve’ and the minimum level of stability that the society has to maintain are important determinants of the limits to institutional change possible in that society over the period in question. The shape of the trade-off

and changes over time are in turn determined by a number of variables and we will consider three important factors that will inform our subsequent analysis.

First, holding everything else constant, the shape and position of the trade-off depends on the political settlement, as the distribution of power determines the strength of resistance to particular institutional changes. The distribution of power is exogenous for the analysis of particular institutional changes but is not exogenous for society. It changes through social mobilizations, political activities creating new political organizations and coalitions, and the process of institutional change itself. Second, the shape of the trade-off depends on the strategies used while introducing the institutional changes. If powerful groups are bought off by sharing some of the benefits from the outset the trade-off is likely to be less steep compared to a strategy of confrontation. However, over time, different strategies may imply different movements of the trade-off curve, depending on the type of institutional strategy that is being implemented. For instance, in some cases early compromises with powerful groups can build up more serious problems later. Thirdly, the position of the trade-off curve over time can also depend on whether incremental or discontinuous changes in the institutional structure are being attempted. Discrete institutional changes focusing on specific institutional changes are likely to face more limited resistance while multiple changes can unite resisting coalitions. But this expectation too may be modified in particular political settlements. In general, though, incremental changes are more likely to be feasible as big changes increase the probability of different coalitions coming together to block change. Finally, with appropriate modifications, the trade-off analysis can also be used to compare institutional performance across countries in a more realistic way.

Political Settlements and the Trade-off Curve

The growth-stability trade-off shown in Figure 11 can only be defined with clearly specified initial conditions. The initial conditions are specified not only in terms of endowments, rights and technological capabilities but also in terms of the formal and informal institutions and organizations that describe the distribution of power in that society. It follows that growth-stability trade-offs are specified for periods when these initial conditions and in particular the distribution of power is relatively stable. A change in the distribution of power or in any of the other initial conditions can be expected to shift the trade-off curve. The institutional changes along a particular path have to be well defined as well as strategies through which incremental institutional changes are introduced. The resistance to particular institutional changes can be very different even in the same country depending on the sectors and the balance of interests affected and the organization and power of these interests. In our trade-off curves we will not be looking at the general problem of institutional change, or even the best path, but at specific paths defined either in comparison with other countries, or paths that are relevant for understanding the performance of actually existing institutions or paths defined by coalitions pushing for specific changes. With these conditions, we are interested in the increase in transition costs associated with incremental improvements in growth along a specific path of institutional change.

The vertical axis indirectly measures the political transition costs of institutional changes by showing the ordinal rank of institutional situations in terms of their implications for 'stability' as perceived by the ruling coalition responsible for the enforcement of institutions and therefore directly subject to transition costs. The

horizontal axis measures economic performance, in this case economic growth. Keeping all other variables fixed, incremental changes in institutions or incremental changes in the enforcement of existing institutions can improve growth. Both count as institutional change. If the resultant distribution of income is contested by powerful groups, higher growth could be associated with higher transition costs with obvious implications for stability as perceived by the ruling coalition. Our first proposition is that the more powerful the groups whose distributions of benefit are threatened by the institutional changes, the steeper the trade-off curve will be. Moreover, any exogenous strengthening (weakening) of these groups will result in the trade-off curve as whole moving towards (away from) the origin.

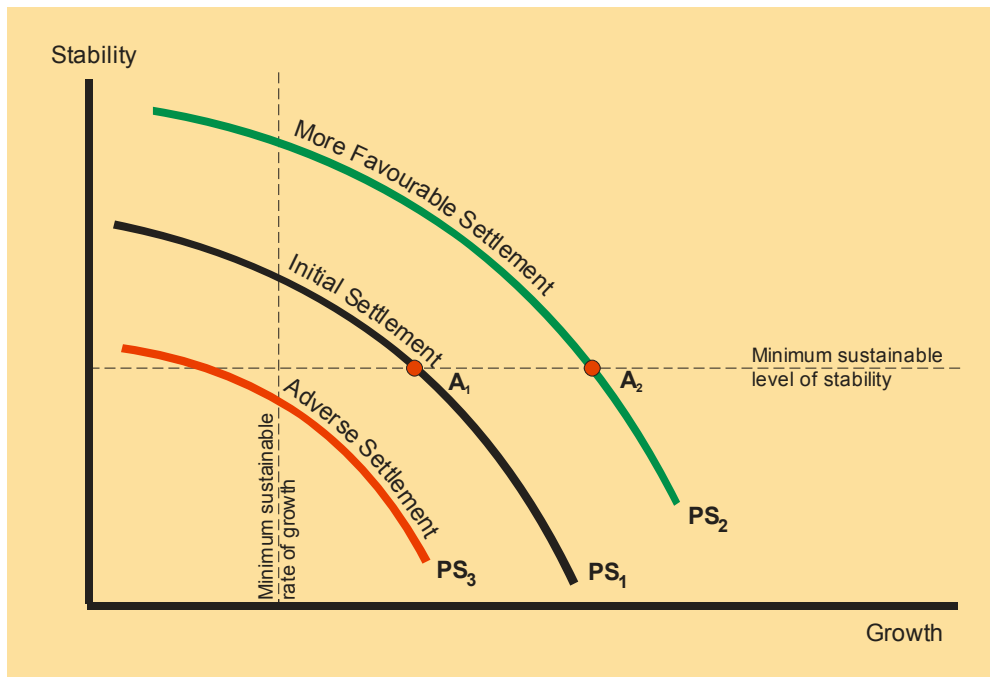


Figure 11 Effects of Different Political Settlements on Trade-offs

Transition costs are imposed primarily on the ruling coalition proposing the institutional change, but there are significant externalities, particularly in the case of violence, and transition costs in general are likely to affect much broader groups in society. An inclusive measure of all the dimensions of political conflict does not exist as transition costs can be inflicted through different mechanisms ranging from legal protests and mobilizations to violent conflict. Each of these mechanisms may inflict measurable transition costs, either specifically on the ruling coalition or more generally on society, in the form of days lost in strikes, the costs of different forms of violence and so on. But the different dimensions of transition costs are not necessarily commensurable and some dimensions may be more important than others in particular contexts. To enable comparisons across situations where the dominant transition costs are different, we use a general category of ‘stability’ to rank situations in terms of the most relevant transition costs appropriate to a particular institutional path.

We assume that the most significant transition costs along a particular path of institutional change can be identified (electoral risk for the ruling coalition, economic costs of strikes, human costs of violence, and so on). We also assume that we can ordinally rank transition costs along a specific path of institutional change in terms of

greater or lesser transition costs even if we cannot measure these transition costs directly. This is a plausible assumption in most cases, as opposed to the requirement of a cardinal measure of transition costs. The stability axis locates institutional situations by their rank in terms of the transition costs most relevant for that path of institutional change. Locations higher up the figure (higher stability) rank lower in terms of transition costs and vice versa. It is worth pointing out that the decline in political stability shown along any particular trade-off curve is not permanent, and refers only to the period of resistance to a specific institution or institutional change. Political stability can improve not only if the institutional change is reversed, it can also improve with the institutional change staying in place if the groups engaging in resistance give up. The latter implies the emergence or revelation of an incrementally different distribution of power.

The horizontal axis measures the actually achieved growth rate (or other measure of economic performance) associated with each institutional situation. Each point on a trade-off curve (shown as a continuous curve for convenience) therefore represents an institutional situation with an associated growth rate and measure of stability. The pace at which stability declines will clearly depend on the strength of the groups opposing the institutional change. If these coalitions are weak, the trade-off curve is more favourable (higher up and/or flatter), if they are strong, the trade-off may be very adverse (lower down and/or steeper). Changes in the strength of these coalitions will also result in shifts of the trade-off curve, as the same institutions will then be associated with greater or lesser effective resistance. Changes in the organization of the political settlement are therefore an important endogenous cause of shifts in the position of the trade-off curve for a particular society.

Depending on the particular political settlement, and the initial institutional situation, incremental improvements in institutions or their degree of enforcement to enhance economic outcomes is likely to face increasing resistance from adversely affected groups. This is because any institutional change or change in the degree of enforcement has implications for the distribution of benefits between affected parties. If we make the realistic assumption that strengthening the enforcement of formal rights is likely to negatively impact the incomes of informal coalitions who may have been involved in their (informal) enforcement or in otherwise determining institutional outcomes, we can expect these groups to organize increasing resistance to progress in these directions.

The ‘minimum sustainable level of stability’ in Figure 11 plays an important role in our analysis. This is the level of stability necessary for keeping together the different interests who define a political settlement. The minimum sustainable level relevant for a particular path of institutional change also depends on the political settlement and the identity of the groups supporting and opposing the direction of reform. For instance, if the resistance is being organized by coalitions on which the ruling coalition also depends, the minimum level of stability may be quite high. The minimum level of stability defines the point beyond which institutional change cannot be pushed without unravelling either the ruling coalition or the political settlement as a whole. Crossing this point in some situations could simply mean an electoral defeat for the representatives of a particular policy. In other contexts it could mean levels of protest and violence that induce the ruling coalition to abandon its attempts. In extreme cases violence could escalate out of control and the political settlement could

itself unravel. Once this happens, the trade-off curve can collapse because the society can descend into significantly greater degrees of conflict and violence. A political settlement also requires a minimum level of economic performance to sustain itself. If economic performance falls below this level the distributive arrangements that sustain the political settlement are also likely to unravel as powerful groups may engage in new mobilizations to ensure that their economic interests are protected.

In Figure 11, the maximum growth that can be achieved with the initial political settlement PS_1 is at point A_1 . If a change in the distribution of power weakened the coalitions resisting institutional change, and the political settlement moved to a more favourable position like PS_2 , this would allow higher growth to be achieved at A_2 along the same path of incremental institutional changes. On the other hand, if an autonomous change in the political settlement resulted in the trade-off curve to move to PS_3 the society would find itself in an unsustainable position because it would not be able to satisfy its minimum economic and stability conditions simultaneously. A settlement like this is likely to unwind into crisis and conflict till a new distribution of power emerges that allows the minimum economic and political viability conditions to be satisfied.

Implementation Strategies and the Slope of the Trade-off Curve

The slope of the trade-off curve can also depend on the strategies that the implementing coalition adopts in response to the resistance they face. Here, there are many dynamic possibilities and only a few instances will be discussed to illustrate. A strategy based on confrontation with the organizations resisting the changes will result in a much steeper trade-off curve to begin with and therefore very limited feasible improvements in the growth rate. In Figure 12, the confrontation strategy results in a steep initial trade-off curve PS_1 , and as a result growth can initially only be safely increased from A_1 to A_2 . (We will discuss later why big institutional changes that take society close to minimum stability conditions can also be dangerous). The high contestation costs and the relatively low growth that is achieved at A_2 are obviously the costs of a strategy where concessions are not made (or very limited concessions are made) to the informal organizations resisting the institutional changes. On the other hand, if the organizations resisting these changes give up their resistance, the positive outcome in this case is that the trade-off curve can move up to PS_2 , and stability improves to A_3 , allowing further growth-enhancing institutional changes in the subsequent period.

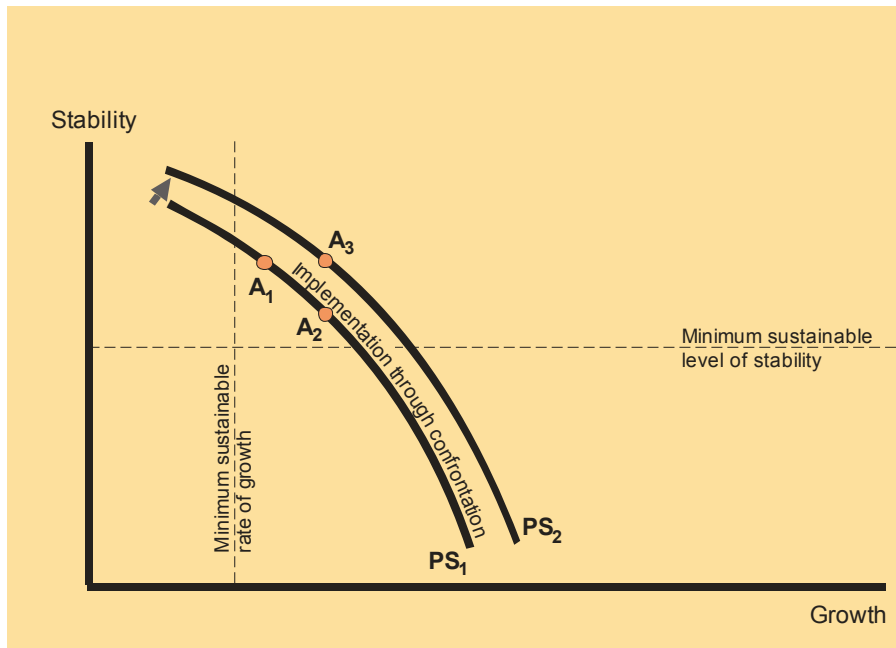


Figure 12 Trade-offs in Confrontation Strategies

In contrast, if concessions are offered very early on to powerful groups, the trade-off could initially be much flatter and may achieve more rapid improvements in growth as a result. For instance, some organizations or networks could be co-opted with benefits in exchange for their support in managing and enforcing the institution. In Figure 13, growth can increase from A_1 to A_2 with virtually no decline in stability. For some growth-enhancing institutions, sharing some benefits with powerful enforcers may not have seriously negative effects on efficiency. For instance, if informal organizations are given a role in protecting property rights, the efficiency of property rights may not seriously decline as a result.

However, for some institutions, the *non-involvement* of powerful groups in the management of the rules may be necessary for their future efficiency. For instance, if industrial policy support is introduced in such a way that powerful groups benefit unconditionally or they are given a say in the allocation of industrial policy support, the effects may be quite different. In the early stages of industrial policy, the participation of powerful groups in determining the allocation of subsidies or in sharing benefits may not be too damaging. This would be the case if at first new production plants are being set up and growth is driven largely by the creation of new capacities. However, the achievement of competitiveness through learning soon depends on how effectively banks and other governance agencies can enforce conditions on subsidy-recipients. Early compromises which involved power brokers in the 'protection' of these subsidies may make disciplining very difficult if not impossible later. This is because any re-allocation to achieve greater incentives and compulsions for learning would be strongly and effectively contested.

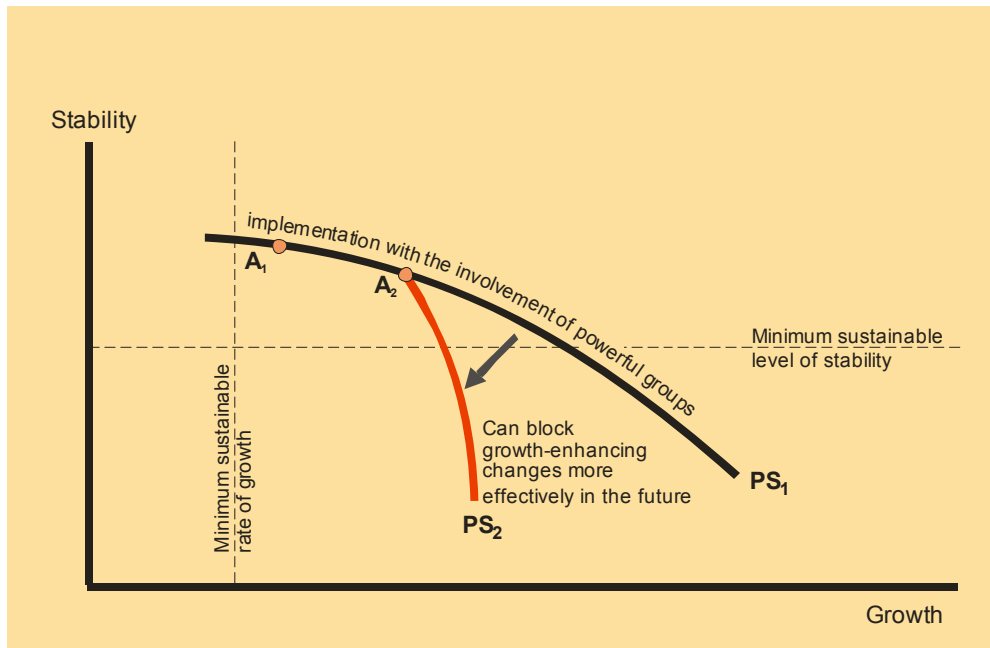


Figure 13 Trade-offs with Significant Implementation Compromises

The result could be that a strategy of early compromises can result in a significant worsening of the trade-off curve to PS_2 in Figure 13 for some types of institutions. If this happens, the favourable trade-off achieved through compromise could turn out to be misleading because sustaining growth could be virtually ruled out. For these types of institutions, taking on powerful groups during the process of implementation may be necessary for dynamic efficiency. This also means incremental changes are more appropriate in these cases, along the lines of Figure 12. Thus, the dynamic effects of different types of compromises can have important effects on economic outcomes. For institutions like industrial policy, growth effects may not be sustainable unless the political redistributions required for stability can be organized in a way that does not hinder the re-allocation of particular subsidies. In our case studies, a common problem across countries was that early compromises were made in the implementation of industrial policy interventions. Given the nature of their political settlements, a gradual roll-out focusing on a small number of applications of industrial policy at a time may have been far more beneficial over time.

Incremental versus Discontinuous Changes

The political settlement and the trade-offs possible are neither exogenous for a society nor constant. The political settlement is evolving at the margin and therefore the shape and position of the trade-off curve can also shift *as a result of* institutional strategies. Changes in the political settlement can happen for a number of reasons. The most important is that autonomous changes in political organizations and new political mobilizations can change the distribution of power and alter the position of the trade-off curve. We will see in our case studies that autonomous changes in political mobilizations have often had important effects on institutional performance and the prospects of institutional change. For instance, if groups who are resisting institutional change become stronger as a result of autonomous changes in political organizations, the trade-off curve can become more adverse, moving towards the origin and/or becoming steeper. Conversely, a shift in organizational strength that weakens these groups in relative terms can shift the trade-off away from the origin or make it flatter.

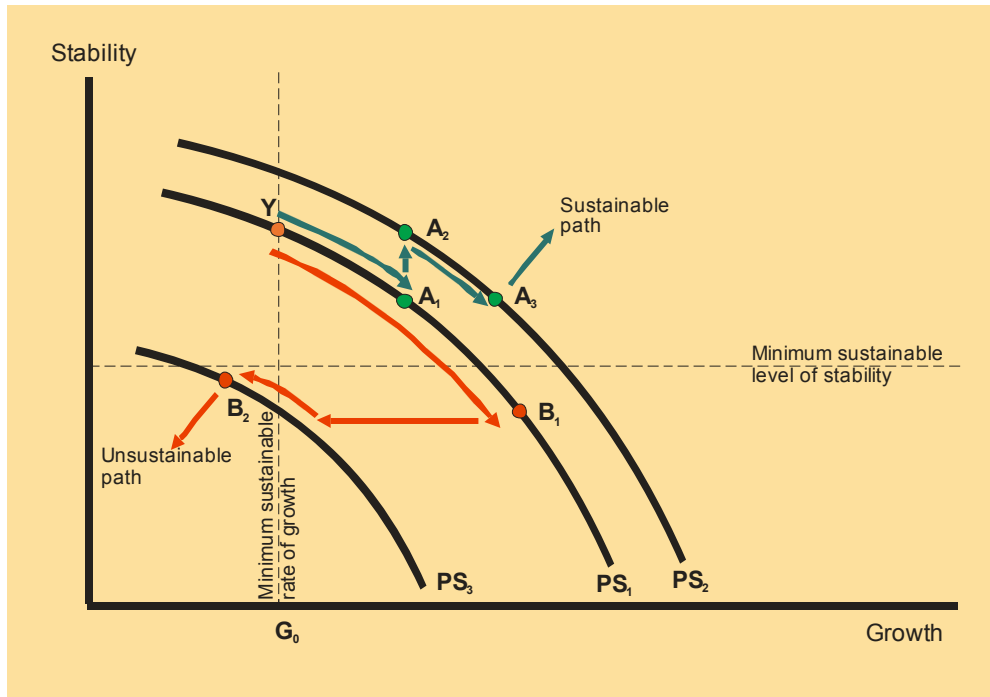


Figure 14 Incremental versus Discontinuous Institutional Changes

The political settlement can also change directly as a result of institutional strategies. The trade-off curves at any time describe the costs of contestation along specific paths. But if the process of institutional change succeeds, the contestation will end and the new streams of benefits created by the institutional change will eventually change the distribution of power. Alternatively, if the institutional change is badly organized and provokes a coalition of interests against it, the defeat of the growth-promoting coalition is likely to establish an even more adverse distribution of power from the perspective of growth. In a dynamic analysis we need to take these effects into account, particularly since historically many developing countries have suffered by attempting ambitious policies whose reversal set them back much more significantly than the reversal of the policies themselves. The framework discussed here provides a method for analysing dynamic effects like these where the political settlement can itself change as a result of success or failure in incremental institutional changes. Figure 14 shows two divergent paths of progress, though by no means the only possibilities. One path is sustainable and positive, the other leads to a collapse of the political settlement.

Consider a society initially at Y, achieving the minimum level of economic growth, G_0 , required to sustain system stability. Social coalitions who may benefit from growth begin to push for institutional changes to achieve higher growth. In the first trajectory, incremental changes in institutions take the society to A_1 but no further institutional changes are attempted in this period. In the first scenario there is opposition to this level of change, it lasts for some time, but it eventually dissipates. How long this takes can vary significantly across contexts, depending on the calculations of the losers about the impact of their defeat on their future bargaining ability. A retreat *will* weaken them but given the small stakes they may find it very difficult to sustain their coalitions and alliances. Conversely, the successful

institutionalization of a new stream of benefits once the resistance ends can enhance the relative power of the growth coalition in subsequent rounds.

When the resistance ends, the trade-off curve shifts up to PS_2 because the incremental institutional change can now be sustained without the transition costs. This has significant dynamic implications. Thus, the improvement in the trade-off curve initially manifests itself as an improvement in stability to A_2 . But the shift in the trade-off curve as a result of an incremental evolution in the political settlement means that further institutional changes along the previous lines are now possible along a better trade-off. In the second period, a further move along this evolutionary path to A_3 may be possible. Incremental institutional changes along this path can therefore become sustainable and growth enhancing.

In contrast, the same society could end up in a deep crisis if the initial strategy was pushed too far, say to B_1 , where stability declines below the minimum stability conditions. This is shown as an alternative trajectory in the figure. This could happen if the institutional changes were not divisible or if political miscalculations were made. Here there is a significant increase in transition costs and an equivalent decline in stability. With the stakes very high, resistance to growth-enhancing institutional changes can be intense and can persist. The contestants can become rapidly stronger as a result of the high degree of instability undermining the political settlement itself. A defeat for the supporters of this institutional change in this case has an adverse effect on the political settlement, which can result in the trade-off curve moving down to PS_3 . Of course, this is not a necessary outcome. Supporters of big bang approaches to institutional change would argue that a big change followed by a confrontation is the only way to defeat the opposition to change. If they are right, the conflict ends in a significant upward shift of the trade-off curve. However, the configuration of forces in most developing countries means that a significant institutional change that sought to create growth-enhancing formal institutions very rapidly would threaten too many powerful interests at the same time to be a winnable fight.

Figure 14 shows a particularly adverse outcome of an attempted discontinuous change where the shift in the political settlement destroys the political settlement. No part of the new trade-off curve satisfies the minimum growth and stability conditions required to sustain the political settlement. Retrogressive institutional changes are likely (to B_2) but minimum viability conditions cannot be achieved. The political settlement is most likely to unravel in a serious crisis, perhaps with significant violence till a new set of more sustainable institutional and political compromises emerge. The framework thus provides a systematic structure for analysing historical experiences and discussing the likely characteristics of different reform trajectories in particular countries on the basis of what we know about the organization of their political settlements. The collapse of the Pakistani political settlement in the late 1960s with the collapse of its industrial policy and the secession of East Pakistan had some of these stylized characteristics. One conclusion that emerges from these types of historical experiences is that in countries where the political settlement is unfavourable and fragile, feasible reform is likely to have to be incremental. In these cases, it is important to look for 'divisible' reforms where growth can be enhanced without the requirement of big bangs or ambitious industrial policies.

Comparisons across Countries

With some modifications this framework can be used to explain why institutional change appears to be much easier in some countries compared to others. The relevant differences may have a lot to do with the shape of the growth-stability trade-offs facing two different growth-enhancing institutional paths. As political stability is an ordinal ranking, we can compare societies by scaling their trade-off curves such that the minimum sustainable level of political stability is set at the same level in a diagram. But this does not mean that the absolute transition costs are at the same level. It also follows that the ordinal ranking of stability only make sense for comparing situations in a particular society at a particular time. Comparing the levels of two curves showing different countries on an ordinal scale does not tell us that one country has a higher or lower absolute level of stability than the other at any point. On the other hand, growth is a measurable characteristic and a country ranking higher than another in terms of growth obviously actually has a higher growth rate. In the example shown in Figure 15, both societies are assumed to initially have the same low growth rate G_0 , which is marginally higher than the minimum required for sustaining their political settlements.

In the diagram, the maximum growth that is achievable for country 1 is lower than that for country 2 even in the absence of any political constraints. For instance, in country 1 the evolutionary path being considered could be incremental changes in land rights as part of an agrarian strategy for accelerating growth. In country 2 the path may show incremental improvements in rules for providing industrial credit for technology acquisition. Of interest to us now is that in both countries incremental institutional reforms are likely to stop well before the maximum potential because of political constraints. The shape of the trade-off curves shows what happens to political stability as institutional reforms are incrementally implemented and enforced. The rate at which stability declines can determine the extent of feasible reform given the minimum level of stability that has to be sustained.

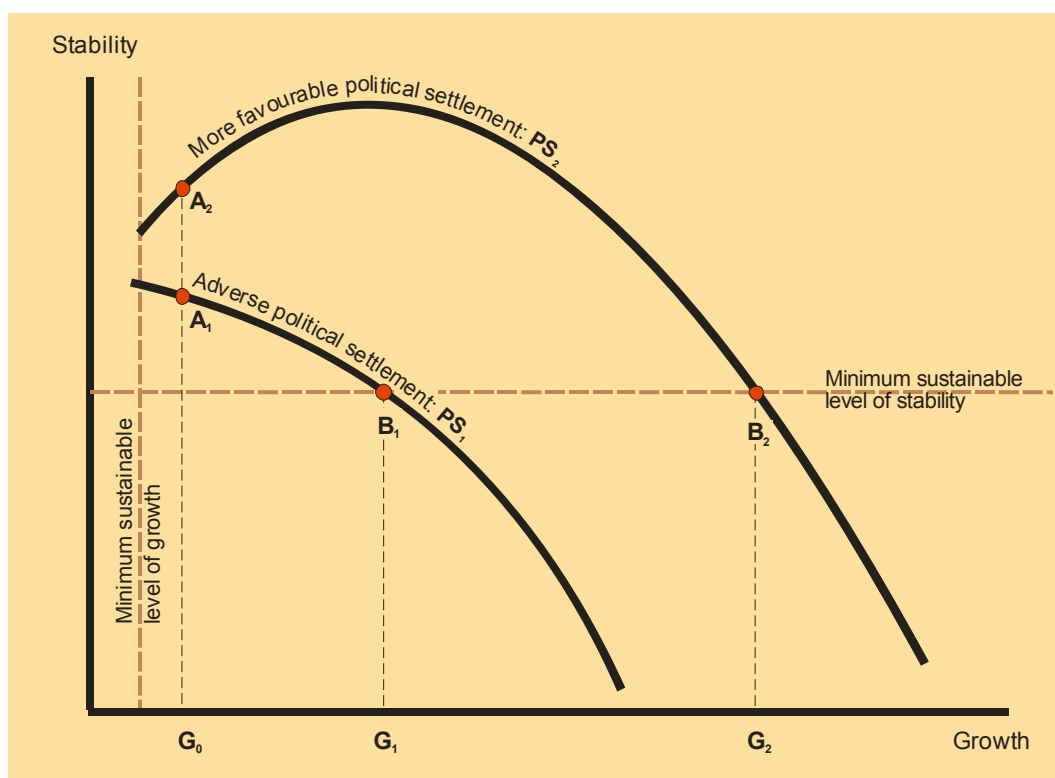


Figure 15 Trade-off Comparisons across Countries

The first society has the more adverse growth-stability trade-off given its political settlement, PS_1 . From its initial position of A_1 it is only able to reach B_1 in the period under consideration before the minimum stability requirement blocks further incremental improvements. Its growth rate can therefore only be enhanced to G_1 . Of course there is no necessary compulsion for growth to even reach G_1 because there may be no pressure on policy-makers or other interested parties to push reform to B_1 . But the latter is the point at which incremental institutional reform along this path is likely to stop were it to be pushed to its limit. The growth rate G_1 is not necessarily the highest growth rate that this society could ever achieve, nor is the decline in political stability a permanent one. Both the political settlement and the ruling coalition can change over time, and different strategies of institutional reform may face different trade-offs. One of the policy implications of our approach is to make us more aware of the alternatives.

In contrast, in the second society the political settlement offers a more favourable trade-off curve, PS_2 . Here, from the initial situation A_2 , institutional reform can proceed to B_2 , achieving a higher growth rate of G_2 . In the diagram shown in Figure 15, institutional changes in the direction of higher growth initially result in *greater* political stability in this society. This may happen if the institutional changes initially benefit groups that are relatively stronger in terms of holding power. If powerful productive groups had been actively campaigning for these changes, their implementation can have a positive effect on stability. Nevertheless, the continuation of incremental changes in the direction of higher growth eventually reduces political stability as we are still assuming this is a developing country with strong informal organizations attempting to maintain their relative distributions of benefits. The rate of decline is more gradual reflecting a different distribution of power, allowing a

higher growth rate to be achieved than the first society. One of the important conclusions of this type of analysis is that the achievement of a move to B_1 in country 1 implies just as much political skill and reform effort as a move to B_2 in country 2. Comparing the achievements of different countries and the seriousness of their reform efforts without an understanding of their political settlements can be seriously misleading.

An analysis of the political settlement can enhance our understanding of institutional performance and processes of institutional change in a number of ways. First, it tells us that the theoretical analysis of institutional efficiency can be misleading without looking at the enforcement costs of different institutions, which are specific to particular political settlements. Institutions which appear to be second-best in theory could actually be first-best in particular settlements. Secondly, the analysis tells us that there are real costs of institutional change measured by transition costs. As societies face very different growth-stability trade-offs, their strategies of reform have to be appropriately different. Countries with unfavourable trade-offs can achieve significant policy successes and yet achieve lower growth. This is not necessarily a problem and indeed attempts to push countries with vulnerable and unfavourable political settlements to adopt ambitious policies can either lead to inaction or even worse, to a collapse. Most importantly, an understanding of the political settlement can help us to discuss the likely impact of different compromises through which growth is sustained. These compromises can in some cases make further growth-enhancing changes much more difficult.

Thus, a better understanding of how the political settlement is constructed in particular contexts can help to identify more promising paths of institutional change. A focus on the political settlement does *not* imply that societies with more adverse political settlements are doomed to suffer persistent poverty. Differences in the distribution of power are not entirely exogenous. While it is not at all responsible to suggest that political settlements can be recast in entirely new ways, political and organizational activity can (and historically have) changed the organization and distribution of power in significant ways that enabled better growth. Political organizations and movements in developing countries need a language and an analytical framework for examining the consequences of different types of political mobilization and organization.

This is particularly important given that the analysis of political mobilization is often articulated in broad populist discourses of empowering the poor or the 'citizens'. However well-meaning, general support for democratization and accountability comes from a Weberian good governance model of politics that has repeatedly shown itself to be unimplementable in the political settlement of developing countries (Khan 2005b). A growth-enhancing agenda requires a different set of analytical tools and categories for engaging in discussions about the changes in the distribution of organizational power that may be growth promoting. If the growth-stability trade-off facing a society is very adverse, a language and analytical framework for discussing the sources of resistance to growth can be useful in assisting social mobilizations that seek to construct alternative developmental coalitions of power.

Feasible changes in the political settlement through endogenous political activity in a developing country will certainly *not* result in the emergence of a Weberian state, and

the expectation that it will can set inappropriate priorities and agendas that result in wasted opportunities. However, feasible changes may enable the emergence of a different combination of formal and informal power that is more conducive for growth. In some societies the political settlement is indeed so unfavourable for growth that attempts to restructure some of the organizations sustaining the settlement (and thereby making some feasible changes in the organization of the political settlement) may be an important precondition for triggering or sustaining growth. An understanding of political settlements in developing countries tells us that a technocratic focus on improving ‘good governance capabilities’ of enforcing a rule of law or trying to significantly improve accountability through reform may be wasting opportunities if taken too seriously. The case of the 2007-2009 Emergency government in Bangladesh (discussed later in our case study section), which wasted a precious moment of opportunity in a futile attempt to achieve good governance and root out political corruption is a case in point.

6. A Typology of Political Settlements

The relationship between power and institutions can differ significantly across countries and over time. While differences between political settlements can be classified according to different criteria, we will focus on i) whether holding power is primarily based on formal institutions or not and ii) whether formal institutions are growth-enhancing or not. This allows us to broadly classify political settlements into four types summarized in Figure 16. First, we define a *capitalist political settlement* where holding power is (to a large extent) aligned with formal rights and institutions, and the latter largely define productive capitalist property rights. This *potentially* allows the capitalist political settlement to have ‘Weberian’ characteristics defined as impersonal and rule-following adherence to formal institutions, though this is by no means observed in every case.

Secondly, we have a very broad group of *clientelist political settlements* which characterize contemporary developing countries. Here significant sources of holding power are *not* aligned with formal institutions. In this case there is a structural problem with the operation of formal institutions according to their own stated rules. As a result (though there may be other supporting reasons as well) formal institutions do not operate in impersonal and rule-following ways and their operation is constrained by the exercise of personalized power. This category covers a wide range of institutional forms ranging from military rule to clientelistic party competition in ‘democracies’. These differences are important and will be discussed later. But they share a common characteristic. Power that is *not* formally institutionalized plays an important role in allocative decisions. Clientelist political settlements also vary greatly in terms of the economic outcomes that they achieve, and this can range from developmental states to states that are on the verge of crisis. However, even in developmental states which appear to have some characteristics of rule-following in resource allocation, the rule-following is typically at the discretion of the executive and is not substantially institutionalized in formal rules. The fact that power may be used systematically in a developmental sense in some ‘clientelist political settlements’ does not thereby make them rule-following impersonal systems.

	Formal Institutions Potentially Support Growth	Formal Institutions are not growth-oriented or have collapsed
Holding power aligned with Formal Institutions	‘Capitalist’ Political Settlement: Formal productive rights dominate as associated incomes are the dominant source of holding power. Formal rights are well enforced, constraining the range of distributive conflicts.	Pre-Capitalist Political Settlements: Variants of feudalism with formal land and military rights aligned with distributions of political-military power.
Significant sources of Holding Power not aligned with Formal Institutions	‘Clientelist’ Political Settlements: Formal productive rights exist but are not well enforced. Powerful groups can influence economic outcomes irrespective of their formal rights. Ranges from developmental states to societies on the verge of crisis.	Political Settlements in Crisis: Formal institutions have virtually collapsed and most informal ‘economic’ activity is supported by or based on the threat or exercise of violence.

Figure 16 A Typology of Political Settlements

Third, we have another group that we describe as *pre-capitalist political settlements* which were historically stable but which generated low growth. Power was aligned to a much greater extent with formal institutions but these institutions were generally not growth-enhancing. Tax collection by military-feudal elites is an example. Clientelist political settlements typically arise out of the collapse of pre-capitalist political settlements. New institutional experiments and social forces emerge, but there is no teleology necessarily taking these countries in the direction of capitalist political settlements. Much depends on the distribution of power between contesting groups in transitional situations. If the distribution of power results in accumulation and investment in productive ways that are gradually formalized we observe a transition in the direction towards the more formal and ‘capitalist’ type of political settlement. If the productive transformation is slow, the ‘clientelist’ phase can continue indefinitely. In some cases, the existing level of formal rights and the rule of law can be undermined to the extent that the settlement falls into a sustained crisis.

This takes us to our fourth and final category where the political settlement is breaking up into significant political instability and violence, and we characterize these as *settlements in crisis*. Here, formal rights have effectively collapsed and cannot be substantially enforced. All or most activity now depends on informal protection by violence specialists and in the worst cases the latter can engage in serious predation, leading these societies into a downward spiral. Our main interest is in the broad group of political settlements characterized as ‘clientelist’. The terms capitalist and clientelist are problematic because they have been used in many different ways. But there is also some merit in using terms that are recognizable and defining them in more specific ways rather than inventing an entirely new terminology.

The Capitalist Political Settlement

Formal institutions appear to work well in advanced countries that are often recognized as having broadly ‘capitalist’ characteristics. We can now define the characteristics of political settlements of advanced countries that make them so different from the perspective of our analysis. A capitalist political settlement requires not just the presence of some pockets of capitalist property rights in an economy, but

the dominance of capitalist profits compared to other sources of holding power. Dominance means that were there to be a conflict, owners of capitalist property rights normally could not be fundamentally challenged by other organized groups. By normal, we are referring to non-revolutionary situations. When the owners of formal rights are politically dominant, the property rights that sustain capitalist production are obviously effective rights that can be enforced by the state at relatively low enforcement cost. Potential contestants now know that in general they have insufficient holding power compared to the beneficiaries of these rights. This is only likely to happen if the capitalist rights are in general substantially productive and the owners of the associated rights can therefore deploy significant resources to sustain their benefits both directly in the context of conflicts, and indirectly through taxes paid to the state to protect these formal rights. When holding power based on the profits of productive asset owners with formal rights is sufficient to sustain their underlying rights, we have a capitalist political settlement. This does not mean there are no distributive conflicts in a capitalist political settlement. Indeed there are, and they are discussed below, but the power of capitalists, workers and other groups are primarily defined by their respective formal rights and incomes which define the main contours of the distribution of holding power in a capitalist society.

The dominance of capitalist rights is not the same as having a section of the economy operating under capitalist principles. If the protection of capitalist rights requires access to holding power and resources generated in the non-capitalist sector, a capitalist political settlement does not yet exist, even if the capitalist sector is significantly large. A capitalist political settlement does not imply an industrial society. Eighteenth century England arguably already had a capitalist political settlement in our sense even though it was still significantly agrarian. The capitalist political settlement is rather a description of the dominance of productive formal institutions in terms of holding power. Private asset owners operating productive operations in this settlement have the holding power to protect their formal rights from potential contestants because the incomes they generate are substantial enough to dominate other sources of holding power. Under these circumstances, holding power will be aligned with the core formal institutions of the economy, private property being the most significant of these institutions.

If formal rights do not provide sufficient incomes to the primary beneficiaries of these rights to ensure their dominance as the most powerful class, the political settlement is not yet capitalist even if the capitalist sector is large. The characterization of the institutions of capitalism as productive does not imply that they are always so, nor that other types of formal institutions cannot be productive. The capitalist political settlement is not necessarily Weberian, but the emergence of a capitalist political settlement is likely to be necessary for a state with Weberian characteristics to function. The capitalist political settlement ensures that formal institutions can be effectively enforced. The Weberian state requires in addition that the enforcement of formal institutions is based on an impersonal rule of law that can be sustained for most if not all citizens.

A capitalist political settlement is necessary but not sufficient for a Weberian state because the latter requires the effective enforcement of formal rules and something more besides. A capitalist political settlement could simply enforce the rights of capitalists without the generalization of a rule of law. This is likely if the distribution

of capitalist assets is very narrow and the rest of the population is so significantly weak that property right holders can effectively enforce their rights without any informal distributive arrangements with the rest of society. Logically, a capitalist political settlement is necessary but not sufficient for a Weberian rule of law to emerge. However, if productive capitalist productive rights are relatively widely dispersed, a Weberian rule of law becomes much more likely. For instance, Germany towards the end of the nineteenth century arguably had a capitalist political settlement without the dispersed capitalism that would enable it to establish a self-sustaining rule of law state.

The protection of formal rights in societies where formal capitalist rights are widely dispersed and substantially productive means that the effective protection provided by the state is likely to become impersonal at some point. Impersonality is simply the enforcement of formal rights without reference to the identity of the holder of the right. As the number of individuals and organizations with productive formal rights increases, and there are resources to enforce these rights because they are in general productive, at some point the enforcement of formal rights acquires the characteristics of a general and impersonal rule of law. If property owners are satisfied that their property rights can be protected through a rule of law enforced by the state, they will collectively have an interest in ensuring that the rule of law is not violated because this undermines the system of protection enjoyed by all property owners. At this point a Weberian rule of law becomes self-sustaining and many formal rights may be substantively protected for all citizens. The Open Access Order identified by North, Wallis and Weingast (North, et al. 2009) has the characteristics of a rule of law state. Our analysis suggests that this is because they are implicitly describing capitalist political settlements where the capitalist rights are sufficiently dispersed to enable the emergence of a general rule of law, though their explanation for the emergence of these characteristics focuses on different factors.

The dominance of the holding power of property right holders in the capitalist political settlement does not mean that other classes and groups are unable to get any redistribution in these political settlements. Political compromises remain necessary and can result in significant redistributions of income. But once property rights become well-protected and well-defined, redistributions can only take place through formal mechanisms like taxes and subsidies that can be generally applied and distributed to generally defined groups. Any system of 'taxation' that targets specific owners of property undermines the protection of the system of property rights and are therefore likely to be resisted given the assumption of the dominance of the holding power of the beneficiaries of formal rights. Thus, redistribution in capitalist political settlements can be significant but always takes the form of collective formal redistribution, where both taxes and subsidies are defined by general rules along the lines of a welfare state. These types of redistributions are clearly possible and sustainable. Those who are taxed still resist, but their resistance to redistributive taxation is not absolute as there is also a collective self-interest of property owners in maintaining political stability. The significant difference is that maintaining stability in a capitalist political settlement does not have to undermine the operation of formal institutions, because the redistribution can itself be conducted through formal institutions like taxes, and the limits are set by political and economic acceptability of the redistributions from the perspective of property owners.

All formal institutions in a capitalist political settlement are not necessarily growth-sustaining. However, the distinction between capitalist and pre-capitalist political settlements that we will look at later is that in the capitalist settlement not only do the beneficiaries of formal institutions have incomes based on rights that give them adequate holding power; their formal rights are substantially productive and growth-sustaining. In pre-capitalist political settlements formal rights also sustain considerable holding power for holders of formal rights but the latter do not have to be substantially productive. This is partly because in pre-capitalist political settlements, some of the formal rights of the dominant classes included non-economic rights such as the differential right to bear arms. This ensured that the beneficiaries of these rights, like the landed or tax-collecting classes could sustain their formal rights on the basis of the holding power created directly by a set of rights that did not have to be significantly growth-enhancing. In contrast, capitalist property rights primarily confer economic advantages to the beneficiaries of these rights as long as they are productive. Unless these rights are capable of generating significant profits, the beneficiaries are unlikely to be able to pay for their protection and are likely to lose assets through bankruptcy.

The institutional reforms that are normally discussed in the context of the ‘good governance’ debate effectively assume that some variant of a *capitalist political settlement* already exists in the countries that are being discussed. This is because the agenda of attempting to create a self-sustaining Weberian state must implicitly make the assumption that formal rules can be effectively enforced with technocratic and bureaucratic reforms that improve the governance capabilities of enforcement. But if the productive sector with formal rights is not productive enough to generate enough resources to dominant society politically, the project will fail as it repeatedly has in developing countries. One of the many weaknesses of the good governance agenda is that it does not recognize that Weberian characteristics can logically only be self-sustaining once a society has a widely dispersed and yet substantially productive set of property rights.

Long before this becomes a viable reform strategy, the focus of reform has to be on feasible incremental reforms that enhance the capacity of a productive sector operating in political settlements with very different characteristics. The focus on market efficiency as the objective of institutional reform is also misleading in contexts where a broad-based productive sector does not already exist. The economic challenge in these contexts is to promote and nurture the capabilities that may make such a sector more likely (Khan 2005b, 2005a, 2007). The critical formal institutions that are essential for growth are likely to be rights and rules that create the opportunities for setting up new enterprises and creating credible opportunities and compulsions for productivity growth and learning (Khan 2008, 2009a, 2009b; Khan and Blankenburg 2009).

But even as an end-state, the implicit model of the capitalist political settlement is not a good guide for understanding institutional and policy priorities in developing countries in the interim. A desirable characteristic of institutional development may well be the *eventual* emergence of impersonal and rule-following governance agencies that enforce formal rules. This does not necessarily tell us very much about the feasible incremental steps that may eventually take us there. Indeed, incremental changes in governance capabilities that attempt to build impersonal and rule-

following enforcement of formal rules in a context where this cannot be done may at best represent a waste of resources and reform opportunities and at worst create new conflicts and contestation in already vulnerable societies.

The full characteristics of a capitalist political settlement emerge very gradually. Most developing countries have significant capitalist features but are far from having the characteristics that define a capitalist political settlement. Only relatively advanced developing countries where the capitalist sector is both substantially productive and economically dominant are moving towards a capitalist political settlement. Differences in class structures and organizational and economic strengths mean that there are significant differences between countries with broadly capitalist political settlements. The distributive compromises between classes, the formal institutions through which distributive compromises are achieved (for instance welfare state structures or their absence) can differ significantly between countries, with implications for formal institutions. We will not be looking any further at these differences as our main interest is to establish the broad difference between the capitalist and clientelist political settlements.

The credibly superior holding power of capitalists in a capitalist political settlement ensures that distributive conflicts with other groups, and in particular labour, normally stay within the economic and political tolerance limits of dominant economic interests. The latter have greater holding power because they have greater economic resources and their institutionally strategic positions in production and investment means they have a significant capability of signalling dissatisfaction with distributive outcomes by withdrawing or slowing down investments. Demands from other classes for redistribution are therefore likely to be calibrated to ensure that capitalist dissatisfaction does not exceed their tolerance limits (though these are flexible and the norms of acceptability can change over time). Occasionally serious distributive conflicts do break out and as always there is always some openness in the outcomes of conflicts so significant gains can occasionally be made by non-capitalist classes. But most often, conflicts re-establish the asymmetric holding power of the dominant classes. In general, this means that the capitalist political settlement is able to sustain the enforcement of its formal institutions through apparently open and unrestricted political competition (Khan 2005b).

Clientelist Political Settlements

In contrast to the capitalist political settlement, many existing formal institutions in developing countries are often not enforced or are only partially enforced. Most developing countries have many of the formal features of advanced countries: they have property rights, they have courts enforcing these rights through a rule of law, and they often have institutions of democracy. But formal institutions here do not behave in the expected ways nor are they impersonally implemented in *any* developing country. This observation is systematic and cuts across differences in culture, history and economic structure. The dominance of ‘personalized’ or informal exercises of power in these countries supports our broad description of these countries as ‘clientelist’. A society has a clientelist political settlement according to our definition when significant holding power is based on sources *outside* the incomes generated by formal institutions. There are important differences between the clientelist and capitalist political settlements with implications for the analysis of institutions and governance. There are also important differences between different types of clientelist

political settlements which have significant implications for the performance of specific institutions and the growth-stability trade-offs facing their implementation.

Significant holding power in developing countries can be based on organizational capabilities, for instance of 'intermediate class' elites who organize clients and use them in political confrontations. This holding power is by definition not aligned with benefits generated by formal institutions. On the contrary, these groups can only capture benefits and sustain their power over time by using informal organizations and/or informal rules to distribute benefits to themselves. These include the use of informal organizations like patron-client networks and the capture of informal incomes like off-budget resources, land, and other types of rents that are created through the exercise of informal political power. Informal power can also be used to change formal laws to benefit groups who would otherwise not have benefited. The existence of these processes means that the protection and enforcement of existing formal institutions is constrained and necessarily so. The apparent economic power of emerging modern sectors with formal rights and the broad distribution of political power are therefore significantly out of line in developing countries, a feature of the transitions they are going through.

Given the balance of holding power, the incomes and rights of the beneficiaries of formal institutions can be effectively challenged through informal processes. Beneficiaries of formal institutions often have to strike informal compromises to (partially) enforce their formal rights. In addition, to distinguish our clientelist political settlement from societies in crisis, we specify that the formal institutions, though partially enforced, are potentially productive and the formal economy is not in overall collapse. This does not mean that an economy with a clientelist political settlement is growing rapidly, though it may be. But we want to distinguish as a separate category the relatively small number of developing country societies where the formal institutional structure has entirely or very largely collapsed and economic activity is in the hands of 'warlords'.

Clientelist political settlements characterize developing countries during their relatively long periods of transition from traditional forms of formal economic and political organization towards modern capitalist forms of social organization. This period of transition does not mean that all these societies are making progress at the same pace, or even that they will all eventually achieve some variant of a capitalist economy. The transition is simply a description of the fact that one set of formal 'pre-capitalist' institutions have broken down and a significant range of new formal institutions that sustain a productive capitalist economy have not yet become self-sustaining. The mismatch between the organization of political power and the formal organization of the emerging economy is explained by the fact that formal rights do not yet describe the operation of a significant enough productive sector such that incomes flowing from these rights constitute the dominant sources of holding power.

A significant part of holding power in clientelist political settlements is based outside the tiny emerging productive sectors. This holding power is often based on control over political processes and organizational capabilities that allow factions to threaten significant costs on society if they are not allowed to capture informal benefits. The sources and organization of political and organizational power have different histories in different countries. At the same time, in most developing countries there are

parallel and often very strong imperatives to develop the new productive sectors and the formal institutions that go with these sectors. Political processes of accumulation supported by informal power often create potential entrepreneurs who find that sustaining their privileges over time requires formal rights as well as informal support to make these formal rights effective and viable. As a result, these societies have a range of formal institutions that are in principle growth-enhancing though their operation may be more or less modified through different types of informal networks.

Our use of the term ‘clientelist’ should be distinguished from existing usages in a number of ways. First, many standard explanations of personalized power in developing countries refer to primordial loyalties or deference supported by culture, the insecurity of the poor, or the absence of democracy (Eisenstadt 1973; Engerman and Sokoloff 2002; Médard 2002; Barbone, et al. 2006). Instead, we have a very general definition that looks for a mismatch between existing distributions of holding power and the structure of formal institutions. Our explanation of the informality that emerges in these contexts can incorporate a wide variety of exercises of power in developing countries that are responsible for the gap between the expected operation of formal rules and their actual operation. This is potentially an advantage because narrower explanations of personalized transactions cannot explain the general observation of some variant of personalized or non-formal power in *all* developing countries regardless of their political institutions, cultures and social histories. However, the specific social, cultural and economic characteristics of societies can of course explain important differences in the manifestations of personalized power.

Secondly, we do not use the term ‘clientelist political settlement’ to describe any particular institutional structure or form of government or any specific set of outcomes. The group of countries that could be characterized as having clientelist political settlements is very diverse and ranges from military dictatorships to party-based democracies in developing countries. They also include very high growth converging countries operating variants of industrial policy and countries with forms of clientelism that stifle growth and which are diverging rapidly from advanced countries. We will discuss these important differences later. Nevertheless, we do not expect an impersonal and broad-based rule of law in *any* clientelist political settlement.

Even the partial enforcement of formal rules in these contexts requires compromises with organizers of informal power. The latter are not always standing in the way of productive activities, though they often may be. In some cases informal power is used to radically accelerate productive accumulation and technology acquisition, and in these cases we have very rapid developmental transitions. These differences are very important for understanding why the good governance approach and its essentially Weberian benchmarks can be misleading as an analytical framework for informing governance priorities and feasible directions of reform in developing countries. These reforms may be desirable but they are most unlikely to be enforceable. The reform approach must be to devise incremental improvements in institutions and governance capabilities for enforcement that make sense in particular clientelist political settlements. In particular, the goal has to be to try and align informal power with productive outcomes so that an eventual formalization of institutions becomes more likely.

The significant feature of a clientelist political settlement from the perspective of institutional analysis is therefore that informal holding power modifies the operation of formal institutions and influences the allocation of resources through informal institutions and political discretion. For instance, informality can modify the operation of important formal institutions, giving many formal institutions informal characteristics. Similarly, the enforcement of formal rights may require payments to informal enforcers, making the enforcement of formal rights informal. Or important allocative decisions may directly be made by informal organizations like patron-client factions according to informal institutional ‘rules’. These and other related aspects of informality in clientelist political settlements can be related to the fact that significant sources of holding power exist outside the incomes generated by formal institutions.

The sources of holding power in different clientelist political settlements cannot be generalized, but they can be described in historical narratives of how different groups and factions were organized to manage societies in the aftermath of the collapse of pre-capitalist empires. During this transition, the emerging capitalist sector is, by definition, not yet economically or politically dominant. Nor are the dominant property owners of the pre-existing economic system still able to politically and organizationally dominate these societies. A significant component of holding power was therefore transferred to organizations led by various groups of ‘intermediate’ class organizations. In many cases, their modes of organization and social legitimacy can be traced back to the colonial period and colonial strategies of constructing administrative and political classes to manage empire.

The intermediate classes (but not only these classes) have organizational power because they are most successful in these contexts in organizing factions with holding power that can be deployed in political mobilizations. Implicitly, patron-client factions in developing countries claim access the resources by threatening to use their holding power to engage in conflicts. How the power of competing factions is organized and deployed is likely to be significant in determining the outcomes of conflicts over institutional enforcement and resource allocation. Differences in the structure of patron-client networks across countries can therefore tell us something about the distribution of power and these differences are likely to matter significantly. We will examine aspects of these differences later.

The organization of patron-client networks have been influenced in many cases by colonial strategies of managing the empire. Colonial strategies of political stabilization had significant and lasting effects on organizational structures in many developing countries. Colonial authorities often selectively recognized the ‘rights’ of organizationally powerful groups as a method of political stabilization and as part of divide and rule strategies (Khan 2009a). These strategies often also involved the promotion of new administrative and political groups as part of political stabilization strategies. Arbitrary interventions in rights have therefore long been a part of ‘modern’ state formation strategies followed by colonial states. Nevertheless, differences in these strategies across countries have meant that the development of formal and informal organizations followed different paths across countries (Kohli 1994; Khan 2000a).

It follows that an analysis of the distribution of informally based holding power cannot be identified in an abstract analysis. We have to see the distribution and

organization of holding power in clientelist political settlements as a historically evolving process where power is embedded in organizations like patron-client organizations, political parties and different types of social movements. The structure and organization of these activities differ significantly across countries and the evolution of these differences can tell us something about the distribution of holding power that is being sustained and protected through informal organizations. An examination of patron-client networks will play an important role in our subsequent analysis as a way of capturing important aspects of the distribution of holding power in developing countries.

The informal distributive arrangements achieved through the operation of informal organizations like patron-client factions are not necessarily dysfunctional in the context of the clientelist political settlement. Indeed, these distributive arrangements may be required for maintaining a stable social order provided economic progress can also be ensured. Indeed, in some cases critical growth-enhancing formal institutions can be effectively enforced and informal power structures can also assist the process of accumulation and technology acquisition. Some clientelist political settlements have therefore achieved staggering success in organizing growth and social transformation because growth was aligned with the interests of powerful groups. Growth at this pace in turn changes the distribution of power and enables a gradual strengthening of formal growth-sustaining institutions. In the most dynamic cases, clientelist political settlements were gradually transformed into capitalist political settlements. Countries like South Korea or Taiwan would fall into these transformational categories.

However, in other cases, the distribution of informal power may be more unfortunate. In these societies growth-enhancing formal institutions may be enforced in ways that damage growth and even these may be few and far between. Attempts to accelerate growth in these contexts can confront strong resistance and declining political stability. Growth in these settlements may be episodic and vulnerable. In the most serious cases, clientelist political settlements may collapse into a category we describe as ‘political settlements in crisis’. Differences in the ways in which political settlements are put together may help to explain some of the differences in institutional performance between developing countries. *While all developing countries have clientelist political settlements, these settlements are substantially different across countries, and change over time within a country, while retaining the broad characteristics of a clientelist settlement.* Our task in subsequent sections will be to define critical differences between clientelist political settlements that can explain differences in institutional performance and in the growth-stability trade-offs they faced.

Our analysis of clientelist political settlement has some similarities with the Limited Access Orders identified by North et al. (2009). In both cases, the social order does not have the rule of law characteristics of the Weberian system. However, in our case there are significant variations possible within the broad clientelist political settlement that do not correspond with the categorization of ‘fragile’, ‘basic’ and ‘mature’ orders in the North, Wallis and Weingast framework. Our distinctions between more and less developmental clientelist political settlements are based on using a framework of patron-client organizational differences that are discussed below. Moreover, our framework does not identify the same ‘doorstep conditions’ for a transition to the

Open Access Order. The most important difference is that in our analysis the development and dispersion of productive ‘capitalist’ organizations is critical for the dominance of formal power that is a precondition for the emergence of a capitalist political settlement. Nevertheless, the significance of the North, Wallis and Weingast analysis is that they too recognize the presence of structural factors that make developing societies different from rule of law Open Access Orders, with the implication that non-Weberian characteristics are neither immediately rectifiable nor necessarily ‘pathological’.

Pre-capitalist Political Settlements

The two other variants of political settlements in Figure 16 are also important but will receive less attention here. The first are *pre-capitalist political settlements*. These describe an earlier historical period. In developing countries this was typically the period before the colonial impact. Here holding power was based to a large extent on the formal rights of dominant groups (such as feudal and military rights of the landed and military classes). The formal rights of ruling groups in these political settlements were typically aligned with their holding power based on their military and organizational capabilities. But formal institutions in these social orders were typically not growth-enhancing and their primary function was to maintain a relatively static status quo. The pace of technical progress was consequently much slower than in the capitalist order that followed. This places pre-capitalist political settlements in the top right-hand corner of Figure 16.

Even though these political settlements were relatively stable historically, they were facing internal disintegration in many parts of the developing world with the growth of internal trading and artisanal manufacturing. In the Indian subcontinent this began to happen as early as the eighteenth century. But the real collapse of pre-capitalist political settlements in the developing world happened in the face of military and economic competition with more productive capitalist societies. Pre-capitalist economic structures and their political settlements by and large collapsed in the developing world as a result of the intrusion of economically more advanced countries during the colonial period. The military defeat of traditional pre-capitalist rulers by European competitors led to the emergence of colonial empires that lasted till the mid-twentieth century or later in most parts of the developing world.

The long period of ‘transition’ that began with the defeat of the pre-capitalist political settlements is in a sense still continuing today. The collapse of these settlements meant that pockets of formal rights appropriate for a new economic and social order were set up, but large pools of organized power inconsistent with these rights remained. The colonial authorities managed these potential sources of threat through various mechanisms, but in particular through the tolerance of organizational activities through which the most entrepreneurial, and therefore potentially dangerous organizers, were sequentially absorbed by being provided with a share of the rents that the formal state controlled. These rather simple mechanisms of absorbing and dealing with informal sources of power have become more complex over time. The transfer of political power to independent states after decolonization meant that the organization of informal power became even more important as a source of rents as ruling coalitions needed the organizational abilities of powerful organizers to construct their ruling coalitions.

Political Settlements in Crisis

The last variant is that of *political settlements in crisis*. This category describes situations where existing political settlements are breaking down perhaps to be reconstructed in new ways. Here, formal institutions have broken down to a significant extent and can no longer assist in the coordination of productive economic activity. Informal political power is correspondingly even more important and given the collapse of formal institutions, is clearly not aligned with formal institutions. A crisis in a political settlement can begin either because political stability declines below the minimum sustainable level or because the minimum level of economic wellbeing or growth cannot be sustained. The latter can in turn reduce political stability further. In the early stages of a crisis the political settlement can occasionally be challenged by outbreaks of political instability or even violence that exceed normal levels and threaten to take the political and economic system further below its minimum tolerable levels of economic performance and political stability.

However, the political settlement in crisis emerges with a substantial unravelling of the clientelist political settlement. The social order begins to break down with outbreaks of sustained violence that can be described as civil war. A political settlement is truly *in crisis* when the previous political settlement has broken down and the society has descended into widespread violence. A breakdown implies that the social compromises and informal arrangements that enabled some formal institutions and the modern productive sector to operate have themselves broken down. 'Widespread violence' is a somewhat malleable term, but it is necessary for the definition because considerable violence can characterize large parts of any developing country, including apparently stable clientelist political settlements like India. There is clearly a grey area because violence at the fringes can increase considerably without a political settlement breaking down. But clearly, as violence increases, a breakdown is likely to happen at some point when the balance of power between classes, groups and factions can no longer be sustained with reference to existing formal and informal institutions. A new political order has to emerge and the non-viability of the previous order is signalled by the emergence of the crisis.

In terms of Figure 16, holding power in this context is even less aligned with formal institutions because the link between benefits based on formal rights and actual holding power is likely to have significantly broken down. A variety of military and organizational capabilities will be deployed by groups during the crisis to establish a new distribution of power but the holding power of these organizations not likely to be based on formal rights. At the same time the formal institutions that existed are not likely to be growth-enhancing in these contexts for the simple reason that organized production is likely to have broken down. Instead, the bulk of the economic resources sustaining conflict in these contexts are likely to be derived from grey or criminal economic activities like smuggling, organized crime, drugs, diamonds, funding from foreign powers, and protection rackets. This places political settlements in crisis at the bottom right hand corner of Figure 16.

The escalation of conflict and violence that lead to the collapse of a political settlement can follow from a combination of inconsistent aspirations of different groups and their failure to judge the true holding power of their opponents. This can easily happen if the holding power of different groups and factions was already closely matched and no group is ready to give up in its desire to establish dominance

over others. The minimum economic and political viability conditions that define a viable political settlement can rapidly collapse in this case, often with significant negative consequences for many groups particularly the most vulnerable. The periods of crisis can be brief or long-lasting, till a distribution of power emerges that can be sustained with a combination of formal and informal institutions that meets both the minimum stability and economic viability conditions for that society. Once this happens, some variant of a clientelist political settlement will once again emerge. The restructuring of the political settlement that takes place in these situations can in turn have long-lasting effects on economic and institutional developments in the social order that emerges.

7. Patron-Client Networks

We are particularly interested in the different ways in which clientelist political settlements can be structured and the implications of these revealed differences in the distribution of power for institutional performance and growth-stability trade-offs. Subtle differences in the distribution of power within clientelist political settlements can be very important for understanding institutional outcomes. While the economic sources of holding power can be relatively easily observed (income and wealth differences), the sources of organizational holding power (organizational capabilities, legitimacy, and so on) are much more difficult to assess *ex ante*. If our analysis required a metric to assess organizational capabilities and holding power *ex ante*, its applicability would be limited. Fortunately, the exercise of informal power is typically reflected in and operates through observable formal and informal organizational structures like patron-client networks, political parties and other organizations. Observations of the structure and operations of these formal and informal organizations can provide critical information about characteristics of the underlying distribution of power that can in turn inform our analysis of institutional performance and institutional evolution.

In developing countries, the informal networks used by powerful groups to generate and protect benefits can be generically described as ‘patron-client networks’. Any informal relationship or organization that involves individuals with different degrees of power can be broadly described as some variant of a patron-client relationship. There are systematic hierarchies and exchanges in these relationships but they are ‘personalized’ because they are not formal contracts that can be enforced by the application of a ‘rule of law’. Patron-client relationships can clearly include a wide variety of relationships through which power is exercised. The goals of patrons and clients, their relative power, and the distribution of benefits they achieve can all vary widely. These networks can operate directly as informal networks or within formal organizations like political parties. As mechanisms through which power is exercised, the typical patron-client network involves a patron as an organizer of power organizing groups of clients who offer their organizational support in exchange for benefits that the patron offers. The organizational power that this type of patron-client network can deploy is an important explanation of why they are able to capture and sustain significant rents in developing countries, often through their involvement in the protection and operation of formal institutions.

Patron-client networks that are deployed to bargain for or preserve informal distributions of benefits are typically organized as factions or collections of factions.

Bigger factions are typically coalitions of smaller factions organized by a higher-level patron. Both factions and coalitions of factions are typically organized as pyramids. At the lowest level, a faction in many developing countries consists of a patron with a group of followers who are locally powerful individuals. Collectively, they appropriate a share of benefits from the local economy by engaging in local enforcement and dispute resolution activities. Sometimes this also crosses the line into expropriation and the extraction of protection money. Bigger patron-client organizations are typically pyramidal organizations of lower-level factions. Here patrons at higher levels organize factions or clients below them to provide them with bargaining power in contests with other equivalent groups or factions for more significant rents. For instance, bigger factions may be constructed to participate in electoral contests. The enforcement or operation of formal institutions may in turn require that particular individuals or organizations are able to access patron-client organizations at the appropriate level to influence the operation of these institutions for a price.

Patrons are typically more enterprising or powerful political entrepreneurs at each level who can mobilize significant groups of clients below them to capture rents and resources for their particular factions at that level. Clients lower down the factional ladder provide the organizational muscle to patrons higher up the pyramid for a share of the rents distributed downwards within the faction. The modern patron-client faction is therefore constructed on the basis of a rational calculation of interests by both patrons and clients and has little to do with traditional deference or cultural values. The class identity of patrons and clients can vary significantly across societies as can the organization of factions and the distribution of power within them. Finally, the ideological symbols that are used to mobilize people and distinguish factions from each other obviously also vary significantly. The fact that factions are often distinguished using traditional cultural symbols like caste, religion or tribe can serve to confuse the fact that these are typically opportunistic arrangements. Patrons are typically unable to keep their factions together unless they are successful in generating rents that they can distribute down the network, and clients are always ready to redefine their allegiances if other factions offer them higher rewards.

Differences in the organization and structure of patron-client networks are likely to reflect differences in the productive organization of societies, differences in their organizational and political histories and differences in their colonial histories. Dominant political organizers in different countries may come from different economic backgrounds and mobilize groups from different backgrounds and organized around different signposts. Factions can be organized along ethnic, religious, tribal, caste or ideological lines; they can be large or small, centralized or fragmented, with strong or weak patrons and so on. The number of competing factions can also differ, affecting the competitive structure in politics and the possibility of coordination across factions. All these variations have important consequences for the ways in which conflicts over rents are organized in different societies and we will summarize some of these differences and the likely effects later.

A number of features of the political competition in developing countries support this interpretation of politics as driven by patron-client organizations. First, political parties in developing countries are typically multi-class organizations that bring together a large number of pyramidal patron-client factions in a pyramidal structure.

Secondly, members of the “intermediate” classes dominate the organizational leadership of these factions. These groups have the capacity to organize factions and therefore it is not surprising that they should play a critical role in the organization of patron-client politics. Factions are very rarely *led* by capitalists and almost never by workers, the landless or poor peasants. Thus even though strong class divisions and class interests exist in developing countries, in most cases and for most of the time, the dominant political organizations represent factional and not class interests. This reflects the fact that factional politics gives feasible access to much more significant rents to the most organizationally powerful groups compared to class politics.

These observations reflect the fact that the classes that occupy an intermediate position in society, often collectively described as the intermediate classes, dominate developing countries in terms of organizational power. The term was popularized by Kalecki (1972) who noted that the urban petty bourgeoisie, rich peasants and state bureaucrats politically dominated post-independence India. Our use of the term differs somewhat from Kalecki. We include a broader group of classes in the category, which we treat as a residual to describe classes that are not capitalist, working class (including the unemployed) or poor peasant (who are at, or close to, subsistence levels). The precise sections of the intermediate classes that are most relevant in particular developing countries can vary significantly depending on their economic and social histories. Nor do we want to say, like Kalecki, that these classes have some shared economic interests that Kalecki thought resulted in their support for an ‘*intermediate regime*’ promoting non-capitalist development. Rather, our intention in identifying these classes is simply to point out that the polar classes do not dominate organizational politics. On the other hand, the intermediate classes too do not act as classes. They simply provide tens of thousands of recruits for leading and organizing factional politics at different levels of society. The economic policies the state follows cannot simply be read off from this fact, and here we differ from Kalecki. The tension between the redistributive demands coming from factional politics and the imperative of ensuring economic growth largely through the capitalist sector can result in sharp shifts in state policy. The state controlled by different patron-client factions has sometimes followed dramatically pro-capitalist policies, and at other times has almost destroyed capitalism.

Our broader definition of the intermediate classes includes rich peasants, middle peasants, the urban petty-bourgeoisie and the educated “middle class”, both employed and unemployed. While these classes have different interests, it is not surprising that they should have collectively provided a significant proportion of the political entrepreneurs of recent history. Compared to workers, poor peasants and the illiterate unemployed, they have a relatively high degree of organizational ability based on their *relatively* high levels of education and wealth. Secondly, though still a relatively small fraction of the population, they are far more numerous than capitalists and large landlords whose numbers are numerically insignificant in most developing countries, and who therefore do not play a central organizational role in politics. Nor is capitalism so developed that the capitalist class can dominate politics indirectly by exercising their purchasing power. The important point is that while political entrepreneurs *from* the intermediate classes play a key role in political organization, it is not the case that the intermediate classes dominate the political scene *as classes*. Thus the political dominance of the intermediate classes can also be interpreted as reflecting the incomplete transition to capitalism.

For Weber too, pre-capitalist societies were characterized by variants of patron-client relationships, but for very different reasons. Weber contrasted the “rational” bureaucratic form of governance seen in modern capitalism with traditional forms of authority in pre-capitalist societies. Patrimonial rule was identified as one of the most important of these pre-capitalist forms of governance, where allegiance to a leader was based on personal loyalty and traditional legitimacy (Weber 1978: 1006-110). What we describe as informality is explained in Weber’s framework by the importance in patrimonial societies of authority exercised by “charismatic” leaders. As charisma entails allegiance to a person and not to an office, by definition, the exercise of power in these societies has to be informal.

While Weber has inspired contemporary sociologists to look for personalized authority exercised through patron-client networks, the patron-client networks we observe in contemporary developing countries are typically not based on traditional legitimacy or charismatic authority. On the contrary, the “contract” between patrons and clients is often surprisingly modern and rational. It is based on an exchange of organizational muscle for material benefits and is readily re-negotiated if clients (or indeed entire factions) are offered better terms by other patrons. Neo-Weberians recognize that modern patron-client relationships are based on the exchange of favours and rewards, and are no longer typically based on charisma or traditional authority. However, they explain the persistence of personalized power in neo-patrimonial models in terms of the weakness of formal structures of democracy that allows patrons to maintain their privileged access to power and rents (Médard 2002).

Weber’s analysis is also different from ours in its underlying analysis of the economy. What interests Weber is the arbitrary and unpredictable nature of patrimonial rule, which he contrasts with the formal and predictable nature of bureaucratic rule. Capitalism, he argues, requires the rule-governed predictability of bureaucratic governance. The arbitrariness of patrimonialism stifles capitalism by lowering investment and preventing long-term planning by capitalists. It also encourages patrimonial rulers to arbitrarily favour their clients by granting them monopolies. Since this description has an uncanny resemblance to features of governance in contemporary developing countries, Weber’s analysis of patrimonialism has informed a new interest in the deleterious effects of patron-client networks and of ‘poor governance’.

Despite its apparent fit with some observations of the governance problem in developing countries, Weber’s analysis is misleading because it conflates the functional requirements of advanced capitalism with an analysis of the constraints and requirements of the period of transition during which capitalism is being created and institutionalized in developing countries. No advanced country organized this process of transition by first successfully institutionalizing a bureaucracy that would pass the test of impersonality and modernity at a time when its productive sectors were still based primarily on, say, peasant or handicraft production. Nor has any country succeeded in institutionalizing an effective rule of law protecting all property rights and contracts without significant incomes generated by a formal modern sector that are sufficient to pay for the enforcement of a general rule of law as a public good. Most developing countries are far away from meeting these entry conditions to formality. Periods of transition between the collapse of formal pre-capitalist systems

and the emergence of a modern capitalist economy have always been characterized by significant levels of ‘personalized’ or informal interventions and institutions despite the presence of pockets of modern capitalist economies. The relevant question is why these arbitrary processes (in the sense of not being strictly rule-following) have led to the growth of capitalist sectors and eventually a successful transition to a rule of law economy in a few countries but not in many others.

We want to extract from observations of patron-client structures important dimensions of the distribution of power that are relevant for understanding institutional performance and growth-stability trade-offs in developing countries. Patron-client structures can throw light on two important dimensions of differences between political settlements, though these are not necessarily the only important dimensions that may be important.

First, the organizational structure of patron-client factions that are involved in forming the ruling coalition of a country clearly matters. The distribution of power between the ruling coalition and excluded factions, and (within the ruling coalition) between higher and lower level factions, tells us something about the likely time horizon of the political leadership and their ability to enforce decisions. If excluded factions are weak, the ruling coalition is likely to take a longer-term view, as their incumbency is more secure. In addition if the lower level factions on whom the ruling coalition depends are easy to control, the ruling coalition is more likely to be able enforce decisions.

Secondly, the capabilities and relative power of productive entrepreneurs within patron-client networks can vary significantly. The relative power of productive interests and their technological and entrepreneurial capabilities can determine the incentives and opportunities of ruling coalitions to pursue particular institutional paths. We now look at these important dimensions of the political settlement that the organization of patron-client factions can shed light on and suggest how they might affect the general characteristics of political settlements in clientelist contexts.

Patron-Client Organizations and the Structure of the Ruling Coalition

An important set of variations in the type of clientelist political settlement can be related to the organization of the ruling coalition. The classification in Figure 17 distinguishes between two dimensions along which ruling coalitions can differ from each other. First, we look at the power of factions excluded from the ruling coalition relative to the ruling coalition. Secondly, we look at the internal distribution of power within the factions that constitute the ruling coalition, in particular between higher and lower levels. These dimensions are important for understanding the likely time horizon of the ruling coalition and its implementation capacities. These ‘political’ differences may be more important than differences in formal political institutions. Clearly, formal political institutions like the institutions of democracy and representation are important. However, a focus on formal institutions can often hide more significant differences in the informal distributions of power affecting the ruling coalition, with more significant effects on the enforcement and operation of formal institutions.

Returning to our two dimensions of interest in the ruling coalition, the first is the ‘horizontal distribution of power’. This describes the power of excluded coalitions

relative to the ruling coalition. If excluded coalitions are weak, the ruling coalition is likely to feel secure and act with a longer time horizon. This means that the interests of the ruling coalition are more likely to be aligned with growth and development. Clearly, there is a range of variation possible here, with the power of excluded coalitions ranging from very weak to being almost as powerful as the ruling coalition. At its limit, if excluded coalitions become more powerful than the ruling coalition, the latter is unlikely to survive. Relative strength can be assessed by looking at the organization and strategies of excluded organizations, the success with which they have engaged in conflicts and the informal and formal distributions of benefits that they have been able to achieve. Excluded coalitions can be weak for different reasons. The most benign possibility is that all or almost all powerful coalitions have been incorporated within the ruling coalition. It could also be that the distribution of power across factions was unequal and factions within the ruling coalition are significantly more powerful because of legitimacy, organizational capabilities or other characteristics. Finally, excluded groups could be potentially strong but temporarily repressed by the ruling coalition. The latter is obviously less sustainable over time.

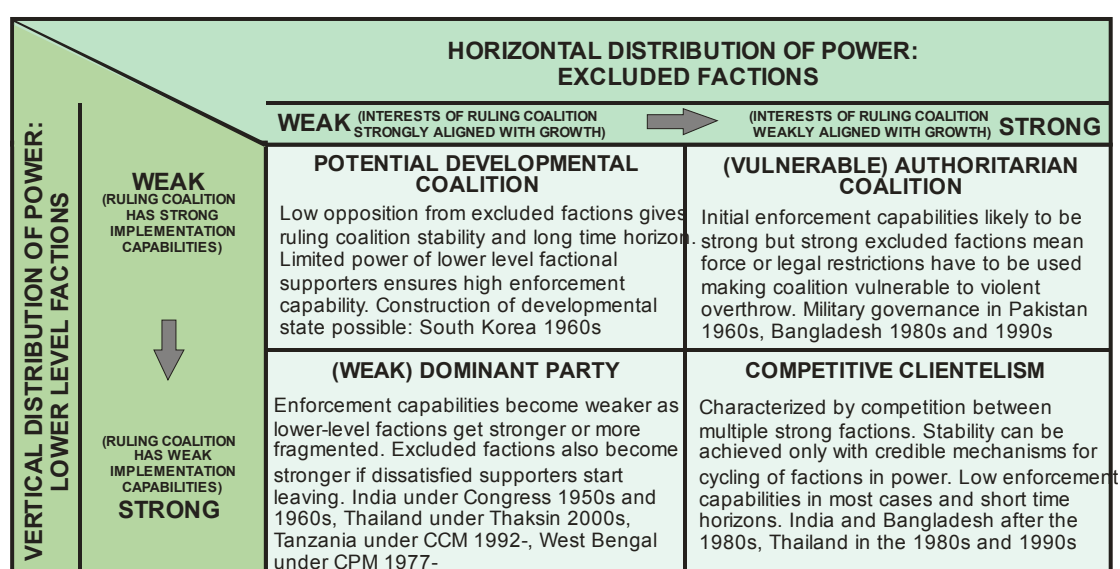


Figure 17 Patron-Client Factions and the Structure of the Ruling Coalition

The second dimension describing the structure of the ruling coalition is the ‘vertical distribution of power’. This describes the relative power of higher compared to lower level factions within the ruling coalition. The greater the relative power of higher over lower levels within the ruling coalition, the greater the implementation and enforcement capacities of the coalition. This is because given the pyramidal structure of patron-client organizations, the more powerful lower level factions become, the greater the number of points at which the enforcement of particular rules can be blocked. Enforcement and implementation now requires much greater collective action and the distribution of rents to many or all lower-level factions to ensure their cooperation. Otherwise, those who are adversely affected by a rule simply have to buy in a small number of lower-level factions to block its implementation. By definition, lower levels in a patron-client hierarchy are always weaker and to some extent dependent on higher levels. But this too can vary from a situation where lower-level factions have little bargaining power to one where they can effectively block or limit implementation if their demands are not met. The first case would correspond to a

situation where lower level clients have little holding power and higher level patrons can pick clients without great cost to themselves. The second describes a situation where lower level factions have significant holding power and can impose serious costs on patrons.

These two dimensions range along a scale but the polar limits define four possible structures of the ruling coalition in Figure 17. The most favourable combination is at the top left-hand corner, which we describe as a 'potential developmental coalition'. Here the ruling coalition has a long time horizon and therefore its interests are aligned with development *and* it has effective implementation capabilities. In terms of the growth-stability trade-off described in Figure 11, this variant of the clientelist political settlement has the most favourable trade-off. Distributions of power that are further to the right or lower down have relatively more adverse growth-stability trade-offs. The bottom right hand corner has the most adverse growth-stability trade-off, but may remain viable because of other characteristics of the economy determining the position of the trade-off relative to minimum viability conditions. The ruling coalition described in the top left-hand corner is a *potential* developmental coalition because these are necessary but not sufficient conditions for a developmental state. The emergence of the latter of course requires other conditions, including the emergence of an appropriate developmental leadership, as well as minimal technological capabilities within the country. The ruling coalition in South Korea from the 1960s to the 1980s approximated these characteristics.

A second type of ruling coalition is shown in the top right-hand corner, which we describe as an authoritarian coalition. Here the ruling coalition faces moderate to strong excluded coalitions but lower-level factions are relatively weak. As excluded factions get stronger, the ruling coalition becomes more vulnerable. By definition, if there are powerful, some institutional mechanisms for controlling excluded groups are necessary. These include legal or constitutional measures banning political activity outside the coalition, implicitly backed by the threat of force. The weaker the ruling coalition of this type, the more likely it is to have to regularly use force. Paradoxically, stronger authoritarian coalitions are less likely to have to use violence. For instance, Tanzania's one-party state under TANU in the 1960s faced very little resistance from excluded factions, but organizational rights were limited in a pre-emptive way to prevent resistance developing. The military controlled ruling coalition in Pakistan/Bangladesh in the 1960s was initially strong but became weaker and more violent over time as excluded coalitions became stronger. It was eventually overthrown by a mass uprising in 1969. The ill-fated BAKSAL one-party authoritarian experiment in Bangladesh in 1975 did not even take off. The distribution of power facing the ruling coalition included significant excluded coalitions (in particular the army) but also strong lower-level factions within the ruling party. In this case, the one-party system was very short-lived as internal factions conspired with excluded factions in the army to assassinate the President.

Authoritarianism is typically overthrown when excluded factions become too strong. But the strength of excluded factions also depends to a large extent on whether the ruling coalition can keep its own supporters satisfied within it. After a critical point, the strength of excluded factions can set off a cumulative decline that undermines the authoritarian coalition. The strength of external factions provides bargaining power to internal factions as they can threaten to leave, and if the leadership is unwilling or

unable to pay the price, some do leave, further strengthening the excluded factions and further increasing the bargaining power of remaining lower level factions. As a result, authoritarianism is difficult to sustain for long in most clientelist political settlements unless there are special factors like natural resource rents or external military support. Like the developmental coalition, enforcement capabilities within the authoritarian coalition can be relatively good, but time horizons are likely to be poorer given the vulnerability of the leadership. Moreover, the presence of strong excluded factions is likely to increase the bargaining power of lower-level faction leaders over time. Thus, the capacity to enforce decisions within the coalition is likely to get poorer over time. As authoritarianism collapses, and has to deal with increasingly powerful lower-level factions, it can acquire hybrid qualities, as we will see in the case of the militaristic clientelism of Bangladesh in the 1980s and 1990s where authoritarianism adopted methods of competitive clientelism.

The third type of ruling coalition is the dominant party that is ‘dominant’ to varying extents and could sometimes be quite weak. Here, excluded factions are weak either because powerful factions have been included within the dominant party or because excluded factions are very fragmented. The characteristic feature that distinguishes it from authoritarian arrangements is that a dominant party could win formal contested elections. If excluded factions are weak, the ruling coalition is likely to opt for competitive elections to boost its legitimacy. Like authoritarianism, the dominant party also faces a structural dilemma. If it includes all powerful factions within it, it can remove powerful factions outside that can challenge it. But it will have too many powerful factions within that are likely to block the implementation of almost anything. Excessive inclusion also means that the distribution of rents within the party will be thinner and leave many factions dissatisfied. On the other hand, leaving powerful factions outside results in the likelihood of external challenges and the possibility that lower-level factions will be induced by the excluded coalitions to leave and join them.

Sooner or later, once dissatisfied internal factions start joining excluded factions or new groups organize outside that cannot be included, the process of cumulative decline begins. Thus, dominant parties are likely to have longer time horizons but weaker implementation capabilities compared to authoritarian systems, but both are likely to decline over time. India under the Congress Party in the 1950s and 1960s, Tanzania under the CCM, West Bengal under the CPM, Thaksin’s Thai Rak Thai in the 2000s were all variants of dominant party coalitions enjoying different levels of vulnerability and weakness. Bangladesh never evolved a sustainable dominant party. The early Awami League in Bangladesh from 1972 to 1975 was a weak and short-lived dominant party that began to fall apart very rapidly. Mujib’s attempt to create a one-party state by constitutional amendment in 1975 was an attempt to create one-party authoritarianism but it was misconceived because the distribution of power was not consistent for its survival.

This brings us to the fourth and final variant which in some ways describes the state of entropy of the clientelist political settlement. This is competitive clientelism, where the number of potential factions is so great or they are so fragmented that the inclusion of all of them in a ruling coalition would not work but neither would a strategy of keeping excluded groups out by legal or military mechanisms. When cumulative decline undermines a dominant party or an authoritarian coalition,

competitive clientelism often emerges as the default type. In this variant, the ruling coalition is formed by a leadership of political entrepreneurs which seek to bring together enough factions to be able to rule but at the lowest price for themselves. The excluded are technically free to organize, restructure and entice included factions to leave, to attempt to form a new coalition. Elections in this system provide a mechanism for testing the organizational power of competing coalitions, and elections are successful if they reflect the balance of organizational power on the ground and if there is an implicit rule of law amongst the competing coalitions that ensures that losers accept the outcomes of these contests without descending into open warfare. Competitive clientelism can provide comparative stability when the underlying factional structure is very fragmented and attempting to construct authoritarian or dominant party solutions would not immediately work. But by its structure, the ruling coalition here has a short time horizon and weak implementation and enforcement capabilities.

The competitive clientelist system is only stable over time if credible mechanisms allow the ruling coalition to be replaced by an alternative coalition which can demonstrate greater organizational power during elections. Voting in these systems is a test of relative factional strength. However, the possibility that the ruling coalition can use administrative and police powers to excessively tilt the balance of the voting outcome can cause a breakdown of the electoral process. In a context of substantive informality, the temptation on the part of the ruling coalition to use administrative powers to target even a few of the informal activities of the opposition is often sufficient to make an impact on the electoral outcome. Once this type of intervention interferes with the establishment of the balance of forces on the ground, the competition between factions can break out in violence. India's competitive clientelism is significantly different from other developing countries in that it has successfully allowed a cycling of factions into and out of power. One possibility is that India's size and diversity helped to prevent any ruling coalition from imagining that it could get away with significant administrative intervention in elections. Intervention would have to benefit a complex coalition of factions and disadvantage another complex coalition, and the complexity itself can help to ensure an informal rule of law emerges for conducting elections.

A further factor that helps the credibility of elections in India is that it is a large federal country and elections are organized at the state level. If excessive violations happen within a particular state, the federal government has strong incentives to intervene to prevent a particular state descending into crisis. The federal government can impose president's rule and re-run the election. Therefore, while election fraud, violence and rigging does happen in India, the parties know that an outcome that is significantly out of line with their organizational strength on the ground cannot be sustained. Third-party 'institutional' oversight of electoral outcomes is far less credible in smaller states like Bangladesh because the ruling coalition includes enough of the relevant factions in a country to believe that it can get away with it. In practice it never can for very long, if only because of the processes of cumulative decline, but the ruling coalition can be tempted. Electoral crises are therefore more frequent and typically lead to occasional military takeovers. But these raise further problems because exit strategies from military rule are complex and many developing countries therefore cycle through periods of (vulnerable) authoritarianism and periods of competitive clientelism. The conventional way of looking at the conduct of

elections focuses on ‘institutionalization’ and the governance capabilities of organizations like Election Commissions. This is only partially useful. Our approach focuses on the organization of factional politics and examines an important additional dimension of the problem.

It is very easy for a clientelist political settlement to evolve into competitive clientelism, but quite difficult to get out of it. Competitive clientelism has some desirable features. Political competition is difficult to constrain in this context and this makes it difficult to institutionally constrain the operation of formal democracy. But democracy is not always stabilizing in these contexts and does not necessarily generate developmental outcomes for the reasons just discussed. Competitive clientelism results in a ruling coalition with short time horizons and weak implementation and enforcement capabilities. *Ceteris paribus*, it has the most adverse growth-stability trade-off in Figure 17. And for competitive clientelism to even achieve a moderate level of stability there has to be a credible distribution of power that ensures that the cycling between factions can continue without an impasse caused by administrative interventions in elections. If this is absent, significant violence can break out between competing factions. All of South Asia is now governed by competitive clientelist coalitions as is much of Africa, though there are exceptions such as Tanzania. Thailand in the 1980s and 1990s was also characterized by competitive clientelist coalitions. But only India has achieved an internal distribution of power that makes its competitive clientelism operate relatively smoothly. An examination of the evolution of factional politics in countries like Bangladesh can identify critical problems with the operation of competitive clientelism.

The organization of the patron-client factions within the ruling coalition and outside is therefore a lens through which to look at the interdependent evolution of institutions, politics and economics in clientelist political settlements. This allows us to look deeper than the formal structure of parties and constitutions, which may not tell us much about enforcement capabilities and institutional performance across countries. Formal military governments can be dependent to different degrees on patron-client networks, making military governments substantially different from each other. Indeed, army-led governments in developing countries have ranged from relatively strong but short-lived authoritarian regimes, as in Pakistan in the early 1960s, to very weak authoritarian regimes with characteristics of competitive clientelism in Bangladesh in the late 1970s and 1980s. In the latter, military leaders formed parties with many characteristics of competitive clientelism where excluded coalitions could compete to be included but could not replace the top man. At other times, military-led coalitions have had developmental characteristics, as in South Korea in the 1960s, or have been strong and long-lived authoritarian regimes like the Baathist regimes of the Middle East.

Patron-Client Networks and the Political Power of (Emerging) Capitalists

The strategies that the ruling coalition can follow and their likely effects depend on another dimension of the political settlement, also implicit in the organization and composition of the dominant patron-client factions. The capabilities and organization of productive entrepreneurs in developing countries can vary significantly. These characteristics determine the effectiveness of the resistance coming from entrepreneurs and other groups to the implementation of growth-enhancing institutions. Importantly, the resistance that is relevant can emerge not only from

factions that want to block an excessive distribution of benefits to productive entrepreneurs but also from entrepreneurs themselves when institutions are introduced that attempt to discipline their enterprises as part of market or industrial policy strategies. As will become clear, the organization of the ruling coalition and the distribution of power with entrepreneurs have mutually dependent effects on the growth-stability trade-off facing particular institutional changes.

Two aspects of the initial characteristics of the (emerging) productive entrepreneurs are relevant for us. The productive entrepreneurs we need to identify depend on the question we are asking. We could be interested in a particular sector or region, or we could be interested in characteristics of the whole economy. The relevant level depends on the institutional question being addressed. The two characteristics of interest are first, the technological and entrepreneurial ‘capabilities’ of the entrepreneurs in question and second, the holding power they can deploy with respect to the ruling coalition.

The technological and entrepreneurial capabilities of the entrepreneurs are effectively defined by historical processes of accumulation and learning and are relatively slow to change. Their organizational and political integration into the ruling coalition and their dependence or otherwise on patrons at different levels can change with significant implications. The holding power of emerging capitalists in developing countries, even if they are high-capability entrepreneurs running big organizations, is unlikely to be entirely or even largely based on the profits generated by their organizations. Sustaining these profits and ensuring that the enterprise survives in a context of considerable informal power presupposes that the entrepreneur is well-networked into informal power structures through which formal rights can be protected at an appropriate price. But sometimes entrepreneurs are themselves powerful individuals who rose up using political accumulation and who still retain strong informal networks.

Alternatively, powerful political networks could depend on the resources entrepreneurs make available either from their formal productive enterprises or because these entrepreneurs have trading and other grey networks from which resources can be generated for political patrons or factions. These entrepreneurs are likely to have considerable holding power because they effectively have their own factions or can buy protection and holding power from factions that are dependent on them. But productive entrepreneurs can also be politically weak if the ruling coalition can operate without the support of particular entrepreneurs. If the ruling coalition has access to funds from informal activities or their own business sources, productive entrepreneurs may be unable to buy themselves much power. This could be the case if the ruling coalition has access to natural resource rents or if, like Thaksin, they can leverage monopoly and trading rents to run the party.

A number of possible combinations are summarized in Figure 18. The top left-hand corner describes relatively high-capability entrepreneurs who are networked with patron-client organizations in ways that allow them to deploy significant holding power. Paradoxically, powerful entrepreneurs are not necessarily conducive for growth in developing countries. This is perhaps true in general because powerful entrepreneurs can be expected to use their power to create rents for themselves, and some of these rents could be damaging for the overall performance of the productive

sector. Powerful entrepreneurs can be expected to try and prevent institutional changes that potentially achieve higher levels of competitiveness but expose them to higher levels of competitive risk or force them to engage in higher levels of investment and effort. As a result, there is likely to be political resistance both to institutions that aim to increase the exposure of existing enterprises to market competition or to the deepening of institutions of industrial policy. The resistance to industrial policy is particularly likely when it moves beyond the initial ‘easy’ protection phase to the creation of compulsions for effective learning that often requires the withdrawal of support from poorly-performing enterprises.

		TECHNOLOGICAL-ENTREPRENEURIAL CAPABILITIES	
		HIGH CAN DRIVE TECHNOLOGY ACQUISITION AND GAIN FROM INDUSTRIAL POLICY	LOW USE SIMPLE TECHNOLOGIES OR ENGAGE IN RESOURCE CAPTURE
HOLDING POWER OF PRODUCTIVE INVESTORS	HIGH DIFFICULT TO DISCIPLINE BUT CAN USE POLITICAL POWER TO DRIVE TECHNOLOGY ACQUISITION	HIGH CAPABILITY AND POWERFULLY NETWORKED Capitalists can drive accumulation but imposing discipline difficult. Productive enterprises possible with exposure to market competition but development of new capitalists constrained. Advanced areas of India after 1990s, Thailand 1980s and 90s	MODERATE TO LOW CAPABILITY POWERFULLY NETWORKED Political power can drive critical early stage accumulation but market or industrial policy discipline difficult to enforce. Competitive low-tech enterprises possible with market competition. South Asia 1950s and 60s, Most areas of India and Bangladesh today
	LOW EASY TO DISCIPLINE BUT NO POLITICAL POWER TO DRIVE TECHNOLOGY ACQUISITION INDEPENDENTLY	HIGH CAPABILITY BUT POLITICALLY WEAK Outcomes depend on organization of ruling coalition. With developmental coalition, effective industrial policy and disciplining possible: South Korea 1960s to 80s. But dominant parties <i>can</i> have adverse effects: West Bengal 1980s and 1990s, Thailand under Thaksin 2000s	MODERATE TO LOW CAPABILITY AND POLITICALLY WEAK Most constrained situation. Outcomes depend on ruling coalition. Developmental coalition could drive early accumulation and disciplining but may not if it has other interests and concerns or a short time horizon: Tanzania 1990s and 2000s

Figure 18 Patron-Client Structures and the Organizational Power of Emerging Capitalists

However, not all rents created by powerful entrepreneurs are necessarily damaging. Some high-capability entrepreneurs, particularly those whose markets are global, are likely to use political power to gain access to resources or government contracts in ways that assist them to accelerate their accumulation and technology acquisition strategies. The implementation of these particular strategies may face less resistance if the capitalists who benefit are well-connected. But these strategies are only feasible for capitalists who already have significant technological and entrepreneurial capabilities, and by definition they are few in number in most developing countries. Nevertheless, pockets of well-connected and high-capability capitalists have driven growth in developing countries like India after the 1980s and in states like Maharashtra from a much earlier period (Khan 2008, 2009b). They were also instrumental in driving growth in the competitive clientelism of Thailand in the 1980s and 1990s (Doner and Ramsay 2000; Khan 2000a; Rock 2000). But the creation of *new* entrepreneurial capabilities is not likely to be rapid with this configuration of power and may indeed be thwarted by arrangements favouring existing capitalists.

The bottom left-hand corner describes high-capability entrepreneurs who are politically weak in the sense of not being capable of deploying significant holding power. Paradoxically, this configuration of power can allow the implementation of very effective industrial policy if the ruling coalition is developmental. The political settlement in South Korea during the critical decades of the 1960s, 1970s and much of the 1980s was characterized not only by a developmental ruling coalition but also a

high capability productive sector that had limited holding power. These characteristics of the South Korean political settlement allowed the implementation of an industrial policy that not only directed significant resources to a growing productive sector, but was also able to enforce discipline and compulsion to ensure high levels of effort in learning. The political weakness of South Korean capitalists was related to the weak development of factional politics in Korea during Japanese rule, such that there were no significant independent political factions that Korean capitalists could have linked up with. Moreover, the close association of Korean entrepreneurs with Japanese industrial interests meant they had limited legitimacy in the aftermath of the Japanese defeat and could not immediately attempt to organize supporters of their own (Amsden 1989; Kohli 1994; Khan 2000a).

However, high-capability capitalists who lack significant holding power can also be vulnerable if the ruling coalition is unable to take a long view and is more interested in immediate resource capture or in the development of other sectors. Thaksin's Thailand in the 2000s is an example of a dominant party system led by an entrepreneur interested in capturing monopoly profits and sustaining power through populist strategies of redistribution, rather than in the development of the Thai productive sector as a whole. This led to significant problems for the Thai industrial capitalist class who faced growing implicit taxes to pay for Thaksin's populism while suffering institutional changes that assisted Thaksin's trading and speculative interests rather than the development of productive industrial capabilities. Eventually these tensions induced a constitutional crisis in Thailand (Khan 2008; Phongpaichit and Baker 2009). A somewhat different factional base of the dominant CPM in West Bengal led to the gradual sidelining of an industrial sector that once had some high capability sectors. The CPM's agrarian base and its responsiveness to the interests of agrarian factions led to a gradual industrial decline of the state as industrial capital preferred to expand into other parts of India (Khan 2008).

The top right-hand corner of Figure 18 shows the possibility of politically powerful and well-connected entrepreneurs or potential entrepreneurs who still have low to moderate technological and entrepreneurial capabilities. In this case, the holding power of the emerging entrepreneurs is more clearly based on their location within powerful political factions. If the ruling coalition is very fragmented, and faces either many powerful excluded factions or strong lower level factions or both, it is possible for individual entrepreneurs to line up with particular factions that can provide them with significant holding power in these contexts. This is because the ruling coalition may be very dependent on the support of a large number of factions and even a small faction protecting or associated with a particular capitalist could block changes affecting that capitalist. This would allow capitalists who still had rather limited resources in absolute terms to deploy considerable holding power. This combination of moderate to low technological capabilities and considerable holding power is a reasonable description of the general characteristics of South Asian capitalists in the immediate post-colonial period, in the 1950s and 1960s.

As in the top left-hand corner, here too capitalists can block growth-enhancing institutional changes that threaten their interests. The difference is that at lower levels of technological development the consequences of blocking growth-enhancing changes are obviously more serious. However, as before, all rent-seeking activities of powerful capitalists are not necessarily damaging from a growth and development

perspective. Powerful capitalists can induce ruling coalitions to promote productive sectors even if they are not immediately very productive. The initial accumulation in South Asia in the 1950s and 1960s was driven by the presence of emerging capitalist interests within the factions constituting the ruling coalitions. These interests can also drive early stage industrial policy while it directs resources and provides protection at early stages of industrial growth. Extensive growth can be very rapid, even if learning and movements towards the technology frontier are slow. So paradoxically, this configuration can create a very favourable growth-stability trade-off for the introduction of industrial policy and an increasingly steep trade-off when industrial policy attempts to move into disciplining and subsidy withdrawal. This can explain why in these political settlements growth was initially very rapid as new firms were established and then faded as industrial policy to raise productivity growth through resource re-allocation was successfully resisted.

Nevertheless, even though industrial policy cannot be fully implemented in these contexts, and the withdrawal of support from poorly performing enterprises is virtually impossible, a significant development of technological capabilities can take place simply by bringing in new capital equipment and enabling entrepreneurs to engage in learning-by-doing. India, Pakistan and Bangladesh enjoyed dramatic growth accelerations with their industrial policies in the 1950s and early 1960s. Even though both output and productivity growth slowed down eventually and the strategies had to be abandoned, almost all of the technological capabilities that subsequently drove growth in different sectors in their more open economies after the 1980s initially developed during this early period (Khan 2008, 2009b).

It is plausible that the failure to achieve significant learning and productivity growth in the industrial policies of South Asia during the 1950s and 1960s was at least partly due to the political ability of the entrepreneurs receiving support to block attempts to discipline them (Khan 1999, 2000a; Chibber 2003; Khan 2009b). However, what enabled supported capitalists to resist the implementation of disciplining is disputed and yet very significant for designing future policy. What gave a small and collectively not very economically powerful group of individuals in post-independence India the ability to resist disciplining when the ruling coalition was based almost entirely on factions dominated by other interests? Indeed, as in South Korea, Indian capitalists did not enjoy high levels of legitimacy in the post-independence period and the official ideology of the dominant Congress Party was socialism.

According to Chibber, individual capitalists had the power to block disciplining because of the ‘wrong’ choice of import substitution policies in India. This meant that capitalists collectively had no interest in supporting disciplining because an individual capitalist who was inefficient had no effect on the profits of other capitalists. In contrast, Chibber argues, if export promotion had been attempted (as in South Korea), capitalists would collectively need high-quality and competitive inputs from other capitalists to be able to export their own products and they would therefore have collectively supported the disciplining of capitalists who were underperforming (Chibber 2003).

Chibber’s argument is intriguing but in the end not persuasive in identifying the source of capitalist power in India and in the Indian subcontinent in the 1950s and

1960s. His argument suggests that shifting from import substitution to export promotion may have broken capitalist resistance by converting capitalists into a group that collectively supported disciplining. Unfortunately, export promotion can also be done inefficiently, as Pakistan discovered in the 1960s. Its subsidies supporting export promotion could not be efficiently re-allocated because re-allocation was effectively resisted. As long as subsidies continued, low quality exports were feasible. The problem ultimately was not export promotion versus import substitution but rather that in both cases industrial policy institutions lacked the power to withdraw subsidies. In theory, import substitution could be combined with gradual opening up and a reduction of protection for selected sectors to achieve the same compulsions for productivity growth. If import-substituting industries knew opening up was credible, they would also have strong incentives to ensure that other capitalists provided them with high-quality inputs required for achieving competitiveness. The weakest part of Chibber's argument is the claim that the Indian state could not discipline individual capitalists because capitalists collectively were not supporting disciplining. Apart from the fact that capitalists had no collective organizations with political clout, the support or otherwise from a class that was tiny in numbers and with relatively limited resources is unlikely to have constrained the decisions of a dominant party ruling coalition based on other power bases.

However, Chibber is undoubtedly right to point out that disciplining was being blocked by capitalists, many of whom had not even achieved significant technological capability or economic power. The characteristics of the political settlement identified here can explain the power of individual capitalists in the Indian subcontinent to block disciplining using their association with powerful factions. Rather than the collective position capitalists may have taken about the usefulness of disciplining, a better explanation is that Indian capitalists could buy into significant informal sources of holding power provided by factions. Individual capitalists could not be disciplined because they were associated with political factions that were powerful. The failure of institutions like the licensing system to re-allocate licenses had little to do with whether capitalists collectively were interested or not interested in supporting disciplining.

The strength and fragmentation of factions in the Indian subcontinent meant that even capitalists who were unable to mobilize significant resources could still buy into particular networks that were part of complex ruling coalitions. Indeed, the historical evidence suggests that individual capitalists were closely associated with particular politicians and factions in the Indian subcontinent from the very outset of industrial policy. This more plausible explanation of the power of individual capitalists also suggests that broad-based industrial policy would not have worked in the Indian subcontinent without significant changes in the political settlement. A shift from import substitution to export promotion would not have achieved a significant change on its own, and the experience of Pakistan in the 1960s supports this hypothesis (Khan 1999). Alternatively, given this political settlement, variants of industrial policy that focused on narrower sectors and technological goals may have performed better if the appropriate (narrowly defined) governance capabilities to implement these institutions could have been developed.

Finally, the lower right hand box describes a difficult situation where entrepreneurs have low technological and entrepreneurial capabilities and are also unable to deploy

significant holding power. Here too, outcomes depend quite significantly on the nature of the ruling coalition. In principle, a developmental coalition could be quite successful in accelerating accumulation and learning in these contexts (provided some technological and entrepreneurial capabilities existed). Ethiopia's attempt to implement learning strategies in the late 2000s is an interesting experiment of this type. However, with limited political voice and holding power, entrepreneurs may also be ignored or expropriated if the ruling coalition has short term extractive goals, or if it is more concerned to promote a different set of class or sectoral interests.

Tanzania's dominant party ruling coalition has been less engaged with its existing entrepreneurial base, despite official support for the private sector in the 2000s. More directed policies of support for accumulation and technology acquisition have not been very aggressively supported because most Tanzanian entrepreneurs appear to be weakly integrated into political networks and have more limited political voice as a result. That many entrepreneurs are Asian or European in origin and not African perhaps makes it more difficult for the dominant party to openly support business interests. The availability of aid rents and natural resource rents further weakens the incentives of the ruling coalition to develop the politically weak productive sector with proactive policies when easier opportunities for meeting minimum economic conditions for the viability of the ruling coalition exist.

An Interactive Framework for Analysing Institutions in Political Settlements

The two dimensions of the political settlement that we have looked at by no means exhaust the different aspects of the distribution of power that can affect institutional performance. But already they indicate the complexity of identifying the most relevant aspects of the distribution of power that can affect the performance of particular institutions. The enforcement of a specific institution and the political costs of enforcement depend not only on the characteristics of the ruling coalition but also on the organization and capabilities of the productive sectors that are affected. A ruling coalition that can be associated with dynamic institutional outcomes with a particular configuration of entrepreneurial capabilities and powers may be associated with very different outcomes with a different set of entrepreneurial powers. Conversely, a particular power configuration describing entrepreneurs can be productive or otherwise depending on the characteristics of the ruling coalition.

Figure 19 shows that institutions that may be associated with growth in a political settlement with one set of characteristics may be associated with declining performance if the combination of characteristics changes. For instance, industrial policy may be superior to open competition if a developmental coalition can support technological learning with high-capability capitalists. But with competitive clientelism or a weak dominant party and/or well-networked capitalists, industrial policy may produce poorer results at a later stage of development than institutions supporting competition. Continuing with industrial policy in these contexts may have negative effects. But the benefits of opening up may be rapidly exhausted as entrepreneurs with the capability to benefit may be few in number. Even political settlements inhospitable for industrial policy may need to devise institutional strategies for sustaining technology acquisition and accumulation that can work given the specific characteristics of their political settlements. These 'non-linear' interactive relationships mean that we need an iterative framework for assessing the likely

performance of specific institutions in the context of the characteristics of particular political settlements.

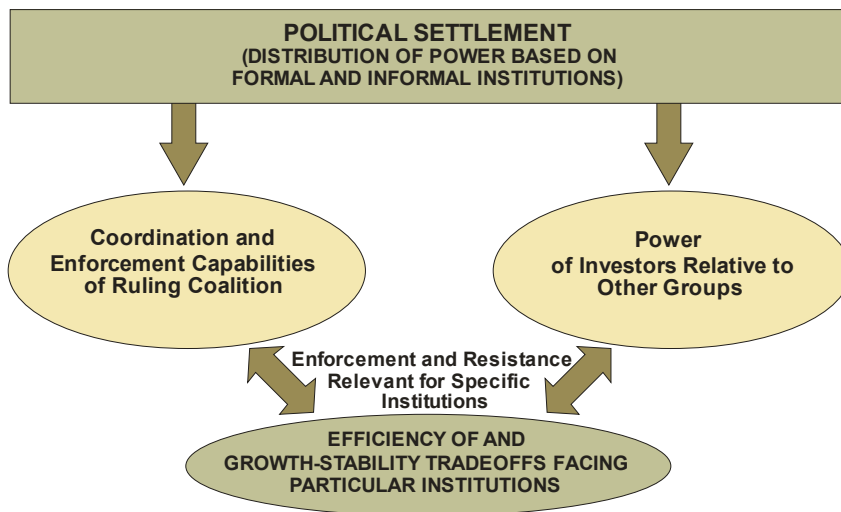


Figure 19 Interactive Relationship between Political Settlements and Institutions

Observations of the organization of patron-client factions and their strategies can provide critical information about aspects of the clientelist political settlement. In particular, the location of capitalists within networks explains their holding power in developing countries, and the factional organization of the ruling coalition determines its ability to coordinate and to enforce. Both of these dimensions of the clientelist political settlement affect the degree of enforcement of particular institutions and the likely growth-stability trade-off facing their introduction. These characteristics allow us to examine the likely growth and stability implications of proceeding along particular paths of institutional evolution. However, given the interaction between these variables, a ‘linear’ analysis of institutions is in general likely to be misleading.

An implication of our analysis is that institutions do not have linearly separable effects on growth. If growth were a linear sum of the effects of a number of variables, the positive effect of particular institutions may be wiped out by other adverse conditions like political instability or culture, but the positive effect of the institution would still be there *ceteris paribus*. The implication of interactive effects of the type described here is that growth effects are *not* a linear sum of institutional and other effects. The effect of differences in political settlements is not just that political variables can potentially swamp the underlying positive effects of institutions. Rather, the political settlement can affect both the magnitude and the sign of the effect (positive or negative) of particular institutions (Khan 1995). This further underlines the importance of identifying critical aspects of the political settlement and assessing the likelihood of the effective enforcement of and resistance to particular institutions in an iterative analysis.

In the next sections we describe broad features of the evolving political settlement in our sample countries using the framework developed here. The aim is not to develop a full political economy analysis of each country or state, but to use the framework of analysis to discuss how the political settlement and changes in the political settlement are relevant for understanding critical aspects of institutional performance in our

countries. To do this we will need to recall aspects of the analysis of earlier papers as we want to show how changes in the political settlement help us to better understand the changing structure of rents and the governance of rents through institutions. Important aspects of rent management and governance in our case study countries have already been described in detail in earlier papers (Khan 2008, 2009a, 2009b). We reproduce summary tables of the major types of rents characterizing our cases from (Khan 2008) in an appendix to this paper.

8. Thailand: The Rise and Fall of Competitive Clientelism

The evolution of the political settlement in Thailand is particularly interesting because it demonstrates the potential danger of attempting to accelerate the achievement of a Weberian state in the context of a clientelist political settlement. In terms of the organization of ruling coalitions shown in Figure 17, Thailand's ruling coalition from the late 1950s was a military-led authoritarian one. Business interests in these early years, according to the classification in Figure 18, were politically weak and only moderately capable. This was a period of rapid import substitution but industrial policy institutions could not be constructed. By the early 1970s, the growing strength of excluded coalitions meant that the authoritarian ruling coalition could not be sustained and Thailand began a process of evolution towards a structure of competitive clientelism following the 1973 student uprising. It is also around this time that the political power of business interests came into their own, with powerful business interests operating through the competitive clientelism that emerged. This allowed relatively rapid growth based on rent-creation by capitalist-dominated factions. This settlement collapsed after the 1997 crisis. The 1997 constitution that emerged partly as a result of a new middle class activism attempted to move the country towards Weberian good governance. It gave considerable powers to the Prime Minister with voting rules that made it easier for a single party to win. It also attempted to increase accountability through checks and balances. The middle class expected the new constitution to result in the emergence of good governance appropriate for a Weberian state, and the beginning of an end to the 'money politics' and clientelism of the past.

Thaksin's victory in 2001 with his Thai Rak Thai Party was a turning point for Thailand. It marked the end of the first period of competitive clientelism. But while his party had a manifesto, and actually delivered on it, it also had to operate through patron-client networks. In terms of Figure 17 Thaksin's coalition was a dominant party ruling coalition, and not a party of the type that we would expect to see in a capitalist political settlement. Paradoxically, the construction of this dominant party was to have seriously adverse implications for Thailand's productive sector, and eventually for its constitution. Thaksin's movement was initially a capitalist-led response to the 1997 crisis, but the diversity of interests within the large ruling coalition led to early failures in evolving a productive economic response. The party's failure to enforce discipline on capitalist interests who needed to be assisted out of the debts they had incurred during the financial crisis happened at the same time as Thaksin and his clique discovered they could, instead, access significant unproductive rents for themselves. The result was that capitalists and the middle class rapidly lost access to political power and the party turned to overtly populist strategies to stay in power. This proved to be wildly successful as an electoral strategy allowing rent capture for powerful interests within the ruling coalition. Despite the presence of a

sophisticated capitalist sector, there was a significantly adverse shift in the political settlement from the perspective of enforcing institutions supportive of productive investments and long run growth.

Thaksin's electoral strategy was so compelling that his re-named party was re-elected even after it was dislodged by a desperate coup backed by the middle class. It was finally dismissed only after extra-constitutional violence and disruption and sustained judicial action following the monarch's advice to judges to save the country. A new government led by the Democrat Party was cobbled together through considerable horse trading in December 2008. This government was not an outcome of an election but relied on the disqualification of some elected MPs and the buying in of others. In terms of Figure 17, despite the fact that the Prime Minister was an educated and likeable leader of Thailand's oldest political party, it was effectively a (temporary) return to a form of authoritarian rule with a democratic face. The new ruling coalition was constructed with the overt support of strong military-bureaucratic intervention. Factions led by Thaksin supporters who had successfully, if cynically, mobilized rural interests and the poor were forcefully excluded by administrative and military action.

THAILAND	
CHARACTERISTICS OF POLITICAL SETTLEMENT	BROAD FEATURES OF INSTITUTIONS AND GROWTH
Vulnerable Authoritarianism with Weak/Moderate Capability / Politically Weak Capitalists 1960s-1970s	Capitalist rights supporting rapid accumulation but with weak industrial policy institutions
Competitive Clientelism with moderate-to-high capability / powerful capitalists: Mid 1970s-2001	Rapid growth supported by factional capitalist rent-seeking and limited industrial policy
'Unproductive' Dominant Party with high capability / politically delinked capitalists: 2001-2008	Adverse formal institutions supporting growth in formal sector but populist redistribution to the poor. Reliance on foreign investments grows
Backlash: Authoritarianism with a Democratic Face 2008	Political and policy uncertainty

Figure 20 Evolution of Political Settlement in Contemporary Thailand

Clearly, the attempt to create a self-regulating party structure that would operate through the protection of formal dominant economic interests had failed, and our analysis can suggest why the attempt may have been premature. It is too early to tell how long it will take Thailand to reorganize a viable version of competitive clientelism that can incorporate the currently excluded interests so that overt and repeated bureaucratic-military intervention is not necessary. The broad features of the evolution of the political settlement in contemporary Thailand are summarized in Figure 20 and discussed in the subsequent sections. The reader should also refer to Figure 25 in the Appendix summarizing some of our earlier work on changing characteristics of growth and governance in Thailand.

Authoritarianism with Weak Capitalists: 1960s to early 1970s

From the 1932 Revolution which ended absolute monarchy till the uprising of 1973, Thai politics was dominated by military-bureaucratic factions and the conflicts between them. In the critical period of the 1960s and 1970s, following Sarit's coup of 1957, the ruling coalition in Thailand was a vulnerable authoritarian one in terms of Figure 17. It was vulnerable because powerful factions within the Thai military and sometimes individuals close to the monarchy were dissatisfied with their relative position or were excluded from the coalition. In addition, Thailand faced a communist insurgency that was used by the ruling coalition to justify clamping down and suppressing demands coming from lower down the social ladder. Emerging leaderships of peasant movements, trade unions and students were repressed, occasionally with violence, and potentially powerful factions were thereby systematically excluded.

Nevertheless, the ruling coalition never acquired the cohesive characteristics of a developmental coalition. This was primarily because the army itself was factionalized and competing generals were building their economic power bases by allying with particular businessmen from a very early stage. In the 1960s, Thai business interests had low technological capabilities, being mostly based in trading and light manufacturing. In addition, because most capitalists were of Chinese origin, they were relatively weak in their bargaining power with the military factions running the country. In terms of Figure 18, Thai business at the time could be characterized as located in between the two bottom row boxes: having moderate to low technological capabilities (but probably high entrepreneurial capabilities!) and with very limited holding power. But while business interests had little autonomous bargaining power, networks emerged from the earliest days with military-bureaucratic factions who exchanged favours and contracts for kickbacks on terms determined by the military-bureaucratic elites running the country (Riggs 1966).

The factions within the army and bureaucracy meant that the generals and bureaucrats did not act like a coherent developmental ruling group. Significant potential opposition from excluded groups like peasants, students and the small but growing numbers of capitalists and the middle class meant that the leadership could not afford to take on the generals too. The tradition in Thailand since the 1930s was for generals to freely participate in business contracts, get appointed to boards of companies and generally take any kickbacks they could negotiate on their own. Coups were frequent. Sarit's coup in 1957 was one of many before and after. While Sarit's period of rule till 1963 was one of relative coherence, subsequent military-led ruling coalitions were more vulnerable and less able to impose discipline within the coalition. In particular, generals and bureaucrats increasingly had their own business clients (Phongpaichit and Baker 1997: 244-322).

These characteristics of the political settlement of the 1960s and early 1970s can help to explain the institutional performance and rents that we observe over this period. On the negative side, it explains why despite much talk of developmental priorities and the apparent existence of an authoritarian state, there were no moves towards the type of industrial policy observed in South Korea or Taiwan. Industrial policy institutions based on conditional and selective assistance and technology acquisition would have been difficult to impose as any capitalist was likely to be the client of a powerful general. Disciplining a particular capitalist by any central authority on grounds of

non-performance or selecting a particular capitalist on the grounds of technological capability would have faced high internal transition costs in the political settlement described. Although capitalists were weakly organized and did not have significant network power of their own to have blocked the effective implementation of industrial policy institutions, the ruling coalition was not appropriate for a low transition cost introduction or implementation of effective industrial policy.

However, the political settlement was very conducive for some types of formal and informal institutions that were significantly growth-enhancing in the context of very limited industrialization. Primitive accumulation that significantly enhanced the capital base of emerging capitalists required the granting of favourable government contracts for construction, imports and exports, and the organization of grey trade in areas like logging. With a political settlement that excluded significant outsiders challenging the allocation of these rents, and weak lower level clients (the emerging business interests), the ruling coalition had clear opportunities and strong incentives to expand and encourage the entry of new businesses. It helped that the ruling coalition was not so vulnerable that it took an excessively short term view. Relatively long-term relationships were set up with emerging businesses, encouraging both sides to invest in productive relationships. For businesses this made sense because they needed to generate income to sustain their relationships with power groups. For the generals, allowing productive investments by their clients enhanced their long-term interests. Thus, the informal ‘institutional arrangements’ through which primitive accumulation was organized were effectively enforced and introduced at low transition cost. The growth-stability trade-off for formal and informal institutions supporting accumulation was very favourable.

Another formal institution during this period was the introduction and operation of import-substituting industrialization policy. This too faced little political resistance and was effectively implemented. This is consistent with the relevant characteristics of the political settlement during this period. As long as import substitution was general and the strategy allowed any businessman with connections to enter and operate, there was little opposition. If basic import substitution had attempted to move further into a more disciplined technology acquisition strategy, our understanding of the political settlement suggests there would have been potentially high transition costs of moving in that direction.

A general feature of the authoritarian political settlement in Thailand is that entry by individual capitalists was relatively easy provided they could pay for informal protection and support offered by the ruling coalition. This feature became even more pronounced as the loose authoritarianism of the 1960s merged into a more systematic competitive clientelism in the 1970s. The ease of entry of potential capitalists into the processes enabling primitive accumulation and providing startup support meant that early growth was very rapid. This helped to accelerate Thailand’s growth into manufacturing from the mid-1950s, and particularly in the 1960s. By the mid-1970s a significant industrial base had emerged based around light manufacturing. As we summarized in an earlier paper and now reproduce in Figure 25 in our Appendix, the rents that drove growth in Thailand during this early period (shown in the first row) were associated with the informal organization of rapid primitive accumulation. The political settlement of this period helps to explain why the institutional arrangements

responsible for these rents were easy to create and rapidly expand, and also why more effective industrial policy did not emerge.

Summary

The 1960s and 1970s were characterized by an authoritarian clientelist settlement with moderately capable but politically weak productive entrepreneurs. The characteristics of this political settlement made it easy to introduce formal and informal institutions that enabled rapid growth through primitive accumulation and the introduction of relatively simple manufacturing technologies. The introduction of institutions with developmental characteristics faced adverse growth-stability trade-offs. More interestingly, the political settlement was undermined by the growth of factionalism within the ruling coalition and the emergence of powerful coalitions outside.

Competitive Clientelism: Mid-1970s to 2001

In 1968, a worried monarch responding to growing social tensions pressed the military to legalize political parties and organize limited elections. In 1969, tightly controlled elections were held, which a party set up by the military won. However, dissent was growing, and with it the strength of social coalitions outside the ruling coalition. Mass student-led protests and then bloody repression in 1973 were followed by an intensification of the Communist insurgency in rural areas. In this context, the pressure for 'democracy' led the already factionalized military junta to come apart with generals identifying with rival parties and businessmen choosing their patrons. A gradual transition to competitive clientelism began. The 1975 elections marked the transition to a party-based organization of factions, with the Democrat Party winning the largest number of seats. It failed to form a coalition big enough to form the government, and in any case a coup in 1976 further delayed the transition. The constitution was re-written in 1978 to enable a strong military role in parliament, allowing serving military and bureaucratic personnel to serve as Prime Ministers or in the Cabinet. With these adjustments, Thailand embarked on a long period of parliamentary rule from 1979 till the short-lived coup of 1991-2 (Phongpaichit and Baker 1997: 323-66). Following the brief coup, which was overturned by massive street protests, parliamentary rule re-emerged till the shock of the 1997 crisis began to significantly change the political settlement once again.

The characteristics of this emergent competitive clientelist political settlement that are relevant for us were the following. First, the ruling coalition no longer tried either to include within it all possible factions with the power to inflict high costs, nor exclude them permanently by force or constitutional arrangements. Rather, the characteristic of competitive clientelism is that the ruling coalition is one of many possible permutations, and the particular coalition emerges through a competitive process both of coalition formation and electoral selection. Each coalition is formed out of lower level factions, as we have described earlier. Stability emerges in this system from an understanding between factions that the ruling faction will make money, but other factions are free to organize and even to woo coalitions within the ruling coalition to improve their chances of winning the next selection game. As long as insiders do not try to block the chances of outsiders too significantly, competitive clientelism can provide tolerable stability through the use of informal power and rent generation for a sequential selection of powerful groups.

In terms of Figure 17, any particular ruling coalition will face significant excluded coalitions who are always mobilizing support to gain enough holding power to win the next elections. The excluded coalitions are not necessarily engaging in excessive violence or inflicting serious costs as long as the implicit rules of the game are adhered to. The ruling coalition also faces strong lower level factions within because the ruling coalition is now dependent on buying in a significant number of lower level factions to form an electoral block that can rule. As a result, the higher levels are continuously engaged in negotiations with lower factions to keep them in the bigger coalition, given that the opposition is always trying to woo away significant factions. This structural feature of competitive clientelism increases the bargaining power of lower level factions and further limits the ability of the ruling group to enforce discipline within itself, even compared to weak authoritarianism. The power of lower level factions also has a tendency to increase over repeated rounds of coalition formation over a number of election cycles. The competition for coalition formation can induce the entry of a greater number of ambitious faction leaders at the local level, increasing the bargaining strength of existing factions and enabling small factions to extract holdup payoffs for joining the winning coalition.

The specific feature of Thai competitive clientelism was, however, the growing strength of business interests. Even during the authoritarian period, business was becoming economically stronger and politically more confident. With the onset of competitive clientelism, the resources big business could deploy became very important for setting up winning coalitions. Lower level factions were increasingly dependent on business support. Thailand did not have strong intermediate classes providing leadership to factions because it did not have a colonial history where these classes were created for colonial political management. This helped Thai business to initially establish its dominance over factions rather easily. Initially, the consolidation of competitive clientelism strengthened the presence of business in politics. Prior to 1969, lawyers and bureaucrats had dominated in the Assembly. But after 1969, the share of business in the Assembly rose rapidly to around one half of the seats. By the 1980s, just under half the Cabinet consisted of businessmen, with the share reaching over 70 per cent in the late 1980s (Phongpaichit and Baker 1997: Tables 10.1 and 10.2). The businessmen in question were not all big businessmen, and there was a growing entry of provincial business interests into politics. Nevertheless, at the higher levels, Thailand was becoming increasingly sophisticated in its industrial structure, as we have described in earlier papers (Khan 2008, 2009b). The organizational structure of business interests was therefore one of moderate to high capability business closely linked to particular factions, the top left hand square in Figure 18.

This combination of characteristics imply some specific features of the clientelist political settlement that are relevant for understanding Thailand's economic performance in the 1980s. The free-entry rent seeking that favoured business interests already characterized Thailand's political economy and continued despite the more open political system because of the dominance of business interests in the organization of factional politics. It was relatively difficult for oligopolistic interests to convert themselves into monopolistic ones as entry could not be prevented for already existing and powerfully networked competitors. It was equally difficult for ruling coalitions to expropriate capitalists or to seriously restrict their rent seeking. This also meant that significant industrial policy initiatives would remain difficult.

Despite the dominance of capitalist interests and a political system in which they had considerable voice, the structure of competitive clientelism, and paradoxically the very dominance of capitalist interests in the organization of factions meant that it was very unlikely that capitalists could be disciplined by institutions that provided conditional rents. The potential growth-stability trade-off faced by institutions supporting learning strategies remained very adverse. A partial exception to this was probably the long-running premiership of General Prem Tinsulanond, from 1980 to 1988. Prem's governments included significant numbers of businessmen, but his strong roots in the army (he was an unelected premier) and his reliance on technocrats gave his government a somewhat more developmental character than the others. He was less worried about opposing factions as he had the capability to repeatedly construct a ruling coalition, and he was therefore more able to contain his own clients and those of others. The limited industrial policy experiments that we see in Thailand in the 1980s, summarized in Figure 25, happen mostly during his tenure (Doner and Ramsay 2000; Rock 2000; Khan 2008).

Thailand's economic performance in the 1980s was also assisted by strong bureaucratic capabilities in sectors like the central bank and the Ministry of Finance. The dominance of capitalist interests in competitive factions helped to ensure that factional polices did not invade these technocratic spaces as the consequences for capitalists in the ruling coalition as well as effective opposition factions would be significant. This ensured that rent seeking did not initially result in fiscal irresponsibility. However, as factions became increasingly driven by provincial and lower-level business interests in the 1990s, these characteristics of relative probity changed. Big business became increasingly unrestrained by factional competition because opposition factions were no longer driven by productive business interests.

The characteristics that ensured that the Thai political settlement had significant growth-enhancing characteristics began to be slowly undermined by both domestic and international factors. At home, the growth of provincial interests meant a growing factionalization of politics and the displacement of big capitalist interests within the factions. This weakened the hold of big capitalist interests on factions, and made parties more interested in rent creation for rural elites and emerging provincial businessmen. This weakened the technocrats and industrial policies moved further down the list of priorities. The second and equally important trend was globalization and the Japanese entry into South East Asia which brought unprecedented volumes of foreign capital into Thailand in the late 1980s. The ruling coalition now had an easy option for supporting growth: make Thailand attractive to foreign investors and forget about the difficult task of developing domestic technological capabilities. As the institutional changes which made Thailand more accessible for foreign capital did not challenge any of the rents that new powerful interests in the political settlement were reliant on, the introduction of these changes faced no significant stability trade-off. The changes in rent strategies in the late 1980s are also summarized in Figure 25.

However, while the introduction of institutional changes that enabled the entry of foreign capital was relatively easy, the creation of institutions that could appropriately manage these capital flows was not. With inflating capital values, stock markets and property prices, it would have been difficult for any regime to introduce effective institutions to keep track of what was real and what was a bubble. For competitive clientelism it was even more difficult. The economic implications of the 1997 crash

have been discussed in an earlier paper (Khan 2008). We now turn to the significant implications of the 1997 crash on the political settlement in Thailand.

Summary

The competitive clientelism of the mid-1970s to the late 1990s was characterized by a competitive clientelist ruling coalition and technologically sophisticated and politically powerful entrepreneurs. Free entry into manufacturing was accelerated with the growth of relatively sophisticated manufacturing capabilities. For a while, developmental industrial policy initiatives were also attempted by a ruling coalition in the 1980s with some developmental characteristics. However, industrial policy initiatives generally faced adverse growth-stability trade-offs and poor implementation. The competitive clientelist settlement was undermined by the growth of rural business-led coalitions which had adverse effects on the efficiency of formal technocratic institutions. The financial crisis of 1997 fatally undermined the political arrangements underpinning the competitive clientelist settlement.

The ‘Unproductive’ Dominant Party: 2001-2008

The rise of Thaksin and the constitutional crisis that eventually engulfed Thailand is a complex story (Phongpaichit and Baker 2009). We will focus only on the broad outlines and the way they affected the political settlement. The crisis of 1997 was an important turning point in a number of ways. The crash destroyed the confidence of the Thai business class in globalization and created a nationalist demand to protect domestic industry. The frustration of domestic capitalists became particularly intense after the Democrat Party agreed to accept western advice coming from the IMF and other bodies that transferred significant Thai assets into the hands of foreigners at very low prices. At the same time, the crash brought to a head long simmering discontent and mobilization by the increasingly assertive and self-confident middle classes for constitutional reform that would see out ‘money politics’. A broad social movement that had forced parliament to allow the drafting of a constitution by consultation had produced a document that was initially opposed by most in the establishment as impossibly radical. But the collapse of confidence in the entire political system in 1997 enabled the new constitution to be rapidly adopted.

The constitution deliberately sought to create a modern political system where strong parties would contest on manifestos. It tried to reduce the weight of clientelist provincial interests by introducing a number of seats to be allocated by party lists. It tried to reduce competitive clientelist lobbying by increasing the power of the Prime Minister over the party, for instance by stipulating that when ministers resigned, they would lose their parliamentary seat, making ministers more likely to stay with the party. The Prime Minister could call an election with forty five days notice, but a candidate had to be a member of a party for ninety days to stand for election. This was to reduce the threat of defections. A number of independent bodies were also created to check and balance political representatives. However, the framers of the constitution did not understand that constitutional rules cannot change the fundamentally clientelist nature of a political settlement. Ironically, these constitutional rules helped to create a dominant party that was in many respects worse for the middle class framers of the constitution and for many of the capitalists who initially supported Thaksin’s party than the competitive clientelism that it replaced.

Thaksin was a well-connected businessman who had dabbled in many things without making any significant money. His fortune changed in the early 1990s when he managed to get the concession for a mobile service and a paging service from the Telephone Organization of Thailand (TOT). In a couple of years he was a baht billionaire, riding on the mobile boom that took his net worth through the roof (Phongpaichit and Baker 2009: 25-61). When Thaksin set up the Thai Rak Thai Party in 1998, his agenda was strongly influenced by the crisis. He spoke of the need to protect Thailand's competitiveness, respond to the aggressive behaviour of global competitors, and to have business values and attitudes replace bureaucratic ones in the running of the country. This struck a chord with both the middle classes who saw the old bureaucratic polity as a cause of the economic mismanagement for which the whole society was paying a price as well as the stricken Thai businesses looking for support and salvation on a scale that the IMF would not recommend. As an intuitive politician, Thaksin also recognized that a focus on big business would not sell and so his rhetoric turned rapidly to the small entrepreneur and the farmer. A rural uplift programme based on debt relief, spending programmes and the 30-baht health cover plan emerged.

The 2001 elections were a combination of new manifesto politics combined with old-style faction building. Thaksin showed that he understood how to do both, creating a winning combination. His party won 248 out of 500 seats but this soon ballooned into a massive majority as a number of smaller parties merged into the Thai Rak Thai. By 2002 he controlled 364 seats. This, combined with the powers the constitution gave the Prime Minister converted Thaksin into a presidential style leader of a massive patron-client coalition. In terms of our classification of organizations of the ruling coalition in Figure 17, this was a moderately strong dominant party. The excluded factions had little power, but Thaksin had bought in many factions into his grand coalition and insider factions did have significant bargaining power. This proved to be significant as we shall see.

The organization of business interests during this period is interesting and paradoxical. Initially, business interests were keen to see a businessman in charge of the country at a point of crisis. In his first term, there were attempts made to revitalize the economy and even to define feasible industrial policy. Indeed, many business interests were close to factions within the dominant coalition. Economic growth sharply increased as a result of Keynesian spending programmes focused on rural spending. The budget deficit did not grow and actually began to shrink as growth picked up because the initial spending was financed by borrowing the vast underused deposits of banks that had stopped lending.

More interestingly, Thaksin started talking about developmental interventions to develop the competitiveness and capabilities of Thai business. Some preparatory actions were taken. The US consultant Michael Porter was paid a million dollars to identify sectors and policies for Thailand to develop competitive niches. By mid-2002 he had identified five unsurprising sectors: tourism, fashion, food, computer graphics and automobiles. Porter provided general and sometimes contradictory recommendations like more openness and an end to 'business connections with government' but also micro-level support for specific sectors and firms. He also recommended a free trade agreement with the US without explaining how this might affect industrial policy interventions.

In the end, the experience of the government with the bailouts organized by the Thailand Asset Management Corporation (TAMC) showed why industrial policy would almost certainly not have worked without a reorganization of political arrangements. These limited experiments in the direction of industrial policy were critical for Thailand and the early compromises were possibly a lost opportunity. The experience may even have dampened any interest on the part of the leadership to proceed in this direction. The TAMC was set up by Thaksin to assist the recovery from crisis by taking up bad loans from banks and to lend to priority sectors. But the immediate lending of state banks and of the TAMC showed the enormous power of factions within the ruling coalition. Phongpaichit and Baker (2009: 112) provide examples of several big businessmen who received billions of bahts of loans and debt forgiveness for dubious business ventures when they were clearly not short of money given their lavish spending on buying golf courses and other activities that were simultaneously going on. The explanation was that these individuals were connected to powerful factions that were part of the new ruling coalition.

Thus, the ruling coalition attempted to implement its industrial policy by engaging in significant compromises with powerful factions within the dominant party from the very outset. In terms of Figure 13, the compromise strategy with powerful factions led to the easy implementation of aspects of the policy (the bailout) because this faced virtually no resistance from any powerful group. However, the growth implications were limited. The bailouts prevented some enterprises going under. But unlike early industrial policy where the allocation of resources to powerful businessmen at least creates new capacity, in the case of bailouts the growth effects were more limited. But more seriously, the compromise strategy had serious negative implication for the future of industrial policy. The recognition of factional power within the party amounted to a significant worsening of the trade-off facing potential industrial policy interventions in the way suggested in Figure 13.

Given the electoral strength of the dominant party, a more confrontational but incremental strategy of implementation as in Figure 12 may have resulted in less significant progress at first, but may have enabled incremental improvements over time. In practice this would have meant a more limited programme of support to particular enterprises with conditions that were enforced even at the cost of some conflict. Whether the leadership turned away from industrial policy options as a result of its negative experiences with bailouts, we do not know. But had the Thai Rak Thai party proceeded with industrial policy, it would have had to address possible internal conflicts given the evidence we have about the operation of its internal patron-client structures. Thaksin would have had to take on some factions politically, which would have meant slower incremental progress, or risk poor enforcement and outcomes.

As it turned out, Thaksin's response was two-fold. First, his own appropriation strategies involving his close family and friends became more open and intense. It could be that he was so hopelessly venal that the acceleration of unproductive rent appropriation by his family would have happened anyway. But if a developmental strategy was not possible because of the internal structure of the party, becoming the biggest of a gang of profiteers also made sense. Secondly, economic nationalism and industrial policy was quietly dropped and replaced with a more populist support for

the poor, for rural interests and the small businessman combined with a growing openness to foreign capital as a way of sustaining growth.

By the time of the second election of 2005, Thaksin had re-invented himself and his party. He was no longer the business leader of Thailand Inc., but a champion of the small farmer and the poor and an enemy of the 'influential figures' in the old bureaucratic polity. He used his powers to pack his supporters in key positions in the bureaucracy and the army, bought in rural power brokers on a massive scale and offered them a winning formula they could not refuse. The Party would continue to build its appeal to the poor with its rural spending and cheap health programmes. Rural faction leaders belonging to the party therefore had a high chance of winning and a very low chance if they stayed out. The ruling coalition was now virtually free of any constraint from either the bureaucratic caste or business, and could create significant rents through their control over the political process. Given the absence of strong internal party discipline which is a prerequisite for creating productive rents, the ruling coalition was likely to create and capture unproductive rents based on government construction contracts (like the new airport) or asset sales. The ultimate losers were the middle classes, but paradoxically they had little voice under a dominant party with a huge parliamentary majority.

The outcome was the most crushing single-party victory in Thailand's political history. In the 2005 elections Thai Rak Thai won 377 out of 500 seats, and it looked like this was going to be the beginning of a long period of rule. In terms of the political settlement, the second election definitively established that the organizations of big capitalists were now largely excluded from power. The factions organized by Thaksin relied on rural organizers and some provincial small capitalist interests, and some business interests closely linked to his network. Excluded businesses lost access. So did the urban middle class. The combination of a dominant party with relatively high capability capitalists who were effectively politically excluded was both new and unexpected. The introduction of formal and informal institutions that squeezed business and middle class interests now faced little resistance. Tax collection from business and middle classes was tightened to finance the new populist schemes in the countryside. Rents were created in government contracts that made infrastructure expensive for business. Any possibility of industrial policy was off the agenda. The growth-stability trade-off suddenly became very adverse for growth-enhancing institutional changes, though Keynesian expansion combined with a return of foreign investment was sustaining overall growth. It is in this context that the last row in Figure 25 makes sense.

Despite Thaksin's nationalist origins, growth in the 2000s was increasingly based on foreign investors, while domestic capital and the middle classes faced worsening institutional conditions. And despite the hopes of the framers of the 1997 constitution, Thailand was not only still a clientelist polity, the dominant party system provided a significantly worse method of constructing the ruling coalition given the particular configuration of power that had emerged. The growth-stability trade-off was now worse, on top of the repression felt by the middle classes and the economic squeeze that they feared would get worse over time.

Summary

The dominant party period of the 2000s under Thaksin was one of a single party ruling coalition based on rural factions to the exclusion of most factions based on business interests. High capability Thai capitalists unexpectedly found themselves politically excluded, as did the middle class. The organization of the ruling coalition and the exclusion of business interests implied a significant worsening of the growth-stability trade-off. Damaging institutional interventions were introduced with little resistance. The ruling coalition engaged created damaging rents for itself and yet maintained massive popularity at the polls. It could only be unseated with significant bureaucratic-military intervention supported by the middle classes, a possibility the middle class framers of the 1997 constitution had probably never envisaged.

The Backlash: Authoritarianism with a Democratic Face 2008

The middle class backlash began with a successful mobilization against Thaksin's many acts of corruption and misuse of power. Thaksin's tax evasion in a multi-billion dollar sale of his stake in Shin Corp. (whose major asset was the mobile company) to Temasek Holdings of Singapore provoked a concerted public protest. Knowing he would win again, Thaksin called elections in February 2006. The opposition boycotted the polls and though Thaksin won unopposed parliament could not be called because of a technicality. The constitution requires a candidate to win at least 20 per cent of the registered votes and as Thaksin was weak in the South, parliament could not be called because of a number of unfilled seats. In September 2006 in the face of a growing middle class mobilization against Thaksin, the army staged a coup. In May 2007, the Thai Rak Thai party was legally dissolved. However, the coup-makers and the middle class did not have an answer to the basic problem that the party was simply a coalition of factions and these factions still had a winning strategy.

In late 2007 the factions that Thaksin had put together took over a small party called the People's Power Party (PPP) to contest the upcoming elections. Despite the absence of Thaksin, who was in exile, the PPP won the biggest number of seats and was just 8 short of an absolute majority. It formed a government with other parties. A new round of mobilizations by the urban middle class began. The middle class opposition appealed to the monarch, distinguished themselves as 'yellow shirts' (the royal colour) and began increasingly violent civil disobedience movements against the 'red shirts' of Thaksin. In a series of moves that verged on both the farcical and the dangerous, the middle class, supported by the army and a resurgent bureaucracy struck back to remove the PPP by any means available. This included removing the sitting Prime Minister for appearing on a television cooking programme and accepting trivial expenses and working behind the scenes to prevent action against increasingly costly occupations of airports and government offices by the yellow shirts that brought the economy to its knees without any response from the law enforcement agencies. A series of court cases also found key Thaksin associates, Thaksin himself and his wife guilty of various tax evasion cases, and finally the PPP itself was dissolved while it was ruling as the governing party on the grounds that several of its MPs had engaged in electoral fraud.

The remaining MPs in parliament were corralled under the Democrat Party to form a government in December 2008 under the likeable Oxford educated Abhisit Vajjajeyra. Despite the external facade, this was clearly a ruling coalition set up and supported by powerful interests in the army and bureaucracy. They in turn were acting with the

support of the resurgent and increasingly class-conscious middle classes appealing to the monarch to save 'the country'. Although the Democrat Party is hardly an authoritarian party, the ruling coalition has features of the authoritarian model in Figure 17. Powerful coalitions were excluded by administrative and legal means, backed by the threat of force. This is unlikely to be a sustainable situation. Unlike the 1960s, the excluded factions in the rural areas and the urban poor are not likely to remain quiescent for very long. There are also powerful organizers who have tasted power and rents and it is a question of time before they begin to assert themselves.

The growth-stability trade-off facing specific institutions during this transition period is not likely to remain relevant for long. Excluded business groups are likely to have increased their access to political power but it is not clear to what extent. The real challenge facing Thailand's polity is how it will respond to accommodate the now powerful excluded factions mobilizing the rural poor, provincial elites and other groups that Thaksin so successfully mobilized. If business and middle class led political factions can incorporate them, a new variant of competitive clientelism could begin to emerge where rents will have to be created for a new and significant block of informal power. If the middle class and business interests attempt to keep this block out by force, Thailand could face more serious crises of adjustments in the future. The relevant feature of this experience of general interest is that it demonstrates the importance of understanding developing country politics from the perspective of clientelist political settlements. Political reform has to be embedded in the resolution of distributive conflicts based on informal power, and different mechanisms of addressing these problems have very different growth implications. The Thaksin experiment showed that an electorally unassailable ruling coalition can be constructed in a clientelist political settlement that has seriously adverse implications for growth.

Summary

The 2008 'victory' of the Democrat Party was effectively a return to a version of an authoritarian ruling coalition because powerful coalitions were excluded by military-bureaucratic interventions. In the context of an empowered rural factional structure and expectations of the poor, the sustainability of this ruling coalition is questionable. In the meantime, some of the more adverse informal institutional arrangements for rent capture by the ruling coalition were reversed. The growth-stability trade-off is less adverse for the operation of the institutional arrangements of competitive entry for high capability firms compared to the dominant party period. But the political settlement is vulnerable to the emergence of new conflicts as powerful factions were excluded by administrative mechanisms.

9. Maharashtra: From Dominant Party to Competitive Clientelism

Maharashtra's strong position in manufacturing in India has a history that goes back to the development of the Bombay textile industry in the mid-nineteenth century (Khan 2008). The location of much of early industrial production in Bombay (later called Mumbai) meant that Maharashtra acquired at a very early stage the biggest concentration of industrial capitalists from all over India. This created a relatively sophisticated capitalist class in the state that was soon closely networked into the factional structures of the Congress Party even before independence in 1947. But it also created tensions with the indigenous Marathi speaking population who were not well-represented amongst the industrial capitalists. For a time, the Congress dominant

party system managed to square this circle by combining a successful factional strategy that gave it the rural vote while remaining responsive to and strongly supportive of politically powerful urban capitalist interests. But by the late 1980s the dominant party ruling coalition began to fall apart. Tensions had begun to grow much earlier with the growing mobilization of groups who were excluded by the Congress factional compromises. But now opposition parties like the BJP and Shiv Sena began to capitalize on and organize the excluded groups, making significant gains in the 1989 elections. In 1995 Congress lost the state Assembly elections and in 1996 the Lok Sabha (national assembly) elections, marking the end of the dominant party system. Though Congress eventually made a comeback, the Maharashtra political system is now much more fragmented, with coalitions and alliances of parties ruling in a competitive clientelist structure.

To a large extent the collapse of the dominant party ruling coalition in Maharashtra mirrors the fate of the Congress as a dominant party across India. The exponential growth in the organizational power of excluded groups across India from the 1960s onwards created strains that the Congress dominant party structure could not accommodate. From the end of Indira Gandhi's Emergency which saw Congress lose power at the centre for the first time in 1977, the dominant party structure was effectively over, and variants of competitive clientelism began to emerge both at the centre and in most states in India. However, the class origins and organization of the excluded groups differ significantly across India, as does the political strength and capabilities of the capitalist classes. In terms of our classification of characteristics of the political settlement, Maharashtra moved from a dominant party system with technologically advanced and politically well-connected capitalists to a competitive clientelist system where the capitalists retained their political power and access.

Unlike Thailand, in Maharashtra competitive clientelism achieved a less favourable political settlement from the perspective of growth compared to the possibilities under the Congress dominant party system. This shows once again the non-linear relationships between institutional and political settlement variables. The difference emerges because in Maharashtra capitalists were politically powerful and had close access to the ruling coalitions in both the dominant party and the competitive clientelist periods. But in the former, the longer time horizon of political leaders allowed both sides to follow informal rules of resource allocation that were more conducive for long-term investments. With the advent of competitive clientelism the business relationships with politicians were more difficult to convert into informal but long-term arrangements of mutual support and this resulted in less favourable institutional arrangements from the perspective of growth. The changes in the political settlement and the implications for institutional efficiency and growth-stability trade-offs closely coincide with the changes in the rents affecting the productive sector in Maharashtra. The broad features of the evolution of the political settlement in Maharashtra are summarized in Figure 21 and discussed in subsequent sections. Readers should also refer to Figure 26 in the Appendix reproduced from Khan (2008).

MAHARASHTRA	
CHARACTERISTICS OF POLITICAL SETTLEMENT	BROAD FEATURES OF INSTITUTIONS AND GROWTH
Congress Dominant Party System with moderate capability / powerful capitalists: 1947-1980s	Institutions support rapid extensive growth in manufacturing and partial implementation of industrial policy
Competitive Clientelism with moderate to-high-capability / powerful capitalists: 1990-	Effectiveness of support for long-term investments decline but pockets of high growth are sustained

Figure 21 Evolution of Political Settlement in Contemporary Maharashtra

The Congress Dominant Party System: 1947-1980s

The Indian National Congress was organized as an inclusive party to fight for Indian independence. Its aim was to include all relevant factions within one umbrella such that the excluded were not significant for the maintenance of political stability or the achievement of economic goals. The strategy of inclusion was never perfect and indeed failed to satisfy many significant minorities, most importantly the Muslims who lived in Muslim-minority provinces of India. The growing discontent of these factions was organized in the Muslim League, which originally operated as a group within the Congress. The demand for Pakistan came from Muslim political elites in central and western India where Muslims were a minority. In particular, Jinnah used the demand for Pakistan as a bargaining tool to try and achieve a guarantee of federalism which he believed would ensure that Muslims all over India could exercise significant voice in an independent India (Jalal 1985: 258). When Nehru and the Congress Party failed to reach an agreement with Jinnah along these lines, and particularly after Nehru rejected the Cabinet Mission Plan proposal for a federal structure for India in 1946, Pakistan suddenly became inevitable. After this catastrophic and possibly avoidable failure of inclusion, Congress was nevertheless able to recover its inclusive strategy in post-independence India.

The trauma of partition probably made Congress much more sensitive to the costs of ignoring demands of factional leaders mobilizing significant constituencies on grounds of exclusion. As early as the 1950s, Nehru gave in to demands for a linguistic reorganization of Indian states even though initially he had been reluctant to concede linguistic identities on the grounds that this would create competing identities. Nevertheless, once the principle was conceded, the unwieldy bilingual state of Bombay, the successor of the even bigger Bombay Presidency of the British, became an obvious target for reorganization. The northern Gujarati speaking part was poorer but Gujarati traders and businessmen were more advanced and entrenched in Bombay city compared to those from the southern Marathi speaking part of the state which claimed Bombay as its own. Indeed, Bombay as one of the earliest hubs of capitalist development in India was home to businesses from all over India, with a significant presence of Parsis and Marwaris in the business community and working people from virtually everywhere. But Marathi business was relatively much less developed.

Given the significant gap between the sources of economic and political power in the state, Congress was remarkably successful in constructing a strategy of incorporating the Marathi intermediate classes in its political structure. This allowed Congress to

continue as the dominant party after Maharashtra emerged as a linguistic state on 1st May 1960. Its strategy was helped by the caste composition of the Marathi population, which had a significant intermediate caste that Congress successfully targeted as its organizational constituency. Congress remained the dominant party in Bombay and then Maharashtra from 1947 till the late 1980s, with a brief spell out of power after Indira's Emergency ended in Congress defeats between 1978 and 1980. By the late 1980s powerful factions had been organized outside the Congress Party who posed credible threats to Congress rule. The dominant party system was clearly coming to an end.

The salience of caste in Indian politics is that political organizers from a particular caste find it easier and cheaper (in terms of the rents it is necessary to deliver) to organize people of their own caste. If the caste structure is itself very fragmented, it makes the organization of factions somewhat more difficult in terms of transaction costs. In the 1930s, before the advent of electoral politics, the Congress Party in Bombay-Maharashtra, as in many parts of India was dominated by the tiny Brahmin caste. In modern Maharashtra, Brahmins are barely four percent of the population. But by the mid-1930s as electoral politics began, the Congress had to find a leadership that could organize and mobilize potential voters. The next rung of the caste hierarchy in Maharashtra consists of an agrarian intermediate caste called the Marathas (not to be confused with Marathi as a language) and the slightly lower-status but closely related Kunbis. The Maratha-Kunbi group alone accounts for over 30 per cent of the population. With such a significant intermediate class group that could serve as organizers and faction leaders, it was obvious where Congress would have to focus to construct its factions for a dominant party. In addition, the most famous Maratha in history was Shivaji, the seventeenth century warrior who fought against the Mughal Empire in Delhi and asserted for a while the dream of Maratha supremacy across India. The Marathas were therefore the obvious social group to provide Congress its faction leaders (Palshikar and Deshpande 1999).

By wooing leaders from the Maratha-Kunbi caste, Congress built up a class of faction leaders who could potentially deliver the 'bahujan samaj' or ordinary folk (though the term often excludes dalits as a special category). The faction-building strategy was particularly successful because the Congress also had access to significant informal funds that it could use for the informal distribution networks on which patron-client factions are based. These funds came from the organization of sugar cooperatives in the state from the 1950s onwards (Banerjee, et al. 2001; Roy 2010). Maharashtra is India's biggest sugar producing state, producing about a third of the national output, and over 90 per cent of this comes from the cooperatives. These were set up to help small producers, who were previously captive to local private monopsonies as there are significant scale economies in sugar crushing and refining and sugarcane needs to be crushed soon after harvest. The cooperatives were set up to be monopsonies that were controlled by small farmers and would in theory offer the best prices.

However, as we would expect, those with the greatest organizational power in the local economy end up controlling the cooperatives. The people who control the cooperatives turn out to be the intermediate class Maratha organizers on whose capabilities Congress began to depend. Control over the cooperatives provided significant sources of rents for the organizers as long as they received informal institutional support from the ruling coalition. Support from the ruling coalition was

necessary because the cooperatives were tightly regulated by government. With this support, the cooperative leadership could first set a purchase price of cane at a low enough level to leave large implicit rents remain in their hands. The buying price was a bargaining game between the leadership and small farmer members. There were limits to how low the price could be set because the leadership also required recognition as leaders. But the price would not be so high that no rents existed.

A further source of rents comes from the fact that the cooperatives raise their working capital from the state's district cooperative banks. The ruling coalition controls these banks and some senior politicians sit on their boards. Repayment of loans is traditionally not very good because of the many uses that are made of cooperative funds. By 2007, of the 182 sugar cooperative factories, nearly 40 percent were losing money and finding it difficult to service their loans (Kaur 2007). However, with good political connections cooperatives can keep going. The sugar cooperative leaders were expected to use these rents both to satisfy themselves as well as to deliver significant vote banks that ensured Congress victories in the countryside, and therefore political power in the state as a whole. This created strong incentives for loyalty to the Congress and created a stable ruling coalition as long as the coalitions excluded by these arrangements remained weak.

Not only were the financial rents from the cooperatives used to fund the personal and political ambitions of cooperative leaders, the capital equipment of cooperatives like cars and trucks were openly used in election campaigns. Between the 1960s and 1980s, one sugar factory (cooperative) provided 200 trucks, 100 cars and various other vehicles for the election campaign of the local Congress MP (Sirsikar 1995: 121). The Congress Party would also have access to the manpower of the cooperatives during election campaigns with all the costs being covered by the cooperative (Sirsikar 1995: 86). In addition, the fact that the leaders of the cooperative supported or were standing for election on Congress tickets made it very unlikely that too many of the thousands of small farmers in a cooperative and their families would vote any other way. Most of the leading Congress Party leaders of the time including Sharad Pawar and Vasandada Patil were closely associated with the sugar cooperatives. Just one of the cooperatives controlled by Sharad Pawar, the Malegaon Sugar Factory, has ten thousand member families, with the typical factory having twenty thousand (Roy 2010). Congress rule in Maharashtra appeared to be impregnable.

The construction of this successful dominant party ruling coalition based on caste and sugar rents had a different outcome in Maharashtra compared to Thailand's dominant party experience because the well-established capitalists of Maharashtra continued to maintain strong links to the heart of political power. Here, the political stability that the Congress enjoyed allowed long-term relationships to be developed between individual Congress politicians and big capitalists in Mumbai. This was a continuation of a long tradition in Bombay Presidency politics where politicians provided licenses and favours to capitalists and in exchange capitalists kicked back benefits over time. As long as the relationship was a long-term one and capitalists were under no pressure to kickback large amounts immediately, the informal relationships were potentially and in many cases actually very productive. They allowed capitalists to engage in long-term investments and provided politicians with growing assets to call upon in the future. These features of the political settlement in Maharashtra can explain the dynamism it enjoyed in industrial growth all through the 1950s to the late 1980s. The

major rent allocations that were consistent with that growth are summarized in the first two rows of Figure 26 in our Appendix.

The long term informal relationships between politicians and businessmen were more important than the formal structure of licensing in explaining Maharashtra's much greater success in industrial growth from 1950 to 1980. The allocation of formal licenses was in fact guided by informal processes within the licensing system, and Maharashtrian business was much more successful in getting more than their share of India's industrial development licenses during the license raj period (Khan 2008). The political settlement in Maharashtra can explain why formal institutions worked so effectively in Maharashtra's favour during this period. The informal exercise of power that allowed Maharashtrian business to get these formal rents was an important, if hidden, part of the story. Perhaps even more interestingly, the long-term informal relationships that were possible in Maharashtra because of its political settlement allowed business to plan long term. Big business houses like Ambani and Bajaj had close links with politicians but could take long-term investment decisions because their relationships with their politician networks were themselves long-term. Moreover, as we outlined in Khan (2008), big business benefited enormously from the clustering and supply chains that were made possible by the strong intervention of bodies like the Maharashtra Industrial Development Corporation (MIDC) that made available high quality land and infrastructure for industrial clusters to develop.

These characteristics of the political settlement can explain why a number of critical formal and informal institutions worked in growth-enhancing ways in Maharashtra from the 1950s right to the 1980s. These institutions provided significant investment opportunities to established capitalists and facilitated clustering and other linkages through land acquisition and infrastructure provision. Their implementation was not threatening the distributive interests of any powerful coalition, and indeed could further the mutual interests of dominant capitalists and politicians. We would therefore expect their implementation to be relatively efficient and that they would face very flat growth-stability trade-off curves. However, moving beyond resource provision and the facilitation of investment to active industrial policy was not likely with this political settlement given the adverse growth-stability trade-offs such interventions would be likely to face. The very networks that worked to facilitate licensing and land acquisition would stand in the way of effective disciplining.

This is one reason why the failure of the industrial policy regime in India is often misunderstood. The introduction of industrial policy was from the beginning undertaken with the active participation of capitalists. Indeed the Bombay Plan published in 1944 by seven leading Indian industrialists outlined the initial strategy of state support that they envisaged would assist India to industrialize. The close networks of Indian capitalists with politicians and bureaucrats ensured that the introduction of the capacity development and investment aspects of industrial planning would be relatively easy, but if the state ever attempted to enforce discipline the growth-stability trade-off could become very adverse. The characteristics of the political settlement would ensure that many politicians would assist in blocking the implementation of discipline on the particular capitalists who happened to be their allies.

Once again, Figure 13 can help to explain the relative success of the expansionist aspects of industrial policy because the implementation of this part of industrial policy compromised with and indeed was driven by the interests of powerful capitalists. Yet, these very compromises ensured that the transition costs facing institutions attempting to discipline and ensure productivity growth would be very high. In Maharashtra, the political settlement was particularly conducive for the accumulation and expansion aspects of industrial policy. Its political settlement enabled the state to benefit the most from the national licensing policy. The fact that some of its capitalists were significantly sophisticated meant that in some pockets Maharashtra would eventually achieve global competitiveness. But the disciplining aspects of industrial policy were not attempted in Maharashtra or indeed anywhere else in India.

Summary

The relatively effective implementation of the formal and informal interventions that supported growth in Maharashtra till the late 1980s (summarized in Figure 26) are explained by the characteristics of its political settlement. Both during the licensing period and afterwards, till the late 1980s, Maharashtra had a political settlement where a dominant party coalition enjoyed stability because of the way in which the ruling coalition was constructed. In addition, the political power and access to particular politicians enjoyed by a sophisticated and organized capitalist class based around Mumbai ensured that growth-enhancing institutions were possible and would be in the interests of the ruling coalition. The political settlement explains why the formal and informal institutional arrangements supporting extensive growth were delivered at little cost in terms of political stability and were well-enforced.

The Rise of Competitive Clientelism 1990-

The stability of the dominant party was undermined by economic and demographic changes that altered the distribution of power between classes and groups in Maharashtrian society. This then allowed excluded political factions to enhance their organizational power by mobilizing and organizing these excluded groups. The sugar cooperatives did not do much for the overall poverty of Maharashtra's agriculture and absolute poverty in the state remained worse than the national average in the 1980s despite its overall wealth due to its industrial and service sectors (Khan 2008). The Maratha caste itself was becoming increasingly divided and those who were not directly benefiting from Congress rent strategies were looking for other organizations to support. Below the Marathas, other castes became restive, known collectively as Other Backward Castes (OBCs) and below *them* the Dalits as well. The pull of so many different forces and organizations demanding inclusion could not be accommodated by the Congress system.

In the 1970s Indira Gandhi precipitated the decline of the ruling dominant party coalition by attacking the mainstream Maratha hold over the state Congress Party. As in other parts of India, her strategy in Maharashtra was to support factions (in this case the marginal Maratha leader S.B. Chavan) against powerful factions (Y.B. Chavan and sugar cooperative bosses like Vasantdada Patil) (Palshikar and Deshpande 1999). This was partly because the growing voices of the excluded were getting stronger, partly because Indira wanted to be the arbiter of state-level conflicts in the fashion of older divide and rule strategies. In the end, the growing confusion across India led to the Emergency of 1975-77. After that, the Maharashtra Congress split and the government from 1978 to 1980 was led by Congress defectors including

Sharad Pawar. When Indira Gandhi returned in 1980 she dismissed the state government and imposed her own non-Maratha loyalists. As the Maratha coalition split, other castes and social mobilizations entered the social fray.

The coming together of two Hindu fundamentalist forces, the Bharatiya Janata Party (BJP) and the Shiv Sena (SS) provided the strongest challenge to the Congress because these two parties appealed to very different Hindu constituencies. The BJP appealed to the upper castes and the more educated middle class voters, many urban, who were dissatisfied with the corruption of Congress and who also wanted a Hindu cultural and political revival. The SS in contrast appealed to a much lower group of social discontent, ranging from disgruntled lower-level Marathas and Kunbis, the OBC urban poor, the urban unemployed and even gangsters and the underworld. This was a new kind of politics that openly combined violence and gangsterism, and generated rents from activities like slum clearance. It openly used a demonization of Muslims to mobilize Hindus, but was also against Dalits because many were Buddhists (Katzenstein, et al. 1997). It also openly celebrated violence and proudly declared, for instance, that it had orchestrated the January 1993 anti-Muslim riots in Mumbai which created 200,000 internally displaced people (Lele 1995).

The combination of the two forces created a significant challenge for Congress in the late 1980s. Its hold was now based on a fine balance of factional forces and could be upset by relatively small re-allocations of factional support or voting choices of electors. The 1995 state assembly elections and the 1996 national Lok Sabha elections were both won by the BJP-SS coalition. While Congress came back in 1998, it was a different, coalition-dependent Congress. The political settlement acquired and has retained all the characteristics of the competitive clientelism described in Figure 17. Capitalists have retained their political capabilities and now operate through factions in different parties, instead of the same one. While this may appear not to have changed things very fundamentally, it has actually had some important effects.

Neither capitalists nor their political allies can afford any longer to take very long-term bets. The result is that business-government relationships are now less about long-term investments in industry and more likely to be about urban property development or the allocation of infrastructure construction contracts where rents and kickbacks are rapidly achieved. The gradual shift of sectoral specialization in Maharashtra towards a much greater emphasis on services happens exactly in the 1990s. This could partly be because the institutional structures required for assisting productivity growth and technology acquisition in industry were in any case weak. But in addition, the long-term informal arrangements backing investment strategies that were possible under the dominant party political settlement now lack credibility. If Maharashtra's politics remains fragmented and competitive this may have important implications for its ability to sustain historical patterns of industrial growth without significant changes in its institutional structure that are effective in the new political settlement.

Summary

The social and economic changes that led to a growth of organizational capabilities outside the ruling coalition could not be accommodated by the Congress Party. Its failure to move rapidly enough allowed its competitors, particularly in Hindu fundamentalist parties, to make big inroads into Maharashtrian politics. The political

settlement changed to one of a ruling coalition that faces competitive clientelism. The political power of capitalists in Maharashtra and their technological sophistication remained constant or even increased. Nevertheless, the new political settlement made unworkable many of the informal arrangements through which industrial capital operated in Maharashtra. The effectiveness of these institutional arrangements declined, and short-term rent appropriation became easier and more attractive. The growth-stability trade-off became relatively adverse, enabling damaging rents to be more easily created, while the informal institutions that supported growth have become more difficult to sustain.

10. West Bengal: The Limits of a Progressive Dominant Party

The partition of India had traumatic effects on West Bengal and Bangladesh as Bengal was partitioned (along with Punjab). At that time, Bengal was ranked equal to the Bombay Presidency in terms of industrial development. But partition had deep and lasting effects not only on trade and inter-sectoral links, but also on class and organizational evolution whose political effects are still unfolding. Initially, West Bengal appeared to have come out better because it inherited Calcutta (now Kolkata) and the industrial base around it. Bangladesh was entirely an agricultural hinterland. But fifty years later, West Bengal had dropped down the state list in India in terms of industrial development to near the bottom of the big states and its per capita income in 2010 is barely above that of Bangladesh. The political settlement as it developed in West Bengal has a role to play in explaining its relative decline, and partition has a role in understanding its evolution.

Congress failed to construct a dominant party coalition in Bengal, either before or after partition. One reason for this was that unlike Maharashtra, the intermediate classes in Bengal did not belong to a single coherent Hindu caste which could be mobilized to organize political stability. The majority of the Bengal peasantry, including the rich peasantry, had converted to Islam. Islamic influences in Bengal are noted from the tenth century, but significant numbers of Muslims are only referred to from the sixteenth. The first British census in Bengal in 1872 established the presence of a Muslim majority in Bengal, but concentrated in the East (Eaton 1993: 113-34). The growth of intermediate class peasant mobilizations in Bengal in the early twentieth century involved in the main the Muslim East, where agrarian Bengal was concentrated. The Hindu intermediate castes were, of course, also mobilized. But unlike Maharashtra, the Hindu intermediate castes were themselves fragmented. While some of these intermediate castes had significant numbers in particular districts, no particular Hindu intermediate caste had significant numbers across the province as a whole. Moreover, and again unlike Maharashtra, castes below the intermediate were well-organized in Bengal, and fragmented into different groups. These were the Scheduled Castes, the equivalent of the *dalits* in Maharashtra (Chatterjee 1997: 69-80).

The organization of an inclusive dominant coalition of intermediate class organizers which were split up in these complex ways did not add up to an acceptable equation within the Congress Party. Given the fragmentation of the Hindu intermediate castes and the overall Muslim majority, the equivalent of a Maratha base would have put Muslims in a dominant position within the Congress. Unlike the Marathas who were antagonistic to Brahmin dominance in the Maharashtra Congress, Hindu Bengali

intermediate castes were willing to work under the leadership of upper castes in the Bengal Congress. The Muslims apparently were not and the Muslim political leadership of Bengal exited from the Congress as early as the 1920s. Paradoxically, this further strengthened the Hindu upper caste control of the Congress because they were now dominant in the numerous East Bengal districts even though without the Muslim intermediate class faction leaders Congress had little effective power in these districts (Chatterjee 1997: 79).

The departing Muslim intermediate class leadership did not initiate separatist or religious political parties. Their secular *Krishok Proja* (or Peasants) Party represented typical middle and rich peasant interests (against the *zamindari* landlords in the first instance) and provided a platform for organizers from the Muslim intermediate classes to organize their own upward mobility (Umar 1980a, 1980b; Rahman and Azad 1990; Hashmi 1994). The Muslim rich peasants were not interested in separatism or partition because in the limited democracy that was allowed after 1935, their electoral advantage allowed their party, the Krishok Proja Party to form governments in Bengal. The partition of Bengal in 1947 was largely the result of all-India events and the failure of negotiations between the Congress and the Muslim League. The latter mostly represented Muslims in the Muslim-minority provinces of India. Nehru's failure to continue negotiations on the basis of the Cabinet Mission Plan, the final federal deal that could have averted partition, resulted in a panic within the League. At that critical juncture, the absence in Bengal of an inclusive organization incorporating powerful organizers from both communities had a significant role to play in allowing the panic and rioting to go out of control in 1946. In the violence that followed, partition briefly became a desirable outcome, but one with many negative long-term ramifications.

The departure of the Muslim intermediate classes in 1947 should have left West Bengal with a simpler task of organizing a ruling coalition. But this was not the case. Constructing a dominant party in a clientelist political settlement requires some mechanism for identifying a limited number of organizationally powerful leaders who are able to effectively organize political stability. Too few and political stability becomes problematic. Too many and the coalition has insufficient rents to distribute and starts to break up. Moreover, for a stable dominant party, the excluded faction leaders must be unable to organize enough power to threaten the ruling coalition. Congress found it much more difficult in West Bengal (compared to Maharashtra) to construct a dominant party with a clearly defined group of insider leaders who could provide it with even a few decades of stability. A number of features of the class and caste organization of West Bengal can help to explain this.

First, caste and class did not map very neatly in Bengal. If the upper caste Hindus (less than ten per cent of the population) had been closely associated with a landlord identity, the rich peasant intermediate castes could have united against them to form a dominant ruling coalition. The economics of landlordism had disappeared anyway, but the upper castes, certainly in the important conurbation of Kolkata, did not even have a landlord identity. They were typically educated professionals and administrators, the proverbial *bhdrolok* or gentlefolk of Bengal. Hindu upper caste faction leaders in Bengal, unlike most other places in India, provided effective and legitimate leadership to all types of movements, including anti-landlord movements representing intermediate class or working class interests. But the loss of East Bengal

paradoxically weakened the upper caste leadership of Congress as their strength was based on their control of the defunct Congress organizations in the East.

Secondly, the complex mix of upper and intermediate castes that had organizational power in West Bengal did not provide clear markers about how to identify the dominant insiders and outsiders in the ruling coalition. Even competitive clientelism requires the identification of two or more factional 'tribes' who can each try to cobble together viable ruling coalitions. These markers did not exist in the chaos following partition so the selection of insiders and the resources they could demand required much negotiation. These features of caste and class help to explain why the West Bengal Congress found it so difficult to construct a stable dominant party. It also explains why caste politics never played the same role in defining ruling coalitions in West Bengal as it did in most other Indian states.

On the other hand, the departure of the Krishok Proja Party and the Muslim League meant that most factional organizers were now affiliated to the Congress so only a Congress government was likely. Secondly, the weakening of the Kolkata-based upper caste Congress leadership (as a result of the loss of their power base in the East) allowed rich peasant leaderships in West Bengal districts (with mixed caste leadership) to assert themselves. The result was a period of intense faction fighting through which a distribution of power and rents was achieved within the Congress and allowed it to operate for a while as a weak dominant party. These internal compromises were not based on caste, ideological or other markers and were therefore necessarily vulnerable to constant renegotiation. Congress continued to operate as a weak dominant party ruling coalition in West Bengal till the mid-1970s. Towards the end it was collapsing into competitive clientelism and a brief attempt at authoritarianism under Indira's Emergency finally destroyed the Congress hold on power. In 1977 a new dominant party, the Communist Party (Marxist) or CPM, emerged. This was a new phenomenon: a progressive dominant party voted in again and again for more than three decades.

Throughout this period, the political power of big capitalists remained weak and declined over time, in contrast to Maharashtra. As in Maharashtra, the dominant big capitalists in West Bengal were not ethnically from the state. But in Maharashtra capitalists initially had long-term relationships with Congress politicians and the latter typically played an important role in the national Congress party. This was not the case in West Bengal. Congress politicians in Bengal did not have a significant presence at the centre, and were in any case too busy keeping a weak coalition together. Long-term relationships between Congress politicians and business houses were therefore less in evidence compared to Maharashtra. With the advent of the CPM, with its focus on an agrarian constituency, the access of business to political power declined further. This aspect of the political settlement meant that the dominant party system in West Bengal was much less successful in developing long-term informal relationships with business. The broad features of the evolution of the political settlement in West Bengal are summarized in Figure 22 and discussed in subsequent sections. Readers should also refer to Figure 27 in the Appendix reproduced from Khan (2008) which summarizes aspects of governance and rents linked to the evolution of the political settlement.

WEST BENGAL	
CHARACTERISTICS OF POLITICAL SETTLEMENT	BROAD FEATURES OF INSTITUTIONS AND GROWTH
Weak Congress Dominant Party with moderate capability / weak capitalists: 1947-1970s	Weak support for accumulation and limited benefits from industrial policy
Strong Dominant Party Left Front Coalition with moderate-to-high capability / weak capitalists: 1977-	Weak institutional support for industry and de-industrialization. Rapid agricultural growth. CPM turn to industrialization in 2000s blocked by high transition costs

Figure 22 Evolution of Political Settlement in Contemporary West Bengal

The (Weak) Congress Dominant Party System: 1947-1970s

It took skilled Congress tacticians like Atulya Ghosh several years of horse-trading, bargaining and reorganizing the party internally to achieve a modicum of stability as a dominant party by 1949. The distribution of power between factions had radically changed with the partition of the province, new expectations and mobilizations had emerged and the province was faced with the economic and political incorporation of a mass of Hindu refugees from East Pakistan. Although there were obviously incidents of violence against Muslims in West Bengal, post-partition violence was significantly less than in Indian Punjab. As a result there was no wholesale migration of Bengali Muslims to Pakistan on the scale seen in western India. Indeed, the significant population transfers to East Pakistan came from Bihar and other Indian states further to the west. The Hindu Bengali *bhrodrolok* had voted to partition Bengal because they could not envisage living under the political rule of the intermediate classes of the East (Chatterji 1995). But their subsequent actions show that they did not harbour any deeper resentment of the Muslims and they certainly did not attempt to carry out any ethnic cleansing.

Congress's immediate problem was to accommodate the large numbers of Hindu migrants from the East who left because they felt threatened by the fact that Pakistan was emerging as an Islamic Republic. The hold on power of emerging Congress leaders was relatively weak because the new coalitions within the Congress were not very stable. A further problem was that the Bengal Congress had been treated with suspicion by the centre, and particularly by Nehru and Gandhi, ever since their conflict with Subhas Chandra Bose in the 1930s. There were few senior Bengal Congress politicians who were close to the centre in the early days. From the perspective of Bengal's Congress politicians in these early days, nurturing and developing long-term relationships with business interests was not their immediate priority. The internal weakness of the Congress coalitions is demonstrated by the collapse of these arrangements by the late 1960s and the emergence of open competition between competing factions along the lines of competitive clientelism.

From the perspective of big businesses, which were mostly run by non-Bengalis, local Congress politicians appeared to be too weak and not very influential at the centre. Big business focused their efforts on achieving direct links with central politicians but already began to feel distant from the mechanisms of state-level power. Interestingly, the smaller-scale Bengali capitalist class was also slow to develop and was not

significantly assisted by state policies. The West Bengal Industrial Development Corporation, the WBIDC (unlike its equivalent the MIDC in Maharashtra) was not backed by Congress politicians to promote industrial zones and encourage the clustering of small businesses which the big business houses could draw on.

The contrast with the dominant Congress coalition in Maharashtra is therefore significant. In Maharashtra, Congress discovered a stable winning formula based on caste and sugar rents to sustain a dominant coalition in power through the 1960s and 1970s. This left Congress politicians free to pursue longer term interests, nurture long-term relationships with businessmen (which already existed) and use institutions like the MIDC to further enhance the profitability of business and their own long-term access to rents. In West Bengal, Congress also cobbled together a dominant party coalition but it was not based on a neat arrangement. The internal arrangements were more fluid, based on shifting allocations of different types of rents to different rural coalitions. Factional leaders did not have the long-term security to develop long-term relationships with business (Bengali or otherwise) and there was therefore no motivation to use collective political authority to develop local capitalism using institutions like the WBIDC.

This combination of characteristics of the political settlement can explain why West Bengal politicians did not try to or did not actually succeed in aggressively getting licenses for businesses based in the state. Throughout the 1950s and 1960s, West Bengal got around half the industrial licenses that went to Maharashtra, despite both states having equally big industrial bases in 1947 (Khan 2008). The ruling coalition was not only too weak to achieve any significant industrial policy interventions, it was too weak relative to the central government and too weakly connected with local business to have a credible strategy of enhancing state-level accumulation. They failed to get a fair share of implicit central government subsidies attached to industrial licenses. They also showed little interest in developing formal or informal institutions to accelerate the development of a Bengali capitalist class.

Congress dominance in West Bengal collapsed a decade before it did in Maharashtra. It was precipitated by the growing inability of Congress to respond to rural poverty and the growing violence coming from the Naxal uprising. In 1967 Congress was defeated by a United Front which included the CPM and a breakaway faction of the Congress called the Bangla Congress which represented middle peasant interests. But this loose coalition collapsed in 1970. Another loose coalition of some of the same parties again collapsed in 1971. The 1972 elections brought the Congress back to power in an election that was widely felt to have been extensively rigged. Naxal violence continued to escalate and Indira Gandhi's Emergency in 1975 was a last authoritarian attempt to preserve Congress rule. It marked a symbolic turning point in West Bengal. The 1977 elections saw a resounding victory for the CPM-led Left Front. Congress would be out of power for at least the next three decades and even after the Left Front started weakening in 2010, the Congress on its own is nowhere close to having the support necessary to form a government again.

Summary

The Congress dominant party system from 1947 till its final collapse in the 1970s was internally weak, weakly connected to the centre and weakly connected to business interests. It could not influence the informal institutional arrangements through which

industrial licenses were allocated by the centre. The growth-stability trade-off was adverse in the sense that if the state leadership pushed big business interests through formal institutions they would very likely confront opposition from internal factions desperate to capture rents for their own survival, and would possibly have to confront powerful interests in central government who were allocating licenses to their clients in other states. Big business did not invest much in building long-term relationships with local Congress politicians either, and were already looking elsewhere for their long-term locational decisions.

The CPM: A Progressive Dominant Party 1977-

The CPM represents a number of paradoxes that are relevant for understanding the political settlement during its long tenure. It was a Communist Party with an ideological commitment to revolution that was repeatedly voted in by election. Despite its significant electoral mandate it did not try very hard to change the distribution of assets or power in ways that could be described as revolutionary. Yet, with rather limited implementation of land reform legislation and the registration of sharecroppers, it appeared to get the undying loyalty of the poor for over three decades. It operated what appeared to be a modern disciplined party machine in a social context where power and personal relationships were dominant organizational forces. It is the last that is of greatest significance for us, and understanding this paradox a little better can help to shed light on the other questions.

These paradoxes can be understood by recognizing that at its grassroots level the CPM could not be acting in a way that was entirely contrary to the requirements of operating in a clientelist political settlement. Its party organizers mobilized power by organizing supporters at the village level in the same way as other faction leaders would do. They also used this power to act in ways that informally changed the way formal institutions operated, or to enforce formal institutions (such as land ceiling legislation) better using this informal power. The use of power as an instrument to create and capture rents for organizers and supporters is of course the typical characteristic of a political organization in a clientelist political settlement. The CPM shared all of these characteristics with any other party operating in such a context.

But there were significant differences as well. Ideology matters and the ideological label that the CPM used to distinguish its ruling coalition from others was initially very useful in creating a dominant party coalition that was big enough to rule (and with enough support to keep winning elections), but not so big that all potential organizers could join. Its ideology also determined its primary clients and this was important in empowering large sections of the poor as clients who benefited from the protection and mobilization that CPM cadres offered. By incorporating a significant chunk of rural middle caste and *bhodrolok* organizers into a single party, the CPM achieved significant political stability and was more successful in countering violence against the poor and against minorities than most other Indian states. However, its huge base in rural middle-peasant organizers also limited its economic strategies in a negative way, and we will turn to this problem later. And finally, the CPM was also a disciplined and modern party machine that combined very modern aspects of organization with an ability to penetrate and operate in rural power structures. It was this combination of modernity with a ‘traditional’ ability to play rural power games that gave the CPM incredible longevity as a progressive dominant party structure.

In his detailed analysis of the operation of the CPM in the Burdwan district of West Bengal in the late 1960s and early 1970s, Ruud (1994) provides many examples of the ways in which the party combined aspects of the informal organization of power in what we describe as a clientelist political settlement with new elements of Marxist ideology and modern party organization. The party's cadres or core organizers were obviously from the socially powerful intermediate classes as only these individuals had the organizational capabilities, education and indeed the free time and resources to invest in political and organizational activity. Party organizers in this case had their close followers but they also appealed to a broader category of the poor to become clients and provide significant organizational power to the faction. The poor would benefit because the party could deploy power to solve their legal and formal institutional problems. For instance, if the faction could deploy hundreds of peasants armed with sticks, the organization could be used to *gherao* (surround) landlords who were not complying with existing laws recognizing sharecropper rights or land ceilings. The organization could also be used to *gherao* police officers who were refusing to enforce the formal law.

These and other examples demonstrate how at the grass-root level the party mobilized informal power primarily to resolve conflicts in favour of supporters and often to enforce formal laws when its clients were adversely affected. Its appeal to the poorer peasants who were mobilized was that belonging to this faction would offer them greater protection as well as rents through the marginally better enforcement of formal laws, or through the resolution of their conflicts in ways advantageous to party supporters. In a general context of poorly defined rights, there was plenty of scope for that. It was the deployment of informal power in these ways rather than changing formal laws or rights that provided the party with its support. The details of Marxist theory also mattered little, except that the overall thrust of policy was to organize the poorer to protect them against the richer. But this did not necessarily stop horizontal conflicts frequently being resolved in favour of party supporters. The operation of the party as an effective organizer of power can help to explain why its policies were not revolutionary and yet attracted a large factional loyalty from the poor for so long.

What is missing from Ruud's story is what the organizers and faction leaders got from the party. Some were no doubt motivated by a social conscience and a core of supporters came from the party's revolutionary and idealistic past. But the party also rapidly grew in the context of the election victories of 1967 and 1971. For instance, from 1968 to 1969, party membership more than doubled from around 10,000 to 23,000 (Ruud 1994: 366). As older party cadres pointed out about the new members, their general education, let alone knowledge of the principles of Marxism, was often very poor. Many of the new people joining were themselves organizers and we can assume they hoped to get something by joining the new winning faction. Initially, this is likely to have been exactly what all factional organizers hope to achieve: social power and prestige, and an ability to resolve conflicts including their own on terms that give organizers access to rents. Over time, the success of the CPM was also based for a time on agrarian strategies that gave middle and rich peasants opportunities for agrarian growth through better access to fertilizers, rural infrastructure and credit.

The party also had distinctive characteristics which should not be ignored. Its ideology was appealing for many. It also introduced higher levels of discipline and inner-party democracy, which were both appealing and effective. In election

campaigns, its ability to mobilize large numbers of cadres and general supporters in a disciplined way no doubt contributed to some of its success (Chatterjee 1997: 137-82). But neither should these aspects of the party be exaggerated. The structure of the party relevant for its day to day operation was highly decentralized. Party units in different villages and regions effectively operated as locally based factions addressing very local problems and using locally mobilized power.

However, aspects of the 'modern' organization of the CPM can help to explain why a significant block of intermediate class organizers could be organized in this way when the Congress had so signally failed. The Congress lacked any principle, caste or otherwise for defining who were the insiders. In the absence of a principle, the number of permutations of factions and the distribution of rents between them become difficult to manage. Congress could have organized a party appropriate for a competitive clientelist context, but it failed to sustain a dominant party in West Bengal. In contrast, the CPM defined a set of principles that initially attracted a relatively small number of organizers. As they proved enormously successful in mobilizing the poor to deliver effective rents from protection and conflict resolution, they became an electoral force. New organizers flooded in, and here the modern organizational structure of the party and its hierarchical discipline served to create a natural and legitimate mechanism of limiting the number of faction leaders. Newcomers had to wait their turn to rise through the party ranks. The anarchic entry and squabbling typical of more open parties was less in evidence. By then, a successful electoral strategy and a large number of effective faction leaders created a sustainable and effective dominant party ruling coalition in alliance with the Left Front partners of the party.

The overall strategy proved to be enormously successful in constructing a dominant party coalition that was unprecedented in its longevity. There were some other features of the social context that probably helped as well. The CPM did not just assist party supporters and the poor to address local problems using local informal power. This was perhaps the most important part of the party's everyday presence but not the full story. In a land scarce poor agriculture, where the poor have no self-respect, the party gave a sense of belonging, for a time at least, to a large number of people. After 1977, its formal policies of limited enforcement of land redistribution and sharecropper registration did make a difference at the margin to poorer sections of the rural population. However, as we summarized in an earlier paper (Khan 2008), the effect on poverty reduction was small and certainly not revolutionary. The more significant effect of the CPM's strategy was to direct resources to middle and rich peasants. This strategy drove high levels of agrarian growth for over a decade beginning in the 1980s.

The CPM faced several problems over time. It was effectively a dominant party in a clientelist settlement and so over time, many aspiring and entrepreneurial organizers felt excluded or blocked in their progress. The method of exclusion was subtle and based on the formal organizational structure of the party. Nevertheless, over time, ambitious organizers found it was less attractive to join the party and more hopeful to stay outside and organize against it. It is important that even at the height of its successes, the Left Front's vote share was always around fifty per cent. The first past the post system ensured this was enough to define a dominant coalition, but relatively small declines in voting support could equally have disproportionately large effects.

When the tide started turning against the CPM in the late 2000s after the crises at Nandigram and Singur, a seven percent drop in the vote share for the Left Front in the 2009 general elections translated into its Lok Sabha seats dropping from 35 (out of 42) to only fifteen.

The second and more significant problem was the effect on capitalist access to political power. The organization of a factional structure that was largely focused on a rural constituency meant that big business's access to political power was now even more constrained. Moreover, the combination of a left-leaning ideology which led to a formal support for trade union rights and the fact that big business in West Bengal was largely non-Bengali constrained the open support that the CPM could offer big business. Nevertheless, in private long-term relationships did develop, but it was mostly used for solving labour disputes rather than positively assisting business to accelerate accumulation or develop into new areas. The high capability big business sector was less powerful in West Bengal than before, and this had significant implications for the strategic choices made by both sides, and the types of formal and informal institutions that the Left Front could introduce and enforce.

The growth-stability trade-off facing formal or informal institutions affecting the modern industrial sector therefore became significantly more adverse. Ironically, this was most damaging for the CPM itself. In the 2000s, its agrarian strategy ran out of steam and the party decided to promote industrialization. A series of miscalculations in its formal and informal interventions in land acquisitions for big industry led to a significant decline in stability and undermined the government. We described these governance crises in detail in Khan (2009a). The constitution of the political settlement explains why the growth-stability trade-off was so adverse. It also suggests that the CPM's own analysis of the situation did not warn it about the nature of the political settlement it was operating in and the likely effects of its overt institutional interventions. It appeared to have underestimated both the strength of the opposition factions that were now ranged against it and the ease with which they could inflict transition costs when the CPM appeared to be attempting the enforcement of institutions that hurt some of its own core constituents.

With hindsight, it is easy to say that much longer preparation was required to build and justify the political links with business and to involve its core factional base in constructing formal and informal institutions that would have enabled core organizers to share the gains from industrialization. Sadly, the signs of discontent were there for some time and the party ignored them at its peril. Whether an electoral recovery can still be staged remains to be seen. If not, the configuration of parties suggests that some variant of competitive clientelism will emerge in West Bengal. This would be a loss for West Bengal because the dominant party structure with its discipline and commitment to growth *could* have created a political settlement that was conducive to some variants of industrial policy. This would have required a pro-active relationship with business and would have required satisfying the core organizers of the CPM through new formal or informal arrangements for sharing the benefits of industrialization. The fact that big business was not well connected to political power in West Bengal may actually have helped in the imposition of conditions, for instance for backward linkages to an emerging Bengali small business sector in exchange for strong state support and implicit subsidies.

Summary

The dominant coalition constructed by the CPM with its Left Front allies was a stable dominant party ruling coalition. Despite its appeal to Marxist ideology and modern party organization, it was essentially an extremely successful factional coalition operating in a clientelist political settlement, with a progressive ideology and some positive effects for the poor. Its real constituency was its rural intermediate class organizers and its economic strategies most benefited this group. However, a characteristic of the political settlement was that powerful business interests were not linked into the ruling coalition. This did not have any effect on the implementation of the CPM's successful agrarian strategies, but when the party turned to an industrial strategy without adequately preparing its internal factions and constructing alternative informal distributions of benefits, it ran into serious trouble. Opposition factions took advantage of the disarray within the party when it attempted to enforce its pro-business land acquisition strategies. The result was not only a failure in the implementation of these institutions, but also a significant worsening of stability and of the Left Front's electoral prospects.

11. Bangladesh: From Authoritarian Rule to Competitive Clientelism

Bangladesh was carved out as East Pakistan, when Bengal was partitioned in 1947. Unlike West Bengal which was significantly industrialized, East Bengal was almost entirely an agrarian economy growing rice and jute. In the 1960s after very limited industrialization had been achieved, another set of violent confrontations between incumbent and emergent elites in Pakistan culminated in 1971 in the separation of East Pakistan as Bangladesh. This was followed by more violence, an attempted imposition of a one-party state, the assassinations of two heads of state, periods of military rule and finally the emergence of a competitive clientelism that faces occasional crises when parties refuse to accept (often with good reason) the organization or results of elections. Nevertheless, despite its apparently dysfunctional governance, Bangladesh has emerged in recent years as a relatively high-growth developing country with a significant base in manufacturing based on the garments and textile industries. With so many dramatic changes, its political settlement has also been changing rapidly over time.

The political settlement evolved in four main phases, each with implications for institutional performance relevant for growth and stability. The first phase, from 1958 to 1971, during the Pakistan period, was an authoritarian political settlement. The two wings of Pakistan shared little in common and had not engaged in a common struggle to achieve Pakistan. Pakistan was the outcome of a failure that primarily involved Nehru and Jinnah, neither of whom came from the territories that became Pakistan. Nevertheless, once Pakistan was created, the elites of the East and West had to find a way of sharing power and rents to live together. They tried for a decade and failed. The outcome in 1958 was a military government that engaged in formal and informal interventions to sustain a vulnerable authoritarian rule. Nevertheless, it was during this phase that Pakistan's industrial policy was most effective, with significant industrialization, mostly in the West, but some in the East as well.

The growth-stability trade-off was relatively favourable for extensive growth through industrial policy. As in India, emerging capitalists were well connected to factions, this time within the authoritarian state, making disciplining difficult and limiting the

prospects of industrial policy. The first phase came to an end because industrial policy created a distribution of benefits between East and West Pakistan that was politically unsustainable. The East's population was bigger than the West, and when an embattled military government allowed elections in 1970, the East Pakistan based Awami League won a majority of seats in the Pakistan parliament on a programme of radical federalization. Once again, a failure to agree about federalization resulted in a further partition, and again with much violence.

The second phase from 1971 to 1975 was a turbulent and violent one as new elites with significant political and organizational power but few economic assets came to power. The gap between formal rights and informal power was now almost unbridgeable. The result was intense primitive accumulation: the capture of assets using political power. The dominant party that had won the election faced the prospect of political and economic collapse. The growth-stability trade-off was not only adverse; it was worsening to a position where the achievement of the minimum economic and political viability conditions was threatened. Famine struck. The response of the ruling coalition was to amend the constitution to create a one-party state. In terms of our Figure 17, the use of administrative measures to define insiders and outsiders gave the ruling coalition authoritarian characteristics. The actual fragmentation of power in Bangladesh at that time was such that an authoritarian state of this type would probably not have lasted very long. But in fact it could not be fully implemented because President Mujib-ur-Rahman was assassinated.

The third phase from 1975 to 1990 was a transitional phase towards full competitive clientelism. This was a form of authoritarianism but with already with some characteristics of competitive clientelism. Military backed political parties engaged in electoral competition with other parties with no formal restrictions on the latter. In fact, of course, everyone knew that winning these elections was impossible for the opposition because of informal administrative measures. But nevertheless, successive ruling parties were constructed out of factions from other parties, and so engaging in political competition was a way of increasing the price which powerful coalitions could demand for joining the ruling coalition.

This was a period when Bangladesh began to slowly recover from years of conflict. The military rulers and military-backed parties began a slow process of privatization, opening up and encouraging industrialization. The garment sector takeoff began in the late 1970s, with institutional innovations under President Zia-ur-Rahman. The growth-stability trade-off began to improve but growth was still sluggish. The entrepreneurial class was weak in terms of technological capabilities but had access to political power, and this assisted a slow recovery through gradual pro-business interventions. But the political arrangements were unsustainable because excluded factions were growing stronger and would not accept the rules of the game set by clientelist authoritarianism. After a series of intense confrontations, the second military ruler, President Ershad, was forced to step down in 1990 and the period of open competitive clientelism began.

The fourth and final period of competitive clientelism witnessed a steady increase in the growth rate. This was probably because the garment industry, after steadily acquiring capabilities, took off in the mid to late 1980s and became a major foreign currency earner. The growth of this sector has been an important contributor to overall

growth. Political competition was organized around two major parties distinguished by very deeply felt differences in the way they defined the ‘nation’. These differences had trivial implications for practical policy issues but allowed the definition of two coalitions big enough to form ruling coalitions. The major political problem was to ensure elections were not manipulated by incumbents to the extent that the excluded faction refused to participate in elections. Business groups became increasingly strong and had influence in and access to both major parties.

The growth-stability trade-off depends on the institutions being examined. For sectors where entrepreneurs had sufficient capabilities to be internationally competitive, the growth-stability trade-off was quite favourable. Institutions that appeared to be dysfunctional were often made to work through informal means and payments. On the other hand, acquiring technological capabilities in new sectors faced significant market failures. Since responding to these market failures typically involves the creation of policy-induced rents, success required the management of productive rents using formal or informal mechanisms. Here, strong connections between capitalists and powerful factions constrained the growth-stability trade-off.

A serious problem facing Bangladesh is that existing political institutions have proved inadequate for constraining the competing parties during elections. An outcome of an election is acceptable if the winner is actually the coalition that can field greater organizational power. But since the incumbent can leverage administrative and policing instruments to tilt the outcome slightly, the result can often be justifiably rejected by the loser if the winner is the incumbent. The attempt to solve this problem through the constitutional mechanism of caretaker governments organizing elections worked for three successive elections but failed in 2007. The sustainability of the competitive clientelist political settlement requires a solution that credibly ensures the possibility of factions cycling through elections. The broad outlines of the evolution are summarized in Figure 23, and a summary of the evolution of rents examined in earlier work is reproduced in Figure 28 in the Appendix.

BANGLADESH	
CHARACTERISTICS OF POLITICAL SETTLEMENT	BROAD FEATURES OF INSTITUTIONS AND GROWTH
Military Authoritarianism with moderate capability / powerful capitalists: 1958-1971	Rapid extensive growth, limited implementation of industrial policy. Unsustainable regional imbalances
Weak Dominant Party and attempted One-Party Authoritarianism with low capability / powerful ‘entrepreneurs’: 1972-1975	Intense Primitive Accumulation with steep collapse of economic and political viability
Clientelistic Authoritarianism with low to moderate capability / powerful capitalists: 1975-1990	Faction-driven rent-seeking drives growth, MFA rents allow emergence of dynamic garments sector
Competitive Clientelism with low to moderate capability / powerful capitalists: 1990-	Institutional support for low-technology manufacturing growth, no industrial policy and constrained infrastructure investments

Figure 23 Evolution of Political Settlement in Contemporary Bangladesh

Military Authoritarianism: 1958-1971

The deep political and economic crisis in Pakistan at the end of British rule was not accidental. The economic underdevelopment of the region was bad enough but in addition trade links with industrial areas elsewhere in India were severed. The reasons behind the political crisis were even deeper. A constitutional crisis in the newly independent Pakistan was almost inevitable given the way in which the country was created. East Pakistan was poorer and less developed, had virtually no indigenous capitalists, and virtually no senior bureaucrats or army officers. West Pakistan too was underdeveloped compared to more advanced areas of India, but many of the immigrant Muslim businessmen and senior bureaucrats from other parts of India settled in West Pakistan as they were culturally closer to that region. The army too was largely drawn from the Punjab region of West Pakistan.

The irony was that the indigenous elites in *neither* wing of Pakistan had been strongly behind the idea of Pakistan. The two most important Muslim-majority areas of India were Punjab (whose western part became the heart of West Pakistan) and Bengal (whose eastern part became East Pakistan). The demographic dominance of Muslims in these provinces meant that Muslims already enjoyed substantial power under the electoral system introduced by the British in 1936. They were not supporters of the Muslim League and had generally not been preparing or mobilizing for partition. When partition suddenly took place in 1947 as a result of a last minute failure in negotiations between Jinnah and Nehru, the two main provinces were unprepared for statehood.

The Muslim League was not organizationally strong in either Bengal or Punjab and faced serious problems in trying to cobble together a Pakistani state. However, West Pakistan's largely Punjabi elites soon discovered they were the dominant group in the new state and this helped many of them to buy into the idea of Pakistan. In contrast, East Pakistan elites remained embroiled in conflicts with the central leadership. As a result of these tensions, the new state of Pakistan faced serious conflicts between elites from the outset and a decade of constitutional discussions failed to resolve formal sharing of power between the two wings.

A central problem was that the relatively poorer and less developed East Pakistan had at that time a bigger population, making it difficult for the economically dominant West Pakistani elites to be assured that they would be able to ensure their political dominance through the electoral system. Even though East Pakistan was relatively underdeveloped compared to the West, its intermediate class political organizers were more organized as it had a longer history of mobilization against colonial rule. Moreover, rich peasants in East Bengal had been in power in the province since the 1936 reforms through parties like the secular Krishok Proja Party. East Bengal's political organizers could mobilize large numbers of people, possibly more than the political elites in West Pakistan could. These asymmetries in the economic, political and organizational capabilities of the two wings made a constitutional settlement virtually impossible. The military coup of Ayub Khan in 1958 was the result.

The imposition of martial law curtailed the organizational freedom to set up political organizations. At the same time, the military realized that economic growth was vital for the survival of the country and so they fostered strong 'political' links with the West Pakistan-based business elites. Rents were now controlled by a dominant

coalition consisting of the military-bureaucratic elite and their close business allies. For a while, the threat of force disrupted the ability of excluded organizers to pose a significant threat to the ruling coalition. At the same time control over access to foreign exchange, the exchange rate, interest rates and tariffs and quotas allowed the state to create rents for privileged business elites. The initial effect was not only greater political stability but also a sustained growth spurt that lasted through much of the 1960s. But the location of political power and entrepreneurial capabilities meant that almost all the manufacturing growth was located in West Pakistan.

The military could not rule without some organization of political forces. The major institutional mechanism for purchasing and organizing stability was the so-called Basic Democracy system that Ayub innovated in 1959, one of the first acts of his regime. This attempted to by-pass the established political organizers based in the towns by creating a new constituency of cheaper organizers in the villages. A system of 80,000 'basic democrats' were elected on a non-party basis. They served as the electoral college for electing members of parliament as well as directly electing the President. Authoritarian regimes have often used this tactic of going over the heads of their immediate opponents and appealing to the interests of those below them. The latter initially demand a lower price and the authoritarian leader often believes they will be easier to control. The provision of relatively limited rents to this large army of rural representatives through rural infrastructure construction programmes and Food for Work programmes for a time created a countervailing source of support for the regime that made it difficult to organize dissent (Sobhan 1968).

In the end, Basic Democracy was self-defeating for the regime. As the rural basic democrats became more confident and ambitious, they saw obvious opportunities in throwing their lot in with the growing dissent in the towns. When this began to happen in the late 1960s, not only did the 'hot house' economic development come under threat, the social order was fundamentally challenged as there were no easy ways of incorporating excluded elites into the system quickly enough. Under pressure in both wings of Pakistan, the military government allowed elections in 1970. They did not foresee that the East Pakistan based Awami League would gain an absolute majority in parliament as the East had a majority of seats in the central legislature. This led to an even more serious constitutional crisis as West Pakistan based elites were unwilling to let an East Pakistan party form the government. The last desperate act of the authoritarian regime was a bloody crackdown on political organizers and their intellectual supporters in East Pakistan in March 1971. As the conflict became increasingly bloody, the political settlement collapsed. The civil disobedience intensified and transformed into a war for liberation and independence. Pakistan's historic enemy India intervened to assist the Bengali struggle for independence and the independent country of Bangladesh was born in 1971.

While it worked, the authoritarian ruling coalition, combined with the significant political access and power of emerging capitalist groups created a feasible political settlement for the rapid imposition of industrial policy. Extensive growth was rapid, as outlined in our earlier paper (Khan 2008). But as in contemporary India with its dominant party coalition, the fact that powerful business groups were strongly networked with particular politicians, and in the case of Pakistan initially with particular bureaucrats or generals, meant that disciplining and resource re-allocation faced very adverse growth-stability trade-offs. The Pakistan experience is particularly

interesting because here despite an export-promotion strategy, individual capitalists could still block resource re-allocations away from themselves just as much as in India. This is relevant for an evaluation of Chibber's (2003) thesis discussed earlier. The experience also challenges the thesis that authoritarian regimes are able to exercise their 'autonomy' to implement industrial policy effectively. It also meant that the locus of political power in the West resulted in unsustainable regional imbalances.

The Basic Democrats provided inadequate feedback about the strength of organized resistance building up below. The military government went too far and too fast in pushing accumulation by a small number of capable capitalists. The response to the absence of significant numbers of capitalists in the East who could undertake large-scale investments with state assistance should have been more assistance to the East or a slower pace of change overall. In the event, the forced accumulation by a small group who were entirely from the West created pent-up dissatisfaction that political organizers could suddenly mobilize with disastrous consequences for the country.

General features of this problem were described in Figure 14 which showed that a big or 'discontinuous' institutional jump (such as the rapid creation of enormous wealth in the hands of a handful of capitalists) can appear to result in a relatively small decline in stability at first, but lead to a collapse of the trade-off once new organizers capitalize on growing social resentment. This is a simplified but plausible description of Pakistan in the 1960s where there was little initial resistance to the institutions that drove growth but was followed by a precipitous decline in stability in both West and East Pakistan from 1968 onwards. A more gradual or incremental set of industrial policy interventions could, with hindsight, have resulted in a more sustainable growth path. Sudden and significant changes in the distribution of benefits in a society, particularly if they are achieved under authoritarian limitations on mobilization can obviously result in misleadingly limited opposition at first, but erupt in significant explosions later. This is more likely if the emerging class inequalities overlap with national, religious or other cleavages that organizers can use to mobilize coalitions in a clientelist settlement.

Summary

The authoritarian ruling coalition from 1958 to 1971 together with a small number of moderately capable and politically connected capitalists defined a political settlement which was initially very favourable for growth-enhancing institutional changes. However, like India, the political power of capitalists prevented disciplining and constrained productivity growth. The imposition of discipline on the privileged new capitalists may have made both state and capitalists somewhat more legitimate in the eyes of the population. Instead, effective authoritarianism initially only allowed only a limited decline in stability. But this hid deep dissatisfaction lower down, particularly with regional imbalances. By the late 1960s, a new generation of organizers emerged who could mobilize the growing dissatisfaction with disastrous consequences for the overall stability of the system.

The Rise and Fall of Dominant Party Authoritarianism 1972-1975

The victory of the excluded Bengali political organizers in 1971 created a new crisis. The Awami League, which won virtually every seat in East Pakistan in the 1970 elections, was clearly for the moment a dominant party. But the aspirations of the new coalition with political power were so extravagant that even the formal rights of

existing Bengali capitalists could not be protected. Not only were abandoned Pakistani assets the target of acquisition by the new coalition, almost all significant assets of Bengali capitalists were also nationalized to construct 'socialism'. Gross over-employment in the now dominant public sector, corruption, looting of products and spares, and the conversion of public property into private property were mechanisms used for rapid primitive accumulation. Entirely new classes of the newly rich rapidly emerged. Paradoxically, under pressure from this emerging class ceilings on private investments were also rapidly being raised (Khan 2008). But the cost was a steep decline in economic performance and growing political conflicts within the dominant party as different groups contested for power and resources.

Behind this crisis was a rapidly evolving political settlement. The dominant party was facing internal collapse with intense conflicts. As early as 1972 a significant section of the 'left-wing' of the Awami League left to form the Jatiyo Shomajtantrik Dal, JSD. If the distribution of rents between internal factions depends on the decisions of a supreme leader, all coalitions have to be confident of their access to that leader, and the leader has to have sufficient authority to impose decisions once taken. The dominant party's factions were already refusing to accept these decisions and some had already left to oppose and unseat the ruling coalition. Mujib's decision that a one-party system could be achieved by constitutional amendment and then enforced using the policing apparatus of the state was therefore a significant gamble. It is not at all clear that Mujib had the authority or the physical force to ensure that all individual organizers would come under a single party structure and then accept the distribution of rents that he imposed.

A related problem was to define the limits of the dominant coalition. There are potentially indefinite numbers of organizers 'out there' who believe they have the capacity to organize for a share of the rents. However, the more organizers who are included, the smaller the rents that existing organizers can capture. The problem for a formal and well-defined ruling coalition in a constitutional one-party state is that it defines insiders and outsiders clearly and creates strong incentives for outsiders to unite against insiders. The one-party state is therefore a particularly difficult type of authoritarian ruling coalition to operate. It creates very strong incentives for outsiders to unite but if it includes too many it undermines the rents of insiders. Successful one-party authoritarian regimes have to have some special feature that allows them to either keep outsiders out, or absorb them at a slow rate. For instance, they could have significant natural resource rents that could be used to finance a credible monopoly of violence at the centre. Or they could be developmental states with a disciplined party structure, where new entrants are offered relatively little but can expect a 'career path' in the party and share the benefits of growth over time. The Awami League in 1975 had no special features which might have sustained one-party authoritarianism.

Despite these dangers, and perhaps because the economic situation was unsustainable (Khan 2008), Mujib moved ahead with the 'Second Revolution' to create a one-party state. In January 1975, Mujib pushed through the fourth amendment to the constitution by threatening to resign in the face of opposition from his own party (Karim 2005: 348). The constitutional amendment changed Bangladesh to a presidential system, with power concentrated in the hands of Mujib who became the president. The amendment provided for the creation of a 'national party' with the sole right to engage in political activity, and all members of parliament and the president

had to belong to this party. In February all parties were suspended and the national party launched. This was the Bangladesh Krishok Sromik Awami League (Workers and Peasants Awami League) or BAKSAL (Mascarenhas 1986: 57).

While there was little public demonstration against the constitutional amendment, the climate of fear was not appropriate for the free expression of views. In secret, many different groups began to plot Mujib's violent removal (Mascarenhas 1986: 64). Mujib himself was aware that the fourth amendment could not represent a permanent solution and was an emergency response to a situation going out of control: 'This one-party arrangement is purely temporary. Once I have saved the country from counter-revolution I will restore multi-party democracy' (quoted in Karim 2005: 258). Mujib's enemies were not only based in other parties and in the army, but within his own party. Many 'rightist' members of his cabinet and indeed some foreign embassies were aware that a strike was being planned against him and his family (Lifschultz 1979; Mascarenhas 1986). And so it was that on the 15th of August 1975, less than four years after achieving independence, the founding father and president of the new country was assassinated.

Summary

The dominant party that won freedom in 1971 failed to establish one-party authoritarianism even though moves in that direction began in 1975. The conflicts within the party were intense and time horizons of factions short. Implementation capabilities for enforcing formal institutions were weak for the same reason. The power of capitalists had been severely curtailed. Bengali capital too was almost fully expropriated. But a *new* proto-capitalist class was rapidly emerging through primitive accumulation. But during the lifetime of the regime the political settlement was very adverse for growth and the growth-stability trade-off was probably entirely below the minimum viability conditions of growth and stability. Mujib's desperate constitutional one-party state may not have worked but it reflected an awareness of the seriousness of the situation.

Clientelistic Authoritarianism 1975-1990

Mujib's assassination brought the military to power through a series of bloody coups and counter-coups. But the military leadership knew by now that neither the Pakistani authoritarian model based on the exclusion of intermediate class organizers by a small military-bureaucratic clique nor the authoritarian one-party model of Mujib would work in Bangladesh. General Zia, who formally became president in 1977 was a decorated freedom fighter and widely popular. He took care to construct a strong constituency of supporters for his rule by constructing a political party that eventually became the Bangladesh Nationalist Party (BNP). It remains one of the two dominant parties in contemporary Bangladesh. The new strategy for constructing the ruling coalition had a number of important features distinct from the earlier phases.

First, the terms on which individual coalition leaders joined the ruling coalition were individually bargained. The terms were simple: the national leader wanted to incorporate the largest number of the most important organizers at the lowest price in terms of the rents that they demanded. A broad ideology of development and nationalism defining the new party allowed organizers from the far left to the far right to seek terms for entry. The price they could extract in terms of their access to future rents depended on their proven organizational capabilities and the significance of their

departure for undermining their erstwhile parties. As other parties were no longer banned, organizers had the chance of proving their abilities outside the BNP before negotiating incorporation. Opposition parties were allowed to set up, operate and contest elections. The only limitation was that the top job was not up for grabs because the dominant party was unlikely to be defeated given its control over the administration. This implicit administrative control defined the ruling coalition as authoritarian, even though formally multi-party democracy was reintroduced with the repeal of the fourth amendment.

Secondly, no attempt was made to define *ex ante* the boundaries of the ruling coalition. The regime maintained the right to calibrate the size of the ruling coalition through a competitive process of assessment and negotiation. This too ensured that excluded elites had an expectation that they may be included on appropriate terms in the future if they played according to the rules of the game. The combination of these two characteristics ensured that the minimum required rents were competitively allocated to the most important political organizers, helping to maintain political stability.

Finally, both Zia and Ershad attempted to check the power of established political organizers by creating new rural voices through ‘decentralization’. These strategies were quite similar to the Basic Democracy strategy of the Pakistani period, but now they were a complementary part of a broader strategy and not the exclusive strategy for organizing stability. Even so, these strategies, particularly Ershad’s attempt to create a new class of political representatives in the newly created ‘upazillas’ (a tier of government constituting a small number of villages), was strongly opposed by urban political organizers. They had a limited effect in enhancing overall political stability, and the attempt to force them through possibly had a negative effect.

The period remained on the whole considerably unstable. Violence continued for a while, particularly within the army, where coups were frequently attempted. Nevertheless, the strategy of ensuring entry to political organizers through individual negotiations proved to be a viable strategy for constructing coalitions. It remains the strategy through which competing political parties in the fourth ‘democratic’ phase construct the coalitions that sustain their power. The strategy implied that the ruling coalition would be turbulent with constant negotiations, infighting and sometimes violence both within the coalition and against those out of power. But in the absence of any better method of determining a distribution of rents in line with organizational power, this has emerged as the operative default mode for constructing ruling coalitions.

Secondly, the openness of the boundaries of the ruling coalition proved to be extremely useful in managing the entry of new aspirants. This allowed the system to respond to changes in organizational capabilities in society. On the other hand, it could not deal with aspirations to become the President. This meant the system was unsustainable in the long run. For instance, it created strong incentives for ambitious officers within the army to try and replace the supreme leader. There were frequent coup attempts under Zia in particular. In fact, Zia was finally killed in a coup in 1981. Eventually it also resulted in strong civilian opposition being organized by ambitious political organizers in other parties. Opposition to clientelistic authoritarianism came

to a head during Ershad's rule. Increasingly intense and violent mobilizations resulted in Ershad being deposed in 1990, marking the end of clientelistic military rule.

A number of important economic changes happened during this period. The most predatory types of primitive accumulation began to die down after most abandoned assets were appropriated. The beneficiaries of the primitive accumulation and the older capitalists gradually regrouped during this period and established political connections with factions within the ruling parties. As many of the new 'capitalists' were direct beneficiaries of 'political accumulation', they were closely networked into existing factional structures. However, damaging politically-created rents continued to be created as part of political stabilization strategies. These included, for instance, rents distributed to supporters of the ruling coalition in government construction contracts, or in import contracts for scarce commodities like sugar and cement.

An important change with the Pakistani period was that rents were no longer seen as having any potentially productive purpose. The state stopped trying to create or allocate rents as part of an explicit industrial policy. Subsidies were no longer justified in terms of industrial policy but began to be justified on welfare grounds. Market failure justifications for infant industry protection or technology acquisition disappeared. This was partly because of the memory of the political fight against Pakistan and the 'socialism' of the Awami League, and partly because the international climate of economic opinion informing policy in Bangladesh had also changed radically in the 1980s. Zia was an advocate of privatization for all these reasons. The rents that public sector industries and the newly privatized industries continued to receive was because the state was too weak to remove these rents from powerful clients, not because the ruling coalition believed that this would accelerate the modernization of the economy. Ironically, as we described in earlier papers, the garment industry takeoff in Bangladesh depended on the presence of a critical set of international rents and institutional innovations that Zia undertook to support the sector (Khan 2008, 2009b). The political settlement allowed the rapid introduction of institutional innovations like the back-to-back LC and the bonded warehouse system, both vital for the garment industry.

Summary

An emerging capitalist sector was now closely networked with the political leadership. The clientelistic authoritarian leaderships had sufficiently long time horizons to build relationships with capitalists and support them to a limited extent. Mutually beneficial relationships developed which supported accelerated accumulation. Technology acquisition could not be properly supported under this settlement but the existence of globally generated MFA rents did allow technology acquisition and disciplined learning in low technology sectors like garments. The political settlement was much more promising for growth than before, and for the first time a Bengali capitalist sector began to grow. Growth-stability trade-offs were favourable for the support and promotion of limited formal institutions supporting specific accumulation strategies.

Competitive Clientelism 1990-

The overthrow of Ershad and the holding of elections under a caretaker government converted the authoritarian clientelistic system into a proper competitive clientelism. The new ruling coalitions had all the characteristics of competitive clientelism

summarized in Figure 17. Capitalists were well-organized and closely networked with political parties, often keeping good relationships with more than one, as parties regularly cycled in and out of power. A fair election has come to mean that the outcome reflects the balance of forces on the ground without the interference of bureaucratic or military officials administering the police, the polling booths and the process of counting the votes. If these administrative tools are controlled by one side or the other, the outcome may not reflect the balance of forces and will then not achieve stability.

The objective of a fair election is not to discover the true preferences of the electorate, partly because true preferences may not exist given the absence of serious differences in the policies that the parties are likely to implement. Rather, elections are processes through which the organizational strengths of the competing coalitions are revealed. Stability is likely to be achieved if the party with a demonstrable superiority in organizational strength wins the elections. The requirement is that no party should be able to leverage its strength by using the administrative apparatus to give it an electoral advantage that is unrelated to its strength on the ground.

To solve this problem, the competing parties in Bangladesh amended the constitution in the mid-1990s in the 13th Amendment that set up a permanent institution of the Caretaker Government. A neutral government was to be set up at the end of every government's term with the last Chief Justice of the Supreme Court becoming the interim head of government. This was a unique institutional experiment to create a credible electoral process for competing coalitions. However, this institutional arrangement was clearly not buttressed by a deeper set of political agreements. The caretaker government system worked for two subsequent elections, despite minor attempts by both parties to interfere in the elections when they were in power.

The constitutional arrangements collapsed in the run-up to the 2007 elections when the incumbent BNP went too far and appeared to interfere with the dates of retirement of Supreme Court judges so that its preferred candidate could head the caretaker government. The result was an increasingly violent standoff which resulted in a series of general strikes (hartals) and violent street confrontations. In a context of increasing uncertainty a group of bureaucrats backed by the military and the international donor community took over power on the 11th of January 2007 as a new emergency interim government. Under the constitution, the caretaker government has to organize an election within two months, but this caretaker government stayed in power for two years under emergency powers it gave itself.

The emergency caretaker government turned out to have been a significant wasted opportunity. The emerging system of competitive clientelism had clearly not yet acquired a set of politically sustainable checks and balances to be fully self-sustaining. The emergency could have been an opportunity for investigating and establishing credible checks and balances and for establishing the precedent that if parties could not agree other institutions in the country would intervene to break the deadlock. But instead, the caretaker government, headed by an ex-World Bank bureaucrat and backed by an army that was closely tied to the 'international community' through its lucrative involvement in international peacekeeping missions took a 'good governance' perspective on how to solve the problem. Their interpretation (no doubt strongly influenced by dominant international policy

perceptions) was that the instability was caused by political corruption. The opportunity for political corruption created distorted incentives for politicians to interfere with electoral outcomes. This analysis suggested that if political corruption could be rooted out and if parties could be made to compete on the basis of alternative manifestos of delivering public goods the problem of electoral violence and standoffs could be rooted out.

For the next two years the emergency caretaker government attempted to address the problem through ‘good governance’ reforms, and in particular through a focus on corruption, believing that the source of political violence was the engagement of political leaders in corruption. Hundreds and possibly thousands of political activists were arrested and incarcerated, including the leaders of the two main parties on charges of corruption. Hundreds of businessmen were arrested and some of them handed over millions of dollars to the new government as ‘ill-gotten gains’ under pressure (which later on turned out to include torture). Thousands of cases of corruption and extortion were introduced in the courts. The whole exercise was deeply flawed not only from the perspective of its flawed understanding of a clientelist political settlement but even in terms of the formal legal procedures that were followed. In the end, almost all the cases had to be abandoned on the grounds that evidence was missing or inadmissible. The experience of anti-corruption cases globally suggests that even a single successful prosecution is very difficult. Not surprisingly, the military caretaker government’s attempt to address the problem in this way failed dismally. The two arrested leaders of the main political parties had to be released, and one of them was elected prime minister in the 2009 elections.

The main effect of the two-year experiment was a collapse in investor confidence. The two main parties whose intransigence and violence had caused the problem in the first place did indeed receive a shock, but in itself this is unlikely to have a lasting positive effect. Without a credible mechanism for organizing elections, the competitive clientelist system cannot deliver political stability and is therefore not sustainable. If we include the experience of the 2007 debacle, competitive clientelism has not worked too well in Bangladesh. The overall implications for growth-enhancing institutional change have been negatively affected by long periods of strife which have mostly been about the political institutions organizing transfers of power rather than conflicts over the implementation of particular economic institutions. The former are obviously more important in ensuring that benefits are distributed over time in line with organizational power, and are therefore critical institutions for sustaining a viable competitive clientelism.

The lack of credibility that elections will deliver the appropriate ruling coalition can result in short-termism and conflict as elections approach. This has indirect effects on long-term investments, particularly where government contracts are involved. For instance, it has proved to be very difficult to get private investors to invest in the power sector. This is an area where future income streams depend on subsequent governments honouring contracts made by previous governments. But one credible threat against incumbent governments is for the opposition to challenge their legitimacy. This makes investors wary of making up-front investments in sectors like power. Thus, vulnerable competitive clientelism can create high transaction costs for some types of contracts and some investments may not be possible at all. Governments have had to bribe investors in sectors like power with excessively large

tariffs and other conditions in countries like Bangladesh, with obvious efficiency and growth implications for the broader economy.

Other types of investments and contracts can operate reasonably well with competitive clientelism, even with the degree of instability observed in Bangladesh, as long as the future income streams in question do not depend directly on payments from the government exchequer. But since infrastructure and power sector investments do require government guarantees for future payments, a vital set of contracts are adversely affected. On the other hand, competitive clientelism provides political access to competing businesses and helps competitive entry into many sectors. This is efficiency-enhancing in low technology sectors. These aspects of the political settlement can help to accelerate accumulation and create conditions sustaining growth.

Summary

The competitive clientelist period after 1990 has had a mixed record. The difficulty of ensuring credible rules for the removal of ruling coalitions has created periods of intense conflict and instability. It has also raised the transaction costs facing some types of vital long-term contracts to the detriment of growth. On the other hand, other institutions have performed well and their implementation enjoys favourable growth-stability trade-offs. The challenge of technology upgrading and industrial policy has not gone away, but has become more difficult to organize. The real challenge for sustaining competitive clientelism is to achieve more credible and less violent methods of ensuring the replacement of ruling coalitions.

12. Tanzania: From Authoritarian One-Party to Stable Dominant Party

Tanzania is the ‘newest’ of our nations, achieving independence from Britain only in 1961 as Tanganyika, and merging with Zanzibar in 1964 to become modern Tanzania. It has also had the least turbulent political history amongst our countries, with the party of independence creating a nation initially using relatively soft authoritarian methods. The party of independence, the Tanganyika African National Union (TANU) also became, under the leadership of Nyerere, the party of nation-building. Nyerere stepped down from the Presidency in 1962 to concentrate on building the party, and through it the institutions, power structures and even the language that would eventually bind the country together. In 1963, Nyerere declared Tanzania was to be a one-party state. The authoritarianism of the early years did not result in significant resistance or violence because excluded social groups (like the non-African capitalists) were weak or lacked political legitimacy. In 1977 the name of the party was changed to Chama Cha Mapinduzi (CCM) after TANU merged with the Afro-Shirazi Party with its power base in Zanzibar. In 1992 the Constitution was amended to enable multi-party elections and Tanzania made a relatively smooth transition to sustain its already existing ruling coalition through a dominant party. The CCM then proceeded to comfortably win the elections of 1995, 2000 and 2005.

The transition from a single-party state sustained by constitutional limitations on other organizations to a multi-party state with the same party emerging as the dominant party is an unusual one. It suggests that the transition was not driven by internal pressure and mobilization from excluded factions. If excluded factions had been internally strong enough to have forced a change in the constitution, we would expect

to see an effect of this on the outcomes of subsequent elections. Rather, the 1992 change is more likely to have been driven by external pressures and expectations. In the early 1990s Tanzania was receiving aid equivalent to almost 30 per cent of its national income and many donors agencies find it difficult to justify to their own parliaments why significant amounts of aid should be given to a one-party state. However, while the combination of significant aid rents with a lifting of formal restrictions on organization may have allowed the same ruling coalition to stay in power, the open electoral system is likely to have an effect on the organization of the political settlement in Tanzania over the longer term. Lower level factions are likely to become more powerful over time, and there is some indication that this is happening.

The Tanzanian political settlement has also been characterized by the weakness of indigenous African capitalists. Not only was capitalism very underdeveloped in pre-independence Tanzania, the post-independence strategies of socialist communitarianism further slowed down the development of a black African capitalist class. The most capable capitalists were and still are members of other ethnic groups like Indians, Arabs and Europeans. Over time the access of business to decision-making politicians has increased. But the political constraints have kept relationships short term and reliant on the generation of quick payoffs for both sides. Despite the growing evidence of business influence on policy, other factors, in particular the ethnicity of capitalists and the political difficulties this raises can explain why the networks of capitalists with the ruling coalition are relatively weak. This explains the prevalence of decisions where quick profits are made, often with damaging economic and social ramifications. It also helps to explain the relative weakness of long-term support for investors, even those engaged in low technology investments which do not require demanding capabilities of disciplining rents over time.

Thus, the political settlement in Tanzania has been characterized by a one-party version of an authoritarian ruling coalition, which later converted itself into a dominant party ruling coalition in a context of substantial aid and natural resource rents. The weakness of capitalists and indeed the overt anti-capitalism of the early Tanzanian state is also a distinctive feature of the Tanzanian political settlement. The construction of the ruling coalition, particularly in the early days was based on important compromises as well as the repression of organized interests that could threaten the unity of the party, which was equated with the nation. These nation-building compromises did achieve a more united and internally integrated African country than many others, but also slowed down processes of class differentiation and the evolution of potential African capitalists. The growth-stability trade-off was therefore adverse during the early years of nation-building under Nyerere because authoritarianism was used for nation-building rather than industrialization. The difference with Pakistan's authoritarianism of the 1960s could not be starker.

Even after the turn towards liberalization and the private sector in the mid-1980s, the basic characteristics of the political settlement have not *significantly* changed in ways that might be more conducive for growth-enhancing institutions. The composition of the ruling coalition has of course changed a little with the transition to a nominal multi-party system and the political tolerance for economic differentiation and emerging capitalism has dramatically increased. But in other respects social compromises and distributions of benefits that maintain social stability remain the

priority for the party and constrain how far it is willing to go with institutional changes that can create significant transition costs. On the one hand, the organization of social resistance by independent political organizers is still weak, but growing, particularly with greater political openness. The weakness of political organizers mobilizing social dissent should make it easier for Tanzania to push in the direction of growth-enhancing institutional changes if the ruling coalition supports it. But on the other hand, if such changes empower capitalists of non-African ethnicity across a broad front, this can raise significant problems of political management in the future.

Tanzanian leaders cannot be unaware of problems in neighbouring Uganda or Kenya with non-African capitalists. Tanzania's endowment of black African capitalists is significantly more adverse compared to say Kenya. These aspects of the political settlement are important for understanding why the ruling coalition in Tanzania has been relatively forthcoming in supporting a small number of high-rent foreign investments in minerals, but not very forthcoming about supporting institutional changes which would assist the development of broad-based capitalism in industry or agriculture. The latter strategy, in the absence of strong industrial policies promoting black African capitalism, would almost certainly produce a domestic capitalism with a non-African face. This in turn would be difficult to manage politically. This constraint may help to explain why Tanzania appears to be failing to capitalize on its superior political stability and effective party machine to accelerate an economic transition in the 1980s and beyond. The summary of institutional strategies and rents in Figure 29, based on Khan (2008), is consistent with this picture, as is the analysis of land rights in Khan (2009a). Land rights in mining can often be created very rapidly for major foreign investors, but in villages where there is a possibility of encouraging a capitalist organization of farming in certain areas, change is very gradual and incremental and what is worse from the perspective of investors, institutional arrangements like land grants often appear to be reversible in the face of pressure.

The development of a broad-based capitalism that is based on emerging African entrepreneurs is preferable on many grounds but is not likely to happen without very active industrial policy. Ironically, the new dominant party ruling coalition may be a less favourable arrangement for managing industrial policy compared to the previous constitutional one-party state. But a dominant party system may still be better than a competitive clientelism that is likely to emerge over the coming years. A better understanding of its political settlement may assist Tanzania to leverage its political unity and its relatively well-coordinated political organizations to develop an industrial policy before further changes in the organization of the ruling coalition make this even more difficult. The broad features of the political settlement in Tanzania are summarized in Figure 24, which should be looked at in conjunction with Figure 29 in the Appendix which draws on earlier work. The periods are discussed further below.

TANZANIA	
CHARACTERISTICS OF POLITICAL SETTLEMENT	BROAD FEATURES OF INSTITUTIONS AND GROWTH
One-Party Authoritarianism with weak capability / politically weak capitalists: 1962-1992	Prioritization of nation-building, ineffective institutions for growth
Dominant Party Coalition with weak capability domestic capitalists and high capability foreign investors / weak political access: 1992-	Moderate institutional support for big foreign investments but weak support for broad-based capitalist growth

Figure 24 Evolution of Political Settlement in Contemporary Tanzania

One Party Authoritarianism and Nation-Building 1962-1992

Compared to South Asia, Tanzania had both significant advantages as well as disadvantages in constructing a ruling coalition after independence. On the one hand, Tanzania's agrarian society was not significantly differentiated and indeed areas of long-settled agriculture were limited. As a result, the fine distinctions between layers of society distinguished by class (and also usually by caste) that we observe in South Asia were simply not there (Daley 2005a). Colonial powers seeking to manage the economy did create structures of 'traditional authority' but they did not develop the complex social governance structures based on empowering and checking and balancing different groups of the intermediate classes in a way that we see in India (Khan 2009a). The intermediate class-led mass social movements and parties that had dominated Indian politics since the 1930s and provided the different streams out of which umbrella nationalist movements were constructed were less developed in Africa in general and Tanzania in particular. The less complex political landscape was an advantage in a relative comparison for constructing the nation and a ruling coalition after independence.

On the other hand, the weakness of the intermediate classes and of potential productive sectors in the economy also created serious problems for constructing a new nation. At independence in 1962, there were only twenty Tanganyikan African students studying for university degrees (Coulson 1982: 90). There were only 3,100 individuals employed in professional, administrative and technical jobs in 1962 and only 1,300 of these were held by Africans, of which 1,100 were teachers, medical technicians or nurses (Pratt 1976). The leadership of the independence movement came from this tiny class of educated Africans. By the 1950s TANU had recruited broadly and had as many as 200,000 members, drawing on the members of new cooperative societies and unions. But organizational power was concentrated with the professional leadership. There was little evidence of mass mobilizations organized directly by intermediate class organizers from below. Nevertheless, by the 1960s colonial powers like Britain had little appetite for prolonging the inevitable and the independence struggle in Tanzania was relatively short. After TANU won all the African seats in the multi-racial elections held in 1958, the transfer of power was achieved relatively quickly by 1962.

The challenge for Nyerere was to construct a national identity and a cohesive nation out of a country with a thin population, 127 ethnic groups, a potentially divisive mix of

Christian, Muslim and indigenous religions and without a long history of struggle against colonialism which could have united all these disparate forces. It is not surprising that nation-building should have been the top priority. The instrument chosen was the party, and the inclusion of all groups on terms that were centrally determined was perceived to be vital for the integrity of the country. This can explain why the party in those early years behaved in an authoritarian way both against capitalists (who were mainly non-black) and whose freedoms were incrementally restricted but also equally strongly against unions and other organizations (Shivji 1976). After a wave of strikes in 1962, independent unions were outlawed in 1964 and replaced with an official party-affiliated union. Following the Arusha Declaration of 1967, the party became overtly anti-capitalist. In particular, non-black African capitalists were made to understand that their privileges were unacceptable in the new social order and policies for correcting inequalities would be adopted. The villagization programme that was implemented with significant authoritarianism and violence in the 1970s also has to be seen as part of a strategy of constructing a settled society that could be controlled and therefore integrated.

The distinctive features of Tanzanian authoritarianism was that it was not in the first place an attempt by a ruling coalition to exclude other *already existing* factions by legal or administrative means backed by a monopolization of force. Excluded political factions that could form an alternative ruling coalition were virtually non-existent. The authoritarian limitations of organizational rights that the Tanzanian ruling coalition imposed during this period therefore only make sense as a *pre-emptive* strike against potentially divisive organizations that *could* in the future be parallel coalitions challenging the ruling coalition. The justification, not implausible, was that a competition between coalitions at that stage of Tanzanian development would have destroyed the nation given the weakness of its national identity and the weakness of its economy. Rather, the perceived problem was that Tanzanian society was excessively fragmented, that freely organized social organizations could pull it further apart, and that the presence, let alone the further development of the capitalist sector, would be divisive for social integrity.

In terms of our classification of ruling coalitions in Figure 17, the Tanzanian ruling coalition actually had characteristics that would put it quite close to a potentially developmental coalition. It faced very weak horizontal opposition from other already-existing political factions and relatively weak demands from lower-level factions and faction-leaders. But this was partly because the economy was relatively underdeveloped and society was disorganized. The perception of the ruling coalition (accurate or otherwise) was that challenges could rapidly be mounted against it if it did not move fast. This persuaded the ruling coalition to focus on limiting organizational and political activities to ensure that alternative factions did not emerge. Nevertheless, the ruling coalition was actually relatively strong and had characteristics close to our definition of a potential developmental coalition. But for it to have capitalized on these coalition characteristics and engaged in a developmental strategy would also have required a rapprochement with capitalists and conditional assistance to develop an employment-generating capitalism. The strategy of development actually adopted, based on public sector companies and the restriction of capitalist rights, was not likely to be developmental. It was pursued largely as part of the same strategy of developing social cohesion rather than economic growth.

The party *was* the state during this period as the bureaucracy and the army were incorporated into the party. Public ownership makes sense from a perspective of nation-building as it was a mechanism of spreading the benefits of new investments across the core constituencies of the party: the middle class bureaucrats and professionals. The social engineering intended to create a distribution of social benefits at each level of society that was relatively egalitarian so that no particular ethnic, regional or other group felt excluded from a 'stake' in the emerging society. From this perspective, the ruling coalition was successful. Tanzania emerged as one of the most socially integrated African countries by the 1980s, with higher levels of literacy and access to basic amenities in rural areas than the African average. On the other hand, this political settlement had adverse implications for economic growth, discussed in Khan (2008) and some of these characteristics are summarized in the first row of Figure 29 which is reproduced in the Appendix from the earlier paper.

Summary

The authoritarian one-party state from 1962-1992 had a ruling coalition that had characteristics of authoritarianism, and in terms of the distribution of power affecting the ruling coalition, it was in fact close to that of a developmental state. However, the ruling coalition was motivated by a perception of a rapid potential fragmentation of society. It used administrative and political power to restrict organizational rights to reconstruct society in what it perceived to be a more cohesive and communitarian way. The authoritarian aspects of the ruling coalition were therefore used for nation-building rather than to sustain a growth-based developmental policy. The capitalist class was in any case underdeveloped to begin with, but under the new strategy faced increasingly overt restrictions. The overall characteristics of the political settlement were not conducive for the support of growth-enhancing economic institutions and created new political configurations in society that would imply very adverse growth-stability trade-offs for many types of growth-enhancing institutional changes in the future.

The Limits of the Dominant Party Coalition 1992-

In the late 1980s, economic conditions made Tanzania increasingly dependent on both aid and the advice of donors, including the World Bank and the IMF. The abandonment of its constitutional one-party state in 1992 has to be understood in this context. A presidential commission headed by Chief Justice Francis Nyalali toured the country, discovered that 77 per cent of the people it talked to wanted to retain the one-party system, but decided in any case to recommend in 1992 that Tanzania should move to a competitive multi-party system (Kelsall 2003: 56). It is very likely that the move to the multi-party system was driven mainly by the concerns of the 'international community' and less by the internal pressure from political organizations and factions that were excluded by the constitutional arrangements. In any case, new parties failed to make much headway, and the CCM now emerged as the dominant party ruling coalition.

A number of features of the Tanzanian economy and polity help to explain the smoothness of this transition. But these features also explain why the fundamental characteristics of the political settlement have not significantly changed either. First, the social engineering of the previous three decades was very successful in ensuring that no independent organizations or factional mobilizations exist which could easily be absorbed into a new umbrella coalition. The management of social order has been

organized in Tanzania through the distribution of formal and informal political benefits through state bodies like village government structures rather than to distinct factional groups competing for benefits. The legal ban on setting up trade unions, political parties and other organizations meant that individuals and groups organized very loosely around state institutions to negotiate and capture benefits appropriate to their usefulness for the state-party. It is very difficult for an alternative party to delink some of these coalitions under an entirely new banner to contest for a different distribution of benefits.

With the emergence of greater economic differentiation, distribution of power and therefore the benefits that different groups can claim have also changed in subtle ways. But even after the constitutional changes of 1992, individuals at the village level have bargained for their rents by being linked with different networks within the state-party structures, and have not found it beneficial to set up clearly separate independent local factions contesting for rents (Daley 2005b). The state and the dominant party still controls vital rents and delinking from factions within the party and setting up a completely separate faction faces a significant collective action problem. The independent faction may have zero bargaining power till many other such factions emerge in other villages and towns with whom umbrella factions of significant holding power can be constructed. Not surprisingly, opposition parties have largely remained relatively hollow shells.

Tanzanian society also sets some hurdles for the construction of new factional parties. The ethnic, regional and religious diversity of the country means that a new party that wants to achieve a critical minimum size has to be significantly diverse in its leadership appeal, regional representation and so on. This gives a huge advantage to the incumbent CCM and works against other parties. Again there is a collective action problem. If many major factions already existed a new faction could ally with some of them to form a new umbrella. Otherwise, a regional or ethnic group that decided to vote for a faction can find itself out in the cold (Kelsall 2003: 60).

However, the lifting of formal limits to organization and the growth of economic differentiation *is* slowly changing the distribution of power affecting the ruling coalition in the directions we expect. Normally, a dominant party ruling coalition emerges because a ruling coalition succeeds in including many or most of the most powerful lower level organizers in that society within a single organization. A dominant party ruling coalition is therefore likely to have fairly powerful lower level factions, which allows it to win in contests against other potential coalitions. In the case of Tanzania, the sequence has to some extent been reversed. The dominant party coalition emerged as a result of externally inspired changes in rules, but nevertheless, it is likely to have the effect of empowering lower-level party and state officials over time. The party must now be more concerned about keeping its lower constituents satisfied and this is likely to increase their bargaining power.

The change is not likely to be rapid given the factors discussed above, but over time and gradually, we expect to see greater organizational power being exercised by lower level members of the party and state to negotiate benefits for themselves. Projecting even further in a somewhat speculative way, if enough of these lower-level party members become organizers of their own supporters, the possibility of opposition factions absorbing some of them increases, and with it the possibility of a move

towards competitive clientelism. The need to raise revenues for running competitive election campaigns is also likely to result in a greater devolution of power to local level organizers who are more successful in raising money through their involvement in economic transactions. Coincidentally, these opportunities are also increasing, largely as a result of a greater tolerance for capitalist investment in sectors where political resistance can be contained.

The greater penetration of foreign investments in sectors like mining and tourism have required the support of local party and state officials, particularly in getting access to land. These acquisitions have often been strongly resisted by local people adversely affected by the changes but where the opposition was localized and involved a single but very big investment, there was an incentive for coalitions of party-state officials from local to very high levels pushing through the required institutional changes for mutual benefit (Kelsall 2003; Khan 2009a). Gradually, these processes have strengthened local and regional party and state officials, whose support and cooperation are required for pushing through mega-projects. Where the benefits are high and the social resistance limited to a particular area, the dominant party has been able to override resistance to particular institutional changes very effectively.

A consequence of the growing power of lower level state and political functionaries is that it is also much easier now for individual investors to suddenly get changes in rules approved or get contracts that then turn out to be very damaging. Examples include the sudden ban in 2000 on the use of Bangladeshi jute bags for packing cashews so that a local but high-cost producer of sisal bags could corner the market. So expensive were the sisal bags and the decision was made so suddenly that many cashew producers could not export their crop (Kelsall 2003: 68). Another example involving a much bigger amount was the long-term power supply contract signed with the Malaysian firm IPTL in 1995 which turned out to be excessively expensive, was opposed by high level officials, but was nevertheless signed, raising many allegations of corruption (Khan and Gray 2006).

Clearly there is now greater political access of capitalists and their ability to influence decisions in the case of individual projects has increased. However, successful influence appears to be restricted to some types of projects and some types of investors. The case for mega-investors in mining and tourism is clear. Both local and central political and bureaucratic representatives stand to gain much by pushing these projects through because there are significant rents that are involved in approving such decisions. The construct of a dominant party ruling coalition ensures that it is difficult for local opposition to spill over into more serious conflicts, given the absence of credible opposition coalitions who could exploit these grievances. When it comes to smaller projects the principle appears to be the same. The types of projects which appear to get special rules passed, like the sisal bags, are typically rent-generating projects because they create immediate monopoly powers for some investors. These are generally (though not necessarily) economically damaging for the broader economy. It is easy to guess what the mutual calculations may have been. What is not in evidence is a long-term relationship between individual capitalists and political patrons, which results in benefits to capitalist that are repaid over time in the form of political contributions, taxes or other benefits.

The latter type of relationship demonstrates true political access. Given that Tanzania has a stable dominant party that expects to stay in power for some time, the absence of such long-term relationships and calculations must have some explanation. It is possible that such relationships are difficult in Tanzania because a long-term association with particular capitalists cannot be kept secret. As the capitalists are generally not socially legitimate on grounds of their ethnicity, such a relationship with particular politicians may turn out to be a liability for them. This could explain why even though deals are struck on an individual basis, Tanzania-based capitalists of Indian or other backgrounds find political access difficult (Khan 2009b).

Summary

The transition to a dominant party ruling coalition appears not to have had strong internal drivers, and did not result in a change in the ruling coalition. However, more power passed to lower levels of the political and administrative structure. More significantly, there has been improved political access for some big investors in sectors like mining and tourism. These have become easier because there are strong incentives to enable institutions to operate and to change institutions when required to enable these investments and limited political constraints. However, in the more important area of medium-sized domestic capitalists who could drive a broader manufacturing growth, the political settlement remains adverse for the effective operation of the required institutions. These features of the political settlement explain rather well some of the problems identified in earlier papers, summarized in Figure 29. To overcome the political constraints that limit possible support for the productive sector Tanzania may have to be much more pro-active in developing an industrial policy that can promote the development of a black African capitalist class.

13. Conclusions

Political settlements are *compatible* combinations of institutions and distributions of power that are also *sustainable* in terms of the economic and political stability requirements of a society. Institutions and distributions of power are interdependent because formal and informal institutions together define distributions of benefits in society. If the latter are out of line with the distribution of power, powerful groups will organize to change the structure of formal and informal institutions. Therefore, an institutional structure has to be compatible with the distribution of power. However, compatibility can be achieved in different ways. Institutions can adapt to the distribution of power, or conflicts can continue till a new distribution of power emerges, or both. An institutional structure with a compatible distribution of power constitutes a political settlement if minimum economic and political stability conditions are also achieved.

For a number of reasons, political settlements in developing countries are significantly different from those in advanced countries. Primarily, this is because in developing countries the size of the formal productive sector (the capitalist sector) is by definition rather small. Therefore, the incomes generated by formal rights cannot be the dominant source of social power in developing countries. Many groups have significant holding power based on organizations that are not strictly part of the formal institutional structure. This implies that informal institutions and the incomes and power distributions sustained by these institutions are a significant part of the 'institutional structure' defining the political settlement in developing countries.

Another way of saying this is that in developing countries, the achievement of stability requires a parallel distribution of benefits based on activities supported by informal institutions. It is therefore not surprising that without exception, developing countries have economies that are characterized by significant informality and informal institutions that have considerable effects on sustaining the overall distribution of benefits and power.

The operation and effectiveness of particular formal institutions cannot be understood without locating them within this overall context. Informal institutions and the mechanisms through which they sustain distributions of benefits and powers can significantly affect the operation of particular formal institutions. Our theoretical framework provides a general explanation for the phenomenon of informality that is consistent with the observation that informality in developing countries appears to be a *general* phenomena, and not one that is associated with particular cultures, economic systems or political institutions.

Political settlements in developing countries have general characteristics that lead us to describe them as “clientelist”. In all developing countries informal power organized through organizations broadly described as ‘patron-client’ organizations play a role in sustaining distributions of benefits and power. The significance of informal arrangements in the political settlement also implies that formal institutions operate very differently in developing countries compared to the expectations of narrow transaction cost analysis. This is a critical theoretical result, which allows us to examine differences in institutional performance between countries, and to understand why institutions evolve through very different evolutionary paths in different countries.

By locating the analysis of patron-client relationships in this framework, we also arrive at a broader understanding of patron-client politics and clientelist relationships in general. These are often ‘rational’ arrangements for sustaining significant distributions of benefits and power. In contemporary developing countries patron-client relationships are rarely based on traditional cultural values or weak democratic institutions as some of the older literature on patron-client relationships suggest. These observations also help to explain why Weberian ‘good governance’ strategies are misplaced because they attempt to enforce institutional structures that are structurally unsustainable. A better understanding of clientelist political settlements can help us to identify institutions and reforms that make sense in the context of actually existing political settlements. If some organizations of power are very adverse for economic development, fundamental changes in the political settlement may be required. The framework of analysis suggested here shows why such judgements are deeply political and can result in significant transition costs that have to be factored into an analysis of the desirability of particular directions of institutional change.

While clientelist political settlements share some broad common characteristics, there are significant variations within this group. Clientelist political settlements can range from developmental states at one end of the spectrum to states on the verge of crisis and collapse at the other. We identify two important characteristics which distinguish variations in the mix of formal and informal power within clientelist political settlements. First, there is considerable variation in the distribution of power between

the ruling coalition and other factions, and between the ruling coalition and lower factions on whose support it depends. These variations affect the time horizons of the ruling coalition, its capacity to coordinate and its capacity to implement rules that may impact on coalition supporters differently. These characteristics are important for understanding the operation of specific formal institutions in these contexts. Secondly, the political power and technological sophistication of productive entrepreneurs also varies. This determines how capitalists link up with different factions in the ruling coalition, and the likely resistance they and others can mount against the implementation of specific institutions. The relationship between these variables is non-linear so 'improvements' along any dimension can have positive or negative effects depending on the characteristics of other variables.

While there are other potentially important aspects of a political settlement, we argue that these characteristics capture significant aspects of the distribution of formal and informal power that helps to explain the operation of particular growth-promoting institutions in developing countries. These features of the political settlement affect the efficiency with which specific institutions can be enforced. They also determine the political costs of trying to improve growth with specific institutions or along specific paths of institutional evolution. This determines what we describe as the growth-stability trade-offs for particular institutions that are operating in specific political settlements.

Using this framework, the paper presents an analysis of how political settlements evolved in our countries in terms of the categories developed in the theoretical framework. The evolution of the political settlement in each case is shown to correlate with changes in institutional strategies in our countries examined in earlier papers in this series, some of which are summarized in the figures attached as an Appendix to this paper. Although the analysis presented for each country is at an early stage of development, changes in the political settlement in each of our countries helps us to understand better the performance of specific institutional experiments and paths of institutional evolution. The framework opens up a new way of investigating institutional performance and evolution.

14. References

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15. Appendix: Summary Tables on Rent Characteristics from Khan (2008)

Policies/Rents	Governance	Outcomes/Vulnerabilities
Rent allocation and rent capture to create domestic conglomerates, 1950- Formal rents based on fiscal incentives, import and export controls, licensing and zoning laws. Informal rents based on ability to negotiate terms on formal rents, and preferential access including to privatized assets, loans, licenses, natural resources and insider information.	Competitive Clientelism ensured access to rents was relatively competitive because of competition between patrons. Entry of new clients could not be permanently blocked and together with hard budget constraints for individual factions ensured that clients knew that assets had to become competitive. A permanent flow of rents to particular clients not feasible.	Rapid growth of large domestic conglomerates in relatively low technology manufacturing: Dramatic growth (particularly 1960s onwards) in low-tech sectors where learning periods were short. But competitive clientelism also damaged autonomy of critical agencies: by the late 1980s and 1990s the Bank of Thailand, the NESDB and other agencies became targets of ruling factions.
Limited Rent allocation by technocratic agencies like Board of Investment (BOI) to accelerate learning and technology acquisition, particularly 1980s Examples are targeted BOI incentives for specific technology acquisition strategies including duty concessions, time bound entry barriers, local content conditions supported by specific incentives.	Requires specific technocratic and political (growth-enhancing) governance capabilities Effective technocratic capabilities existed in some agencies and there were moments of political support for such strategies even in overall context of competitive clientelism.	Some upgrading and diversification through conditional support particularly over 1980-97 Examples include diesel engines 1980-85, cathode ray tubes 1985 onwards. But growing politicization of agencies in a context of cheap capital imports limited development of these capabilities. BOI moved to support firms independent of nationality by mid-1980s.
Non-discriminatory rent allocation to all technology providers including FDI, particularly 1997- Local content rules, local ownership rules and setting of national technology priorities all abandoned Initially rents for FDI were provided by cutting tariffs and taxes but as these are bid down further incentives require big investments in education and skills.	Negotiated through active business-government dialogues and regulated by international agreements such as WTO and FTAs FTAs and WTO limit capability of governments to induce learning-by-doing in new sectors by creating temporary rents. Governance focus shifts to ensuring quality of skills in formal education.	Rapid growth of FDI in assembly operations where agglomeration economies already exist Automotive sector success story but ownership of technology and bulk of profits is foreign. Growing challenge of increasing low domestic value added. Country vulnerable to relocations of foreign capital. Effects of populist politics pose a continuous danger.

Figure 25 Characteristics of Rents and Governance: Thailand

Source: Khan (2008)

Policies/Rents	Governance	Outcomes/Vulnerabilities
Rent allocation to big business for learning on a significant scale 1950-80 Licenses, credit, limited amounts of industrial land allocated to investors.	Affected by common Indian problem of disciplining learning rents BUT significant expansion of industrial base Big business had long-term relationships of financing politics: As a result both sides could take a long-term pro-industry view.	Deepening Industrialization of Maharashtra Maharashtra gets a significant share of industrial licenses. High growth of all industrial sectors.
Rent-creation for growth sectors continues after liberalization based on strong business-politics relationships 1980-90 Negotiation of incentives, formal policies, land, and implicit subsidies for technology upgrading continue.	Stable and long-term relationships between business groups and key politicians continue But under growing threat from populist, nativist and exclusivist types of populism playing on persistent and high levels of poverty.	Growth Acceleration in Industry 1985-90 Driven by higher technology sectors like automobiles and pharmaceuticals.
Populist redistributive rent creation by fragmented ruling coalitions 1990- Mobilization of intermediate class supporters using budgetary and off-budget rent creation. Populist strategies of mobilization such as those based on Marathi nationalism.	Traditional parties split and less stable coalition governments emerge Business less able to maintain long-term relationships with politics in this context. BJP-Shiv Sena coalition government emerges in 1995 signalling the emergence of new political patterns.	Shift of investors into areas where learning risks and other sources of market failures were lower Rapid growth of high-valued services (financial services, software) and deceleration of industrial growth after 1990

Figure 26 Characteristics of Rents and Governance: Maharashtra

Source: Khan (2008)

Policies/Rents	Governance	Outcomes/Vulnerabilities
Rent allocation to big business for learning but with limited dynamism 1950-80 Licenses, credit, limited amounts of industrial land allocated to investors.	Affected by common Indian problem of disciplining learning rents PLUS specific state problem of weak long-term relationships with big investors who are often non-Bengalis Big investors lack confidence in long term commitment of political process to incentives for industrialization.	'De-industrialization' of West Bengal 1950-80 West Bengal gets a smaller share of licenses and financing compared to its competitors but its contribution to Indian industry shrinks even more rapidly as domestic business relocates. Growth of small scale and low productivity manufacturing.
Rent allocation and redistribution of land in agriculture to benefit small and medium peasant constituency 1977-1990 Ceiling-surplus land redistributed, sharecroppers registered, agricultural subsidies distributed to target recipients through decentralized government.	Disciplined mass party organization operating through <i>panchayat</i> system of decentralization Effective targeting of rents and asset redistribution to core constituencies of small and medium peasants. Motivated by electoral calculations of ruling Left Front, which remains electorally unbeatable over this period.	Rapid agricultural growth for a decade Agricultural yields and output increase but hits ceilings due to unfavourable population density, very small size of farms, and poor infrastructure.
Significant Policy Shift to Big Business: 1994 Industrial Policy Subsidies and incentives for big business plus extra incentives for mega-projects after 2000.	Strong executive support but conflicts emerge with parts of the Left Front's power base Weakness of Bengali capital continues to obstruct the development of a politically powerful domestic industrial constituency. Opposition's ability to mobilize disaffected intermediate classes makes political price of big business policy potentially very high.	Rapid growth of industrial approvals in moderately big projects and implementation of at least one mega project in Haldia Petrochemicals in 2001 Haldia's success balanced by failures in Singur (Tata Nano) and Nandigram (chemical hub) in 2007-08 when opposition parties successfully mobilize parts of the Left Front constituency. Clarity of policy weakened.

Figure 27 Characteristics of Rents and Governance: West Bengal

Source: Khan (2008)

Policies/Rents	Governance	Outcomes/Vulnerabilities
Ongoing asset and rent capture by emerging propertied classes 1971- Significant acceleration of primitive accumulation by Bengali elites after 1971, continuing with lesser intensity after 1975. Driven by the use of political power to capture or influence the granting of government contracts, land, bank loans and subsidies.	Series of transitions leading to competitive clientelism: Competitive clientelism weakly institutionalized in the post-1990 democracy, and vulnerable to breakdown during elections. Leads to Emergency of 2007-2008 that attacks political corruption but fails to introduce 'good governance'.	Rapid growth of medium-scale capitalists after 1980s Competition between factions produced a relatively broad-based capitalism But aggressive primitive accumulation also source of intense political instability. Ability of state institutions to implement growth-enhancing policies weakened by factional competition.
Rent allocation to accelerate learning and technology acquisition since the 1950s but with poor results Examples include subsidized credit allocation by industrial banks up to the 1980s, tariff protection, subsidies for export promotion.	Technocratic capabilities weaker since 1971 and political environment unfavourable for rent-creation for growth But occasionally growth-enhancing institutions can emerge with political support: examples include bonded warehouses and back-to-back LCs for the garments sector in the early 1980s.	Formal policies to upgrade technology generally not successful Factional politics prevents disciplining and credible rent-withdrawal necessary for sustaining growth. Growth policies only successful when policies are narrowly defined and rent-withdrawal is exogenous (eg MFA).
Fortuitous learning rents for garment sector created by MFA in the 1980s Quota rents created by MFA had significant if fortuitous effects for technology acquisition in the garments sector.	Effective because of strong support for the sector by the executive and a supply of entrepreneurs emerging out of primitive accumulation MFA created a time-bound set of rents that could not be prolonged through domestic political processes. The executive had the capacity to engage in focused institutional innovations with significant effects.	Rapid growth of garments sector Unprecedented growth rates achieved by garments sector, supporting a growth acceleration for the industrial sector as a whole. But extensions based on this experience required to achieve technological upgrading and move up the global value chain.

Figure 28 Characteristics of Rents and Governance: Bangladesh

Source: Khan (2008)

Policies/Rents	Governance	Outcomes/Vulnerabilities
Ujamaa Socialism: Rent allocation to public sector for learning and collective development 1967-1985 Industrial development through public sector 'parastatals'. Agricultural development through villagization and collective farming.	Disciplined one party state but inclusion of all managers within state-party meant disciplining of performance would be weak In fact, experiment did not last long enough to test if the disciplining of non-performers was possible	Some industrialization 1967-78 but reversed after 1978 Uganda invasion and external shocks Disciplined party and aversion to private accumulation in Ujamaa period meant there were very few black African elites who could become potential capitalists when socialism began to be rolled back.
Liberalization and Privatization 1985- Privatization of parastatals primarily benefited foreign investors. Significant growth contribution of gold mining due to attractive rent sharing opportunities for foreign investors.	Arms length formal relationships with business but informal relations probably based on suspicion and short term rent sharing Rent sharing in mining weighted towards investors Key challenge of developing dynamic black African capitalist sector not addressed.	Rapid growth of mining sector and some growth of manufacturing and utilities particularly with foreign participation Significant imbalance in sharing mining rents with foreign investors. Slow growth of manufacturing despite very small base.
Significant aid rents financing social spending 1990- High rates of growth of public spending arithmetically add to growth rate and could raise social productivity in the long run through health and education.	Governance reforms aimed at donor community such as PFM, commitment to anti-corruption, progress on multi-party democracy Efficient service delivery in health and education may not be sufficient for achieving sustainable growth path.	Significant growth in public spending on health and education High GDP growth rates sustained by public spending but questions about whether aid at these levels can continue. Expectations of aid financed spending can have damaging political and economic effects if aid is suddenly suspended.

Figure 29 Characteristics of Rents and Governance: Tanzania

Source: Khan (2008)