Abstract: A political settlement refers to the ‘social order’ in which institutions and governance policies are located. A sustainable political settlement is a consistent combination of institutions and a distribution of power such that the two are compatible and mutually supportive. In developing countries, formal institutions alone cannot produce distributions of benefits that can satisfy all powerful groups. This is because the modern productive sector, which is primarily defined by formal institutions, is too small to generate benefits compatible with the overall distribution of power. Hence, without exception, developing countries have significant informal institutions and informality in the operation of formal institutions. These modify the distribution of benefits to achieve a tolerable compatibility between the overall structure of institutions and the distribution of power. The model shows that informality is part of the construction of the political settlement in these countries and not a feature, for instance, of culture or weak democratic institutions. This explains the significant role of informal institutions and in particular of patron-client organizations and clientelist politics in developing countries. Developing countries have ‘clientelist’ political settlements, but they also vary greatly in their details depending on their internal configuration of power.

A typology is developed for distinguishing between political settlements. In addition, important characteristics are identified that distinguish clientelist political settlements from each other. The broad typology is important because it shows that the Weberian good governance approach makes inappropriate assumptions about political settlements in developing countries and identifies reform goals that are structurally unachievable. The finer characterization of differences between clientelist political settlements is important because at the level of particular institutions, the political settlement determines enforcement costs. This explains why similar institutions can perform very differently (indeed some beneficial institutions can become damaging
ones) and why the introduction or enforcement of particular institutions can face very different ‘growth-stability trade-offs’ as a result of the resistance of powerful groups.

Two dimensions of difference between clientelist settlements are important. The first is the organization of the ruling coalition and its relative power vis-à-vis excluded factions and its own lower-level factional supporters. The second is the level of development of productive entrepreneurs and their power relative to the ruling coalition. Both these dimensions are responsible for significant differences in the incentives of ruling coalitions and the costs of enforcing specific institutions.

The framework is applied in our case study countries to outline how their political settlements evolved over time in terms of the characteristics identified. The evolution of their political settlements closely tracks changes in the performance of their institutions and their institutional strategies. This establishes the analytical and policy significance of the model for evaluating the effectiveness of particular institutions in specific political settlements and the political costs of their implementation.
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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.

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.

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](image)

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 ability 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.

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.
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 enforcement 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.

![Diagram of the interdependence of power and institutions](image)

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, social movements and so on 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.
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 2000a; 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 2000a, 2000b). 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’. 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. 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.
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.

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](image)

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.

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.

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.
The first society has the more adverse growth-stability trade-off given its political settlement, PS₁. From its initial position of A₁ it is only able to reach B₁ in the period under consideration before the minimum stability requirement blocks further incremental improvements. Its growth rate can therefore only be enhanced to G₁. Of course there is no necessary compulsion for growth to even reach G₁ because there may be no pressure on policy-makers or other interested parties to push reform to B₁. 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 G₁ 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, PS₂. Here, from the initial situation A₂, institutional reform can proceed to B₂, achieving a higher growth rate of G₂. 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 2005a). 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.
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 2005a, 2005b, 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 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 2005a).

**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, 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. The existence of these processes means that the protection and enforcement of 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 2000b).

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 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 differences 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.

We describe the informal networks used by powerful groups to generate and protect benefits 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 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 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. More significant 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 groups or factions for more significant rents. For instance, bigger factions may be constructed to participate in electoral contests or to gain entry into other formal organizations that provide access to rents.

Patrons are therefore 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.

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

Patron-client organizations typically play a critical role in descriptions of how ruling coalitions in developing countries are structured. Ruling coalitions differ in terms of the relative power of excluded factions and the mechanisms through which they are excluded. They also differ in terms of the internal distribution of power within the factions that constitute the ruling coalition. The distribution of power between the ruling coalition and excluded coalitions and within the ruling coalition can help to explain the implementation capacities and the likely time horizon of the ruling coalition. These differences in the informal distribution of power characterizing the ruling coalition are more subtle than the differences in formal political institutions that often attract more attention. There are clearly important differences between countries in terms of formal political institutions. However, similarities and differences in formal political institutions can often hide more significant differences in the informal distribution of power between the ruling coalition and other factions in society and within the ruling coalition. These differences in the organization of power may be more important for identifying the incentives and limitations of governments.

The organization of the ruling coalition can therefore vary along two important characteristics that can be examined by looking at the deployment of patron-client factions within and outside the ruling coalition. The first we describe as the ‘horizontal distribution of power’. This describes whether the coalitions excluded from the ruling coalition are relatively powerful or not. Clearly, if they were more powerful than the ruling coalition the latter would not be stable, but there is a wide range of power that the excluded coalitions can have ranging from very weak to almost as powerful as the ruling coalition. This 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.

The significance of this aspect of the distribution of power is that it affects the security of the ruling coalition and therefore the time horizon over which it is likely to make institutional and other policy decisions. Excluded coalitions can be weak for different reasons. The most benign possibility is that the most powerful coalitions have been incorporated within the ruling coalition. It could also be that for historical reasons, the distribution of power across factions was unequal and a few factions are significantly more powerful because of historically inherited legitimacy, organizational capabilities or other characteristics. But finally, excluded groups could actually be strong but could be (temporarily) effectively repressed by the ruling coalition.

The second characteristic describing the structure of the ruling coalition is the ‘vertical distribution of power’. This describes the relative power of higher compared to lower factions within the ruling coalition. Lower factions must in general be weaker and in a position of dependence on the leadership of higher level factions. But there is a significant range of variation from one where lower-level factions have little bargaining power and have to scramble for the attention and recognition of higher level leaders to one where lower-level faction leaders can hold higher levels hostage if their demands are not met. This aspect of the structure of the ruling coalition is also important because it determines the enforcement capabilities of the ruling coalition when interests within the coalition are likely to be hurt. With a distribution of power where lower-level organizations are weak, the leadership of the ruling coalition has considerably greater implementation powers for policies as compared to a situation where lower-level organizations are strong. This is because all policies have distributive implications for lower level factions and if they have the capacity to block the implementation of policies unless their distributive demands are satisfied, most policy could be blocked or significantly distorted.

Each of these characteristics describing the ruling coalition can range along a scale but the polar limits define four possible structures of the ruling coalition in Figure 17. While actual cases are likely to have intermediate characteristics, the four polar types are of interest for classifying clientelist political settlements. The first combination is described in the top left-hand corner of Figure 17, which we describe as a ‘potential developmental coalition’. The ruling coalition in this case faces weak excluded groups along the horizontal scale and weak lower-level factions along vertical scale. The weakness of excluded factions gives the ruling coalition a relatively high degree of stability giving it a longer time horizon for planning. The weakness of its own lower-level factions also gives it relatively good implementation capabilities as the leadership is able to override internal opposition to difficult decisions. The ruling coalition in South Korea from the 1960s to the 1980s approximated these characteristics. However, these characteristics only define a potential developmental coalition because a developmental state has other requirements in terms of the distribution of power that we discuss later.
A second type of ruling coalition is shown in the top right-hand corner, which we describe as an authoritarian coalition. This ruling coalition has moderate to strong excluded coalitions but lower-level factions are weak. The stronger the excluded factions, the more vulnerable the ruling coalition. If excluded factions are moderately strong, their exclusion must be based on some exercise of executive, bureaucratic or military powers. Hence this ruling coalition is described as authoritarian, though authoritarianism in this context may not necessarily involve the use of force. In fact some authoritarian coalitions, such as the one we will discuss in Tanzania during the 1960s may have a ruling coalition that faces very little resistance from excluded factions, but nevertheless decides to take pre-emptive action to limit organizational rights to prevent resistance developing. If lower level factions were also strong, an authoritarian coalition would be most unlikely to survive because external factions would be able to woo away critical supporters of the ruling coalition by offering them better deals. In these circumstances, the authoritarian coalition may resist violently for a time, but is likely to collapse into competitive clientelism.

Authoritarianism is difficult to sustain for long in most clientelist political settlements. Its survival depends on the weakness of lower-level factions within the ruling coalition. As these become stronger, excluded factions have the option of trying to offer some of them a better deal if they defect. The ruling coalition may not therefore collapse immediately, but it becomes unstable. Like the developmental coalition, enforcement capabilities within the authoritarian coalition can be relatively good, but time horizons are likely to be more limited 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. Excluded factions are likely to offer discontented lower-level supporters of the ruling coalition increasingly better offers for defecting. Thus, the capacity to enforce decisions within the coalition is likely to get poorer over time. The military controlled ruling coalition in Pakistan/Bangladesh in the 1960s is an example of an authoritarian ruling coalition whose ability to survive declined over time. The ill-fated BAKSAL one-party authoritarian experiment in Bangladesh in 1975 did not even take off because factions within his own party were too strong and conspired against the President with his future assassins.
The third type of ruling coalition is the dominant party that can be dominant to varying extents and could sometimes be quite weak. Here, excluded factions are weak either because most powerful factions have been included within the dominant party or because excluded factions are divided. Dominant parties can therefore often operate in formal electoral systems though electoral outcomes may be partially influenced in different ways. However, the dominant party may be quite constrained by its own lower-level factions, which are relatively strong by assumption. The stronger the lower-level factions, the weaker the party in terms of its implementation capabilities. Like the authoritarian coalition, this coalition is also inherently unstable, in this case because excluded factions are likely to get stronger over time. The strong lower-level factions that the dominant party incorporates are unlikely to remain contented over time. Conflicts within the coalition are likely to see the defection of some lower-level factions, which strengthens excluded factions, making dominant party systems unstable over time. As long as excluded factions remain weak, the dominant party is likely to take a longer term view of policy and institutions, but its weak implementation capacity prevents it from being systematically developmental. 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.

The dominant party faces a dilemma. If it includes all powerful factions within it, it ensures there are no powerful factions outside to challenge it. But it means that it will have many powerful faction leaders within who are likely to block 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. Its time horizon may therefore not be very long, and its implementation capacities may decline over time.

Finally, the instability of both authoritarian and dominant party versions of the clientelist political settlement makes the fourth type very important. This is competitive clientelism, where the coalition in power faces strong excluded coalitions contesting its hold on power, as well as having strong lower-level coalitions. The latter provide it with significant organizational power but can also constrain the resource allocation decisions of the leadership. Governments in developing country democracies typically have characteristics of competitive clientelist coalitions. Given that both dominant party and authoritarian coalitions face internal problems of sustainability, competitive clientelism often emerges as the default type of coalition. Paradoxically, once lower-level factions become stronger and more numerous, competitive clientelism can provide greater stability because it is a relatively open system of bargaining and coalition formation. Discontented faction leaders within the ruling coalition are free to leave and join the opposition and the ruling coalition can attempt to buy in powerful factions from within the opposition if their price is right.

The characteristic of competitive clientelism is that the time horizon of the ruling coalition is obviously shorter, and the capacity of the ruling coalition to implement anything against the interests of particular faction leaders within its own coalition is also much weaker. In addition, this governance structure faces additional problems of
ensuring a cycling of power without an impasse and possible violence breaking out between competing factions because the ruling coalition has strong incentives to use administrative powers during elections. All of South Asia is now governed by competitive clientelist coalitions as is much of Africa, though Tanzania is an exception. Thailand in the 1980s and 1990s was also ruled by competitive clientelist coalitions. But in all cases apart from India, competitive clientelism has periodically got into trouble as ruling coalitions have attempted to manipulate electoral outcomes.

The competitive clientelist system is only stable over time if credible mechanisms allow the ruling coalition to be replaced with an alternative coalition when the latter can demonstrate greater holding power. As the organizational power of competing coalitions is exercised to mobilize votes in elections, voting here is a test of relative factional strength. However, the possibility that the ruling coalition can use administrative and police powers to marginally (or significantly) 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 is the only developing country that successfully operates an electoral transfer of power between competing clientelist coalitions. What makes India different? One possibility is that India’s size and diversity helps it to organize third-party enforcement of the electoral rules through which competing political organizations can enter and exit the ruling coalition. As elections in India are contested at the level of each state, the Election Commission has the credibility to be impartial because if it behaves too partially, federal forces have strong incentives to intervene to prevent a particular state descending into crisis. An impasse between warring parties at the state level also means that 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 out of line with the organizational strength on the ground cannot be sustained. Third-party oversight of electoral outcomes to ensure that they reflect organizational power is not credible in smaller states. A common response to crisis is that the military takes over. But this raises further problems because exit strategies from military rule are complex and as a result many developing countries cycle through long periods of (vulnerable) authoritarianism and periods of competitive clientelism.

The organization of the ruling coalition can therefore provide insights into the constraints on institutional performance. The formal structure of parties and constitutions may not indicate the distribution of power that actually defines characteristics of the political settlement. Even formal military governments can be significantly dependent on the power of patron-client networks, making military governments substantially different from each other. The threat of force is only a short term strategy, and military governments have to rapidly construct coalitions of factions to achieve stability. As soon as they do, they can be classified in terms of the power of excluded coalitions and of lower-level faction leaders. Army-led governments in developing countries have sometimes had characteristics of vulnerable authoritarian regimes, as in Pakistan in the 1960s, and very weak
authoritarian regimes with characteristics of competitive clientelism in Bangladesh in
the late 1970s and 1980s. Military leaders have often attempted to form parties which
in some contexts acquired many characteristics of competitive clientelism with the
difference that excluded coalitions could not actually hope to win elections but could
expect to be bought into the ruling coalition if they demonstrated significant holding
power. At other times, military-led coalitions have had developmental characteristics,
as in South Korea in the 1960s, or have been strong authoritarian regimes as in 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 ‘capacities’ 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
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 ruling coalitions have access to sufficient funds from informal activities or their own business sources, even high-capability and productive entrepreneurs may be unable to buy into much holding power.

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.

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 2000b; 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 2000b).

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, 2000b; Chibber 2003; Khan 2009b). However, what enabled supported capitalists to resist the implementation of disciplining 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.