

# The Political Settlement and its Evolution in Bangladesh

**Mushtaq H. Khan<sup>1</sup>**

*Abstract: This paper develops a framework for analysing political settlements and applies it to look at the evolution of the political settlement in contemporary Bangladesh. Conventional institutional analysis has not successfully explained why developing countries have systematically failed to achieve the 'Weberian' institutional structures of advanced countries. Conventional good governance reforms essentially attempt to assist developing countries to move towards variants of advanced country institutional structures. The framework of political settlements suggests that this analytical and policy framework is mistaken. The configuration of holding power between economic, political and bureaucratic organizations in developing countries reflects the low level of development of productive capabilities. In general, this distribution of holding power will not support the full enforcement of formal institutions. Rather, formal institutions are inevitably modified in their design and enforcement so that the distribution of benefits is compatible with the distribution of holding power. This framework allows us to look for differences in the organization of power within developing countries and the implications of these differences for the enforcement and operation of particular institutions that are relevant for understanding aspects of development.*

*Developing countries are characterized by variants of 'clientelist political settlements' and a typology is developed that shows how variations in the distribution of power within and between economic, political and bureaucratic organizations can result in significant differences in the constitution of the political settlement. This framework is then used to look at the evolution of the political settlement in contemporary Bangladesh. The country went from a period of military authoritarianism during 1958-71, dominant party authoritarianism from 1971-75, clientelistic authoritarianism from 1975-90 and finally competitive clientelism from 1990 onwards. This evolution is related to changes in the enforceability of critical institutions (defined as changes in the growth-stability trade-off facing the enforcement of particular institutions). The analysis forms the background for a detailed analysis of three particular sectors in contemporary Bangladesh in a companion paper entitled 'Growth, Institutional Challenges and the Political Settlement in Bangladesh'.*

**December 2011**

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<sup>1</sup> Professor of Economics, SOAS, University of London, e-mail: [mk100@soas.ac.uk](mailto:mk100@soas.ac.uk), <http://www.soas.ac.uk/staff/staff31246.php>

## Contents

The Political Settlement and its Evolution in Bangladesh.....	1
1. Introduction.....	1
2. Institutions, Organizations and Development.....	2
3. Governance, Growth and the Policy Debate.....	7
4. Economic organizations and their capabilities .....	10
5. Political organizations and clientelism .....	14
6. Political Settlements and Institutions.....	20
7. Political Settlements in Developing Countries and the Implications for Policy.....	25
8. Differences between Developing Countries .....	34
The Organization of the Polity.....	37
The Organization of the Bureaucracy .....	52
The Organization of the Economy .....	55
9. The Political Settlement and the ‘Micro’ Analysis of Institutions .....	63
10. The Growth-Stability Trade-off.....	68
Political Settlements and the Trade-off Curve.....	70
11. The Evolution of the Political Settlement in Bangladesh .....	73
12. Military Authoritarianism: 1958-1971.....	80
13. The Rise and Fall of Dominant Party Authoritarianism 1972-1975.....	85
14. The Transition Period of Clientelistic Authoritarianism 1975-1990 .....	95
15. Vulnerable Democracy 1990- .....	103
Bengali versus Bangladeshi Nationalism and Democratic Vulnerability.....	106
The Absence of (Informal) Rules for Live-and-Let-Live Cycling.....	113
Economic Organizations under Vulnerable Democracy.....	118
16. REFERENCES .....	122

## FIGURES

Figure 1 Relationships between economic and political organizations.....	17
Figure 2 Political Settlements as Macro-Political Systems .....	22
Figure 3 A Typology of Political Settlements .....	25
Figure 4 The Configuration of Political Organizations and the Ruling Coalition.....	38
Figure 5 The Configuration of Bureaucratic Organizations .....	52
Figure 6 The Configuration of Economic Organizations .....	56
Figure 7 Variants of Clientelist Political Settlements.....	65
Figure 8 The Analysis of Individual Institutions within a Political Settlement.....	66
Figure 9 The Growth-Stability Trade-off .....	70
Figure 10 Stages in the Evolution of the Political Settlement in Bangladesh .....	75
Figure 11 Growth and Crisis under Authoritarianism 1958-71 .....	84
Figure 12 The Dominant Party 1972-5 .....	94
Figure 13 Growth led by new sectors under clientelistic authoritarianism .....	101
Figure 14 Growth with Vulnerable Democracy 1990- .....	105

## TABLES

Table 1 East Pakistan/Bangladesh Growth Trends 1950-2005.....	73
Table 2 Sectoral GDP Shares Bangladesh 1980-2005.....	78

## 1. Introduction

Sustaining growth, particularly in developing countries, requires institutional solutions to market failures. If the relevant market failures are primarily the result of weak property rights, the appropriate solution would be to focus on governance reforms that strengthen property rights. This is essentially the approach of ‘good governance’ reforms, with their emphasis on property right enforcement, enforcing the rule of law, enforcing anti-corruption and improving political accountability. In theory progress in these directions reduces the transaction costs of protecting and transacting with property rights and thereby directly reduces the severity of market failures that may be constraining investment, learning, technology acquisition and other processes necessary for growth. While many of these reforms are desirable in their own right, theory and evidence from across developing countries suggests that these reforms are inadequate for addressing important market failures that developing countries face, and in any case these reforms are difficult to implement to any significant extent in most developing countries. At the heart of the problem is that the analysis of development has paid inadequate attention to the critical problem of how the relative power of organizations in that society affects the enforceability of different institutional rules. We capture this aspect of development and policy in our concept of the ‘political settlement’ which describes a specific distribution of power between relevant organizations in a country. The political settlements in developing countries make them structurally different from most advanced countries and in many cases significantly different from each other. Development requires institutional solutions that address the market failures relevant for that country and that can be implemented *in that particular political settlement*.

This interactive analysis of institutions and their implementation brings us back to the problem of governance, but in a different way. Implementing solutions to market failures keeping specific political settlements in mind focuses policy attention on governance capabilities that are likely to be quite different from the capabilities required to enforce general good governance requirements. The enforcement of institutions of the type that would satisfy ‘good governance’ conditions may be infeasible in the typical developing country, but a focus on developing particular enforcement capabilities that are feasible in that political settlement and which solve important constraints on development can yield significant developmental outcomes. Indeed, a closer look at developmental success stories of the past century suggests that this was actually how development was achieved in countries that in no case satisfied the requirements of good governance. We highlight the different implications for policy by referring to ‘governance for growth’ or developmental governance as a strategy of developing governance capabilities necessary for addressing market failures in specific political contexts. The policy challenge is to identify institutional instruments for addressing market failures that can be adequately enforced in a particular settlement given existing enforcement capabilities or feasible improvements in enforcement capabilities through targeted ‘developmental governance’ reforms.

The significant differences in the performance of similar institutions across countries are a challenge for economic theories. One response has been to go beyond individual institutions and look at broader ‘social orders’ to explain differences in performance between societies (North, et al. 2007; North, et al. 2009). Our analysis also recognizes the importance of the macro-political equilibrium in a society and suggests a two-

stage analysis. Identifying critical aspects of the ‘macro-political equilibrium’ is important because it affects the ‘micro’ analysis of particular institutions and organizations located within this macro-equilibrium. The analytical frame of ‘political settlements’ identifies relevant aspects of the macro-political equilibrium that can affect the operation of particular institutions and organizations at the micro level (Khan 2010). We define a political settlement as a combination of institutions and a distribution of power between organizations that is reproducible over time. Once a reproducible macro-political equilibrium emerges, the relative power of different organizations is relatively stable and evolves along stable paths. The two-stage analysis of political settlements can help to explain why similar formal institutions and organizations appear to perform very differently across countries and over time. Once a political settlement emerges, the distribution of benefits across organizations has to be consistent with the relative power of organizations. Otherwise, organizations will mobilize, bargain and put pressure on other organizations and the state to change formal and informal arrangements to bring the distribution of benefits back into line with their actual relative power. In developing countries, the distribution of power between organizations typically does not allow the enforcement of many formal institutions (such as property rights) that are modelled on more advanced countries. These institutions are informally modified or partially enforced to ensure that the distribution of benefits is in line with the actual distribution of power, and many organizations informally operate to ensure these outcomes. This insight can help to explain why institutions and organizations that appear to be very similar in terms of their formal description actually operate very differently across countries. The underlying political settlements in every country also evolve over time, but they are usually evolving in path dependent ways except at moments of rupture and crisis.

The paper is structured as follows. Section 2 provides definitions and identifies the challenges of sustaining development. Section 3 summarizes the limitations of the ‘good governance’ agenda and the importance of focusing on alternative ‘developmental governance’ capabilities that are derived from an analysis of specific political settlements. Section 4 elaborates our framework of political settlements as a tool for understanding the efficacy of different policy responses. The subsequent sections develop the example of Bangladesh since the 1970s to illustrate how changes in the political settlement can affect the choice and viability of growth strategies.

## **2. Institutions, Organizations and Development**

We define institutions and organizations as in the institutional economics literature (North 1990). Institutions are the ‘rules’ that describe how social actors act. Property rights that define who can do what with an asset are institutions because they are complex sets of rules. The rules describing taxation, subsidization or the regulation of economic activities are therefore also institutions, though some economists would make a distinction between rules that can be easily changed, which they would describe as policies, and reserve the term institution for rules that are more difficult to change. Since there is considerable vagueness in what is difficult or easy to change, we prefer to describe all social rules as institutions. Some institutions like constitutional rules may be procedurally difficult to change or may be deeply embedded in supporting culture and values. Others may be more easily changed through legislation, like rules about what can be taxed and at what rates. Institutions are ‘formal’ if the rules are enforced by the state and ‘informal’ if the rules are self-

enforced or enforced by non-state actors. Informal institutions are rules that are not enforced by formal state agencies. They include behaviour supported by habits, customs, cultures and values. But they also include rules (that may appear to be formal) but are actually enforced by informal agencies like mafias and patron-client organizations or by state agencies acting in informal, personalized ways. Informal institutions can therefore also describe formal institutions that have been modified in their application as a result of the informal activities and pressures of particular interests.

Formal institutions are usually generalized and impersonal, which means that they are defined to apply to all individuals or organizations of a particular type. This is often a characteristic of rules that are enforced at a social level by a state. In contrast, informal institutions are arrangements between specific groups and by definition are unlikely to be universal in the sense of being applicable to all individuals or organizations of a particular type. For instance, property rights that are protected in an impersonal way by state are formal institutions. But if the state is unable to protect the rights of all formal property owners and only a few are able to do deals with the police to protect their property, the latter are informal institutions in the sense that the application of the formal institution has been modified in informal ways. Some informal institutions can indeed be generalized in their application, for instance informal cultural norms may be widely shared. But in general, informal rules are likely to be personalized in the sense that they describe the relationships between particular individuals or organizations. Various reasons have been offered to explain the dominance of informal institutions in developing countries including the weakness of state organizations charged with enforcing formal institutions. If technological and bureaucratic capabilities were the primary reasons for poor enforcement, the 'good governance' reform agenda may have been implementable with some external assistance. But developing countries have remained decidedly 'non-Weberian' regardless of many attempts at strengthening the enforcement of formal institutions.

An example of a formal institution would be the rules for awarding public contracts according to formal criteria. If the rules are followed and adequately enforced, they are formal institutions. In contrast, informal institutions can be self-enforced rules like the rules devised by a group of fishermen to determine the times when each of them can fish on the same stretch of river. If these rules are observed reasonably well, they constitute a set of self-enforced and therefore informal institutions. The term informal also describes the operation of a nominally formal institution whose enforcement is partial or modified through other social processes. For instance, if contracts that are supposed to be awarded according to formal rules are actually awarded on the basis of the private networks and agreements linking the bidding parties with public officials, the implicit rules determining who gets the contracts are informal institutions, or a combination of formal and informal institutions (for instance if some formal qualification criteria also have to be met). The economic consequences of any particular formal institution clearly depend not only on what the rules specify but also on the degree to which they are actually followed or enforced. Given the importance of different types of informal institutions in developing countries, economic and social outcomes cannot just depend on the formal rules. The actual behaviour of social actors may be quite different as a result of modifications of the formal rules or by the application of entirely informal rules.

Organizations are the agencies that operate under these institutional rules. Firms, political parties, trade unions and mafias are all examples of organizations. Particularly important organizations from the perspective of governance are the bureaucratic organizations of the state that are involved in the enforcement of formal rules. Governance capabilities describe the capabilities of these government agencies for enforcing formal rules. In general, organizations may operate within the formal institutional rules in society, or they may violate these rules, as in the case of mafias or many political parties in developing countries. In a Weberian state, the agencies of government not only enforce formal rules but they are also bound by the formal rules that they collectively enforce. Within the organization there may be further rules describing the rights and responsibilities of individual members or subgroups. Internal rules constitute internal institutional arrangements and these too may be formal or informal. Formal internal rules are general rules that are impersonal while informal rules describe patterns of behaviour that may apply to different individuals differently. In developing countries, organizations themselves have many elements of informality and personalization in their internal operations. In informal organizations leaders are likely to be linked to their followers through personalized relationships rather than rule-following obligations and responsibilities.

Most organizations pursue both economic and political goals to varying extents but some organizations can specialize in one or the other. Specialist political organizations organize their members and broader constituencies to achieve political goals. Typically they seek to change institutional rules in society in ways that favour themselves or particular constituencies. If they act informally, they may simply seek to modify the implementation of formal rules without actually trying to change them. Changes or modifications in rules create benefits for some groups that can be described as 'rents'. As a result, political activity can be described as rent seeking. Rent seeking is not necessarily purely redistributive because changes in institutional rules can also have negative or positive effects on productive activity. Thus, the 'political' rent-seeking activities of organizations can create growth-enhancing or developmental rents as well as socially damaging one (Khan 2000a, 2000b). Economic organizations in contrast are engaged primarily in organizing economic activities. But the production of goods and services also involves the production of surpluses that have the character of internal rents within productive organizations (Alchian and Demsetz 1972). Thus, most organizations are engaged in the search for and protection of rents either within or outside the organization. Their activities can be described by the rules they actually follow, some of which may be formally defined and enforced while others are informal. Their rent seeking activities can have positive and negative effects on production, distribution and development. This is the overall context that the analysis of institutions and organizations addresses.

A state's governance capability refers to its ability to enforce formal institutions. However, enforcement capabilities may vary quite significantly depending on the institution that is being enforced. For instance, the same state may have enforcement agencies that are quite effective in enforcing urban property rights but state organizations may be weak in enforcing contracts in rural areas. A general characterization of a state as strong or weak in terms of its governance capability can therefore be unhelpful, particularly in developing countries. 'Good governance' in the policy literature refers to state capabilities of enforcing formal institutions across the board, in particular formal property rights. If all property rights and contracts could be

enforced by state agencies, markets would be efficient and socially beneficial activities of production and exchange could be based on voluntary contracting between individuals and organizations. In other words, there would be few market failures, though distributive justice would depend on the initial allocation of rights. Many developing countries adopted policies that attempted to achieve generic good governance capabilities, particularly in the 1980s and beyond. These policies sought to strengthen the technical and bureaucratic capabilities of key governance agencies in an attempt to convert countries with significant informality and enforcement weaknesses into rule-following ‘Weberian’ states.

But despite these attempts, there are no Weberian states in developing countries in the sense that the enforcement of the rule of law is effective enough to constrain all or almost all public and private organizations. This is not accidental as there are a number of important reasons why developing countries retain significant aspects of informality in their institutional operation. First, developing countries have limited public finances and effectively enforcing formal institutions is a costly activity. The public finance problem is clearly a function of low levels of social productivity that limit the fiscal resources available for enforcement activities. Poorer countries have smaller productive sectors by definition, so the public resources available for enforcing property rights and enforcing contracts are limited to begin with. The enforcement of formal institutions like property rights is expensive. The protection of property rights (and the associated enforcement of contracts based on these rights) as a public good assumes that asset owners can collectively pay for this enforcement. This condition does not hold in developing countries. In this and the other characteristics discussed below, developing countries clearly vary along a range, and advanced developing countries increasingly acquire characteristics of advanced countries and gradually improve their enforcement capabilities.

Secondly, the existing structures of formal rights in developing countries are typically inappropriate for organizing modern productive activities. The ownership of land and assets, the organization of production and other features of the economy have largely carried over from a pre-capitalist history. Raising social productivity requires transforming and re-allocating pre-existing rights and creating new rights appropriate for new economic activities. These processes can result in significant distributive conflicts as the relative status and incomes of pre-existing organizations can be expected to change significantly. The gradual creation of new rights and organizations appropriate for a more productive economy creates new income streams and begins to transform the distribution of income and power. But during this period of transition, the organizations that are actually powerful in developing countries are typically not the formal productive organizations that will eventually dominate once the transition is complete. The formal institutional structure adopted by developing countries is primarily designed to support productive organizations in the modern sector even though these organizations are not yet dominant. Property laws, contract laws and corporate laws are derived from advanced country models to support new types of productive organizations. But powerful organizations based on other sources of power are unable to capture significant incomes under modern formal rules because they lack the capital and capabilities to engage in modern productive activities. As a result, the *full* enforcement of property rights in line with the needs of an emerging modern economy is likely to result in a distribution of benefits that is significantly out of line with the pre-existing distribution of power across organizations. It follows that many

powerful organizations in developing countries can only generate incomes commensurate with their political power by engaging in the violation of formal rules in ways that enable them to claim a share of the social net product.

Thirdly, modern productive organizations are few in number in developing countries and indeed this is the most important reason why poor countries are poor. Put simply, the organizational capabilities for setting up productive organizations are not yet widely available. Organizations that have the capability to engage in productive activities in a competitive global market are few in number even if formal institutions appear to support these organizations. Missing organizational capabilities can explain the well-known paradox that developing country firms using the best available machines with workers and managers who appear to have adequate formal skills frequently fail to achieve international competitiveness. Their wage advantage is typically outweighed by their weak organizational capability to operate competitively. Organizational capability is embedded in the routines that individuals within the organization follow. The routines supporting efficient teamwork have to be learnt by members of the organization but this learning largely involves the acquisition of 'tacit knowledge'. Tacit knowledge cannot be acquired in codified ways, for instance in schools and colleges. Rather it has to be acquired through learning-by-doing. As organizations experiment with different internal hierarchies, management systems, incentive structures and even physical layouts of factories and offices, they grope towards achieving embedded organizational capabilities that are appropriate for achieving competitiveness.

These experiments, or learning-by-doing processes, are far from simple and constitute some of the most important challenges for modernization and development. Developing countries face much more significant challenges in acquiring organizational capabilities than advanced countries because the latter only need to modify existing capabilities as technologies change. Advanced countries already have many people who have worked in competitive organizations and developing new organizational capabilities involves incremental changes and absorbing incremental personnel. In contrast in developing countries, the entire team including supervisors and managers may not have worked in modern competitive organizations before. Many workers may never even have seen a factory before. Clearly, the learning here is much more time consuming and uncertain in terms of the outcome. The cost and uncertainty of organizational development in poor countries explains why success has often been associated with institutions and enforcement mechanisms that create opportunities, incentives and compulsions for organizational learning. This is particularly true for achieving growth that is broad-based across different sectors, technologies and regions. Specific incentives and compulsions for enforcement are required to accelerate the creation of new organizations that can achieve globally competitiveness. In a context where formal institutions and policies are difficult to fully enforce, solving these problems often requires combinations of formal and informal arrangements that assist the achievement of these objectives.

Finally, political organizations also tend to be different in developing countries but not because of lower organizational capabilities. But compared to advanced countries, they are less likely to follow formal rules and more likely to capture rents that are not legally generated. Moreover, their organizational activities are also less likely to be financed by resources generated in the modern economic sector. In contrast, in



advanced countries the rent seeking of political organizations is likely to be rule-following and limited to rents available through the redistribution of legal budgetary resources or legal changes in institutions. They are also likely to be financed to a significant extent by resources coming from modern economic organizations that now dominate the economy. An important consequence is that powerful feedbacks operate in advanced countries constraining the activities of political organizations such that they are more likely to be responsive to the requirements of economic organizations. This is not necessarily always beneficial for society as a whole. For instance, the 2008 financial crisis in advanced countries was largely the result of the economic dominance of financial organizations in some countries and the political influence they could purchase, allowing them to successfully lobby for increasing levels of deregulation. On the other hand, the absence of strong feedbacks from economic organizations can also be problematic. Weaker feedbacks mean that political organizations can persistently seek rents that are likely to be damaging for the economy.

These reasons help to explain why developing countries tend to score poorly in terms of the enforcement of property rights, the rule of law and other 'good governance' requirements. The problem is not just that the enforcement capabilities of formal agencies charged with enforcement duties happen to be weak. Rather, the deeper reasons explain why these capabilities are unlikely to be strong. Developing countries do not have the resources to fully enforce formal institutions, the existing structure of formal institutions is typically inappropriate and requires substantial changes, economic organizations have limited capabilities to pay taxes and may themselves require assistance through informal arrangements and finally political organizations have strong incentives and opportunities to engage in informal rent seeking activities given the limited rents available through fiscal transfers. Conventional institutional theories are also weak in explaining why the same formal institutions appear to have such different effects across countries. But by recognizing differences in the macro-political economy across countries, these differences in the operation of formal institutions can be explained. We analyse the macro-political economy as a 'political settlement'. A political settlement is an interdependent combination of organizations and institutions in a society that is reproducible and therefore satisfies the minimum conditions of economic and political viability. Political settlements can sustain different distributions of power between organizations, and this constrains the degree to which particular formal institutions can be enforced and the ways in which they operate. Thus, differences in the political settlement can explain why similar formal institutions appear to perform very differently across countries. But first we look at organizations and governance in more detail.

### **3. Governance, Growth and the Policy Debate**

The discussion about institutions and governance needs to be located in the context of the policy debate about governance. If governance agencies in developing countries have to improve their capabilities of enforcing institutions, which institutions should they try to enforce and how should governance agencies achieve better enforcement? Before the 1980s, it was common to assume that developing countries needed to address significant market failures constraining learning and technology acquisition. It followed that they needed to have governance capabilities to successfully enforce broad-based interventions like tariffs and subsidies to overcome important market

failures. Strategies such as tariff-based import-substituting industrialization allowed extensive growth (the replication of production of a particular type without productivity growth). This is a necessary condition for triggering growth in developing countries as productivity growth can only follow as a result of learning-by-doing within the plants that are set up. However, growth is only sustainable if it moves from the extensive to an intensive phase with learning-by-doing actually resulting in an improvement of productivity so that protection is eventually not required. The latter requires the enforcement of rules to ensure that new organizations put in high levels of effort in attaining international competitiveness. This was often missing, resulting in slow or non-existent growth in organizational capabilities. Without the appropriate governance capabilities on the part of states to enforce high levels of effort by organizations receiving support, growth strategies were likely to fail if start-up plants continued to require subsidies to operate. In these cases, infant industries refused to grow up, subsidies proliferated and became a way of life, and public sector enterprises made persistent losses.

In contrast, the dramatic success of a small number of East Asian countries in the 1960s and beyond was based on their ability to manage policy-induced rents using both formal and informal enforcement such that incentives and opportunities were created for high levels of effort in building new capabilities (World Bank 1993). These enforcement capabilities can be described as *developmental* governance capabilities. It would have been reasonable to conclude that if less dynamic countries wanted to improve their performance, they would have to strengthen similar governance capabilities for correcting market failures. If it was difficult to develop these capabilities on an extensive scale, then the range of policies addressing market failures would need to be scaled back to be compatible with the enforcement capabilities that could actually be developed. Instead, the response from the late 1970s onwards was to equate all intervention with the creation of damaging rents and therefore to abandon all rent creating strategies. As a result, strategies for assisting economic organizations to develop their organizational capabilities or to address other market failures were also abandoned. The shift towards liberalization and 'good governance' strategies was actually even more ambitious in terms of the enforcement capabilities that were now required. The new approach assumed that it would not be necessary to address market failures because it should be possible to make markets more efficient *across the board* by improving the *market-enhancing* governance capabilities of agencies enforcing property rights and the rule of law. In theory the effective enforcement of property rights could reduce market transaction costs (and therefore market failures) sufficiently and allow private contracting to solve problems of development (Khan 2007a, 2008a). But the theory did not account for the factors constraining the enforcement of formal institutions in developing countries.

While many of the good governance reforms are desirable in themselves as goals, they are unlikely to be implemented to a significant degree in developing countries because of the *structural* factors discussed earlier that constrain the enforcement of formal institutions (Khan 2007b). It is not surprising that an empirical relationship between market-enhancing governance and accelerated economic growth has not been established. There is a weak positive relationship identified in many regression exercises between actual improvements in 'good governance' indicators and economic growth. But the strength of the relationship is weak, and the regression analysis shows that the additional growth that achievable improvements in good

governance can offer is limited (Kurtz and Schrank 2007). Deriving important policy conclusions from the results of weak multi-country regression results is problematic. For one thing, given the two-way causality that everyone accepts between good governance scores and economic growth, it is difficult to identify the true strength of the relationship in one direction using available econometric techniques.

Another problem is that the data to test these theories is weak and available only from the 1990s (Arndt and Oman 2006). Given the limited support from cross-section data, supporters of good governance policies (for instance, Kaufmann, et al. 2007) have sought support in long-run econometric exercises using instrumental variables such as in the work of Acemoglu, Johnson and Robinson (2001, 2002). Here instrumental variables that explain where settler colonialism was established are found to correlate with high per capita incomes today. The authors claim that this is because settler colonialism established stable property rights. But the econometrics only establishes that settler colonies did better, it does not establish that they did better *because* they first established stable property rights. Other factors were also correlated with the onset of settler colonialism, for instance, the entry of settlers with higher human capital (Glaeser, et al. 2004). More significantly for the claims of good governance theory, the period of economic transformation in settler colonies was historically one of violent property right disruptions (Khan 2009a). These transformations involved significant transfers of assets from indigenous populations to settlers. But settler colonialism did not *first* establish property rights that *then* allowed efficient markets to transfer assets from indigenous populations to more efficient users. Rather, settler colonies used ‘institutions’ of violence to destroy pre-existing rights by force. Paradoxically, these forced transfers allowed them to carry out rapid transformations in the organization of production that achieved the growth in productivity that subsequently allowed property rights to be adequately protected. But what is of interest to developing countries is the process of transformation (and not the end state these societies achieved) and that process was neither based on stable property rights nor on minimizing social costs.

There is strong evidence of a long-run correlation between the level of social productivity and the strength of protection for property rights. But the causal links go in both directions. As assets become more productive, they can begin to pay for their protection and property rights are likely to be better protected. Equally, everything else being the same, if property rights are better defined there will be positive effects on contracting possibilities, and therefore on the productivity of assets. The policy question however is about feasible governance priorities during the period of *transformation* when asset use and social organization are rapidly changing. The transition is a period when traditional societies are becoming unsustainable in the face of modernizing processes and exposure to competition and new productive firms and sectors are gradually emerging. Far from establishing that good governance was a precondition for these transformations, settler colonialism with its extreme disregard for the rights of indigenous populations shows that these transformations involved considerable injustice and conflict. But the extent of injustice and the human costs involved in the settler colonialism lauded by Acemoglu et al. makes them entirely inappropriate as models of how to achieve developmental transformations today. Thus, neither the cross-section nor the instrumental variable regressions provide convincing evidence that countries have made a significant transition from poverty to prosperity by *first* achieving good governance capabilities. We can accept that

improvements in good governance capabilities could result in *some* improvements in development performance, but we have no evidence that *achievable* improvements along these dimensions of governance will be sufficient for developmental transformations.

The role of governance during these processes of transition has to be understood in this context. Structural features of developing countries rule out the achievement of good governance conditions to the extent that relevant market failures would disappear. At the same time, the models of forced transitions under colonial settlement are not desirable either. The role of policy must be to create incentives and constraints to move organizations in productive directions within the limits set by inherited political settlements. The discussion of *developmental* governance was for a time dominated by the experiences of the East Asian tigers in the 1960s and 1970s (for instance Amsden 1989; Wade 1990). Unfortunately, these were also inappropriate models for most developing countries because they had exceptional political settlements that allowed them to manage an extensive range of interventions and the associated rents. Most developing countries do not have these capabilities and are unlikely to attain them given *their* political settlements.

East Asian capabilities are unattainable in most developing countries, but not because the East Asian countries had the mysterious ability of ‘picking winners’. This common but misleading characterization of East Asian industrial policy implies a degree of prescience that neither private investors nor bureaucrats can be expected to have, and indeed East Asian countries did not have it. Their success was based on supporting investment in areas where new organizational capabilities could be developed and having the *ex post* capability to withdraw support from areas that were clearly failing rather than picking *ex ante* winners in some mysterious way. Nevertheless, this governance capability is sufficiently demanding to be out of reach for most countries on the scale that a few East Asian countries achieved during their rapid transformations. The distribution of power across organizations in most developing countries precluded attempts at disciplining organizations benefiting from rents. But it was equally futile for them to hope that they could achieve significant good governance capabilities in relatively underdeveloped societies. The only realistic strategy for most developing countries must be to build developmental governance capabilities on a more modest scale, taking into account the market failures they face, and the constraints on institutional enforcement set by their political settlements.

#### **4. Economic organizations and their capabilities**

Economic organizations refer to firms involved in the organization of economic activity. They include organizations involved in production in industry and agriculture but also financial organizations like banks and other service providers. Economic development is nothing but the transference of economic activity out of traditional low productivity organizations to modern high capability ones that are able to organize production in globally competitive ways. But the capabilities enabling organizations to be competitive are difficult to achieve. Economists used to think that competitive production was simply a function of selecting technologies that were appropriate for the factor prices and skills of the country. It is now clear that the organization of competitive production requires significant capabilities embedded in organizational routines and the ability of personnel within the organization to operate

these routines. Acquiring these organizational capabilities is much more difficult than acquiring machines or workers with the right formal skills. Indeed, significant market failures can prevent organizations from acquiring the required level of organizational capabilities to operate even the simplest technologies. Without strategies of developing these capabilities, opening up access to markets through liberalization is insufficient for sustaining development. Nor are low wages alone sufficient for ensuring that organizational capability will be built up by foreign or domestic investors.

The problem for developing countries is that even when a workforce with the appropriate formal education is available for particular production processes, most of them are unlikely to have been employed in a competitive organization operating these technologies before. Indeed, by definition, much of the workforce in developing countries has never worked before in any high-capability competitive organizations. Learning organizational routines is much easier for one or two people joining a high-capability organization that is already competitive. This is why immigrants from developing countries coming to advanced countries with the appropriate formal education but no experience of modern organizations nevertheless typically learn to function within modern organizations quite rapidly. The learning is much slower, more uncertain and requires much greater effort when the organization as a whole has not evolved the routines that enable it to be competitive. The problem is only slightly easier for foreign investors in developing countries because they presumably know what a capable organization looks like, but even they have to invest a lot in imparting that knowledge to local workforces, supervisors, supplier networks and so on. This also requires considerable learning-by-doing by foreign investors to understand local problems and conditions. Moreover, given that foreign companies are likely to have more advanced technologies, they do not necessarily have an advantage in setting up organizations with competitive capabilities in developing countries (though they may in some sectors and technologies).

Building organizational capabilities when the organization itself has not achieved these capabilities requires significant additional investments on top of the investments in machines and labour because while the learning is taking place, the organization is not as profitable as it should be and is possibly making losses. But the success of these investments depends critically on all the stakeholders putting in high levels of effort during this learning process. This is by no means assured because effort is costly and experimentation can result in job losses or task redefinition at all levels of the organization. Investors are therefore likely to be subject to significant moral hazard problems given asymmetric information problems and limited contract enforcement capabilities in developing countries. Not surprisingly, building organizational capabilities through private investment and contracting is subject to contracting failures that can be described as market failures. Investors in organizational development would have to be sure that all stakeholders have incentives and compulsions to put in high levels of effort, that investors could extract some value from the investments to limit their loss in case of failure, and get their agreed share of profits in case of success. All of these requirements are subject to significant contracting problems, particularly in developing countries where the underlying structure of property rights and the formal contract enforcement capabilities of the state are weak. At the same time, if the problems facing the construction of competitive organizations are not addressed, an exposure to the

market can lead to divergence rather than convergence, as happened in many developing countries under colonial rule. This is not surprising because exposure to the market without solving the capability development problems can destroy weak organizations that do not have the capability to survive international competition.

For instance, between 1873 to 1947 when India was forced to adopt free trade policies under British colonial rule, its per capita income declined from around 25% of US per capita income to under 10% (Clark and Wolcott 2002). This was a period of close to zero tariffs, strong protection of the rights of British investors and virtually no restrictions on the repatriation of capital and profit. The reason was simply that it was not profitable for anyone to invest in modern manufacturing or agricultural production in India while Indian handicraft manufacturing based on more primitive organizational principles was destroyed by exposure to international competition. The competition was not entirely fair because the British further tilted the playing field against Indian handicraft production by imposing domestic taxes that accelerated the decline that would almost certainly have happened anyway (Khan 2009a). The sobering fact is that the productivity of Indian workers was so low that even very low wages compared to Britain did not give India a competitive advantage in basic manufacturing. Potential Indian productive organizations may eventually have become competitive if sufficient investment and effort was put into building organizational capabilities and the relevant tacit knowledge of the workforce and management. But who would take this risk given the contracting problems? The problem of organizing capability development remains one of the most significant problems facing development in contemporary developing countries.

*Organizational capability* refers to the organizational routines and the knowledge to operate these routines that is essential for sustaining competitive production outcomes. Without this 'know-how', investments in the best available machines and in workers with apparently the right formal education can fail. Owners, managers and workers somehow have to acquire the know-how to operate new types technologies and this typically requires organizing large numbers of people in very specific ways. The relevant capabilities are embedded in a combination of new routines, new tacit knowledge embodied in key personnel and new hierarchies and incentives within the organization. There are many ways of organizing management, factory layouts, supervisory structures, quality control structures, incentives and hierarchies even for producing a single product. This is demonstrated by the many different ways in which firms are organized for different technologies, and differently organized for the same technology in different countries (Williamson 1985; Whitley 1992). The organizational structure that will work best for a particular technology in a particular country depends not only on the technology but also on the initial conditions in the country describing hierarchical relationships in society which can sustain or rule out particular types of internal firm hierarchies and operating procedures. Typically, creating effective organizations therefore involves a lot more than copying a blueprint, because not only is the optimal blueprint likely to vary across countries, but the functions and tasks of different individuals within the blueprint is not codified knowledge that can be learnt in books, but is rather tacit knowledge that has to be learnt through a process of experimentation and learning-by-doing.

Poor countries remain poor because they fail to construct organizations with these organizational capabilities. Indeed without such organizations, poor countries can

paradoxically suffer from capital flight and the outmigration of skilled workers. The know-how involved in setting up factories, organizing production lines, managing quality control and order flows, maintaining work flows and so on is mostly 'tacit knowledge' that cannot be learnt in books and manuals. It can only be acquired through learning-by-doing with high levels of effort. What is learnt is essentially a combination of routines that are embedded in the ways in which organizations are set up and associated tacit knowledge embodied in the personnel that operate within these organizations (Nelson and Winter 1982; Stiglitz 1987; Lall 1992; Lall and Teubal 1998; Lall 2000a, 2000b). Without these capabilities, a firm that appears to have all the requisite machines and a workforce with the required formal skills will still be unable to produce goods or services at a competitive price-quality combination. Any production under these circumstances requires implicit or explicit subsidies, either from the public purse or from investors taking a bet on the organization achieving competitiveness in the future. Since the learning-by-doing required for organizational capability development requires a period of *doing*, a period of loss-making and implicit subsidization is necessary. But protection, temporary subsidies or other ways of financing the learning will only succeed in developing competitive organizations if the organizations have strong incentives and compulsions to rapidly acquire the capabilities necessary for achieving competitiveness.

Development therefore involves a lot of effort in building organizations that can engage in competitive production. Investment in physical capacity and formal education are necessary but not sufficient. At least as important are the investments in building organizations. This amounts to financing periods of loss-making when learning is taking place and the organization is by definition unable to be profitable. But financiers (including society if the financing is a public subsidy) should only be doing this if they can be sure they will not lose out because of poor levels of effort by those benefiting from the financing. Private financiers may not be able to contract for or enforce these conditions, particularly in developing countries, and as a result they typically avoid investments in organizations where substantial capability has yet to be acquired. Policy *can* address these market failures by reducing the cost or risk of financing loss-making learning periods, provided the governance capabilities are in place to ensure that the opportunities created are not wasted in their turn (Khan 2000a, 2009b). In the literature on technology acquisition, it is recognized that responding to these market failures involves the creation of opportunities for new organizations in new sectors. Whenever this happens, the firms benefiting from these opportunities are effectively getting direct or implicit rents that have variously been referred to as *learning rents* (Khan 2000a), *contingent rents* (Aoki, et al. 1997: 14-18) or *performance-indexed rewards* (World Bank 1993). But to achieve the learning objective, rents have to come with complex formal or informal conditions that create incentives and compulsions for the receiving organizations to put in high levels of effort into the learning process.

One way of examining the conditions that explain the success or failure of learning rents is to analyse the rent seeking processes associated with the creation of these rents. If policy results in the emergence of any policy-induced rents, this inevitably induces rent seeking. Rent seeking is the expenditure of resources by organizations that seek to get the rents that are available or to change the allocation or conditions associated with the rents. Not only does rent seeking imply a resource cost since resources are used up in these activities, rent seeking can also subvert policies in ways

that prevent the resolution of the market failure (Khan 2000a, 2007b). Rent seeking can be damaging either because it distorts policy *ex ante* so that in the name of correcting market failures rents are created for unproductive rent seekers. In this context, an *ex ante* policy failure would be the creation of rents for organizations that already have competitive capabilities or that have no possibility or intention of achieving these capabilities. Or rent seeking can subvert policy *ex post* if rents can be retained by recipients who have no ability or intention to solve the market failure. In this context, an *ex post* failure would involve firms retaining their subsidies even if they failed to achieve competitiveness. The important point is that in a world requiring solutions to market failures, rents will emerge and rent seeking cannot be reduced to zero. The aim should rather be to ensure that the resource cost of rent seeking and any distortion in policy is not so great that the net effect of policy is negative. The lower the rent seeking cost and the lower the policy distortion, the better, but aiming for zero rent seeking is equivalent to aiming for zero carbon emissions to save the environment (Khan 2000b). The social objective in both cases is to maximize the net benefit.

## **5. Political organizations and clientelism**

Political organizations also operate differently in developing countries, both internally and in their external operations. Their organizational capabilities are by no means low but these capabilities are focused on doing different things. Political organizations in all countries aim to create or protect rents of different types for their members and supporters. But in advanced countries political organizations have to operate in rule-following ways both internally and in their external activities. The rule-following characteristics of politics in advanced countries is often described in terms of states being Weberian, in the sense that states follow rules themselves and enforce rules on those accessing the state. Since the function of political organizations is to influence or operate state institutions, in advanced countries political organizations are also generally rule-following themselves. In contrast in developing countries political organizations are characterized by a significant degree of informality both in their internal organization and in their public activities. The informality refers to the fact that their operations are not constrained by formal rules. For instance, leaders often appear to be exercising significant discretion in what they do and how they do it. Political organizations in developing countries are therefore often described as engaged in personalized or patron-client politics. Their behaviour is not necessarily entirely unconstrained but the relevant constraints are largely informal, and depend on the implicit limits on their activity set by the activities and responses of other organizations. The observation of informality in the operation of political organizations is systematic across all developing countries irrespective of their cultures, economic policies or political institutions.

The formality or informality in the operation of political organizations is important because they describe differences in the rent seeking process that are in turn related to the types of rents being created. The rent seeking process is only likely to be formal and legal if the rents themselves are legally created and regulated, for instance legal rents created through fiscal redistributions. If a society can legally create sufficient rents to satisfy most political organizations, and it can enforce rules that say that only legal rent seeking will be allowed, rent seeking could be restricted to formal rule-following processes. The ability of economic organizations to deliver sufficient



surpluses for the enforcement of formal rules while also providing enough legal redistribution through the tax system is a necessary, but not a sufficient condition for ensuring that most rent seeking remains legal. An example of legal rent seeking would be legally regulated spending by competing political organizations to win elections to decide how to raise and allocate fiscal resources. Some political organizations may wish to break the rules but in principle if most political organizations find it in their interest to follow rules, and there is effective enforcement of the rules, a minority can be deterred by policing. But in a society where the lion's share of rents is created outside the framework of law, it is implausible that the rent seeking process for gaining access to these rents can be mainly legal. Many of the most important rents in developing countries cannot be legally endorsed because their creation violates principles of universality or equity. Examples include preferential access to jobs, granting contracts to preferred firms, creating business opportunities for preferred entrepreneurs, prioritizing the allocation of public goods and using political power to facilitate asset accumulation. For these types of rents, the rent seeking expenditures of political organizations who want these rents for their members cannot follow mainly formal or legal procedures. The rent seeking expenditures in this case are likely to include expenditures in informal politics, like building informal networks within and across political organizations to bargain and protect these rents.

The internal organization of political organizations in advanced and developing countries will also broadly reflect the fundamental differences in their dominant rents and rent seeking strategies. If political organizations are mainly involved in competing for legal rents, it is likely that rule-following behaviour can also be enforced in their internal organization. Indeed there are likely to be strong pressures in that direction. Members of these political organizations who are providing or raising finance have little to gain by not having clear and transparent procedures for selecting office-holders and holding them to account. Office-holders who want to engage in secret deals are in general unlikely to be able to offer much more to their members compared to those who promise transparency. But if the political organization is engaged in building informal networks to compete for informal rents, internal organizers with much to hide are most likely to succeed in generating rents for the organization. It is difficult for transparency and accountability to be enforced within such political organizations and there is likely to be limited support for this within the organization if success required their leaders to follow informal and personalized strategies. In other words, characteristics of informality such as personalized politics, involvement in political corruption, patron-client relationships and clientelism that characterize developing country political organizations are not just accidental features of these organizations.

Clearly the differences described here vary along a scale and we are only describing overall characteristics that may differ in detail across countries. Individual political organizations in an advanced country may have some of the informal characteristics described for developing countries, and many developing countries can have significant elements of formality in some of their political organizations. Moreover, as developing countries become more prosperous and create more rents through legal and fiscal processes, their political organizations are also likely to evolve. As a result, developing countries at different levels of development always have mixed characteristics, with greater elements of formality as they become more developed. But it is still a useful generalization to describe the differences between political

organizations in advanced and developing countries in terms of the overall level of formalization of their rent-seeking activities. The analytical framework of political settlements provides a general framework identifying the implications of these differences and shows why they are relevant for understanding the policy approach to institutional and governance reform in developing countries.

Underlying these differences in political organizations across countries is economic development itself. The prosperity of advanced countries is based on economic organizations with high levels of organizational capability. By definition, these organizations dominate production, which is why average social productivity is high. This in turn implies that the most important property right transformations have already taken place and the existing structure of property rights effectively underpins a large number of significantly productive organizations. Collectively these economic organizations can also pay for the protection of these rights. As a result, advanced countries tend to have well-defined and protected structures of rights, and these rights underpin the activities of its productive organizations. The dominant economic organizations also have the ability to pay taxes that promise significant rents to political organizations that play by rules of not fundamentally threatening the rights of the productive organizations that generate the social surplus. Their interdependent interests ensure powerful feedbacks so that political organizations do not generally transgress the collective interests of productive organizations (Khan 2005a). Any significant infringement of the rights underpinning productive activity threatens to reduce the rents available to political organizations. The resources available to productive organizations also allow them to directly support their own political organizations.

Economic organizations can therefore engage in their own rent seeking through political organizations. This rent seeking can be socially beneficial if the rents allow an increase in net social benefits. Subsidies negotiated by productive organizations may enhance net social benefits if they enable market failures to be overcome, for instance by allowing investments in training or research that may otherwise not have taken place. But rent seeking by economic organizations may also create rents that reduce net social benefits, for instance if the rents are based on setting up monopolies. In a society with many diverse productive organizations, there are likely to be feedback mechanisms to limit negative outcomes. If rent seeking by a coalition of economic organizations threatens the interests of too many organizations outside the coalition, the latter are likely to respond with political activity to counter this rent seeking. Thus, outcomes of rent seeking in advanced countries are often damaging, but feedback mechanisms are likely to ensure (at least most of the time) that the evolution of rent seeking does not spiral out of control in the direction of economic non-viability.

The relationship between economic and political organizations is very different in developing countries. High capability economic organizations that can generate significant surpluses are by definition scarce. They are not likely to collectively generate enough of a surplus to pay for the protection of generalized property rights as a public good, nor enough of a surplus to make legally generated rents sufficient to satisfy political organizations. Moreover, the property rights required for modern productive activities will not yet have emerged, and historically inherited property rights structures are likely to be inappropriate for modern productive organizations

(Khan 2009a). From the perspective of political organizations, these features significantly affect their dominant strategies. The absence of many legal rents means that rent seeking goals can only be pursued by targeting the creation of informal and often illegal rents. The fact that governance agencies cannot enforce formal rights in these contexts also means that rent-creation based on violating these rights is viable.

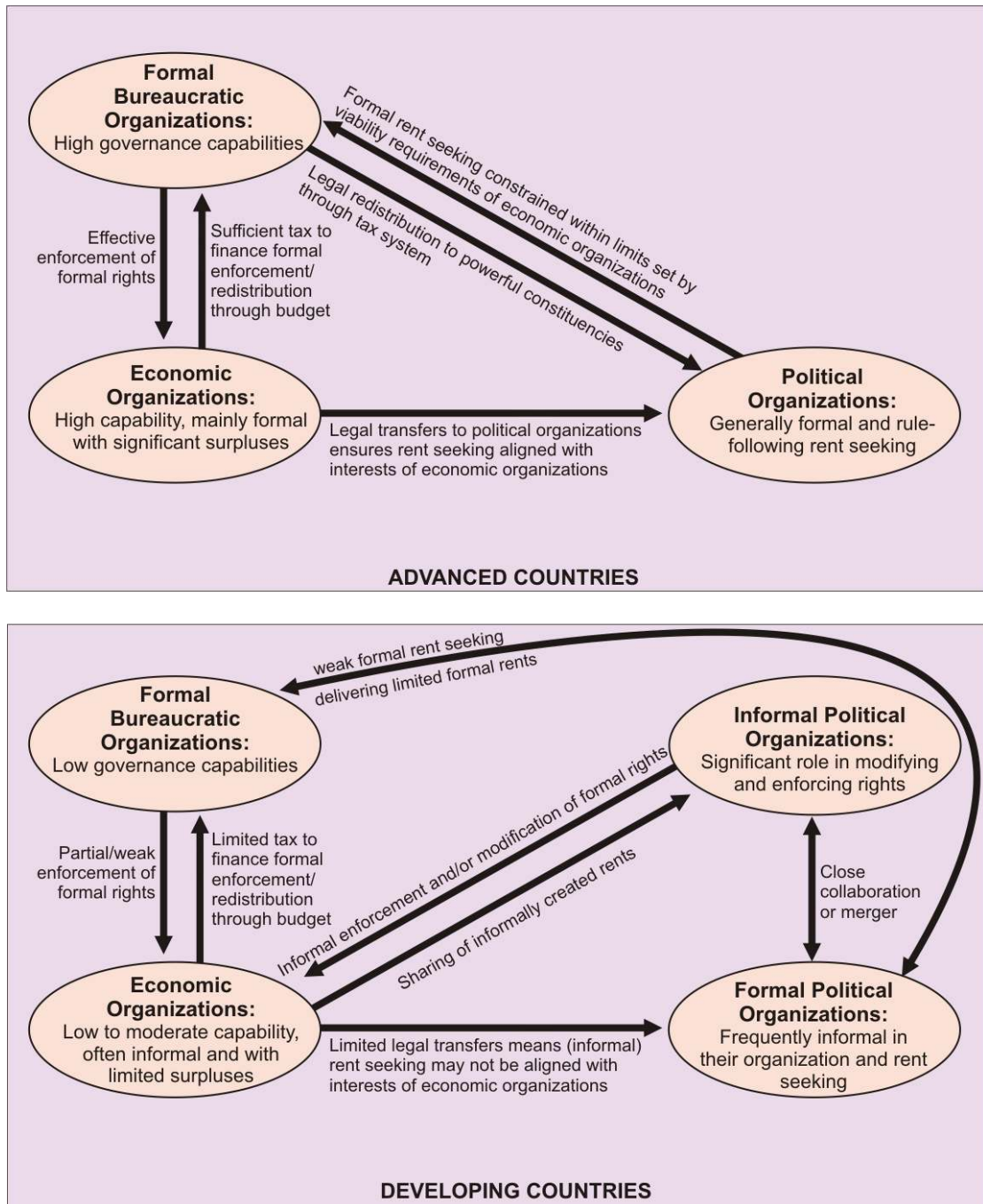


Figure 1 Relationships between economic and political organizations

These interdependent relationships between economic and political organizations and the enforcement of rules by formal and informal enforcement organizations are summarized in Figure 1. The two parts of the figure identify in simplified form some

of the differences between advanced and developing countries. In reality, most countries are somewhere in between these ideal types, and economic development gradually allows poor countries to acquire increasing characteristics of advanced one. However, the simplified picture can help to identify some of the differences in the relationships between different types of organizations in richer and poorer countries. In advanced countries, most economic organizations have high productive capabilities and most of them generate surpluses. As a result, economic organizations can pay significant taxes that allow the enforcement of formal rules by the formal bureaucratic agencies of the state, and also provide enough resources in the budget to enable formal legal rent seeking to be attractive for political organizations. Economic organizations also contribute to the financing of political organizations so that many political organizations are directly aligned with the interests of economic organizations.

These factors can help to explain not only why formal rights are adequately protected in advanced countries, but also why much of the rent seeking by political organizations is constrained within legal rules. The formal bureaucratic organizations referred to in the figure are state agencies involved in the enforcement and transfers of rights. These include agencies of the bureaucracy, the police and the legal enforcement framework as well as fiscal agencies that are involved in formal redistribution. Typically advanced countries enjoy 'good governance' because these bureaucratic organizations are effective in the enforcement of formal institutional rules and in transferring incomes in accordance with formally agreed rules. Political organizations can seek to create changes in incomes by changing formal rules, including rules for redistributing resources through the budget. In any case they are not likely to seek rents that significantly harm the economic viability of the productive sector as the latter after all is the source of the formal rents available for redistribution through the tax system and also contributes significantly towards the running costs of political organizations through its political contributions and other 'rent-seeking expenditures'.

The second part of Figure 1 shows a very different set of relationships between organizations in developing countries. A critical difference in initial conditions is that economic organizations do not have the capabilities to generate significant surpluses. This means that the resources available for formal bureaucratic state organizations are limited, and both formal enforcement and formal redistribution are likely to be less effective than in advanced countries. In addition, the limited resources of economic organizations mean that they are unlikely to make significant contributions to formal political organizations that are sufficient to constrain their activities in ways that are aligned with the interests of the former. Consequently, formal political organizations do not dominate the political sphere, and a variety of informal political organizations play a significant role. The informality of these political organizations refers to the fact that the resources that fund them and the rents that they generate for their members and supporters are not themselves 'formal'. Their funding may come from a variety of grey sources or by sharing rents generated for economic organizations that could not be generated or defended if they were transparent. As a result, formal political organizations in developing countries may operate with a large element of informality and they may also be closely aligned with entirely informal political organizations. The latter can range from mafia-like enforcement organizations to informally constituted networks of patrons and clients. Examples of the activities of

informal political organizations include the informal protection of the rights of economic organizations (for a share of the profit), the informal allocation of public resources that can amount to informal redistribution, but ultimately also predatory expropriation from economic organizations that amounts to a destruction of their formal rights.

Thus, in some cases, informal enforcement may simply enforce formal rights for an additional price but often formal rights may also be altered as a result of informal enforcement. For instance, a firm may have a formal right to acquire land but property rights may be so weakly enforced that the market transaction costs of acquiring land may be too high. A relationship with an informal political organization with enforcement capabilities may enable a firm to acquire land using informal negotiations, informal enforcement of the agreed contracts and so on. The price at which it acquires the land may be similar to a notional market price and the informal activity may then be simply described as a mechanism for reducing transaction costs. On the other hand, the political organization could also use its informal power to reduce the price to much below the market price and claim a share of the informal rents that are thereby generated. In the latter case, informal enforcement could effectively attenuate the rights of landholders or even destroy their rights if their land is expropriated. Indeed, in the typical developing country context it is difficult to assess what a notional market price would be because many significant land and asset transactions can simply not happen without a substantial involvement of informal political enforcers.

Apart from the fact that economic organizations in developing countries do not have the capability to finance the enforcement of formal rights, there is a further problem that is more subtle. The formal institutional structure in developing countries is often modelled on advanced countries and reflects the requirements of modern economic organizations. This is not surprising because apart from the natural emulation of more advanced countries, it is reasonable to expect that as economic organizations in poorer countries become more productive, they will actually need formal institutions that are similar to ones in more advanced countries. But initially, formal economic and political organizations are weak and politically marginal. Formal institutions like corporate laws or rules for organizing elections, if they could be properly enforced, would generate distributions of benefits for organizations that would be significantly out of line with the actual relative power of these organizations. Modern economic organizations are still weak and lack competitive capabilities. The organizers of formal politics are also relatively weak relative to the informal networks within political organizations. The powerful organizations in such a society are those that base themselves on informal organizations based on patron-client networks. An adherence to formal institutional rules that implicitly favour formal economic and political organizations would clearly generate results that would be out of line with the real distribution of power. This is another way of explaining why significant informal adjustments in the operation of formal institutions are necessary and inevitable for generating rents for powerful organizations in such a society. These informal rents and rent allocation decisions bring about a distribution of incomes that is more closely aligned with the actual distribution of organizational power and indeed serves to reproduce this distribution of power over time.

The gap between the theory and reality of formal institutions in developing countries is therefore not just the effect of weak enforcement but is more usually the result of systematic modifications in the operation of formal institutions brought about by the activities of informal enforcement organizations. Economic organizations in developing countries readily adapt to these opportunities, and many of them do very well by collaborating actively with political organizations to create new rents. Some of these rents may be damaging for the overall economy and others may not be, but the feedback mechanisms constraining the rent seeking by political organizations are weaker in this context. These structural features imply that the formal agencies of the state cannot be reformed or strengthened to become more like state agencies in advanced countries without corresponding changes in the capabilities and therefore the relative power of other types of organizations. This has important implications for our understanding of governance reforms in developing countries that typically focus on strengthening the formal bureaucratic enforcement and service delivery agencies of the state. To some extent the formal governance capabilities of these organizations are of course amenable to policy, but significant changes in the direction of creating a rule-following ‘Weberian’ state require many interdependent changes in the systemic interaction between organizations as shown in Figure 1.

## **6. Political Settlements and Institutions**

For a society to reproduce itself, its institutions and organizations must interact in a way that allows at least a minimum level of economic activity and political stability. The institutional rules (both formal and informal) and the organizations responding to these institutional rules must be interacting in a way that allows minimum economic and political conditions to be achieved. Given the features of different types of organizations in a society, the formal and informal institutional structure influences their activity and therefore the economic and political viability of social reproduction. If economic organizations get sufficient formal and informal protection and support to pursue their productive activities, the minimum level of economic viability can be met or surpassed. At the same time, all organizations and in particular political organizations must be sufficiently satisfied with the distribution of incomes and benefits coming to them to keep their attempts at changing institutional rules within bounds that maintain the minimum level of political stability for social reproduction to continue. Organizations are always mobilizing to change or modify institutions in their interests and no society is static in this sense. But if existing institutions or proposed changes threaten the interests of powerful organizations the result can be an increase in social conflict and mobilization that has significant effects on political stability. Beyond a point, the social order can begin to unravel, but normally long before that, institutions are likely to change incrementally in response to organizational pressures provided that economic viability can also be sustained. Sometimes, however, societies pass the point of no return and discontinuous changes in institutional arrangements follow.

As long as a society is not in a crisis, the interaction between its organizations and its institutional structure sustains, by definition, a reproducible macro-political order which satisfies the minimum requirements of economic and political viability. We describe a reproducible macro-political order as a *political settlement*. The critical feature of a political settlement is that at the social level it is an *operational equilibrium* in the sense that organizations collectively operate in a stable manner with operational features that can be identified over time and the institutions that

support these operational features are themselves stable and reproducible over time. An operational equilibrium is based on organizations achieving a mix of formal and informal institutions, and in the case of developing countries, possibly significant informal adjustments in the operation of formal institutions in ways that allow the minimum economic and political viability conditions to be met. The operational equilibrium is never absolute because institutions and the balance of power between different types of organizations are always changing. Nevertheless, if significant features of an operational equilibrium are identifiable over time, it is useful to identify and analyse the system as a political settlement.

The stability of an operational equilibrium can itself vary along a range and as a simplification we will find it useful to distinguish between *strong, moderate and weak* levels of operational equilibrium. A strong equilibrium describes the most stable political settlement, where institutions closely support the interests of dominant organizations and overall levels of social conflict are therefore very low. In this case, the broad features of the institutional order does not face concerted challenges from organizations and the structure of both are likely to be reproducible over many years. Political settlements in many advanced countries are a strong operational equilibrium in this sense even though they are always evolving at the margins. A moderate operational equilibrium is one where conflicts or inconsistencies in the balance between organizations and institutions result in persistent moderate levels of social conflict. The persistence of conflict increases the probability that the overall features of the political settlement could change relatively soon. Nevertheless, the broad features of a moderate operational equilibrium can last for many years, though with moderate levels of ongoing conflict. A weak operational equilibrium is the most vulnerable variety and while this society is still not in a full crisis, there are irreconcilable differences between organizational interests and institutions in some parts of the system resulting in persistent high levels of conflict. The conflict is not high enough for the social arrangements to begin to collapse, which is why the institutional and organizational structure can still be counted as a political settlement, but there is a higher probability here of a crisis very soon. The weakness of the operational equilibrium is measured by levels of conflict: its features can nevertheless be reproduced over many years. Clearly there is a range of variation in the stability of the equilibrium described by a political settlement, and these can be broadly identified by the equilibrium level of social conflict, repression or violence that is a feature of the social equilibrium each case.

The relevance of identifying features of political settlements is twofold. First, at the micro-level, the effects of introducing new institutions will depend on the political settlement that is operating at the societal level as the latter will affect the ways in which a particular institution is likely to be enforced or modified. Secondly, the political settlement defines the feasibility of different directions of institutional reform in terms of the consequences for conflict and stability. For both these reasons, the political settlement is critical for analysing the statics and dynamics of institutional performance. The interdependence between institutions and organizations defining the political settlement at the social level is summarized in Figure 2. Institutions include both formal and informal institutions and informal modifications of formal institutions. Organizations include economic, political, state organizations and informal enforcement organizations. One direction of causality runs from institutions to the distribution of power across organizations. Institutions define or describe the

opportunities, rights and obligations of organizations of different types and therefore determine the distribution of incomes across organizations. The distribution of incomes in turn contributes to the relative power of different organizations to engage in activities to protect their interests. However, this is not a determinate relationship because relative incomes are not the only source of the relative power of organizations. The ability to organize and engage in influencing activities also depends on the relative organizational abilities and legitimacy of organizations. The reverse direction of causality is from the distribution of power across organizations to their activity that determines the evolution of institutions. If the distribution of incomes that an institutional structure supports is out of line with the actual power of organizations, attempts to enforce these institutional rules is likely to result in activity to change these institutions. The iteration is likely to continue till the system achieves some degree of equilibrium between the interests supported by institutions and the relative power of organizations. Implicit in this equilibrium is the achievement of levels of economic activity and political conflict that are sustainable.

Sustainability implies that economic outcomes at least allow economic reproduction and that both economic and political outcomes are acceptable given the expectations of powerful organizations in that society. As the structure and interests of organizations can vary, all societies are not tending towards a unique political settlement. Differences in the initial conditions describing the organizational power of different types of organizations and historically prior institutional trajectories can result in very different political settlements in countries that have similar resource endowments or similar levels of economic development. At the same time, the degree of variation that is possible in political settlements is also not indefinitely high. By looking for the interdependent features that limit variations in how political settlements are put together, we can get an analytical handle on how institutions operate in different contexts. When an institutional and organizational structure becomes reproducible the institutional structure sustains the distribution of power across organizations and the operation of organizations in generating economic and political outcomes in turn allows existing institutions to be protected and reproduced.

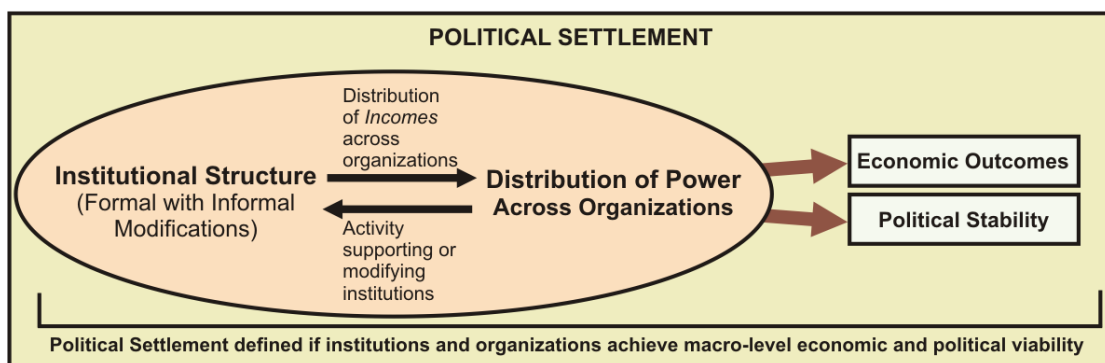


Figure 2 Political Settlements as Macro-Political Systems

Organizations can be expected to use a variety of mechanisms to ensure that the institutional structure will protect their interests. These mechanisms range from spending money in political activities that seek to change the legal framework to activity that include engaging in conflict or violence to persuade governments to change institutional structures. All of these activities can be broadly described as ‘rent



seeking'. In advanced countries, the rent-seeking process is likely to be largely legal and formal (following legal rules), and the changes brought about are likely to be changes in formal institutions. In developing countries, both the process of influencing and the eventual institutional outcome are likely to have large elements of informality.

The relative power of organizations in Figure 2 can be measured by their holding power; the ability of a particular organization to hold out in actual or potential conflicts against other organizations, including the enforcement organizations of the state. The organization that can survive longest in a conflict with organizations with contrary interests is likely to be able to achieve a change in formal or informal institutions in line with its interests. If competing organizations agree in their assessments of their respective relative power, conflicts are unlikely because institutions will adapt to reflect the interests of more powerful organizations. Conflicts happen when competing organizations do not accept a distribution of benefits as reflecting their true relative power. Conflicts are essentially a mechanism for establishing both a shared understanding of relative power and a distribution of benefits that is in line with this distribution of holding power. Holding power is in turn a function of a number of economic, political and other characteristics of organizations. Holding power is *partly* based on economic power, because the ability to hold out in a conflict can be aided by the ability of an organization to spend money to protect its interests. But holding power is also based on the political ability of an organization to organize collective action: to mobilize its supporters to absorb and inflict costs during conflicts, to mobilize ideologies to consolidate and keep members committed and to create links with other organizations that enhance its holding power.

Holding power is thus correlated to some extent with economic power, but is also based on other organizational capabilities. Organizations that have access to greater economic resources enjoy an advantage in terms of holding power but this may be outweighed by the holding power that other organizations can muster based on their greater ability to absorb pain during conflicts, or to inflict pain by mobilizing supporters using non-economic resources like ideology or social relationships. This is why holding power cannot be reduced to a narrow reading of economic power: richer organizations do not always win in conflicts. However, if an organization is powerful even when it does not generate significant incomes, it can only sustain its relative power over time if it is successful in using its power to modify formal institutions or engage in informal enforcement activities to generate additional incomes for itself. If it does this, its non-economic sources of power can be reinforced and reproduced over time, but not otherwise.

This is another way of understanding why informality in the enforcement of institutions and the informal modification of many formal institutions are so deeply embedded and difficult to change in developing countries. The informality is part of the operational equilibrium that ensures that the overall institutional structure is acceptable to and compatible with the interests of the organizational structure. In contrast, in advanced countries, the formal institutional structure supports formal economic organizations that happen to have high capabilities and therefore dominate society in economic and political terms. Their dominant holding power in turn means that they can directly and indirectly pay to enforce the formal institutions that support their existence. The operational equilibrium between institutions and the distribution

of power across organizations in advanced countries is achieved through the enforcement of formal institutions that support the dominance of powerful competitive economic organizations. These organizations pay for the enforcement of formal institutions because the latter protect their interests and this ensures the operational equilibrium.

Reproducibility in a political settlement requires both political and economic viability. In any political settlement there is always ongoing political activity to change institutions and this contestation results in a level of political conflict that is the 'normal' or equilibrium level of conflict for that political settlement. A stable political settlement has a strong operational equilibrium, which means that institutions enjoy a high level of support from organizations while enabling economic viability. The equilibrium level of political conflict is therefore likely to be low. At the other end, in a weak operational equilibrium, the political settlement is vulnerable and involves a significant level of contestation. Here, there is a significant mismatch between the distribution of benefits supported by the institutional structure and the distribution of power between organizations. The persistent level of political instability is likely to be high as powerful organizations continue to contest the institutional structure. The evolutionary path out of vulnerability is not necessarily simple. It may not be achieved simply through institutional changes that bring institutions into line with the political power of organizations. Such an adjustment may not necessarily be sustainable unless these changes also achieve economic viability. If the political organizations contesting institutions are political organizations or informal enforcement organizations, too great a degree of adjustment in their interest may result in a precipitate decline in economic viability and be resisted by economic organizations and some state organizations that fear a social collapse. Vulnerable political settlements based on a weak operational equilibrium can therefore persist with high levels of conflict if there are structural trade-offs between economic and political viability.

As long as the minimum economic and political viability conditions are met, the broad features of the institutional-organizational structure may be reproducible and changes are likely to be incremental and path-dependent. Indeed, most of the time the evolution of institutions and organizations with any type of political settlement (strong, moderate or weak) is incremental and path dependent. Individual institutions and organizations evolve within the limits set by this macro-level political settlement, though the political settlement will itself be changing in an evolutionary way as the distribution of power between organizations gradually changes. A social crisis only emerges if economic or political viability conditions cannot be met. The crisis can lead to a significant and non-incremental restructuring of institutions and organizations. These discontinuous changes in the path of social evolution can be described as discontinuous changes in the political settlement.

The minimum level of economic activity and political stability that avoids a crisis depends on the expectations of critical organization and can vary across societies. Some poor societies can have reproducible political settlements despite low growth, substantial poverty and considerable political instability and even violence. The turbulence may be sustainable for some time if no coalition of organizations has the holding power to drive a change in the institutional structure towards a new and more sustainable equilibrium. Thus, a weak operational equilibrium can reproduce itself

with high levels of conflict or low growth or both, the result being a vulnerable political settlement. The existence of a political settlement therefore does *not* imply that the economic or political outcomes are desirable or that there is an absence of conflict. Nor does vulnerability necessarily mean that the political settlement will collapse into crisis. A political settlement only implies that a combination of institutions and organizations have achieved reproducibility by achieving minimum levels of economic and political conditions. The distinctions between political settlements in terms of the strength of the operational equilibrium refer only to the levels of political instability and contestation, and therefore the *likelihood* of change.

## 7. Political Settlements in Developing Countries and the Implications for Policy

The differences in the distribution of power across organizations that describe the differences between advanced and developing countries can be presented at a high level of generalization and abstraction. There are clearly some very broad differences in the relative power of different types of organizations between advanced and developing countries that can help to identify some critical differences in their political settlements. In particular, the better enforcement of formal institutions in advanced countries has a structural explanation because the enforcement of formal institutions is aligned with the interests of powerful organizations that benefit from the enforcement of these institutions. In contrast, in developing countries the weaker enforcement of formal institutions is only proximately due to weak technical and bureaucratic capabilities of formal enforcement organizations. The latter do indeed have limited capabilities, but there are deeper reasons why these capabilities cannot be readily improved. The productive organizations that stand most to gain from the enforcement of these institutions are too weak in terms of their own capabilities to pay for the enforcement of formal institutions and many powerful organizations are able to claim income streams precisely because they are able to modify the definition and enforcement of formal institutions.

	Formal Institutions Potentially Support Productive Organizations	Formal Institutions do not Support Productive Organizations
Holding power aligned with enforcement of Formal Institutions	<b>'Capitalist' Political Settlement:</b> Formal productive rights dominate and associated incomes are the dominant source of holding power. Formal rights are well enforced.	<b>Pre-Capitalist Political Settlements:</b> Variants of feudalism with formal land rights aligned with political-military power. Insufficient support for productive organizations made these settlements unviable.
Significant sources of Holding Power not aligned with enforcement of Formal Institutions	<b>'Clientelist' Political Settlements:</b> Formal rights do not yet support many productive organizations. Powerful organizations generate incomes by informally modifying and enforcing rights. Formal rights consequently weakly enforced.	<b>Political Settlements in Crisis:</b> Formal institutions close to collapse. In extreme cases, informal 'economic' activity can be supported by the threat of violence or directly based on a war economy.

Figure 3 A Typology of Political Settlements

Figure 3 summarizes the differences between four broadly defined political settlements that are useful for understanding the differences between countries. 'Capitalism' is used as a term to describe an economic system where high-capability economic organizations account for the bulk of social production. Economic

organizations in advanced economies have been based on private ownership and control of capital, though in theory other forms of ownership are possible. But so far, the organization of production in advanced economies has been largely capitalist and we will restrict our attention to this reality. The capitalist political settlement describes an advanced economy where high-capability capitalist economic organizations dominate the productive sector. There are obviously significant differences within the group of capitalist settlements, with the details of formal institutional arrangements differing widely. These differences can explain substantial differences in the growth and distributive outcomes across advanced capitalist countries. However, all advanced capitalist countries share some common features: in all cases modern capitalist economic organizations dominate the economic sector, their formal institutions support these organizations, the formal institutions are effectively enforced, and their states are generally rule-following.

An economic system based on a large number of high-capability organizations requires formal institutional structures to protect their interests and regulate their interactions simply because this is the most efficient way to protect the interests of a large number of organizations with similar interests. The economic dominance of high-capability economic organizations allows them to generate sufficient surpluses to dominate the political process based on redistribution, and their surplus is also sufficient to enforce the rules that protect the interests of these organizations. The mutually supportive relationship between formal economic and political organizations described for advanced countries in Figure 1 therefore applies in this case. The political settlements here allow the enforcement of *formal* institutions that support the operation of these economic organizations because they are powerful and can ensure the enforcement of these formal institutions.

Developing countries are collectively quite different in terms of these characteristics. Most developing countries have formal institutional structures that could *potentially* support high-capability economic organizations, and often these institutional structures are modelled on more advanced countries. Nevertheless, their economic organizations are currently underdeveloped and this is at the root of the weak enforcement of formal institutions. Most economic organizations do not have the capabilities to engage in competitive economic activities. As a result, the attempt to enforce an institutional structure that is appropriate for a capitalist economy inevitably results in conflicts of enforcement with organizations that are currently powerful but whose activities are not and cannot rapidly become high-capability organizations. Many powerful organizations in developing countries (including ostensibly economic organizations) have little to gain and possibly much to lose from the enforcement of institutional arrangements that assume that they can generate their incomes in competitive markets by engaging in productive activities. To protect their incomes and ultimately their relative power they understandably seek to modify through informal processes the implementation and enforcement of the formal structure of rights borrowed from advanced capitalist countries. In other words, the lack of ‘alignment’ between the current distribution of power across organizations and the notional distribution of power that would support the enforcement of formal institutions lies at the heart of the social order problem in developing countries.

Thus, it is not surprising that formal institutions are insufficiently enforced in developing countries, and informal institutions and informal modifications of formal

institutions play an important role. The characteristic feature of developing countries is therefore a significant level of *informality* in the organization of politics and the enforcement and modification of formal institutions through informal methods. The informality in their economies and in their politics is significant and we describe these political settlements as '*clientelist*', reflecting the personalized and informal nature of political organization in these countries. As with the capitalist political settlement, there are significant differences within the broad group of clientelist political settlements. Countries with these characteristics range from East Asian developmental states of the 1960s to states close to economic and social crisis. Nevertheless, all these states share some common features: informality in the organization of politics and the enforcement or modification of rights using informal methods that go beyond rule-following enforcement by state organizations. The analysis of growth and development and of policy and reform priorities in these contexts has to recognize the characteristic features of these political settlements.

The specific informal modifications that formal institutions are subjected to depend on the historically inherited distribution of dominant organizations and the particular paths of incremental institutional change that are being pursued in particular countries. Only when the vast majority of economic organizations have become high-capability and competitive is the distribution of organizational power likely to support a substantial enforcement of formal rules. Before that, *informal* institutions and arrangements, in particular operating through clientelism, play an important role in adjusting the distribution of benefits to protect the interests of powerful economic and political organizations that are either outside the formal sector or are ostensibly formal organizations with significant informal characteristics.

The two other types of political settlement are not directly relevant for developing countries but help to understand historical evolution and the extreme cases of crisis. The pre-capitalist political settlement describes the organization of developing societies before the impact with colonial powers revealed the economic inefficiency and backwardness of their economic arrangements. Formal institutions in these pre-capitalist societies defined the rights of powerful military and bureaucratic organizations. These formal rights could be formally enforced because the distribution of social benefits supported by formal institutions was aligned with the relative power of organizations. Landlords, for instance, possessed formal rights over land and other resources and typically had the formal military-organizational power to enforce these rights. As a result, pre-capitalist political settlements in Asia and elsewhere did not have anything like the modern clientelist political arrangements and informality in enforcement that we observe in contemporary developing countries. However, the pre-capitalist political settlements did not even potentially support the organization of productive enterprises that is the hallmark of modern production that we loosely describe as '*capitalist*'. Pre-capitalist systems of social organization were stable in their own terms but could not survive exposure to the competition coming from countries that were further advanced in terms of the capitalist organization of their societies.

The fourth and last type is that of a political settlement in crisis. This is not really a normal political settlement but describes a situation where formal institutions have effectively collapsed because of the absence of support from powerful organizations. This outcome is most likely to describe situations where high levels of political

conflict between organizations with incompatible goals prevent the organization of activity in formal productive organizations and formal institutions atrophy as a result. In these crisis situations the economic activity of society is likely to be carried out by informal organizations that use entirely informal methods to protect their activities. In extreme cases these societies can become war economies with the result that levels of political conflict and violence can reach very high levels. To the extent that a path out of the crisis is difficult to find, high levels of conflict and violence can continue for long periods. However, unlike a more normal political settlement, reproduction here is not based on an operational equilibrium between an institutional and organizational structure that reproduces the social structure. Rather, society here is likely to be fragmented into a number of non-interactive parts engaged in conflict with other parts as in a civil war or in a warlord-run economy. Such a 'society' can evolve in sudden non-incremental ways through the imposition of a social order by a coalition of organizations on others. If this results in a viable political settlement the conflict can come down to socially tolerable levels. The outcome then is likely to be some variant of a clientelist political settlement.

The developmental transformation is essentially a transition of societies whose productive activities are largely organized in low-productivity organizations to ones where 'modern' productive organizations with high productivity dominate the production of goods and services. We are therefore looking at the transition of societies with essentially clientelist political settlements towards societies with 'capitalist' political settlements. All developing countries are not making this transition at the same pace and along the same trajectory, and some may even be retrogressing towards crisis towards the lower-right hand corner of Figure 3. Indeed, the next section summarizes the very wide differences that are possible across developing countries in the details of their political settlements. These imply very different challenges of transformation, and suggest that quite different institutional solutions and trajectories may be best in different circumstances.

Certainly, the reform agenda which assumes that developing countries have capitalist political settlements are the least likely to be helpful in these contexts. And yet, the agenda of reform that assumes that institutional and policy priorities for developing countries are to make markets more competitive and efficient and to make democracies more competitive and accountable assumes that the monumental transformations that led to the emergence of capitalist political settlements in a few countries has already happened everywhere. If it has, then a focus on formal institutions that sustain the competitiveness of productive organizations that already have high capabilities would suffice. These formal institutions could be adequately enforced without significant informal adjustments. In theory, such an economy could be largely regulated through these formal institutions of low transaction cost markets, together with an effective regulatory structure to maintain competition and with a state that can effectively deal with important contracting failures, business cycles and distributive demands within limits acceptable to the productive sector. But these conditions are far away from those that characterize the typical developing country.

The relevance and likely effects of different types of institutional changes depends on the characteristics of the overall political settlement. As the share of modern economic organizations in the overall economy increases and as these become the dominant organizations setting the limits of the polity, a transition to the dominance

of formal institutions that support the organization of the economy becomes possible. This transition is not instantaneous but can stretch over years or decades. But we would expect to see the growth of formalization and of institutions supporting the existence of independent organizations contracting with each other under a rule of law. We would also expect to see political institutions that engage in formal rent seeking within a rule-based system with the limits of distribution set by the political and economic acceptability of the dominant economic organizations. These transitions are likely to be contested and gradual. For most developing countries the end-state does not give useful guidance about what the immediate priorities need to be in terms of institutional reform or policy to support the transition along different dimensions, and particularly to support economic development. Thus, while we can agree about the general features of the capitalist political settlement as the destination for developing countries (remembering also the significant institutional and political differences between advanced capitalist countries), we need to understand much better how developing countries with clientelist political settlements are actually organized now. This is important for assessing the likely economic and political effects of particular trajectories of institutional change.

The first problem is that when modern productive organizations account for a small part of the economy, it is very likely that even the formal property rights over critical assets are not *appropriately* defined. Property rights are complex rules that define many dimensions of use-rights and decision-making rights over an asset. They can be defined in different ways, but unless the rights defined over the asset are appropriate for the requirements of economic development, the rights may actually hamper rather than facilitate development. In theory, as long as every dimension of use, allocation and decision-making is clearly defined and allocated, the allocation of rights across individuals or organizations does not matter. But this is in theory. Every dimension of use and decision-making cannot be defined at low cost and the mechanisms of formal enforcement of rules are in any case weak in developing countries. Under realistic conditions, where transaction costs are not low, the initial definition and allocation of rights *does* matter. If the initial definition of formal rights is inappropriate, value-enhancing re-allocations of the asset through private contracting in a ‘market’ may be effectively precluded. Thus, the problem in developing countries is not just that formal institutions are not being adequately enforced, but that the structure of formal institutions may also need substantial restructuring over time (Box 1).

#### Box 1 Land Rights: Missing or Inappropriate?

The case of land rights provides a good example of how rights can be inappropriately defined. Very rarely are rights over land entirely missing in developing countries. The problem is more complex: rights do exist, but they are “inappropriate” for enabling the re-allocations of land required for economic development. Most developing countries have complex structures of land rights that can also vary significantly from region to region within the same country. Before the emergence of modern economies, what mattered were the occupancy rights of tenants and the right of the state and of landlords to collect taxes and claim a share of the surplus produced on the land. Property rights emerged to solve these problems. In the *zamindari* parts of the Indian subcontinent, for example, multiple layers of sub-tenants were entitled to a share of the revenue. These right holders could buy and sell their revenue rights but the actual peasant who was the occupier of the land suffered no change in land use as a result. As land revenue declined in importance, one of the many lower-level ‘sub-tenants’ often became the legal owner of the land but the history of multiple revenue rights often left

conflicts between land records and tax records and often recorded multiple owners of the same land. In Tanzania, collectively owned village land was leased to peasants with a lack of clarity about who had priority in deciding changes in land use. In these types of cases, different stakeholders possess slightly different rights over the same piece of land and no stakeholder may have a clear priority in determining changes in land use through sale. In addition, occupants with partial ownership rights may not have bothered to sort out land records by contesting conflicting records of other owners because the sale of land had never been an issue. Many variants of inappropriate land rights exist in different contexts.

In these contexts, defining and enforcing existing property rights somewhat better will not necessarily resolve developmental problems. In the examples above, to enable the market to address land use and land allocation problems rights have to be *transformed* in particular ways. What is missing is often a clearly defined right that gives a particular stakeholder the right to transfer land to different uses. These changes are likely to be intensely contested and take a long time to achieve. In the meantime attempts to transact land can face very high transaction costs even if existing rights were somewhat better enforced.

Ironically, informal modifications of formal land rights often happen to enable transactions with inappropriate formal rights. For instance, in India with its British colonial past, the state's formal right of eminent domain was often used beyond its formal remit to enable the state to acquire land for private investors. But this generated intense social protests and opposition in the 2000s. The criticism of this use of informal state power was often entirely justified. Genuine investors did need informal assistance but once this was available politically-connected investors also acquired land for private real estate development or other purposes where the forced acquisition of land from poor peasants at a relatively low price was much less easy to justify.

In other countries (including some parts of India, Bangladesh and Pakistan), high transaction costs in land markets have led investors to use the informal power of local mafias to negotiate land transfers and enforce contracts. These informal power networks often work closely with formal state administrative structures and political parties and the dividing line between informal and formal arrangements and indeed between crime and politics can be blurred. Once again, sometimes the outcomes are beneficial for all sides if there are no alternative mechanisms for transferring land to higher-valued uses, but equally, in many cases power and politics have been used to expropriate assets of the poor and the less powerful. Underlying the problem is a real issue of high transaction cost markets and confused and contradictory rights which will take years if not decades to sort out.

(Source: Khan 2004b, 2004a, 2009a)

Apart from many rights being inappropriately defined, state capabilities for *enforcing* rights are also weak for reasons discussed earlier. These capabilities are partly weak because of the limited resources available for enforcement activities. But enforcement is also weak because powerful organizations do not want strict enforcement. If powerful individuals and organisations operating under particular rules support their enforcement, not only is it easier to raise the resources to strengthen enforcement, the task of enforcement becomes much easier. In advanced countries, most organisations have an interest in supporting the enforcement of the formal institutional structure, because even if an individual organisation could benefit by free riding, breaking rules is not in general essential for the survival of these organisations. The formal institutional structure, if properly enforced for everyone, would allow an individual organisation to engage in business and survive. Most organisations therefore support the enforcement of the formal institutional structure.



This is not the case in many developing countries. The formal institutional structure (including for instance the structure of property rights over land) often needs to change substantially before it can support the activity of many, if not most, organisations. This means that most economic organisations in developing countries engage in “informal” practices even if the organizations are formally constituted as legal entities. Many of the most powerful economic organisations, including those in the formal sector rely on informal modifications of formal rights or they need to engage in transactions and contracts that are not supported by formal rules. Both require informal access to political power and informal enforcement. As a result most organisations whether with apparently formal rights or without are unlikely to support *every* incremental improvement in the enforcement of formal institutions, as improvements in some directions may adversely affect the informal activities on which their immediate survival depends.

Improvements in the enforcement of some formal institutions can thus face widespread resistance in developing countries even from organisations that would theoretically benefit in the long run from their proper enforcement. Their resistance may not be public because no-one wants to openly support informal arrangements, but the resistance may nevertheless be intense. Understanding this paradox is very important for designing reforms that can make a difference in developing countries. Many firms are involved in activities that violate formal rules simply because the formal institutional framework is inappropriately defined and poorly enforced. They do this not just to work around red tape and other obstacles, as is commonly supposed, but more fundamentally to enforce contracts and to get access to assets for which appropriate property rights and markets are not available. A more stringent enforcement of the existing formal rules is likely to have a negative impact on many firms until a full transition to an appropriate and adequately enforced formal structure can take place. But that transition could take decades, and in the meantime a slightly better enforcement of some existing rules may worsen the survival chances of particular enterprises and organizations. This transitional problem in the enforcement of institutions is quite different from the situation in advanced countries and has significant implications for planning and implementing reforms.

These observations also apply to institutions and policies addressing market failures understood as contracting failures. Weak enforcement capabilities have meant that developing countries suffer from significant *state failures* as well as *market failures*. Taxes, subsidies or regulations can address market failures if they effectively target particular problems. This requires that the conditions for a successful outcome are monitored effectively and that the incidence of the tax or subsidy or the penalties for failing regulatory conditions match the achievement of targets. State failures in this context are generally associated with a failure to monitor conditions effectively and enforce the allocation of rewards or penalties appropriately. This was frequently the case, for example, with efforts by states in developing countries to accelerate technology acquisition by infant industries (Box 2). Technology acquisition and learning is subject to serious contracting failures in developing countries but success requires effective monitoring and disciplining of firms receiving support. Formal rules that define the conditions of support and the conditions that need to be fulfilled would not work on their own given the general limitations of formal enforcement in all developing countries. Successful industrial policy countries typically combined

elements of informal pressure, threats and sanctions with formal enforcement capabilities to achieve results. In contrast, less successful countries suffered informal modifications to their formal policies as powerful organizations were able to pursue an easier life by protecting themselves from disciplining.

#### Box 2 State Failures in Accelerating Technology Acquisition

The low productive capabilities of economic organizations are amongst the most serious constraints on development in developing countries. Most of the potential workforce has not previously worked in a modern factory and have limited experience of quality control, timekeeping, and the challenges of meeting international competitiveness. This applies not just to production line workers but often to managers and entrepreneurs too. Buying the machines is the easy part of investment. The difficult part is to set up the factory in such a way that internal bottlenecks are minimized, high levels of quality can be maintained, wastage of inputs minimized and targets met on time. This requires learning-by-doing within the factory as the different stakeholders work out the most appropriate way to set up and manage a competitive factory, and the specific arrangements that work in a particular country have to be worked out by trial and error. During that process the stakeholders have to put in a lot of effort and therefore have to have incentives and compulsions to do so.

The contracting problem emerges because during the experimentation and learning-by-doing the enterprise is by definition not fully profitable and may even be making losses. Someone has to finance the low or negative profits with the expectation of higher profits in the future. This is a serious contractual problem in developing countries. Private financiers are not likely to invest in an enterprise which is not already competitive because they are unable to enforce contracts that ensure high levels of effort and allow them to withdraw their investment in case effort by stakeholders within the enterprise turns out to be poor.

This market failure has elicited a range of state responses that have sometimes been referred to as “industrial policy” and sometimes as “investment and technology policy”. At its heart has been an attempt to solve the contractual problem of financing learning-by-doing by providing finance to “infant industries”. The instruments have ranged from import controls and tariffs that raised domestic prices and provided “rents” to finance the learning period, to low interest loans, equity support, and other forms of subsidies. But these strategies only worked in a few countries (mainly in East Asia) where the state had the capability to monitor outcomes and the enforcement capacity to withdraw support if the pace of progress was slow. In the absence of these capabilities infant industries “refused to grow up” or achieved limited competitiveness, and the policies eventually had to be abandoned. Given the limitations of formal enforcement in *all* developing countries, the success of some countries was based on their ability to deploy a combination of formal and informal mechanisms to enforce the conditions required for ensuring high levels of effort in a context of learning.

(Source: Khan 2009b; Khan and Blankenburg 2009)

Policies that seek to improve the productive capabilities of particular enterprises face another problem. Formal rules have an implicit political requirement which is that the policy should be neutral across regions, classes and sectors. Neutrality means that individuals or organizations with similar rights should be treated equally, not that all individuals or organizations should possess similar rights. For instance, neutrality means that all owners of similar assets should be taxed at the same rate; it does not mean that all individuals should own the same value of assets. But even this understanding of neutrality cannot be sustained in a developing country. The creation of *new* institutions and property rights or the upgrading of technological capabilities

of some organizations cannot be neutral. The developing country state cannot treat all individuals with the same rights equally because it is changing the structure of rights. Some individuals are inevitably privileged and others find their previous rights are now worth a lot less or have disappeared. In addition, given the low level of initial capabilities, everyone who may have been similarly entitled to gain new rights or claim similar support for capability development is likely to fail to obtain similar rights in practice.

Hence, the role of the state is fundamentally different in developing countries, a difference we mark by describing the role of the state as *transformational* (Khan 2004a). A transformational state is not, and cannot be, neutral and its functions are not limited to the usual textbook ones of service delivery. This raises further problems for specifying the formal rules of engagement for a state in a developing country as formal rules need to be neutral at least in the limited sense of treating all individuals and organizations with similar initial rights equally. Of course, this does not mean that all developing country states perform their transformational tasks well: many if not most may be performing rather poorly. There is no guarantee that powerful organizations and the state will interact to change institutions and rights in productive directions. The state may even be retrogressive if its interaction with society results in institutions and rights being altered in adverse ways. The response to this must be to identify the organization of the society and the incremental transformational strategies that are most likely to be implementable and have a significant impact. The expectation that a better enforcement of existing rights and a reliance on enforcing institutions that enable market contracting will do the trick is in general likely to be very wrong for the typical developing country.

These “technical” requirements of an appropriate reform agenda constitute one side of the reform challenge. The other part of the challenge is to understand the organisation of the *political* forces in that society and why they may support or resist policies that can be identified in abstract as feasible in terms of addressing important market failures. A feasible reform strategy has to be *both* economically beneficial *and* consistent with the broad configuration of political forces in that society, so that its implementation will not result in a political breakdown. Politics in all countries involves redistributing incomes through the political process, in other words, politics always involves creating and allocating *redistributive rents*. If powerful groups in society demand income redistribution, political stability requires organising this redistribution. Redistribution can have negative effects on incentives and induce rent-seeking costs, but the benefit is the political stability that may otherwise not have been achieved. Redistribution is necessary but not sufficient for stability, and some redistribution can undermine stability if losers strongly resist the redistribution.

In advanced countries, the political redistribution that keeps societies together is organised through a formal process of taxing and re-allocating resources through the budget. In contrast, in developing countries a significant part of the redistributive rents that keeps society together have to be organised and allocated outside the budget because the formal sector is not big enough for formal taxation to provide all the resources required for political stability. Instead, the ruling coalition has to generate or allow enough informal rent creation for its most powerful supporters to hold together. These rents often appear as informally allocated privileges or as political corruption. The difficulty is that sometimes political corruption is indeed very damaging as

political power can be used to expropriate from productive sectors. But equally some political corruption is unavoidable as it describes the informal rent generation and allocation that achieves political stability in these contexts (Khan 2002, 2005b, 2005a, 2006). But whether or not corruption achieves political stability, informal rent generation can pose problems for strengthening the transformational capabilities of the state. For instance, the political imperatives facing the ruling coalition may induce it to concede rents to powerful constituencies in ways that undermine developmental rent management. If the owners of enterprises receiving financing for learning happen to be politically powerful, the state cannot credibly impose conditions on them for performance. The result of this rent capture means that potentially developmental rents become redistributive rents with adverse consequences for development. A reform strategy that aimed to enhance the enforcement capabilities of particular state agencies would not make much headway if it did not recognise that the problem was essentially political and not bureaucratic or technocratic.

Understanding these political constraints properly is the first step in designing effective institutional capacity-building strategies. Many reform strategies fail simply because from the perspective of the ruling coalition they were never meant to work. An analysis of the political settlement can help to identify the types of reforms that are likely to be implementable. This analysis can not only help to identify the reforms that are likely to be implementable in that context but also to examine whether the configuration of power in that society has to change if development is to be sustainable. In some contexts, the political configuration may be so adverse that it may be difficult to envisage any incremental strategy that would make a significant impact. The distribution of power across organisations in a society is not an exogenous variable for the reform process in the medium term. The configuration of power can be changed through political mobilisation and the establishment of new political organizations. These political strategies can allow the construction of a new ruling coalition that may face different constraints in managing particular rents. Indeed, a very constrained economic future may persuade some elites to take the initiative to reconfigure the political settlement of the country.

## **8. Differences between Developing Countries**

The distinction between capitalist and clientelist political settlements identifies broad differences in the ways in which formal institutions operate in advanced and developing countries. There are in addition many important differences *between* developing countries associated with differences in the relative power of organizations. Since organizational power is only partly based on economic power (particularly in developing countries), the history of organizational development across countries is important for understanding these differences. Some differences can be traced to differences in the organization of pre-capitalist societies that determines ‘initial conditions’ in terms of the organization and legitimacy of different groups during the transition to capitalism. In addition, in many countries new classes and groups were organized as a result of the social engineering carried out by colonial powers. Colonial strategies of creating social balances for supporting colonial rule often left significant legacies in terms of the relative power and legitimacy of different social groups and their organizations. In many cases these social balances were simply reproduced after the departure of the colonial power and continued to evolve in path-dependent ways in the post-colonial period.

The relative power of organizations can be compared along different dimensions and at different levels of detail depending on the question being addressed. To keep the comparisons simple, it is obviously necessary to select a few important dimensions. The complex institutional-organizational structure of any society can be broken down into a number of subsystems: political, economic or even more narrowly defined ones, depending on the problem being analysed. The *operational equilibrium* of institutions and organizations can then be examined for each subsystem. Clearly, the characteristics of any subsystem will depend on other subsystems and subsystems are also likely to overlap to some extent. As a result, when analysing features of the operational equilibrium in any subsystem we have to take into account the characteristics of other subsystems in that society. Subsystems within a society can have different levels of stability and they can have a direct or indirect effect on economic outcomes by affecting the institutions relevant for economic activity. The features of the overall political settlement can then be identified by analysing the interaction of its critical subsystems.

Three critical subsystems describe important characteristics of the overall political settlement. These correspond to the domains of the three important types of organizations identified in Figure 1: *political organizations* (including informal enforcement organizations) that are primarily engaged in broadly defined rent-seeking activities; *economic organizations* that are primarily engaged in productive activities (but are also likely to engage in parallel rent-seeking activities) and formal *bureaucratic organizations* of the state charged with the implementation of formal redistributive and enforcement strategies (even though they may also be involved in substantial informal activities). The activities of these organizations are focused in one of three parallel subsystems though clearly their activities cut across all subsystems. First, there is the subsystem of institutions and organizations that define the *organization of the polity*. Here, the main players are political organizations, which interact with formal and informal institutional rules guiding their activity. The relative power of political organizations that make up the 'ruling coalition' is important in determining how institutions and policies are formulated and the effectiveness of their implementation. A second subsystem defines the *organization of governance* in a society. Here the main players are bureaucratic organizations involved in implementing the formal institutional rules that define the formal structure of governance. The relative power and capabilities of different agencies is an important determinant of the types of institutions that can be enforced. Finally, the *organization of the productive sector* describes the organizations involved in the production of goods and services and the institutional structure guiding their activities. Here, the distribution of power between productive organizations and vis-à-vis other types of organizations determines the likely effects of different types of formal rules guiding economic activity. The three subsystems overlap and influence each other but their characteristics can be separately examined as a starting point. Together, the broad features of these subsystems define important differences within the broadly defined *clientelist* political settlement. These differences in turn help to explain differences in the operation and effectiveness of institutions across countries.

The analysis of the operational equilibrium within a subsystem can be simplified by focusing on the distribution of power across the most important organizations relevant for that subsystem. This is one side of the two-sided balance between institutions and

organizations that an operational equilibrium represents. However, it is more difficult to identify the features of an institutional structure precisely because organizations can modify the operation of formal institutions in informal ways that may not be immediately obvious. It is usually easier to reduce variations in the relative power of organizations to a few critical dimensions that are relatively easier to observe. Moreover, the distribution of power between organizations is usually more persistent compared to changes in formal institutional rules. A change in formal institutional rules without an accommodating change in the distribution of power across affected organizations is likely to only result in subtle modifications in the enforcement and implementation of these institutions so that the outcomes are acceptable to powerful organizations. These outcomes could be very different from the outcomes associated with the same formal institutional rules in other countries where the distribution of power between organizations was different. Indeed, one of the main puzzles that we want to address is that apparently similar formal institutional structures appear to perform very differently across countries.

A description of the relative holding power of organizations is therefore a useful starting point for a classification and analysis of variations within subsystems defining political settlements. The holding power of organizations relevant for the subsystem will determine the informal adjustments in formal institutions that are required for an operational equilibrium to be sustained. If the required informal adjustments have not yet happened, or are heavily contested, or if they result in unviable economic outcomes, the subsystem will be subject to instability and contestation and the operational equilibrium (at least in that subsystem) is likely to be weak. Even if there is an operational equilibrium of some variety, differences in the relative power of organizations can explain significant differences in informal adjustments of formal institutions that result in different development outcomes across countries. An examination of organizational power and its evolution therefore provides a lens for examining the parallel evolution of formal and informal institutions in these subsystems and ultimately in the political settlement as a whole.

In the case of political organizations, we focus on two dimensions of variation in the relative power of organizations. The first is the power of political organizations within the ruling coalition compared to organizations that are currently outside. The intensity of the contestation between them helps to determine the time horizon of the ruling coalition and the types of institutions and policies they are likely to support. The second dimension looks at the relative power of higher-level political organizations within the ruling coalition compared to lower-level ones. This affects the capacity of the ruling coalition to enforce the institutions it has decided are important. In the case of bureaucratic organizations we focus on two similar dimensions: the relative power of lead bureaucratic agencies compared to other horizontally located agencies and the relative power of higher-level agencies relative to lower-level ones. Finally, in the case of productive organizations where relative power is more closely connected to economic capabilities, we focus on the productive capabilities of organizations relative to their competitors in other sectors and countries, and also their holding power relative to other types of organizations in that society. These help to explain both the types of formal institutional rules that can be enforced in each subsystem and the degree to which they can be enforced. In some cases the operational equilibrium could be quite close to the formal institutional structure, in other cases quite far

removed. The stability of the operational equilibrium can also vary widely, as can the implications of the subsystem for the pace and direction of economic development.

The three subsystems are closely related. Indeed, the interdependence shown in Figure 1 suggests that strong bureaucratic enforcement capabilities or political organizations concentrating on formal rent seeking are unlikely when economic organizations are weak and have low capabilities. However, this does not mean that the relative power and capabilities of different types of organizations are *perfectly* correlated such that the features any subsystem are determined by the features of others. Indeed, there is a substantial openness in the variants of organizational strategies within a subsystem that may prove to be viable given the characteristics of other subsystems, as well as considerable resistance to change (and therefore path dependence) once the relative power of different organizations has been established. This implies that subsystems with significant differences in their features can be reproducible across countries that otherwise appear to be similar and are at similar levels of development. Clearly, by *describing* the relevant differences in organizational power across countries that are sustainable we are not explaining the *origin* of these differences. That cannot be done without reference to the historical evolution of different countries. However, an analysis of currently existing variations in the relative power of organizations along a number of dimensions can explain significant differences in the institutional performance of countries and the trajectories of their development.

### ***The Organization of the Polity***

Political organizations and their interplay with the institutions defining the rules of political engagement define the organization of a polity. The institutional rules in this subsystem primarily describe the rights and responsibilities of political organizations and the methods they may use to gain power. Institutional rules in different countries can be differentiated at various levels of detail. A broad distinction is often made between democratic and authoritarian institutional rules. Under democratic institutional rules, organizations are relatively free to organize and compete for votes in order to form a ruling coalition. The ruling coalition has the right to change lower-level rules through legislation within limits set by the constitution. Under authoritarian arrangements, organizational freedoms are curtailed in different ways, affecting the formation of the ruling coalition. Both 'democratic' and 'authoritarian' institutional rules show considerable variation within many further distinctions in the rights and constraints that organizations face under each system. In addition, there is a significant grey area between democracy and authoritarianism because restrictions on organizational freedoms can increase along different dimensions till democracies become less free and may ultimately be judged to be authoritarian regimes. On the other hand, in every democracy there are restrictions on what organizations can legitimately do and restrictions on how they can be set up. The most important point from our perspective is that regardless of the institutional rules, the operational equilibrium of the political subsystem depends on the relative power of the political organizations operating within it and their ability to reproduce this distribution of power within the (formal and informal) institutional rules. This is why similar formal rules describing the polity can be associated with very different levels of conflict and instability in different countries, and sustain different economic outcomes.

In developing countries, rent-seeking by political organizations very often involves informal enforcement and redistributive activities. These are the core activities of patron-client networks organized by political entrepreneurs. At the most basic or primary level, an effective political organizer will organize supporters-clients who will offer their organizational support to the organizer in exchange for a share of the rents the network collects. Lower-level organizers can in turn have their own clients who are the basis of their own organizational power. The primary political organization is therefore pyramidal network of patrons and clients under an organizing patron. The viability of the organization depends on its success in mobilizing organizational power to carry out enforcement activities for a price and mobilize and capture other types of rents. The benefits that are captured are distributed down the pyramid to sustain the organization. Larger political organizations, including political parties, are simply coalitions of these networks, each primary pyramid slotting into an appropriate position in a bigger pyramid depending on the organizational power the particular organizer can deploy and the payoffs they are able to negotiate from higher-level organizers. Bigger organizations are engaged in more significant enforcement and rent capture activities. The constituent primary networks participate and benefit depending on the activity in question and the informal rules of internal participation and rent sharing. Clearly such structures are fluid and cannot be entirely regulated by formal rules. Even when there is an apparent formal structure of rules defining say the organization of a political party, the relevant internal organization may be based on an informal organization of primary pyramids with many of the exchanges within the coalition based on informal negotiations and relationships. The pyramid that constitutes the ruling coalition can be characterized both by the number and strength of the coalitions it includes and excludes, and the power of higher-level organizations vis-à-vis lower-level ones within the ruling pyramid. These organizational differences in the construction of the ruling coalition have significant implications for the enforcement and operation of the formal institutions defining the political structure, and for institutions more generally.



Figure 4 The Configuration of Political Organizations and the Ruling Coalition

Figure 4 shows two dimensions of variation in the distribution of power between political organizations that are of interest from our perspective. The bi-directional



arrows remind us that the range of variation along these dimensions is continuous but for ease of exposition the figure divides each range in two. In reality, societies are located at varying intermediate positions. The 'horizontal distribution of power' describes the power of excluded political organizations relative to those within the ruling coalition. If excluded coalitions are weak, the ruling coalition is likely to feel more secure and adopt a longer time horizon. As excluded organizations become more powerful, the ruling coalition is likely to feel more vulnerable even if it resorts to the use of repression to ensure its hold on power. At the limit, if excluded coalitions become more powerful than the ruling coalition, the latter is unlikely to survive irrespective of the institutional methods used for sustaining the ruling coalition.

The relative strength of excluded organizations can be assessed by looking at their strategies. The strength of excluded organizations can be measured either by the benefits they are able to capture despite their formal exclusion from the ruling coalition or by the resistance they put up to their exclusion. But care has to be exercised in assessing this resistance. Organizations can appear to be quiescent for different reasons. The benign possibility is that excluded organizations are actually weak, either because powerful organizations already belong to the ruling coalition or because the excluded are currently too disorganized to have significant holding power. The less benign possibility is that excluded organizations are quiescent because of administrative, legal or military restrictions on their activities. In this case their temporary quiescence does *not* necessarily signal weakness but it may be quite difficult to assess how strong they actually are before a conflict breaks out. The more intense the capacity of repression, the more likely that excluded organizations are actually strong and their exclusion is likely to be unsustainable. Other features of political activity may provide an indication of the strength of excluded political organizations. In particular, a growth in the bargaining power of lower-level organizations within the ruling coalition can indicate that excluded organizations are growing in strength. This makes the threat of defection to the opposition a credible threat for lower-level organizations within the ruling coalition and can allow them to demand more resources. The relative power of excluded organizations is therefore closely related to the relative power of lower-level organizations within the ruling coalition. We now turn to this second dimension of variation.

This describes the 'vertical distribution of power' within the ruling coalition. By definition, lower levels in a patron-client hierarchy are weaker and to some extent dependent on higher levels. But their relative weakness can vary significantly from a situation where they have almost no bargaining power to one where they have the ability to dictate the terms on which rents are allocated within the ruling coalition. When lower level organizations have little holding power, higher levels can select the rent-allocation strategy and select the lower-level organizations required to implement these policies and institutions. Under these conditions, higher-level organizations are likely to enforce institutions and strategies that maximize the return to the ruling coalition and the rents claimed by lower-level organizations are likely to be relatively low. In contrast, when lower level organizations have significant holding power, they may block policies or institutions that deprive any powerful lower-level organizations. Under these conditions, the policy freedom of the coalition leadership is likely to be very limited with adverse implications for the total return the ruling coalition can generate and the share that lower-level organizations can claim is likely to be higher. In this scenario the ruling coalition may be unable to enforce many rules or policies

that could otherwise have enhanced the overall net return to society. The constraint on enforcement is likely to be the most significant adverse implication of strong lower-level organizations rather than the distribution of rents in favour of lower-level organizations. Moreover, organizations outside the ruling coalition may now find it easier to block the enforcement of rules that are against their interests. They will find it easy to find one or more lower level organizations within the ruling coalition who can (for a share of the rents) block the implementation of particular rules that hurt the rents of particular organizations. So for instance, we should expect the disciplining of industrial policy conditions to be very weak under these circumstances. The variations along these dimensions define a two-dimensional space but Figure 4 simplifies the exposition by defining four 'limiting-case' variants of the ruling coalition.

*Strong Patrimonialism (usually in equilibrium with Developmental States)*

At the top left-hand corner is a ruling coalition whose characteristics of exclusion and enforcement we describe as *strong patrimonialism*. The term patrimonialism here refers only to the more or less effective claim of a ruling coalition to rule exclusively as of right (its patrimony) and should not be confused with other uses of the term in the sociological literature. Clearly, neither the ability to override excluded groups nor lower-level organizations within the ruling coalition can be absolute, but one of the features of strong patrimonialism is its ability to identify growth strategies from above and implement them to a large extent. This can (under certain conditions) result in a virtuous cycle of growth where the legitimacy of the ruling coalition is enhanced by growth and allows the coalition to continue to enjoy its status of strong patrimonialism for some time. In the long run strong patrimonialism cannot be a lasting feature of any society as growth is likely to create new and powerful organizations outside the ruling coalition. However, if the ruling coalition does not accelerate growth fearing such an outcome, its strong patrimonialism status may paradoxically come to an end even faster as a result of declining legitimacy and the coordination of collective action by excluded groups to challenge the ruling coalition. While it lasts, such a ruling coalition has interesting characteristics that can explain the success of institutional rules supporting developmental states in some developing countries.

An important implication of the limited contestation from horizontally excluded groups is that the ruling coalition is likely to have the confidence to adopt a long time horizon in its rent seeking. This can help to align its interests with the enforcement of institutions required for long-term development as the latter are most likely to maximize the net benefit a ruling coalition with a long time horizon. In addition, the effective power of higher-level organizations over lower-level ones means that the ruling coalition has strong implementation capabilities for enforcing a broad range of policies and institutions. Its growth-supporting strategies are therefore less likely to be blocked because they threaten the rents of particular organizations. These features imply that this is *potentially* the most developmental coalition, provided the institutional rules required for a developmental state emerge, and bureaucratic organizations have the technical and bureaucratic capabilities for enforcing and managing these institutions. It is also necessary that the economic organizations that are assisted with these strategies have the technological capabilities to benefit from growth-supporting policies. If these conditions are fulfilled, the emergence of institutional rules and governance capabilities appropriate for a developmental state

are likely to emerge because the ruling coalition will have strong incentives to move in that direction.

Errors of judgement on the part of the leadership or the absence of compelling internal or external pressures on the leadership to deliver growth could mean that the institutions of a developmental state do not emerge even though they could potentially have been enforced. But it is likely that they *will* emerge because most state leaderships are likely to recognize that their leadership positions and legitimacy will be much stronger if they can capitalize on their enforcement capabilities to support developmental strategies. The same realization is likely to result in efforts to improve the capabilities of bureaucratic organizations and their governance capabilities if these were weak to begin with. In theory, authoritarian institutional rules in the political sphere are *not* necessary to sustain the hold on power of a ruling coalition with strong patrimonial characteristics because opposition from excluded organizations is weak to begin with. However, institutional rules that impose discipline on economic and political organizations in society as part of a developmental strategy can have aspects of '*developmental authoritarianism*'. They formally describe the enforcement capabilities of a strong patrimonial coalition. Historically, therefore, developmental states have been associated with *some* authoritarian institutional characteristics that limited the ability of organizations to block policies or resist the enforcement of institutional rules that were judged to be important by the leadership. But these restrictions on organizational activity are likely to be associated with strategies of imposing *economic discipline* rather than repressing excluded political organizations by force because the latter is unnecessary in this scenario. Clearly, as the relative power of excluded political organizations increases, the characteristics of restrictions in these authoritarian states can also change significantly.

It is important not to confuse these institutionally authoritarian characteristics of a developmental state with the harsh repression of excluded organizations in weaker authoritarian states where excluded organizations are stronger and the legitimacy of the ruling coalition is much more limited. The distribution of power across political organizations in the case of strong patrimonialism implies that 'developmental' authoritarian institutional rules supporting a developmental state are likely to be in a strong operational equilibrium with organizations given their weak ability to resist these institutions. This means that informal adjustments of the formal and informal rules of a developmental state are likely to be relatively limited. Off-budget payments to political organizations (both within and outside the ruling coalition) are likely to remain because of the common features of all developing countries discussed earlier that limit the scope of budgetary transfers and an entirely formal organization of society. But the terms of both formal and informal resource allocations, the sums allocated to different organizations and in particular the conditions under which both formal and informal support can be withdrawn are likely to be defined and enforced by the leadership of the ruling coalition.

These characteristics of developmental states can give the misleading impression that these states are 'Weberian' or rule-following. In fact, they are unlikely to be strictly rule-following for the reasons that affect *all* developing and transition economies. Developmental states in developing countries are likely to have substantial aspects of informality in the definition and enforcement of rules and in the allocation of resources. In particular, the ruling coalition may exercise informal power and

networks in enforcing rules, whether formal or informal. But nevertheless, a ruling coalition with strong patrimonial characteristics will be able to define and enforce both formal and informal rules supporting its economic strategies more effectively and the informal adjustments to formal rules brought about by powerful organizations to protect *their* interests are likely to be less significant compared to other configurations in Figure 4. Political stability is also likely to be relatively high once an operational equilibrium emerges. Moreover, the fact that developmental state institutions are likely to be effectively enforced means that growth is likely to be high in this operational equilibrium. This in turn supports the legitimacy of the ruling coalition and is likely to set off a virtuous cycle that enables strong patrimonialism to be sustained for a substantial length of time. Indeed once established, a strong patrimonial developmental state could successfully oversee a significant social transformation of a society.

Examples of coalitions with strong patrimonial characteristics include the coalitions ruling in South Korea and Taiwan from the 1960s to the 1980s. The distribution of power between political organizations in these configurations helps to explain why *effective* institutional solutions emerged that could accelerate economic development. These institutional solutions involved the creation and disciplining of significant developmental rents and the characteristics of the ruling coalition helped to ensure that the organizations receiving these rents could be effectively disciplined. Developmental results were generally positive. The support that economic organizations received in these examples was often formal, including credit from publicly owned banks and other forms of subsidies. However, the manner in which organizations were disciplined often employed informal threats and sanctions that were not always enshrined in law. Sometimes, these informal methods could also result in extortion from organizations that were not aligned with the interests of the ruling coalition. Nevertheless, if the ruling coalition has a long time horizon, it is in its interest to ensure that growth-enhancing strategies are effectively enforced as this gives it the highest returns over time. Countries with these characteristics can therefore sustain high levels of growth over several decades.

Compared to most other developing countries, the East Asian developmental states achieved high levels of political stability as well as high rates of economic growth. These outcomes are consistent with the existence of a strong operational equilibrium in the political subsystem between what we describe as ‘developmental’ authoritarian institutional rules and strong patrimonialism describing the distribution of power between political organizations. Other features of the polity in these countries were of course also important, including internal and external pressures to adopt growth strategies. But without the strong patrimonialism in the distribution of power between political organizations the ruling coalition would not have had the long time horizons and high implementation capabilities that characterize a ‘developmental state’. Unfortunately, this distribution of power between political organizations is not common. Its emergence in East Asia in the 1950s and 1960s was very untypical and this is why the results of the East Asian developmental state have not been easy to replicate in other countries even though the formal institutional instruments of a developmental state were adopted by a number of developing countries (including Pakistan in the 1960s). The differences in results were largely due to differences in their enforcement capabilities. The disciplining of economic organizations was typically much poorer in countries which lacked strong patrimonialism. In particular,

economic organizations supported as part of a formal development strategy found it easier to protect their rents without having to deliver results.

*Vulnerable Patrimonialism (usually in equilibrium with Authoritarian Regimes)*

Two other variants of patrimonialism can be identified with different implications for the operational equilibrium in the political subsystem. Both are weaker variants of patrimonialism, and neither can fully support the institutions of a developmental state as an operational equilibrium. While they have differences, they are similarly disadvantaged compared to strong patrimonialism in that they are less likely to enjoy virtuous cycles of growth and legitimacy. Both are likely to gradually move towards a crisis in sustaining the operational equilibrium and the distribution of power between organizations is also likely to evolve in the direction of variants of competitive clientelism before a significant social transformation can be achieved.

The first of these two variants we call *vulnerable patrimonialism*. Here excluded political organizations are relatively much stronger than in the case of strong patrimonialism, and the ruling coalition is therefore vulnerable. This configuration can still result in a patrimonial ruling coalition if the ruling coalition believes in and wants to establish an exclusive right to rule. It could still attempt this even though it is qualitatively more vulnerable than in the strong patrimonialism case but here it would have to use authoritarianism more directly as an institutional instrument of ensuring its rule. One effect of vulnerability is that its time horizon is likely to be shorter than in the case of strong patrimonialism. Nevertheless, the claim of the ruling coalition that ruling is its 'patrimony' may still be partially implementable if the ruling coalition has a leadership that is able to get the coalition to act in a coordinated way to enforce the institutions of exclusion. This implies that higher-level organizations within the ruling coalition can impose discipline on lower-level ones. If this condition is met, the implementation capabilities of the ruling coalition may be high enough both to ensure exclusion through the enforcement of rules of exclusion (and therefore a stable operational equilibrium with authoritarian institutions) and for reasonable economic and political outcomes sufficient to sustain its legitimacy for a time.

Given this distribution of power, democratic institutional rules defined as the relatively free competition for power between political organizations are unlikely to result in a stable operational equilibrium. The dominant political coalition is likely to win in an open electoral competition. However, competition between organizations for political power is likely to increase the bargaining power of lower-level organizations within the ruling coalition for reasons discussed later. A stable operational equilibrium is therefore unlikely as the distribution of power described as vulnerable patrimonialism is likely to rapidly evolve with democratic institutional rules. Some variants of authoritarianism can provide a moderate operational equilibrium for vulnerable patrimonialism, at least for a time. Institutional rules restricting the organizational capabilities of excluded organizations can be described as 'authoritarianism' and range from relatively minor restrictions to quite severe levels of repression. Provided that the strength of excluded organizations is not too great and implementation capabilities of the ruling coalition are sufficient to enforce the level of repression required, there may be a moderately stable operational equilibrium with authoritarianism. A well-organized and disciplined ruling coalition may persuade excluded organizations to accept their exclusion at least for a time. In many cases of vulnerable authoritarianism, the real extent of exclusion may be far less

than the formal exclusions suggest. In many cases exclusion may only be achieved through a combination of institutional exclusion with substantial payoffs to excluded organizations. In the latter cases, the operational equilibrium is weak and excluded organizations are likely to get stronger over time relatively rapidly. Vulnerable authoritarianism is therefore usually associated with *authoritarian regimes* with different combinations of political stability and economic performance.

The operational equilibrium in this case is likely to have a number of characteristics different from that associated with strong patrimonialism. First, the strength of excluded organizations is by definition higher and these organizations are likely to periodically test the ruling coalition's institutional restrictions on their organizational freedoms. As a consequence, we can expect the ruling coalition will be called upon to demonstrate its repressive capabilities more frequently than in the case of strong patrimonialism. Secondly, the vulnerability of the ruling coalition means that while it has reasonable implementation capabilities, it is unlikely to embark on institutional and developmental strategies that have long gestation periods. Generally, this is likely to result in less developmental strategies because rents that can be quickly generated are less likely to be associated with value-enhancing strategies. This prevents a strong virtuous cycle developing because economic outcomes are poorer and political stability is periodically tested. The legitimacy of the ruling coalition is therefore weaker. Thirdly, ruling on the basis of repressive capabilities is unsustainable for very long. As a result, formal rules of organizational exclusion are likely to be significantly adjusted by informal payoffs to powerful excluded organizations. These strategies are likely to further strengthen excluded organizations but can for a while prolong the life of the ruling coalition.

Informal adjustments to authoritarian rules of exclusion are common in weak authoritarian regimes. Informal payoffs and opportunities are regularly created for oppositional groups as a way of reducing their opposition by 'buying them off'. This can enhance political stability but complex informal rent distribution driven by political concerns is very likely to have negative implications for growth. In a context where the ruling coalition did not have a long time horizon to start with, the gradual accretion of informally negotiated redistributive rents to many different organizations is likely to further reduce growth prospects. On the other hand, attempts to include currently excluded organizations within the ruling coalition are likely to be resisted by organizations already within the ruling coalition as this dilutes their own access to rents. If carried through to a significant extent, this strategy transforms the distribution of power into the 'ineffective patrimonialism' variant that is discussed later.

Furthermore, the weak bargaining power of lower-level organizations in this configuration is not sustainable. Their holding power can be expected to increase more or less rapidly. Excluded organizations (which are powerful by definition) have strong incentives to induce lower-level organizations within the ruling coalition to defect by offering them higher rents if a new ruling coalition can be formed with their assistance. These attempts inevitably increase the bargaining power of lower-level organizations within the ruling coalition because they can demand higher rents and can dictate the distribution of rents to a greater extent, or they can actually start defecting. In either case, there is likely to be a relatively brief window of opportunity during which a 'vulnerable patrimonial' ruling coalition with authoritarian rules has an operational equilibrium that can deliver high growth with reasonable political

stability. This operational equilibrium is likely to be upset by the very strategies of sustaining this institutional structure, which result in a change in the relative power of its lower-level organizations. As this happens, the implementation capabilities of the ruling coalition can be expected to decline, with a corresponding decline in the ability of the leadership to discipline the allocation of rents and the enforcement of institutional rules that are vital for its economic objectives. This in turn feeds the perception of excluded organizations that the ruling coalition has a finite life, leading to redoubled efforts to organize resistance and to detach lower-level organizations from the ruling coalition. This is why vulnerable patrimonialism is vulnerable and unlike strong patrimonialism is unlikely to sustain high levels of growth over long periods. A sudden collapse of the operational equilibrium is also likely.

The cumulative relationship between defections, the power of lower-level organizations and the power of excluded organizations explains why an authoritarian coalition based on vulnerable patrimonialism can suddenly face a crisis, as happened in several North African and Middle Eastern countries in 2011. Of course, authoritarian regimes can vary across a range. Authoritarian coalitions facing weaker excluded coalitions (those towards the centre of the horizontal range of variation in Figure 4) are less likely to have to use violence or to make informal adjustments to the same extent. This makes them less vulnerable and more likely to sustain themselves over time. For instance, after the blood-letting of 1973 that brought Chile's Pinochet to power, the regime faced relatively little opposition till the transition to democracy. It did not have the implementation capabilities of a developmental state (or indeed a developmental ideology) but was able to push through market-based structural reforms relatively rapidly. In contrast, the military-controlled ruling coalition in Pakistan/Bangladesh in the 1960s faced initially weak excluded coalitions, but had to resort to violence as excluded coalitions became stronger strengthened lower-level organizations within the ruling coalition became correspondingly stronger. The latter began to obstruct the effective implementation of developmental strategies and also began to defect to join excluded organizations. Pakistan's developmental state institutions and policies delivered high growth in the first half of the 1960s but implementation worsened thereafter. The ruling authoritarian coalition was eventually overthrown by a mass uprising in 1969.

In general, authoritarianism in the context of vulnerable patrimonialism is difficult to sustain for long unless there are special factors like natural resource rents or external military support that bolsters the exclusion capabilities of the ruling coalition. Even with these special factors, this configuration is unlikely to be stable for very long or to sustain an operational equilibrium with developmental institutional rules. External rents can increase the exclusion and repression capabilities of the ruling coalition but they also increase the incentives of excluded political organizations to try and overthrow the ruling coalition. Intense contestation by excluded organizations can in turn increase the power of lower-level organizations. Resource-rich authoritarian regimes end up making significant unproductive payoffs to their supporters with very negative effects on developmental transformations. As with developmental coalitions, the enforcement capabilities of authoritarian coalitions are initially relatively good, but time horizons are likely to be poorer given the vulnerability of the leadership. Moreover, given the tendencies for lower level factions to get stronger over time, the implementation capabilities of an authoritarian coalition are likely to get progressively weaker. Looking at these features of the operational equilibrium with vulnerable

patrimonialism, we can begin to explain why authoritarianism is often not developmental and also suffers from progressively weaker implementation capabilities (Khan 2010).

*Constrained Patrimonialism (usually in equilibrium with Dominant Parties)*

In the third variant of patrimonialism the ruling coalition is not vulnerable to external attack and therefore believes it can rule indefinitely. Its characteristic feature is that there are few powerful organizations outside the ruling coalition. Almost all powerful organizations and factions have been included within the ruling coalition, which typically takes the form of a *dominant party*. Its negative feature is that as there are a large number of relatively powerful organizations within the ruling coalition, the leadership has to deal with a greater number of lower-level organizations that are relatively powerful. This distinguishes it from strong patrimonialism, compared to which it has weaker implementation capabilities: hence the term ‘constrained’ patrimonialism. In contrast to vulnerable patrimonialism, the dominant party does not have to use administrative or military power to exclude others to the same extent and in many cases such a party can rule by winning elections. In principle, constrained patrimonialism can be in an operational equilibrium with democratic political institutions. However, in some cases, the dominant party can be additionally protected by institutional restrictions on the activities of other organizations. If these restrictions are relatively minor, the distribution of power can still be described as a variant of constrained patrimonialism. On the other hand, if the restrictions are necessary for ensuring the continued rule of the dominant party, then the distribution of power is closer to either vulnerable patrimonialism or the fourth variant of competitive clientelism that we discuss later. Constrained patrimonialism can therefore be in an operational equilibrium with either authoritarian or democratic political institutions though the two equilibria operate slightly differently.

The dominant party in ‘constrained patrimonialism’ enjoys a longer time horizon compared to authoritarian regimes in ‘vulnerable patrimonialism’ because it faces a lower risk of being removed from office by powerful excluded organizations. This potentially gives this ruling coalition a greater interest in adopting a longer-term developmental strategy. In principle, the creation of rents associated with the promotion of new productive capabilities requires a long time horizon for the political coalition to reap the benefits from these rents. As against this, the dominant party requires a large flow of internal rents to its supporters from the outset, unless it is a well-disciplined party that can make credible promises to its members about payoffs in the future. An example of a disciplined dominant party would be the Chinese Communist Party in the 1980s and beyond. However, in the typical dominant party, supporters are unlikely to find promises of future benefits credible enough to forego demands for immediate benefits. In these cases, the dominant party may have to generate significant rents from the outset, and it is unlikely to be able to do this by focusing on developmental strategies. Thus, despite their longer time horizon, many dominant parties are likely to pursue damaging rent creation strategies to satisfy large numbers of restive supporters.

In addition, whether or not the dominant party is able to focus on developmental strategies, all dominant parties find that their implementation capabilities are constrained, and this is the characteristic feature of *constrained* patrimonialism. The source of the constraint is that the ruling coalition includes many political



organizations that have been absorbed within it. As a result, there are many potential points at which implementation can be vetoed simply because any group that is dissatisfied can exercise a blocking action on implementation. Again, a disciplined dominant part with strong internal discipline and credible rewards for those who follow party directives may not suffer from this problem to a very great extent. The implementation capabilities of this coalition are normally weaker not only compared to strong patrimonialism but also compared to early stage authoritarian regimes underpinned by a vulnerable patrimonialism. In the latter, lower-level organizations are less able to block policies or block the enforcement of institutions that are contrary to their particular interests. The precise characteristics of stability, the time horizon and economic strategies of the ruling coalition will depend on the strength of excluded organizations, the strength of lower-level organizations, the degree of internal discipline and institutional structure within the dominant party and characteristics of other subsystems in the political settlement.

Like vulnerable patrimonialism, constrained patrimonialism has internal stresses that potentially limit its life span. The operational equilibrium in this context is unlikely to be very strong or stable. If the ruling coalition attempts to enhance its stability by including all powerful organizations within it, it can remove threats from outside, but at a price. Rents are spread more thinly within the coalition and attempts at institutional enforcement that threaten to change the distribution of rents are likely to be blocked by powerful internal organizations. Alternatively, the ruling coalition could try to generate a large quantity of rents over a short time horizon to satisfy its internal demands but economic development is likely to be very adversely affected in this case because hastily generated rents are likely to involve growth-reducing policies. The unwinding of a dominant party can happen in various ways. If opposition parties are allowed, and there is some degree of electoral competition, the dominant party can face a sudden defeat at the polls if economic development and the enforcement of institutions become very poor. This can be precipitated if dissatisfied groups and factions within the ruling party start joining excluded groups or leave the ruling coalition to set up new political organizations. Defections are particularly likely if it is difficult to change the leadership of the dominant party. Political organizations outside the dominant party can also start to offer promises of more rents to lower-level organizations within the ruling coalition to induce them to leave. Regardless of the sequence of events in particular cases, once a cumulative decline of a ruling coalition starts, it may be difficult to stop.

Constrained patrimonialism can also be in an operational equilibrium with authoritarian political institutions that limit the degree of freedom with which new political organizations can be set up outside the ruling coalition. In these variants the cumulative decline can be slowed down for a time. The dissatisfaction of lower-level members of the party is likely to grow over time as losers from successive policy changes increase in number. At some point some powerful lower-level organizations are likely to break free of the ruling coalition and become powerful excluded organizations. Their presence and the likely offer of better benefits to lower-level organizations can further strengthen lower-level organizations within the ruling coalition, setting off a process of cumulative decline. While the sequence of triggering factors may vary across cases, the internal stresses within the ruling coalition mean that a cumulative decline is likely to be set off at some point. As with vulnerable patrimonialism, the presence of natural resource rents and external rents in the form of

military and other forms of aid can slow down the process of challenges to the leadership but does not necessarily change the features of this subsystem to a significant extent. Examples of dominant parties under constrained patrimonialism include the Congress Party in India in the 1950s and 1960s, the CCM in Tanzania, the CPM in West Bengal from 1977 to 2011 and the Thai Rak Thai in Thailand from 2001-2006. Each was a variant of a dominant party with somewhat different internal characteristics. They also operated in different institutional contexts, with the resulting operational equilibrium characterized by different levels of stability and developmental outcomes.

*Competitive Clientelism (usually associated with Developing Country Democracies)*

This brings us to the fourth and final variant of the distribution of power across political organizations where there is a substantial level of fragmentation in the distribution of power across political organizations and within the ruling coalition such that higher levels have more limited powers over lower levels. This is *competitive clientelism*, where the number and strength of clientelist political organizations is such that the inclusion of all of them in a ruling coalition would not work and neither would a strategy of keeping excluded groups out by legal or military mechanisms. As we have seen, there are dynamic factors supporting a temporal growth in the relative power of both excluded political organizations and lower-level organizations within the ruling coalition. As a result, competitive clientelism is likely to be the default structure of clientelist political settlements. However, if this configuration of political power emerges at very early stages of development when economic organizations are also underdeveloped there are likely to be problems with achieving political and economic viability. Competitive clientelist political organizations can sometimes be in unstable operational equilibrium with authoritarian institutions but they are typically associated with *developing country democracies*.

The only sustainable (if vulnerable) arrangement with this configuration of power is an operational equilibrium with political institutions (formal and informal) that can ensure that excluded coalitions can cycle in and out of power in an orderly way. When the ruling coalition is replaced by a new coalition the political settlement technically changes, but is replaced by a new political settlement that retains the competitive clientelist characterization of its political organizations. The new political settlement is therefore substantially quite similar except in the identity of the organizations constituting the ruling coalition. In practice there may be further differences in the identity of the dominant economic and bureaucratic organizations as these are likely to have close links with political organizations in developing countries. Nevertheless, the stability of the political settlement in this case refers to the potential of smooth changes in the identity of the ruling coalition without either excessive political violence or the transition to a different configuration of political organizations such as a vulnerable patrimonialism that supports authoritarian institutions.

In developing countries the weakness of formal institutions implies that the smooth cycling of political organizations into and out of power requires informal institutional arrangements between competing organizations. Informal arrangements are essential for ensuring that competing coalitions believe that their chances of becoming the ruling coalition are proportional to some agreed measure of their relative power. Democracy in developing countries is therefore typically based on an operational equilibrium between variants of competitive clientelism and formal and informal

institutions that credibly ensure access to power for the coalition that can mobilize the greatest organizational power. This, rather than a rule-following competition for power between parties with different manifestos for taxing and spending, describes how democracies work in developing countries. The ruling coalition in developing countries is formed by political entrepreneurs who seek to bring together a large enough number of political organizations within their coalition to be able to rule but not so many that rents are spread too thinly. The excluded are technically free to organize, organize new groups and entice factions currently included in the ruling coalition to leave and join them in an attempt to form a new coalition.

Given the relative power of the excluded, a stable operational equilibrium requires the recognition on the part of the ruling coalition that excluded coalitions will cycle into power sooner or later so that attempts to exclude them do not extend to outright repression. Elections provide a mechanism for testing the organizational power of competing coalitions, and elections are successful if they reflect the balance of organizational power on the ground. But given the difficulties of enforcing formal institutional rules in developing countries, the sustainability of electoral competition cannot simply be based on formal electoral rules. A stable democratic system with competitive clientelism is only likely to be sustainable if there is an 'implicit rule of law' amongst competing coalitions that ensures that all competing factions follow the same formal and informal rules in organizing themselves and losers accept the outcomes of these contests without descending into open warfare. Competitive clientelism can only sustain political stability when institutions and particularly informal institutions emerge to provide credible assurances to excluded organizations that they can eventually gain power by building their coalition within these rules and they do not need to engage in excessive levels of violence to oust the ruling coalition.

If the underlying distribution of power between political organizations is as in the lower right hand corner in Figure 4, an attempt to institutionalize authoritarian rules or even a dominant party can produce worse outcomes than if an attempt was made to institutionalize a competitive democracy. For instance, attempts to sustain authoritarianism as an institutional arrangement when the underlying distribution of power approximates competitive clientelism can result in an unstable operational equilibrium with high levels of violence and very poor economic outcomes. The activity of powerful political organizations to change institutional arrangements that seek to exclude them can result in very significant costs for society associated with the ensuing contestation. The activity to change significant institutional arrangements like authoritarianism or a one-party system can be seen as a large-scale rent seeking process where the costs of violence and disruption are significant 'rent-seeking costs' inflicted by excluded political organizations. Occasionally, the violence unleashed by a ruling coalition can destroy the organizational power of excluded organizations so that the underlying distribution of power is eventually no longer competitive clientelist. If this happens, an authoritarian type of regime can be established as a stable operational equilibrium. But in the typical case where violence breaks out against an authoritarian regime operating in a configuration of competitive clientelism, the likely route to a more stable equilibrium is through an abandonment of authoritarianism. A transition to the institutional arrangements of 'democracy' can (after a sustainable equilibrium has been achieved), provide relatively better results compared to the attempt to preserve an authoritarian institutional system in a competitive clientelist configuration of power.

Thus, the institutional arrangements associated with developmental states, authoritarian regimes or dominant party coalitions can be associated with developmental outcomes in some contexts, but only if the underlying distribution of power between political organizations support these institutional arrangements. In the presence of competitive clientelism, authoritarian institutional arrangements are likely to be associated with poorer development outcomes compared to societies where the underlying political distribution of power is corresponds to some variant of patrimonialism. Indeed, with competitive clientelism, variants of democratic institutional arrangements may offer the best developmental prospects for that society to the extent that the distribution of power cannot itself be altered through political reorganization.

Understanding the institutional requirements for achieving a stable operational equilibrium with competitive clientelism is important because it is the likely political settlement underpinning developing country democracies. The collapse of authoritarian arrangements in developing countries is most likely to happen in the context of a change in the underlying distribution of power in the direction of competitive clientelism. The likely outcome is the eventual emergence of democracies in the context of an evolution towards competitive clientelism rather democracies that approximate to Weberian social democracies. The achievement of an operational equilibrium in this political configuration faces challenges from a number of directions. First, political stability power in the context of significant informality in institutional rules requires that the ruling coalition understands that excluded political organizations are powerful and cannot be excluded by formal or informal repression. Stability will only be achieved if the ruling coalition internalizes the futility of using administrative power as a long-run strategy of exclusion. Secondly, the design of governance institutions in this context has to take into account the specific problems of short-termism and generally weak implementation capacities. The imperative of focusing on developing targeted governance capabilities is most important in this context precisely because of the general characteristics of competitive clientelism.

The different variants of the clientelist political settlement display important differences but in every case, attempts to develop broad-based 'good governance' capabilities for the state organizations enforcing formal institutional rules are likely to fail. The futility of a primary focus on good governance reforms is particularly serious in contexts of competitive clientelism with its short time horizons and weak political implementation capabilities. This may appear paradoxical because moderately stable democracies in competitive clientelist contexts appear to have features of political accountability that authoritarian or dominant party systems appear to lack. But developing country democracies have features that are significantly different from advanced country social democracies and in particular, the institutional and political balances on which the social equilibrium is based are typically very fragile. Equally, attempts at introducing developmental state institutions in competitive clientelist contexts are also likely to fail. Developmental strategies used by developmental states require long-term rent management and implementation capabilities that are likely to be missing in competitive clientelism. The most appropriate developmental strategy in contexts of competitive clientelism is likely to be targeted strategies of rent management in sectors and over time horizons that are credible given the characteristics of this political settlement.

The more fundamental problem for competitive clientelism is that the institutional conditions for a stable operational equilibrium are frequently violated because the ruling coalition has a temptation to believe that it can use its administrative powers to keep the opposition excluded. In other words, the ruling coalition can suffer from the misapprehension that it can enforce authoritarian institutional rules. But the real distribution of power between political organizations in this context precludes authoritarian solutions and attempts in that direction only result in repeated crises of violence. This can paradoxically create strong pressures for organizations like the military to attempt to re-create an authoritarian coalition based on its stronger exclusion capabilities or for the ruling coalition to attempt to construct a dominant party, often by co-opting military and security forces within the ruling party. Military-authoritarian institutional arrangements are sometimes possible for short periods as an operational equilibrium with competitive clientelism but only with significant rent distribution by the 'authoritarian' leadership to political organizations or with significant amounts of repression that is unlikely to be sustainable for long. Given the underlying distribution of power, operational equilibria with authoritarian institutional arrangements are likely to be short-lived unless there is a successful political project of social engineering to reconstruct political organizations to change the underlying distribution of power.

A sustainable competitive clientelism requires credible institutional arrangements that allow the ruling coalition to be replaced in periodic elections by an alternative coalition if the latter demonstrates greater holding power. This cannot be ensured simply through formal electoral rules in societies where much happens informally. Informal institutions have to be in place reflecting the recognition by the ruling coalition that the use of administrative power to exclude powerful coalitions cannot transgress acceptable limits. This is difficult to achieve. As a result, democracy is not always stable in developing countries nor does it necessarily generate developmental outcomes. All of South Asia is today governed by variants of democratic institutional arrangements in the context of competitive clientelism as is much of Africa. Thailand in the 1980s and 1990s was characterized by an institutional equilibrium of competitive clientelism with quasi-democratic institutional arrangements. But only India has achieved an operational equilibrium that makes its competitive clientelism operate relatively smoothly. One reason for India's exception is paradoxically its size and diversity. This actually helps to inoculate its ruling coalition from imagining that it can get away with significant administrative interventions to exclude currently excluded organizations. Intervention to benefit a complex ruling coalition of diverse factions is itself complex and the complexity helps to ensure an informal rule of law emerging for conducting electoral contests in a way that outcomes reflect the relative power of political organizations.

A further factor that helps the credibility of elections in India is that it is a large federal country with elections organized at the state level. If excessive violations happen in a particular state, the federal government has strong incentives to intervene to prevent that state descending into a local crisis. The federal government can impose president's rule and re-run the election. Therefore, while irregularities, violence and in particular, the use of 'black' money from the informal economy does happen in India, competing parties know that an outcome that is significantly out of line with their organizational strength on the ground cannot be sustained. Smaller countries do not

have this credible third-party ‘institutional’ oversight of electoral outcomes and their ruling coalition can believe (wrongly) that they can hold on to power using administrative exclusion as a strategy for excluding the opposition. As a result, electoral crises are frequent in the typical developing country democracy and often the only exit route from the ensuing crisis is a military takeover that results in another transition problem. An understanding of this aspect of the political settlement suggests that the problem is unlikely to be solved simply by attempting a stronger enforcement of formal electoral laws. Considerable attention has to be given to strategies that can assist the evolution of an informal rule of law for political coalitions, and a shared understanding amongst elites about how this political settlement actually works.

***The Organization of the Bureaucracy***

Bureaucratic organizations are the agencies that enforce formal rules and implement formal policies. In developing countries, these organizations also operate in informal ways and may be engaged in informal enforcement activities (as when the police or courts enforce the law but only when informal arrangements and connections are invoked). The agenda of governance reforms has sought to enhance enforcement capabilities in developing countries by targeting the technocratic and technological capabilities of bureaucratic agencies involved in the enforcement of formal institutions and the implementation of formal policies.

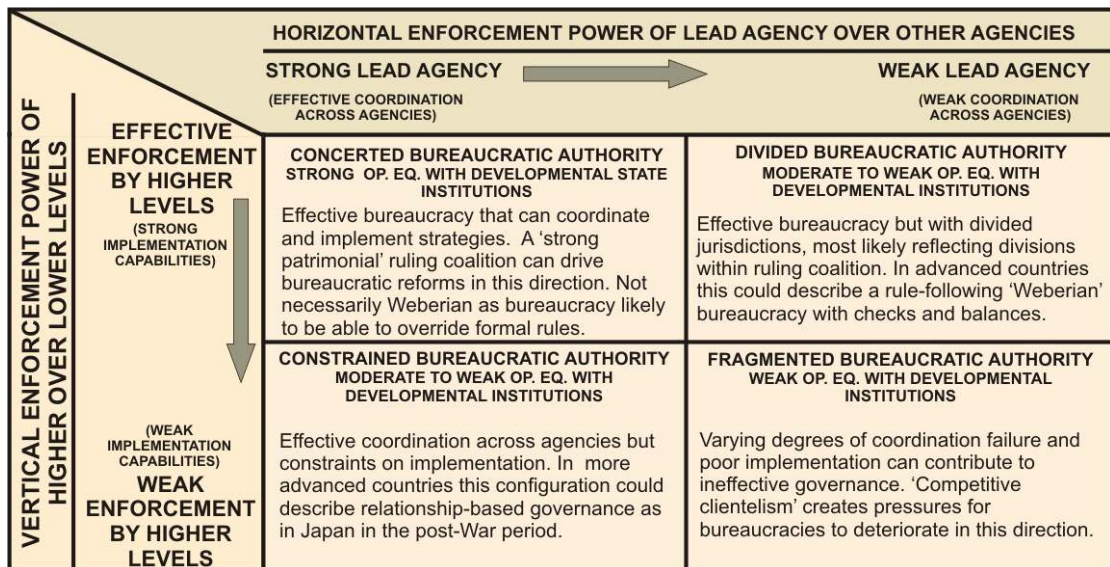


Figure 5 The Configuration of Bureaucratic Organizations

Apart from these technological and technocratic capabilities, the effectiveness of bureaucratic organizations also depends on the configuration of power across these organizations and their relationship with organizations in other subsystems. The configuration of power across political organizations is likely to have an important effect on the organization of bureaucratic agencies and the distribution of power across bureaucratic organizations. Figure 5 classifies bureaucratic subsystems in terms of the relative power of lead agencies vis-à-vis others (the horizontal distribution of power across bureaucratic organizations) and the enforcement capabilities of higher level agencies over lower level agencies (the vertical distribution of power across bureaucratic organizations). As with the classification of political organizations, we

simplify the range of variations across developing countries by looking at the four corners of the configuration.

#### *Concerted Bureaucratic Authority*

Theoretically the most effective bureaucracies in developing countries are concerted bureaucracies located at the top left-hand corner of Figure 5. Here the lead agency has the effective power to coordinate across other agencies allowing coordination across agencies. The lead agency refers to the agency through which the political leadership can attempt to coordinate policy implementation and the enforcement of rules. The lead agency is not necessarily the same across countries, and could for instance be the presidential office, the planning commission or the finance ministry. In addition, in this configuration, higher bureaucratic levels have the capability of enforcing decisions so that lower-level bureaucratic organizations implement the strategies of enforcement. The capability of higher levels of the bureaucracy to enforce and implement decisions requires the existence of bureaucratic capabilities and systems but also the existence of a hierarchy of enforcement that enables obstruction or contrary interests at lower levels to be disciplined and thereby limited. For obvious reasons, this distribution of power can be in a stable operational equilibrium with the formal institutional structure of a developmental state bureaucracy.

There are obvious parallels between this bureaucratic structure and a political system characterized by strong patrimonialism. There is also likely to be a causal link between the configuration of political organizations in strong patrimonialism and the development of bureaucratic capabilities in the direction of concertation. A strong patrimonial ruling coalition will have the incentive to reorganize the bureaucracy in the direction of concerted bureaucratic authority if it was not already organized in this way. Not only is a strong patrimonial leadership likely to have the capacity to set such a bureaucratic reorganization as a priority, it can also ensure that lower levels of the bureaucracy or parallel agencies of the bureaucracy are not able to block implementation or follow contrary strategies. The latter typically implies that obstructive bureaucratic agencies are acting with the political support of some political organizations, and this is unlikely when the distribution of power between political organizations is of the strong patrimonial type. The emergence of concerted bureaucratic authority enables a patrimonial ruling coalition to implement its strategies and maximize its returns over time. Thus, it would be plausible to expect strong patrimonialism to be associated with the emergence and development of concerted bureaucratic authority in the bureaucratic subsystem.

#### *Divided Bureaucratic Authority*

In this configuration the lead agency is unable to enforce coordination across all agencies even though higher levels are able to enforce implementation by lower levels. For instance, different branches of government or different sections and ministries may be able to protect their jurisdictions from the intervention or coordination of other jurisdictions. In advanced countries the separation of powers between different branches of government can be an intended feature of the constitution. In the constitutional model of the United States checks and balances are built into the administrative structure to ensure that political intervention can be limited and checked by adversely affected interests operating through alternative branches of government such as the judiciary (Okuno-Fujiwara 1997). With a well-established market economy and as long as significant economic restructuring is not

required, this configuration of the bureaucracy can be reasonably effective, particularly in providing established capitalist interests with a degree of confidence that policies will not be easy to change in arbitrary ways. But even in advanced countries, this type of bureaucratic organization can become a liability at times of crisis or economic restructuring when coordinated decisions have to be made and implemented. The ability of adversely affected interests to resist changes by mobilizing different branches of the government and bureaucracy can have high social costs in such contexts.

In developing countries, divided bureaucratic authority is not likely to be solely the outcome of a design feature of a constitution based on checks and balances between different branches of government. The formal constitution is in any case not likely to be fully implementable given the general characteristics of informality and weak enforcement of formal institutions in developing countries. Divided bureaucratic authority is more likely to represent a transition phase when a concerted bureaucracy is becoming more fragmented as a result of different branches of government being able to act more autonomously. This is most likely to happen if the political configuration of power is itself changing in the direction of greater fragmentation, with different agencies being responsive to and protecting the interests of different sets of political organizations. As long as implementation capabilities are high and higher levels can impose discipline on lower levels, the main problem that the bureaucracy is likely to face is that policy coordination and coherence is likely to be compromised. This bureaucratic configuration can be in a moderate to weak operational equilibrium with developmental policies and institutions. If formal policies and institutions adversely affect powerful organizations, these can be blocked using both rule-following as well as informal mechanisms that exploit the divided authority of different agencies.

#### *Constrained Bureaucratic Authority*

A third configuration can emerge if higher bureaucratic levels have a limited ability to impose discipline and implementation on lower levels but effective coordination across agencies can be achieved. The weaker capabilities of enforcing discipline on lower levels in this case can be due either to poor technocratic and bureaucratic capabilities of the bureaucratic subsystem or because lower levels can be mobilized and supported by powerful political organizations to protect their interests if these are threatened by policies or institutions that the ruling coalition is trying to enforce. This bureaucratic configuration is most likely to be associated with dominant party systems where there may be a coherent and coordinated economic programme that the top bureaucrats in each agency accept but its implementation may be blocked because powerful organizations that are adversely affected can block its implementation by operating through lower-level bureaucratic organizations.

A very specific variant of this bureaucratic structure operated in post-War Japan during its rapid industrialization (Okuno-Fujiwara 1997). Coordination across agencies was possible but lower levels of the bureaucracy were relatively powerful and concertation from above was more difficult as a result. Nevertheless, coordination operated at the local level as a result of coordination across agencies and economic interests. This resulted in a uniquely Japanese style of implementation through consensus-building at different levels of the bureaucratic and economic system that had higher implementation costs than a concerted bureaucratic system, but benefited



from better information flows as a result of the process of building consensus. However, consensus-based implementation can face problems at times of crisis when significant restructuring is required that generates winners and losers. Losers can have strong relationships with some parts of the bureaucratic structure and the necessity of all bureaucratic agencies to achieve consensus in this system can slow down or block implementation at times of crisis. In developing countries this bureaucratic configuration can be in a moderate to weak operational equilibrium with developmental institutions and policies. It is likely that formal developmental policies that hurt powerful interests will result in informal arrangements with lower levels of the bureaucracy to soften their implementation and impact.

#### *Fragmented Bureaucratic Authority*

The fourth configuration is much the most problematic one because here both coordination across agencies *and* the imposition of discipline on lower levels of the bureaucracy are both weak. This could have a number of contributory reasons. The formal structure of checks and balances in the constitution and rules of business of the bureaucracy could prevent close coordination across agencies based on formal procedures. There may be weaknesses in the technocratic and bureaucratic capabilities of agencies that prevent higher levels from adequately monitoring and imposing discipline on lower levels. Most importantly, a fragmented (competitive clientelist) political structure could result in different levels and agencies of the bureaucracy operating in alliance with competing political organizations and interests.

The policy implementation and rule-enforcing capabilities of the bureaucracy are weakest in this case. The operational equilibrium with developmental institutions and policies is likely to be weak. We can expect significant levels of informal adjustments that dilute the implementation and enforcement of formal developmental policies. This configuration of bureaucratic authority is likely to be associated with competitive clientelism, though it may also emerge in either of the weaker patrimonial systems too. A competitive clientelist political subsystem is likely to have a ruling coalition that is too weak to lead a restructuring of the bureaucratic system towards greater professionalism and concertation. Indeed, the presence of competitive clientelism can lead to progressively more fragmented bureaucratic structures as competing political organizations will tend to politicize and work through their own bureaucratic agencies, resulting in progressive internal fragmentation across agencies and levels of the bureaucracy.

#### *The Organization of the Economy*

The final subsystem that constitutes an important part of the overall political settlement of a country is the subsystem of economic organizations producing goods and services. The types of economic organizations and their political linkages are likely to differ significantly not only across countries but across sectors and regions within a country. Two dimensions of variation describing the economic organizations in a developing country are relevant for us. The first is the average technological and entrepreneurial 'capabilities' of the organizations in question and second, the holding power they can deploy to protect their interests. As we are referring to developing countries, we assume that the modern economic organizations that we are describing here are a small part of the economic structure. The economic organizations that need to be described depend on the question we are asking. We could be interested in a particular sector or region, the characteristics of a subset of firms, or the average

characteristics of the whole economy. The relevant level of abstraction depends on the question being addressed. The important point is that when we describe economic organizations as having high, moderate or low productive capabilities, we are referring to the modern sector, or some part of the modern sector, and not the economy as a whole. For some types of analysis, a description of the average economic organization of the modern sector is required, for other questions a differentiated analysis of the power and capabilities of economic organizations across modern sectors and regions may be required. The two dimensions of variation are shown in Figure 6 and once again we will focus on the four ‘corner’ variants while remembering that most countries and most sectors will have organizations that are likely to be intermediate cases.

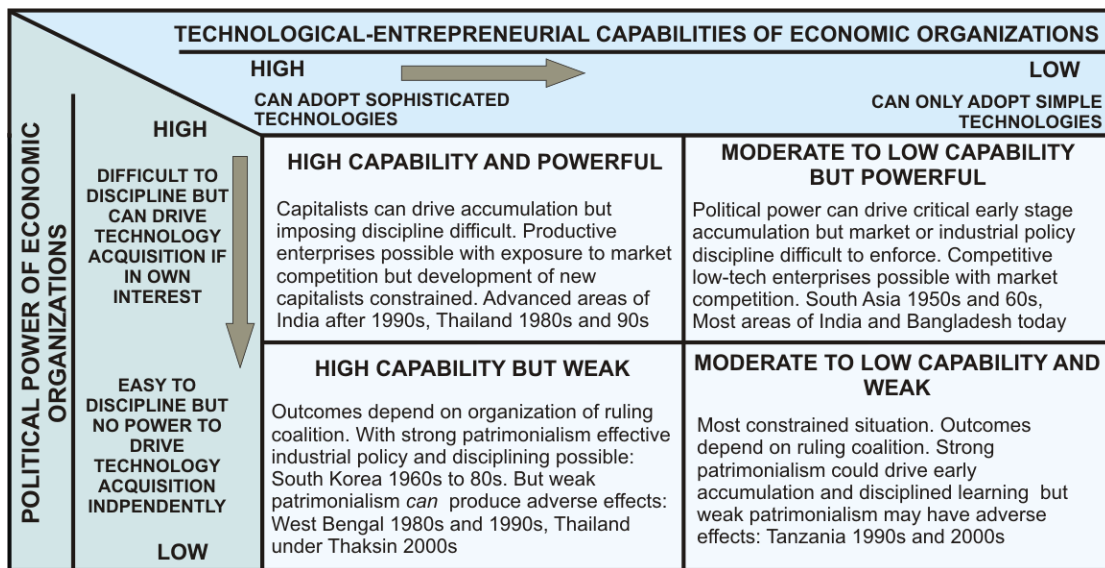


Figure 6 The Configuration of Economic Organizations

The first dimension of variation describes the distribution of technological and entrepreneurial capabilities across economic organizations within the modern sector. The technological and entrepreneurial capabilities describe the productive capabilities of the individuals and teams within the organization. An economic organization with a high productive capability is more likely to find technology adoption and learning strategies beneficial as it is likely to achieve competitiveness rapidly in the technologies it is using or in technologies further up the technology ladder. Conversely, organizations that have no reasonable possibility of achieving competitiveness are likely to focus on unproductive rent capture. Developing countries typically operate well within the technology frontier for most products and services, and as a result, even potentially productive economic organizations are unlikely to be immediately competitive in most activities. The achievement of competitiveness requires a considerable investment of time, effort and resources in technology adoption and learning. This, rather than the innovation of new products or services is the challenge for most economic organizations. The learning-by-doing is more likely to be successful if the organizations have adequate levels of technological and entrepreneurial capabilities. This in turn depends on their prior experience in producing similar products even if they have not yet fully achieved competitiveness in the technologies that are currently being acquired. As economic organizations approach the technological frontier they have to move from learning to innovation,

and new problems emerge. However, most developing countries are far away from the frontier for most of their sectors of economic activity. Indeed, this is what defines them as developing countries.

The second dimension of variation describes the relative political power of economic organizations. Political power is a measure of the ability of the organization to engage in 'rent seeking' activities to protect its interests through a political process. Clearly, economic power is one source of power because this provides the resources to buy access to the political decision-making process or to engage in conflicts of different types. But wealthier organizations are not always more powerful because power is also based on the capacity to organize collective action and to access and make links with other organizations, in particular political organizations. The relative power of economic organizations can therefore depend not only on their economic power but also on the configuration of political power that defines the cost and ease with which political power can be purchased. Economic organizations can be expected to be more powerful if it is easy and cheap to make political alliances with political organizations or to buy access to the political decision-making process. In contrast, even wealthy economic organizations may be relatively powerless if their access to political power is limited as a result of the configuration of political organizations. Emerging economic organizations in developing countries, even if they are high-capability organizations, are unlikely to exercise political power entirely through formal processes. Economic survival and growth in developing countries often requires access to informal power structures through which formal and informal rights can be negotiated and protected. Indeed many entrepreneurs who lead economic organizations often accumulated their initial wealth by means of close links with political organizations and still retain strong links with these organizations.

At the same time, political organizations also depend on the resources entrepreneurs can provide either from their productive enterprises or through grey networks based on informal trading and financing activities. Entrepreneurs and their economic organizations linked to political organizations in this way are likely to have considerable holding power because they are effectively protected by and can mobilize the political organizations that are dependent or linked to them. But even if economic organizations are providing resources to political organizations, they can still be politically weak if the political organizations within the ruling coalition can operate without the support of *particular* entrepreneurs. If the ruling coalition is cohesive enough and can collectively negotiate resources from economic organizations, particular economic organizations may still find it difficult to protect themselves from disciplining or even predation. The political power of economic organizations thus depends not only on their capacity to provide resources to the political system but also on the organization of the political system. The political power of economic organizations also depends on whether political organizations have other sources of funding. Natural resources, aid or other resources accessible to political organizations can reduce their dependence on economic organizations. Finally, the ability of economic organizations to mobilize their own collective action or to finance their own political organizations can obviously enhance their holding power.

The top left-hand corner in Figure 6 describes an economic subsystem where organizations have relatively high capability and political power, usually because they

are networked with political organizations in ways that allow them to deploy significant holding power. Paradoxically, this configuration is not necessarily the most conducive for driving growth in developing countries. This is perhaps true in general because powerful entrepreneurs and their organizations can be expected to use political power to create rents for themselves, and some of these rents could be damaging for the overall performance of the productive sector. For instance, powerful entrepreneurs can be expected to try and prevent institutional changes that ensure high levels of competitiveness that can expose their organizations to higher levels of competitive risk or force them to engage in higher levels of investment and effort. As a result, economic organizations are likely to resist institutions that aim to increase either market discipline through competition or state discipline enforcing conditions for policy support. The resistance to the latter is particularly likely when policy support for learning moves beyond the initial ‘easy’ protection phase when plants are first set up to the more difficult stage when competitiveness has to be enhanced. The latter requires credible compulsions on economic organizations receiving support to ensure high levels of effort during the learning process. This includes, for instance, the withdrawal of support from poorly-performing enterprises to establish that support is not unconditional. In many circumstances therefore, politically connected economic organizations can present obstacles to the introduction and implementation of institutional rules that impose market or state discipline on their activities.

However, powerful economic organizations are not necessarily always obstructive for economic development. If high capability economic organizations are *close to the competitiveness frontier*, they may have strong internal incentives to reach the frontier and access potentially significant market-based profits. Under these circumstances, economic organizations can use their political power to create temporary rents that allow them to engage in learning-by-doing to reach the frontier. Given their internal compulsions to put in high levels of effort, there is also a high likelihood of success under these conditions. But these strategies are only likely to emerge if powerful high-capability organizations are ‘close’ to the competitiveness frontier. The closeness depends not just on the level of technological and entrepreneurial capabilities but also on the location of the competitiveness frontier. If the organization is far away from competitiveness given the technologies and products in which it has invested, it is likely to use its political power to create and protect permanent unproductive rents as it has little hope of becoming competitive. However, if the organization is close to the competitiveness frontier, political power may sometimes be useful for assisting it to negotiate temporary support that allows it to reach the frontier. Pockets of well-connected high-capability capitalists have driven growth in this way in developing countries like India after the 1980s (Khan 2008b, 2009b). They were also instrumental in driving growth in Thailand in the 1980s and 1990s (Doner and Ramsay 2000; Khan 2000b; Rock 2000). But these configurations are vulnerable and require attractive returns if competitiveness can be achieved. If powerful economic organizations are *far from the competitiveness frontier* it may not be rational for them to try and use their political links to get support in an attempt to reach the frontier. In these cases, the likely strategy is to use political power to create rents for the economic organizations that are likely to be damaging because they benefit the organization without raising productivity or otherwise benefiting the broader society. The growth of damaging business-government relationships in India in the 2000s demonstrates what is likely to happen when strong business-government relationships continue and

the majority of economic organizations that have not already become globally competitive are too far away to pursue productive rent-creation strategies.

The bottom left-hand corner describes high-capability organizations that are politically weak in the sense of not being able to deploy significant holding power to protect their particular interests. Paradoxically, the political weakness of economic organizations in this configuration can allow the implementation of effective industrial policy if the ruling coalition is a strong patrimonial one and adopts developmental strategies. 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 ruling coalition with strong patrimonial characteristics but also a productive sector characterized by high-capability economic organizations with limited independent holding power. These characteristics of the South Korean political settlement allowed the implementation of an industrial policy that not only directed significant resources to the productive sector, but also effectively enforced discipline and compulsion to ensure that economic organizations put in 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 within the ruling coalition that individual Korean capitalists could have linked up with. Moreover, the close association of Korean entrepreneurs with Japanese industrial interests during the colonial period meant the former had very limited legitimacy after the Japanese defeat and could not immediately attempt to organize to protect their political interests (Amsden 1989; Kohli 1994; Khan 2000b).

However, this configuration of economic organizations also does not necessarily ensure growth and development. Politically weak but high capability economic organizations can be vulnerable to predation by political organizations (in the sense of revenue extraction) if the ruling coalition is unable to take a long view and is more interested in immediate resource capture to satisfy its political requirements. Thailand in the 2000s under Thaksin is an example of constrained patrimonialism operating through a dominant party system that sustained its power through populist strategies of redistribution rather than the development of productive sectors. The populist strategies led to significant problems for the Thai industrial capitalist class who faced growing implicit taxes while Thaksin's own commercial interests were protected. Eventually these tensions induced a constitutional crisis in Thailand in the late 2000s (Khan 2008b; Phongpaichit and Baker 2009). A somewhat different constrained patrimonialism in the state of West Bengal in India under the dominant CPM party from 1977 to 2011 also 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 withdrawal of effective support for industrial upgrading and led to a gradual industrial decline of the state as industrial capital relocated to other parts of India (Khan 2008b).

The top right-hand corner in Figure 6 describes politically powerful economic organizations with low to moderate productive capabilities. In this case, given the low economic capabilities of the organizations, their high holding power is likely to be based on their connections with powerful political factions. The holding power of economic organizations is likely to be high if the ruling coalition is fragmented and characterized by weak patrimonialism or competitive clientelism. This allows

individual economic organizations to line up with particular political organizations either within or outside the ruling coalition that in turn have the holding power to resist the decisions of the leadership of the ruling coalition. This can clearly provide particular economic organizations with significant holding power that can be used in different ways. In particular, economic organizations can block growth-enhancing institutional changes that threaten their interests. Given the lower levels of productive capabilities in this configuration, there are obviously serious consequences of blocking the imposition of market or non-market discipline on economic organizations. However, as before, all rent-seeking activities of powerful capitalists are not necessarily damaging from the perspective of development. Powerful capitalists can induce the ruling coalition to promote productive sectors even if they are not likely to immediately become very productive.

The industrial growth in South Asia in the 1950s and 1960s was driven by emerging capitalist interests with close links to political organizations within the ruling coalition. These interests defined early industrial policy supporting economic organizations investing in new technologies by providing them with protection and subsidized credit and other inputs. Extensive growth was rapid, even if learning and movements towards the technology frontier were slow. The problems with industrial policy emerged later when it became clear that the political power of these organizations reduced their incentives to put in high levels of effort in enhancing productivity. This was not surprising given that their rents were assured even if they did not or could not achieve competitiveness. In many developing countries growth was therefore initially rapid as protection allowed new firms to be established but growth could not be sustained as high levels of effort to raise productivity could not be assured. India, Pakistan and Bangladesh enjoyed dramatic growth accelerations with their industrial policies in the 1950s and early 1960s. Although output and productivity growth slowed down eventually, almost all the technological capabilities that subsequently drove growth in different sectors after the 1980s were developed during this early period (Khan 2008b, 2009b).

As in the case of powerful high-capability economic organizations, the critical variable here is once again the *distance of the economic organization from the competitiveness frontier*. A moderate-to-low capability economic organization may be reasonably close to the competitiveness frontier for some basic technologies and products. These firms will then have strong internal incentives to achieve global competitiveness if there are significant market-based rewards for firms achieving competitiveness. Under these conditions, politically connected firms may use their political access to create temporary rents for themselves to help finance learning-by-doing and to persuade the government to solve other problems that may otherwise have constrained them from reaching the competitiveness frontier. But as before, if the *distance from the competitiveness frontier is significant* or if the profits from achieving competitiveness are not very high, powerful economic organizations can be expected to use their power to create unproductive rents for themselves. It is more likely that economic organizations with moderate to low productive capabilities are far from the competitiveness frontier in most sectors. In these cases political power weighted towards the economic organization is likely to be deleterious to the imposition of discipline that may have accelerated learning and the achievement of competitiveness. At best, low capability economic organizations with political power

may engage in primitive accumulation to create wealthy organizations that may invest in their own capability development to become more competitive in the future.

Economic organizations with low productive capabilities and considerable access to political power characterized many parts of South Asia in the immediate post-colonial period, in the 1950s and 1960s. The failure to achieve significant learning and productivity growth in South Asia during the 1950s and 1960s was at least partly due to the political ability of the entrepreneurs receiving industrial policy support to block attempts to discipline them (Khan 1999, 2000b; Chibber 2003; Khan 2009b). On the other hand, moderate capability but powerful economic organizations close to the competitiveness frontier in sectors like garments drove rent strategies in Bangladesh in the 1980s that took them to the competitiveness frontier. The sources of power that enabled economic organizations to resist disciplining are important because they imply specific policy responses. What gave a small group of economic organizations in post-independence India (or Pakistan) the ability to resist disciplining when the ruling coalition was based almost entirely on political organizations dominated by other interests? Indeed, as in South Korea, capitalists in the Indian subcontinent did not enjoy high levels of legitimacy in the post-independence period and indeed the official ideology of the dominant Congress Party in India was socialism.

According to Chibber, individual capitalists had the power to block disciplining during this period because import substitution policies in India created the wrong incentives for capitalists. Chibber argues that capitalists were politically powerful but 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. It asserts that capitalists were powerful without explaining what gave them this power, and the core of his argument is that import substitution did not create incentives for this powerful constituency to support the government in enforcing discipline on individual capitalists. His argument suggests that shifting from import substitution to export promotion may have broken the power of individual capitalists to resist by ensuring that capitalists as a group would collectively support disciplining. The implicit claim here is that the establishment of a collective capitalist interest would change the balance of power between the state and individual capitalists when it came to imposing discipline.

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 by individual capitalists. 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 from individual capitalists. In theory, import substitution could be combined with a gradual opening up and a reduction of protection for selected sectors to create strong compulsions for productivity growth. If import-substituting industries believed that a

gradual opening up could be enforced, they would also have strong incentives to ensure that other capitalists provided them with high-quality inputs required for achieving competitiveness. It is not export-promotion that creates incentives for productivity growth but the credibility of the state declaring that support would be for a limited period. 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. An alternative analysis of the political settlement in India can explain the power of individual capitalists to block disciplining using their association with powerful political organizations. Rather than the collective position capitalists may have taken about the usefulness or otherwise of disciplining, a better explanation is that Indian capitalists could buy into significant informal sources of holding power provided by political organizations that were not in turn well-coordinated in a cohesive ruling coalition. The ruling coalition in India was a weak variant of constrained patrimonialism, with a dominant party, the Congress Party, which was internally divided in many factions and with relatively weak leadership control over different factions. Individual capitalists could not be disciplined because they could develop associations with particular political factions that were powerful. The factions needed the economic resources and rents that the capitalists could generate or kick back to the faction. In return, the individual economic organization would be protected and be able to resist attempts to discipline the conditions under which it received support. The failure of institutions like the licensing system to allocate or re-allocate licenses in line with objective criteria that it had set itself had little to do with whether capitalists collectively were interested or not interested in supporting disciplining. Rather, the failure was a result of individual capitalists being linked to powerful politicians and their factional organizations within the Congress Party. As a result, these economic organizations could not be disciplined by the lead agencies charged with monitoring and enforcing industrial policy institutions.

The fragmentation of political organizations in India meant that even capitalists who were unable to mobilize significant resources were able to find some powerful political organizations hungry for resources and willing to offer their support to particular capitalists and their organizations. Indeed, the historical evidence suggests that Indian capitalists were closely associated with particular politicians and factions in the Indian subcontinent from the early twentieth century and these links were developed further during the early industrial policy period. 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 corner of Figure 6 describes a difficult situation where entrepreneurs have low technological and entrepreneurial capabilities and also lack any significant political power. Outcomes will once again depend quite significantly on the interface with the ruling coalition. In principle, a strong patrimonial 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 accumulation and learning strategies in the late 2000s under its dominant party ruling coalition is an interesting experiment of this type. However, with limited political voice and holding power, entrepreneurs in this economic configuration may also be expropriated if the ruling coalition objectives change to short term extractive goals as a result of its perceived vulnerability or other reasons. Particular entrepreneurs and their organizations can also face expropriation if they do not fit into the particular regional or sectoral interests of the ruling coalition.

If the ruling coalition is not able or interested to push accumulation and technological progress, economic organizations that are politically weak are unlikely to be able to drive economic policies. For instance, Tanzania's dominant party ruling coalition in the 2000s was based on a relatively weak patrimonialism, and tending to transform in the direction of competitive clientelism. The ruling coalition had a limited engagement with economic organizations despite official support for the private sector during this period. Directed policies of support for economic organizations have not been aggressively supported. In this case, one reason was that many entrepreneurs were Asian or European in origin and not African and this perhaps made it more difficult for a vulnerable dominant party to openly support business interests. At the same time, business interests were themselves too politically weak to drive policies and institutions from below. The availability of aid and natural resource rents further weakened the incentives of the ruling coalition to develop the politically weak productive sector with proactive policies when easier opportunities for meeting the minimum resources requirements for the viability of the ruling coalition existed.

## **9. The Political Settlement and the 'Micro' Analysis of Institutions**

The political, bureaucratic and economic subsystems together describe the most important organizations in a society. The operational equilibria within and across these subsystems defines a political settlement if the minimum economic and political viability conditions for system reproduction are achieved. At the macro-level, the political settlement describes the mutually supportive institutions and organizations that constitute this reproducible system. Figure 2 summarized the interdependent relationship between institutions and the distribution of power between organizations. *Institutions affect the distribution of power* because institutions sustain a distribution of economic benefits across organizations and contribute to their holding power. At the same time, *the distribution of power across organizations affects institutions* because powerful organizations are likely to determine the evolution of, and modifications in, formal and informal institutions to achieve the distributions of benefits most aligned with their relative power. Once a sustainable equilibrium between institutions and organizational interests emerges, both the institutions and the

distribution of power become mutually supportive in a reproducible economic system. An operational equilibrium at the macro-level does *not* imply that growth is high or that social conflict is low but only that the levels of economic activity and political stability achieved allow a reproduction of the institutional system. The first level of analysis is thus to describe the operational equilibrium of the political settlement at a social level, and in particular the economic outcomes and levels of political stability or conflict associated with the reproduction of that particular operational equilibrium. Once this emerges, the evolution of institutions and organizations takes place in path dependent ways within the constraints set by the macro-political settlement.

The analysis of the characteristics of a political settlement at the macro-level is a necessary starting point for a second level of analysis of particular institutions at the micro-level. The economic effects of any particular institution is likely to depend on the characteristics of the political settlement within which it is embedded as the latter determines the modifications that are likely to be necessary for the institution to achieve an operational equilibrium. At the same time, the political costs of changing or introducing particular institutions are also likely to depend on the macro-political settlement because the resistance or support that particular institutional changes face will depend on the configuration of organizational power in which the institutional change in question is to be located. As new institutions or changes in institutions affect the incomes of relevant organizations, the resistance or support of particular organizations can be predicted. The implications for resistance and therefore for political stability will depend on the configuration of power across affected organizations. Typically, the analysis of institutions ignores the organizational and political structure in which the institution is supposed to operate and this is why standard institutional analysis is unable to explain why apparently similar institutions have significantly different effects in different contexts. An understanding of differences in the construction of the political settlement across contexts can help to explain a significant part of these differences in institutional performance.

This analysis is particularly relevant for policy assessments of the feasibility and likely outcomes of different directions of incremental institutional change. The distribution of organizational power supported by the macro-political settlement can help to explain the joint economic and political implications of introducing or changing particular institutions. Every incremental institutional change is likely to involve a combination of formal and informal modifications to these institutions depending on the macro-political settlement (with incremental implications for growth and development) as well as resistance or support from competing groups of organizations (with incremental consequences for political stability and conflict). The outcome of any particular institutional change will therefore be a combination of changes in economic outcomes and in overall political contestation and stability that cannot be read off just from the characteristics of the institution without looking at the political settlement in which it is being located. The micro-analysis therefore identifies a specific 'growth-stability trade-off' emerging as a consequence of particular paths of incremental institutional change in the context of a political settlement. The characteristics of this trade-off depend on the specific institutional change that is being considered as well as the characteristics of the macro-political settlement. Some directions of institutional change are likely to have more adverse growth-stability trade-offs in particular political settlements because they involve more significant threats to the interests of powerful organizations.

The macro-political settlement can be described by putting together the interactive features of the three subsystems that describe the political, bureaucratic and economic organizations of a society. In each case, the strength of the operational equilibrium with existing institutional structures and the economic consequences of informal modifications depend on the interests and relative holding power of the dominant organizations in these subsystems. Figure 7 summarizes the characteristics of a number of political settlements in developing countries that are all variants of the broadly defined clientelist political settlement. The effective interventionist institutions of the East Asian developmental state achieved rapid and sustained social transformations. But the effectiveness of these institutions is only imperfectly understood by looking at the institutional features of industrial and other policies in these countries. More fundamental was the effective and strong operational equilibrium between these institutions and a configuration of organizational power that allowed the enforcement of particular formal and informal institutions. The features of the distribution of power between different types of organizations that underpinned the developmental state are summarized in the first row of Figure 7. The operational equilibrium allowed the enforcement of rapid transfers of assets to modern productive sectors and the enforcement of effective learning strategies and other policies that accelerated the capability development in economic organizations.

<b>Variants of Clientelist Political Settlements</b>	<b>Political Organizations</b>	<b>Bureaucratic Organizations</b>	<b>Economic Organizations</b>
<b>East Asian Developmental State</b> (eg South Korea 1960s): Rapid social transformation	Strong Patrimonialism in operational equilibrium with institutions of Developmental Authoritarianism	Concerted Bureaucratic Authority in operational equilibrium with institutions addressing market failures including industrial policy	High capability politically weak enterprises in strong equilibrium with institutions ensuring effective disciplining of conditional rents
<b>Authoritarian States</b> (Pakistan 1960s): Rapid initial growth but declining economic and political viability leading to stalled transformation by late 1960s	Vulnerable Patrimonialism in operational equilibrium with institutions of Repressive Authoritarianism	Divided Bureaucratic Authority in weak operational equilibrium with developmental institutions	Moderate capability politically strong enterprises in equilibrium with institutions supporting accumulation but weak equilibrium with institutions disciplining conditional rents
<b>Democratic Planned Economy</b> (India 1960s and 1970s): Rapid initial growth but declining economic and political viability leading to slowing transformation	Constrained Patrimonialism in operational equilibrium with Dominant Party rule under democratic political institutions	Divided Bureaucratic Authority in weak operational equilibrium with developmental institutions	Moderate capability politically strong enterprises in equilibrium with institutions supporting accumulation but weak equilibrium with institutions disciplining conditional rents
<b>Democratic Market Economy</b> (Bangladesh 1980s-): Rapid growth in sectors that could achieve competitiveness on their own but political contestation slows transformation	Competitive Clientelism in weak equilibrium with democratic political institutions supporting multi-party democracy	Tending towards Fragmented Bureaucratic Authority in weak operational equilibrium with developmental institutions	Moderate capability and moderately powerful enterprises in weak operational equilibrium with market-supporting institutions

Figure 7 Variants of Clientelist Political Settlements

In contrast, many authoritarian states in developing countries had superficially similar formal institutions, and their leaderships attempted to follow similar strategies of support for capability development in export-oriented economic organizations. The much poorer performance of these states, including Pakistan in the 1960s has elicited a number of explanations focusing on small differences in policy instruments but none of them are entirely satisfactory. The major difference between the performance of authoritarian and developmental states can be located in the distribution of organizational power that resulted in very different types of operational equilibria for apparently similar institutions attempting to address similar economic problems. In Pakistan's authoritarian state, institutions that attempted to direct resources to productive sectors faced much higher political costs in terms of instability. In addition, institutions that attempted to enforce discipline on firms receiving support for technology adoption were subverted by coalitions of these firms and powerful political organizations. The distribution of power across political organizations meant that economic organizations could easily form coalitions with powerful political organizations to protect their interests (Khan 1999).

Figure 7 shows a few more examples of the possible variations in the constitution of a clientelist political settlement. From the perspective of the political settlements framework, the critical differences between clientelist political settlements are located in the distribution of power between organizations in one or more areas. In each case, the overall configuration achieves reproducibility of the system but with different rates of economic growth and overall political stability, and possibly with different levels of sustainability of the system over time. In addition, the characteristics of the macro-level political settlement are important for our second level of analysis, which focuses on the economic and political effects of *particular* institutions at the micro-level. This level of analysis is shown in Figure 8. It looks at the implications of introducing particular 'incremental' institutions within a specific political settlement.

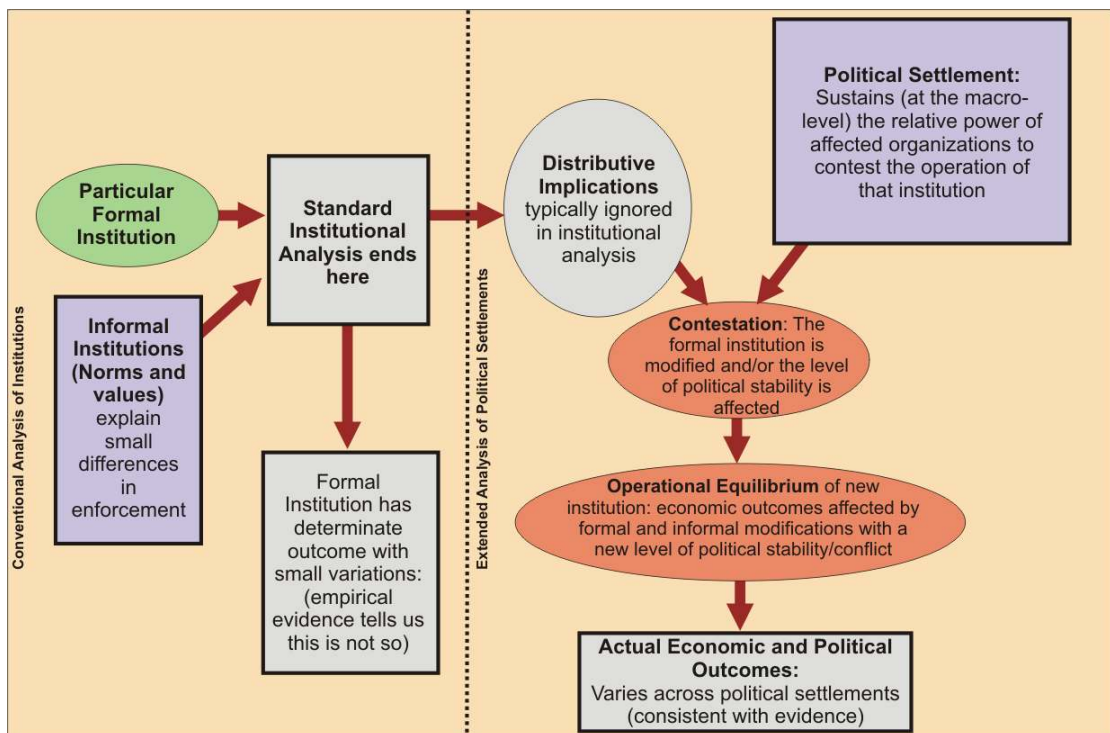


Figure 8 The Analysis of Individual Institutions within a Political Settlement

Standard institutional analysis typically looks at the economic implications of particular institutions in isolation. The conventional theoretical analysis of institutional outcomes is shown in the left-hand half of Figure 8. The standard analysis does recognize that the norms and values of the population may affect the costs of enforcement. For instance, if the respect for private property is internalized in norms, this is likely to reduce the costs of enforcing private property rights. But in the absence of significant distributive conflicts, the enforcement of socially desirable institutions should lead to accommodating changes in cultures and values. The latter can only explain significant differences in the performance of similar institutions if we believe that values are exogenously given and are *not* amenable to change in response to economic opportunities. Otherwise they can at best explain relatively small and transient differences in institutional outcomes before economic opportunities result in accommodating changes in values.

However, values and norms may not always evolve to support apparently beneficial institutions if there are distributive conflicts between different groups preventing their enforcement. An institution may result in an increase in net social benefit but with the benefits and costs distributed in ways that are resisted by powerful groups. If contestation prevents the enforcement of the potentially beneficial institution, cultures and values are unlikely to change in ways that support its enforcement. In this case, the norms in question are not independent variables explaining the poor outcomes; rather they are dependent variables reflecting the failure of enforcement. The failure of enforcement, in turn, can be explained by juxtaposing the change in the distribution of benefits associated with the particular institutional change and the relative power of the organizations affected. If powerful organizations are adversely affected, they are likely to successfully contest the enforcement of the institution. The result is likely to be some combination of formal or informal modifications to the institution that in turn affect the economic outcome and perhaps also an ongoing resistance to its enforcement that affects the overall level of political contestation in society. The effect of any particular institution therefore depends not only on the description of the institution but also on the macro-political settlement which describes the distribution of power between the organizations affected by the particular institutional change.

The extended analysis of institutions in the context of the political settlement is shown in the right-hand half of Figure 8. The particular (incremental) formal institution that is the subject of policy implies specific distributive outcomes that may or may not be consistent with the distribution of organizational power described by the political settlement. The contestation over enforcement then explains the varying economic and political outcomes that can be associated with the same institution in different contexts. This analysis has a number of important implications. First, if the enforcement of formal institutions is constrained by the distribution of organizational power sustained by the ‘social order’, we can begin to explain why the performance of institutions and policies has varied so greatly across countries. A corollary is that the institutions and policies that are developmental can vary significantly across countries. What may be theoretically a ‘second-best’ institution may actually be ‘first-best’ once we account for differences in resistance and enforcement costs that may result in a worse outcome in some contexts if we attempt to follow the best institutional strategy suggested by an analysis that ignores the political settlement.

Secondly, an analysis of the political settlement also explains why ambitious developmental strategies of the East Asian type have generally failed in most developing countries. The East Asian states adopted institutional responses to market failures that made obvious sense if they could be adequately enforced. Their good fortune was that they also had very specific political settlements that allowed the enforcement of these specific institutional strategies. In particular, they had inherited weak political organizations as a by-product of Japanese strategies of colonial rule. In contrast, in the more typical British and French colonial strategies, indigenous elites were used in the colonial administration together with strategies of divide and rule. Political organizations therefore evolved to be both much stronger and more fragmented as colonial powers encouraged countervailing political organizations to balance each other and thereby reduce the cost of suppressing them collectively (Khan 1999, 2000b).

Thirdly, the characteristics of the political settlement in developing countries can explain why in general, good governance strategies that attempt to introduce and enforce market-enhancing institutions have also fared poorly. The social order in developing countries has to be responsive to powerful organizations outside the formal economy. The enforcement of formal institutions is unlikely to protect the incomes of these organizations. These incomes are by definition likely to be based on informal institutions and informally managed rents. Powerful organizations can therefore be expected to resist the enforcement of formal institutions and to successfully modify their enforcement in ways that ensure their access to significant rents. Finally, in some countries, the political settlement may be so adverse that the space for feasible institutional and policy reforms may be very limited. There may be no feasible improvements in institutions and in the capabilities of bureaucratic organizations that would allow even a few important market failures to be adequately addressed. Here an understanding of political settlements and the experiences of other countries may suggest strategies of political reorganization to change the political settlement itself. But the difficulty and hazards of such strategies need not be stressed.

## **10. The Growth-Stability Trade-off**

The introduction of institutions that are incompatible with the interests of powerful groups can be expected to result in resistance 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 society in general have multiple dimensions. We include in 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 in it 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. Note that a change in the relative power of organizations brought about by organizational activity is only sustainable if the new distribution of power is reproducible, in other words, if a new political settlement eventually emerges.

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. In this case, there is an informal modification of the formal institution that results in lower contestation and instability but very likely at the price of an inferior economic outcome compared to the theoretical outcome associated with that institution. However, over time, informal modification strategies may gradually change the relative power of organizations to imply further movements in the trade-off curve. For instance, in some cases early compromises with powerful groups can build up more serious problems later by strengthening the relative power of these groups and resulting in a further deterioration in the trade-off over time. Conversely, in some cases a confrontation strategy that has high initial transition costs in the form of political stability can if successful reduce the power of unproductive organizations to hold up future changes and result in a more favourable trade-off curve in the future. But the sequence may be otherwise in both cases. For instance, confrontation could result in the fragmentation of a fragile coalition supporting change and result in a more adverse trade-off in the future, and so on.

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. Small incremental institutional changes are obviously likely to face more limited resistance while simultaneous changes along a number of fronts that can be described as 'discontinuous' can unite a number of coalitions of organizations to resist the changes. But once again, there may be paradoxical effects over time. Incremental changes may result in sequential modifications of the formal institutions that are being introduced in such a way that the motivation for further institutional changes is dampened. Discontinuous changes may by-pass this problem. Nevertheless, in general it is much more likely that incremental changes will face a more favourable trade-off in the immediate future as well as over time.

The observations above are relevant for the analysis of institutional change within a particular country. The trade-off analysis can also be used to compare institutional performance across countries in a more realistic way as long as we remember that the effects of different political settlements on levels of political stability are not directly

comparable across countries. Nevertheless, a better qualitative analysis of institutions and institutional change is possible if we begin with a comparison of the differences in the relative power of organizations affected by similar institutional changes and the likely effects of their support and resistance for particular trajectories of institutional change.

### *Political Settlements and the Trade-off Curve*

The growth-stability trade-off shown in Figure 9 can only be defined with clearly specified initial conditions. The initial conditions are specified not only in terms of resource 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 macro-political settlement is relatively stable. A change in the distribution of power or any of the other initial conditions can be expected to shift the trade-off curve. The institutional changes along a particular path also have to be well defined together with the strategies of management and modification 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 interests affected and the organization and relative 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 by the actual trajectories of institutional change in the context of a particular political settlement.

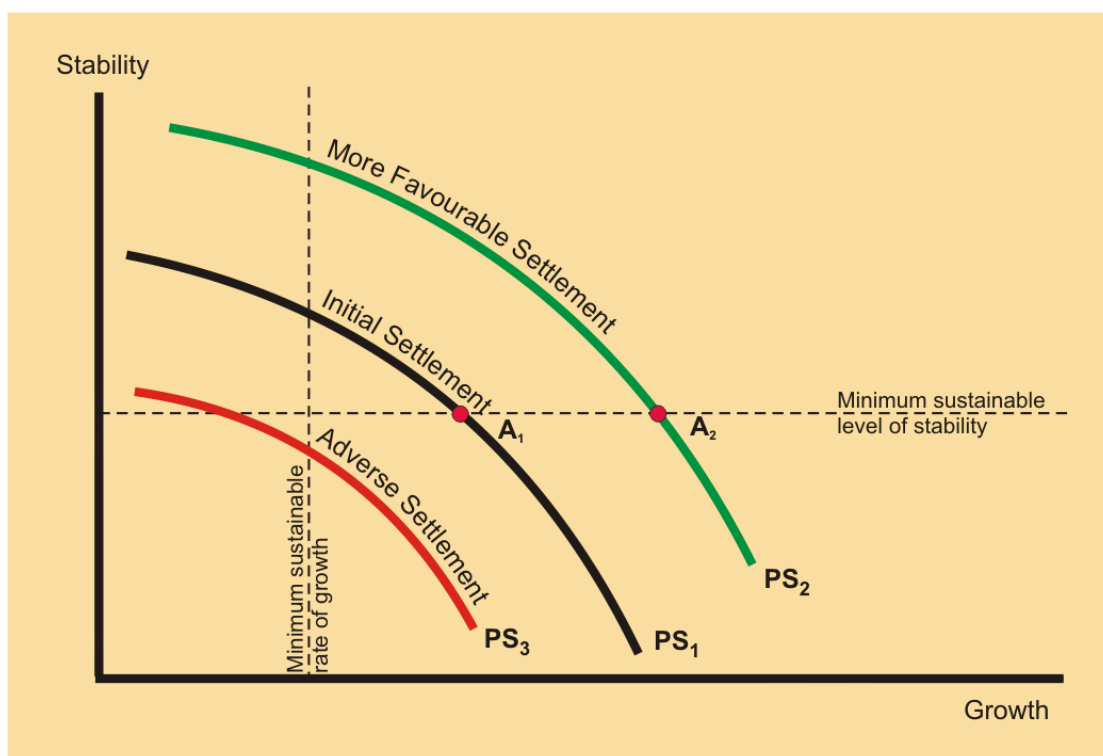


Figure 9 The Growth-Stability Trade-off

The vertical axis indirectly measures the political transition costs of institutional changes by showing the ordinal rank of institutional situations in terms of their implications for 'stability' as perceived by the ruling coalition responsible for the



enforcement of institutions and therefore directly subject to transition costs. The horizontal axis measures economic performance, in this case economic growth. Keeping all other variables fixed, incremental changes in institutions or incremental changes in the enforcement of existing institutions can improve growth. Both count as institutional change. If the resultant distribution of income is contested by powerful groups, higher growth could be associated with higher transition costs with obvious implications for stability as perceived by the ruling coalition. Our first proposition is that the greater the holding power of 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 affecting the broader society, particularly in the case of violence. Transition costs in general are likely to affect much broader groups in society, and indeed this may also be part of a strategy of putting pressure on the ruling coalition. An inclusive measure of all the dimensions of costs unleashed by 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 directly on the ruling coalition or indirectly through effects 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 need to 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 at least rank situations in terms of the most relevant transition costs along a specific path of institutional change. This means that we know whether one situation ranks higher or lower in terms of transition costs compared to another situation 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 situations distinguished by different institutional characteristics in terms of their rank. Institutional characteristics refer to the extent to which a particular institutional change has been implemented or enforced. 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 necessarily permanent and refers only to the period of resistance to a specific institution or institutional change. However, the period of resistance can be long or short and is itself the subject of analysis. If the institutional change is rapidly accepted then the power of previously powerful organizations must have changed as a result and the macro-political settlement has itself evolved in a particular direction. Thus, political stability can improve either because the institutional change is reversed, or if the groups engaging in resistance give up. The latter implies the emergence and 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 of the institutional situations that were ranked along the y-axis. Each point on the trade-off curve (shown as a continuous curve for convenience) therefore represents a specific institutional situation (defined by the degree to which an incremental institutional change is implemented and enforced) described in the diagram in terms of its associated growth rate and its rank in terms of stability. The pace at which stability declines will clearly depend on the strength of the groups opposing the institutional change and the other characteristics of the institutional change discussed earlier such as the strategy of modification, the scale of the change and so on. If the resisting 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 supporting and opposing coalitions can also result in shifts of the trade-off curve, as the same institutional changes will then be associated with greater or lesser effective resistance. Changes in 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 9 plays an important role in our analysis. This is the level of stability that is tolerable for the ruling coalition given the reproduction conditions of the macro-political settlement. The minimum level of political stability required for a particular path of institutional change depends on the political settlement but also on the identity of the groups affected by the reform. For instance, if the resistance is being organized by coalitions on which the ruling coalition depends, the minimum level of stability may be quite high. The minimum level defines the point beyond which institutional change cannot be pushed without unravelling the ruling coalition and therefore changing the political settlement. Crossing this point in some situations could simply mean an electoral defeat for the ruling coalition. In a competitive clientelist configuration this may result in the emergence of a new ruling coalition without changing the overall characteristics of the political settlement, but the current ruling coalition will obviously not push institutional change to the point where this becomes likely. In other contexts it could mean a more fundamental change not only in the identity of the organizations that are dominant but in the organization of the political settlement itself. In extreme cases violence could escalate out of control and the political settlement could unravel into a sustained crisis.

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 9, the maximum growth that could be achieved with the initial political settlement  $PS_1$  is at point  $A_1$ . This would only be achieved if the ruling coalition had incentives and compulsions to push growth to that point. The diagram simply tells us that such an outcome would be feasible in terms of the political settlement. 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.

## 11. The Evolution of the Political Settlement in Bangladesh

The borders of Bangladesh emerged in 1947 when the British province of Bengal was partitioned and parts of Assam were added on to create East Pakistan, which became the eastern wing of the uniquely bifurcated new state of Pakistan. East Pakistan became Bangladesh in 1971 when the two wings of Pakistan separated. Unlike West Bengal which was significantly industrialized, East Bengal in 1947 was almost entirely an agrarian economy growing rice and jute. The economic backwardness of the new state of Pakistan and the perceived threats to its survival combined with a failure to find a constitutional arrangement that could simultaneously reflect the relative populations of the two wings (East Pakistan was more populous) and the interests of dominant economic, political and military organizations (almost entirely located in West Pakistan) resulted in the emergence of an authoritarian governance structure in 1958. In the 1960s substantial progress towards industrialization was achieved from a very low base. However, both economic growth and political evolution changed the balance of power between organizations in ways that made the industrial policy institutions and the authoritarian political structure unsustainable. The result was another set of violent confrontations between incumbent and emergent elites in Pakistan culminated in 1971 in the separation of East Pakistan as Bangladesh.

Table 1 East Pakistan/Bangladesh Growth Trends 1950-2005

	Manufacturing	Industry	Agriculture
<b>1950-1955</b>	9.5	11.5	2.4
<b>1955-1960</b>	8.5	8.6	0.3
<b>1960-1965</b>	10.6	17.4	3.2
<b>1965-1970</b>	5.3	7.7	2.8
<b>1970-1975</b>	-9.8	not available	not available
<b>1975-1980</b>	5.1	5.9	3.3
<b>1980-1985</b>	4.5	5.5	2.8
<b>1985-1990</b>	4.6	5.4	1.6
<b>1990-1995</b>	7.9	7.2	1.7
<b>1995-2000</b>	5.5	6.3	4.7
<b>2000-2005</b>	6.5	7.1	2.4

Sources: Lewis (1969: Table 1), World Bank (2008)

The birth of Bangladesh in 1971 was followed by more violence that grew in intensity in the early years of the state. The conflicts over resources between competing groups of ‘primitive accumulators’ became more intense as the previously excluded Bengali elites now had access to state power to accelerate their own accumulation strategies. Initially, of course, these processes were very wasteful because the accumulators were not productive and their accumulation strategies seriously damaged an already vulnerable economy. And yet, this accumulation was creating a future class of capitalists who would play a role in driving growth in the next decade. Nevertheless,

this was a period of substantial instability, with an attempt to create a one-party state in 1975, the assassinations of two heads of state in 1975 and in 1981, periods of military rule and finally the emergence of a competitive clientelism with an emergent multi-party democracy in 1991. The latter faced periodic crises of electoral transition when parties refused to accept (often with good reason) the organization of elections or their results. Nevertheless, despite its apparently dysfunctional governance, by the turn of the century Bangladesh emerged as a relatively high-growth developing country with a growing base in manufacturing based on the garments and textile industries and gradually branching into other sectors. The trends in growth rates from 1950 to 2005 are summarized in Table 1. The political settlement in Bangladesh has clearly changed over time and these changes are relevant for understanding the nature of the institutional and policy challenges the country faced over time.

The evolution of the political settlement can be divided into four main phases, each with implications for institutional performance relevant for growth and stability. These are summarized in Figure 10. The first phase, from 1958 to 1971, during the Pakistan period, was characterized by a vulnerable patrimonialism as a description of the relative power of political organizations and authoritarian political institutions. This was an outcome of the coup of 1958 that brought in a military-led government and a new constitution that created political institutions with authoritarian characteristics. Bureaucratic organizations in the new state had limited capabilities for concerted action. Economic organizations had low capabilities and in addition, the dominant economic organizations were politically well-connected making it difficult to discipline these organizations when that was necessary. Nevertheless, it was during this phase that Pakistan's industrial policy was most effective in generating growth, with significant progress in industrialization, mostly in the West, but with substantial progress in the East as well, as can be seen in Table 1.

The growth-stability trade-off was relatively favourable for the implementation of a strategy supporting *extensive* growth. A pro-industry industrial policy supported a high rate of accumulation in industry assisted by exchange rate, interest rate and subsidy policies. Rapid industrial investments took place in new sectors in which the country had little or no prior experience. As in India, the new capitalists were well connected to political factions, in the case of Pakistan with politicians and bureaucrats within the authoritarian state. This meant that despite the state being formally authoritarian, it lacked the political capacity to discipline apparently weak economic organizations and this limited the prospects of industrial policy when it had to move beyond its extensive phase (when new economic activities were initiated) to the intensive phase (when the new organizations had to graduate to global competitiveness so that subsidies could be removed and made available for developing further sectors). The low productivity growth within the new firms being set up in industry would eventually have made the strategy unsustainable. In Pakistan, the challenge to the policy came first from a different source: the distributive conflict between West and East Pakistan that changed the distribution of power and undermined the political settlement.

<b>Bangladesh: Evolution of Political Settlement</b>	Political Organizations	Bureaucratic Organizations	Economic Organizations	Institutions and Outcomes
<b>Military Authoritarianism</b> <b>1958-71 (East Pakistan)</b>	Vulnerable Patrimonialism initially in operational equilibrium with institutions of Repressive Authoritarianism. Emergence of competitive clientelism in the 1960s destroys this op.eq	Divided bureaucratic authority in weak op. eq. with developmental institutions. Growth of regional politics leads to politicization of East Pakistani bureaucratic organizations and open revolt in 1971	Moderate capability and politically strong enterprises in op. eq. with institutions supporting accumulation but weak op. eq. with institutions disciplining conditional rents. Bengali-owned organizations few in number and of lower capability	Institutions of industrial policy achieve rapid growth but with low productivity growth. Collapsing op. eq. of political institutions results in increasing political instability in the late 1960s and the violent partition of the country to create Bangladesh
<b>Dominant Party Rule becoming Dominant Party Authoritarianism</b> <b>1971-75</b>	Constrained patrimonialism in op. eq with democratic institutions to sustain dominant party rule. Competitive clientelism begins to emerge undermining this op. eq. Short-lived attempt to impose one-party state (dominant party authoritarianism) fails to achieve an op. eq.	Divided bureaucratic authority and very weak op. eq. for enforcing formal institutions in post-conflict economy. Bureaucratic agencies collude with political organizations to engage in 'political accumulation' (primitive accumulation)	New economic organizations have strong political connections and weak productive capabilities. Existing Bengali-owned economic organizations of moderate capability are nationalized. New economic organizations provide cover for primitive accumulation	Formal institutions of 'socialist planning' are very weakly enforced. Informal modifications support significant primitive accumulation. Weak op. eq. of political institutions results in significant political instability till regime is violently overthrown
<b>Clientelistic Authoritarianism</b> <b>1975-90</b>	Competitive clientelism in moderate but deteriorating op. eq. with constrained democratic institutions (top leader cannot be removed). Composition of ruling coalition flexible with entry and exit determined by relative power revealed by competitive politics	Divided bureaucratic authority but some improvements in capabilities. Moderate to weak op. eq. for enforcing <i>some</i> developmental institutions and policies	Economic organizations approach global competitiveness in low-technology sectors and political access enables some sectors to negotiate developmental support (the garments sector)	Formal institutions and informal modifications support growth in some sectors that are able to achieve global competitiveness. Moderate op. eq. of political institutions results in moderate political stability till the second half of 1980s. Authoritarianism overthrown in 1990
<b>Vulnerable Democracy</b> <b>1990-</b>	Competitive Clientelism in moderate to weak op. eq. with democratic institutions supporting multi-party democracy. Vulnerability due to absence of informal institutions supporting 'live and let live' behaviour by political parties	Divided bureaucratic authority tending towards fragmented bureaucratic authority (as a result of growing politicization of the bureaucracy) results in weak op. eq. with developmental institutions	Moderate capability and moderately powerful enterprises in weak op. eq. with market-supporting institutions. Political connections of economic organizations that are <i>not</i> close to frontier results in damaging rent capture and political corruption	Formal institutions and informal modifications support sectors that are already globally competitive but support for new sectors limited. Op. eq. of political institutions results in moderate political stability but with frequent breakdowns

Figure 10 Stages in the Evolution of the Political Settlement in Bangladesh

The industrial policy that was applied in Pakistan created a distribution of benefits between East and West Pakistan that was politically unsustainable. It favoured the development of economic organizations that already had moderate productive capabilities and these were almost entirely based or at least owned by entrepreneurs from the Western wing. The strategy of developing an East Pakistani capitalist class was half-hearted and insufficient. The fact that the East's population was bigger than that of the West meant that the distributive conflict rapidly took the form of a mass movement for democracy. As new political organizations emerged and began to

coalesce into a grand coalition, particularly in East Pakistan, the distribution of power between the ruling coalition and excluded organizations began to change. The effective distribution of power was no longer a vulnerable patrimonialism by the late 1960s but had shifted effectively towards competitive clientelism. The operational equilibrium of authoritarian political institutions was no longer sustainable without the use of excessive amounts of violence. Not surprisingly, the embattled military government eventually allowed elections in 1970, and the East Pakistan based Awami League won a majority of seats in the Pakistan parliament on a programme of radical federalization. But a transition to democratic political institutions could not be achieved because the powerful economic, political and military organizations of the West refused to accept the outcome of the elections. The result was another partition, with much violence.

A second phase in the evolution of the political settlement covers the period from 1971 to 1975. A diverse coalition of organizations had come together to fight the authoritarian state and these coalitions now came to power at the head of a new state. The inclusion of almost all politically relevant organizations within the ruling coalition meant that the political system had a constrained patrimonial structure. Constrained patrimonialism has limited enforcement capabilities in general, but in this case the low economic capabilities of the economic organizations aligned with the ruling coalition meant that it had very limited capabilities to enforce limits on unproductive rent capture by its own constituent organizations. Organizations that appeared to be economic organizations were effectively organizations in close alliance with political organizations and engaged in unproductive resource capture. This obviously had dire consequences for the economy. This was a turbulent and violent period as the new elites with political power had few productive economic assets or supporters with such assets. It was not surprising that the political organizations in the ruling coalition had no interest in enforcing the formal rights of the productive sector. Their goal was rather to use formal and even more so informal political power to capture assets and resources for themselves. The result was intense 'primitive accumulation': the capture of assets using political power. This was necessary to satisfy the aspirations of important organizations within the new ruling coalition, but the pace of the primitive accumulation meant that the ruling coalition rapidly faced the prospect of political and economic collapse. The growth-stability trade-off was adverse for almost any growth-enhancing institutional strategy. Moreover the trade-off was rapidly worsening to a position where the achievement of the minimum economic and political viability conditions was threatened. Famine struck and the attempt of the ruling coalition to keep its hold on power through authoritarian responses rapidly began to unravel.

A constrained patrimonialism had produced a dominant party through the electoral system but its electoral dominance could no longer be guaranteed given the economic and political crisis that was unfolding. Many of its constituent organizations were dissatisfied with what they were getting and wanted to leave. Some did begin to leave and began to challenge the ruling party from outside. Effectively, the distribution of power began to change in the direction of competitive clientelism. The response of the ruling coalition was to amend the constitution to create a one-party state, effectively attempting to institutionally maintain the dominant party by changing the political rules of the game. The use of administrative measures to define insiders and outsiders created political institutions with authoritarian characteristics. Keeping the ruling



coalition formally inclusive by administrative decree would at best be a weak operational equilibrium given that the underlying distribution of power was moving away from constrained patrimonialism towards competitive clientelism. In fact the one-party state could not even be implemented at all because President Mujib-ur-Rahman was assassinated in 1975 with the tacit knowledge and support of organizations within the ruling coalition.

The third phase from 1975 to 1990 was a transitional phase towards the political institutions of multi-party democracy. The underlying distribution of power had already shifted substantially in the direction of competitive clientelism. Political institutions that were entirely authoritarian could no longer be in operational equilibrium with this distribution of power. The coalitions ruling during this period were led by military leaders, and formal and informal institutional limits on political competition continued over this period. But repressive authoritarianism of the type that was instituted in the 1960s could no longer be in operational equilibrium with the very different distribution of power across political organizations that had evolved. The interim solution devised during this transition period was to have military backed political parties engaged in electoral competition with other parties with little or no formal restrictions on the latter. In fact, of course, the participants knew that winning these elections was impossible for the opposition because of informal administrative measures. But the ruling party was constituted out of coalitions absorbed from other parties, and the electoral process and open political competition served the purpose of helping to identify the most powerful political organizations which needed to be accommodated within the ruling coalition. The political competition was therefore functional in helping to construct the most effective ruling party in terms of the political organizations that were included and the price at which they were included. The political calculations for constructing an effective ruling coalition in a context of competitive coalition began to emerge during this transition period.

This was also the period when the economy began to slowly recover from years of conflict. From 1980 to 2005, the agrarian nature of the economy began to gradually change. Table 2 shows that the share of industry in GDP grew from around twenty to almost thirty per cent, with agriculture moving in exactly the reverse direction. The military rulers and military-backed parties began a slow process of economic reforms that moved away from the centralized 'socialism' of the immediate post-independence period, with (very gradual) moves towards privatization and liberalization. The garment sector takeoff began in the late 1970s, helped by lucky international accidents like the Multi-Fibre Arrangement (MFA) but also because ad hoc institutional changes on a small-scale could be effectively implemented and enforced under the more stable operational equilibrium in the political sphere under President Zia-ur-Rahman. The growth-stability trade-off began to improve but growth was still sluggish. Economic organizations were still weak in terms of technological capabilities and still had considerable access to political power. In some sectors, economic organizations were close to the global competitiveness frontier in technologies that were relatively simple, like garments. In these sectors, the political connections of economic organizations helped to get policies modified in ways that could assist these organizations to achieve international competitiveness. This assisted growth through gradual pro-business interventions in these critical sectors with relatively simple technologies where the emerging economic organizations with productive capabilities could hope to achieve competitiveness.

Table 2 Sectoral GDP Shares Bangladesh 1980-2005

		1980	1990	2000	2005
Bangladesh	Agriculture	31.6	30.3	25.5	20.1
	Industry	20.6	21.5	25.3	27.2
	Services	47.8	48.3	49.2	52.6

Source: (World Bank 2008)

However, this was a transitional period because the political institutions of controlled democracy were in increasingly unstable equilibrium with intensifying competitive clientelism. The latter was evolving as excluded factions were becoming relatively stronger and were increasingly unwilling to accept the rules of political competition set during this period. After a series of intense confrontations, the second ex-military ruler, President Ershad, was forced to step down in 1990 and the period of multi-party political competition under competitive clientelism began.

The fourth and final period is one of a moderately stable but vulnerable operational equilibrium of democratic institutional rules with competitive clientelism. This period also witnessed a steady increase in the economic growth rate. The garment industry played an important role in the economic fortunes of the country in this period. After steadily acquiring competitive capabilities, its growth took off in the mid to late 1980s and it rapidly became the major foreign currency earner of the country. Political competition was organized around two major parties distinguished by deeply felt differences in the way they defined the 'nation'. These differences had trivial implications for practical policy issues but allowed the definition of two coalitions big enough for each to form a ruling coalition. The major political problem was to ensure that elections were not manipulated by incumbents to the extent that the excluded faction refused to participate in elections. The crucial transitional election of 1991 was held under an ad hoc caretaker government that was non-partisan. The non-partisan administration during the election meant that the losing Awami League accepted the result and their demand for a permanent constitutional arrangement for a caretaker government to organize elections led to the 13<sup>th</sup> Constitutional Amendment of 1996.

The system worked till 2007 when the caretaker system was undermined by the incumbent Bangladesh Nationalist Party interfering with the process that determined the head of the caretaker system. The resulting crisis resulted in a two-year emergency caretaker government backed by the army that attempted to solve the problem of political instability by attempting to implement good governance reforms. The political settlement could not, of course, be changed to approximate those of advanced countries and the system reverted to its equilibrium of multi-party democracy with competitive clientelism. However, instability remains high and in 2011 the ruling Awami League pushed through the 17<sup>th</sup> Amendment that did away (amongst other things) with the caretaker system. The opposition BNP has stated very clearly that it will not participate in elections unless the caretaker system is re-instated. The sustainability of democratic institutions therefore remains vulnerable.

A serious problem for the operational equilibrium of democratic institutions with competitive clientelism is that formal institutions are insufficient for ensuring



acceptable elections. There are general limitations in enforcing formal institutions in clientelist political settlements. In a context where all formal institutions are informally modified, it is not surprising that formal political institutions have proved inadequate for constraining the competing parties during elections. Violations of the rules constraining the illegal financing of political parties are widespread. In addition, the incumbent can leverage bureaucratic organizations involved in administration and policing to tilt the outcome slightly. This is one reason why the bureaucracy has been increasingly politicized over time. The electoral result can therefore often be justifiably rejected by the loser if the winner is the incumbent. If elections are close in terms of the numbers of votes cast for the two major parties (which is often the case in Bangladesh), the outcome can depend on administrative obstacles created for the losing party in a small number of constituencies. Politically, the outcome of an election is acceptable to the loser under these circumstances only if it is very clear that the winner can field significantly greater organizational power. The attempt to solve this problem through the constitutional mechanism of caretaker governments during elections worked for three successive elections but failed in 2007. The sustainability of the competitive clientelist political settlement requires a solution that credibly ensures the possibility of factions cycling through elections. This credibility is likely to depend on informal 'institutional' arrangements between the two main parties that assures a 'live-and-let-live' understanding on areas of major concern and therefore ensures that the loser can cycle back to power after a term in opposition. This informal understanding has not emerged.

An unfortunate consequence of competitive clientelism has been that bureaucratic organizations have become more fragmented and of lower capability over time. This is the result of a creeping politicization of the bureaucracy with wholesale transfers that amount to the effective demotion of senior bureaucrats after every change of the party in power. As a result, the time horizons of bureaucrats undoubtedly shrink and incentives are created for bureaucratic investments in developing party loyalties rather than in their professional capability development. Economic organizations have on the whole gradually enhanced their competitive capabilities though most remain in relatively low technology sectors like garments and textiles. The growth-stability trade-off in this political settlement depends on the institutions and policies being examined. For sectors where entrepreneurs possess sufficient capabilities to become internationally competitive rather rapidly, the growth-stability trade-off can be quite favourable. Institutions that appear to be dysfunctional can often be made to work in the interests of competitive economic organizations through informal means and side-payments. Thus, the property rights of these enterprises are effectively protected (for a price) and they are able to influence policy and its implementation sufficiently to remain viable. On the other hand, acquiring technological capabilities in new sectors that are far from the competitiveness frontier faces a much less favourable trade-off. Responding to these market failures typically involves the creation of relatively long-lasting policy-induced rents to enable learning-by-doing to be financed. Success requires the management of these rents by enforcing conditions for their allocation using formal or informal mechanisms. These requirements are difficult to meet when political power is fragmented and bureaucratic organizations have weak capabilities and are linked to political power. In this context, informal modifications of formal institutions have a negative effect because the enforcement of conditions can be easily subverted. Thus, in sectors where economic organizations are relatively far from the competitiveness frontier growth-stability trade-off was fairly adverse.

## **12. Military Authoritarianism: 1958-1971**

The roots of the economic and political crises with which Bangladesh began its life as an independent country in 1971 has to be understood by looking at the legacies of the Pakistan period. Pakistan itself faced serious political and economic challenges when it became independent in 1947 and the patterns of economic and political development that were adopted deepened the crisis in its eastern wing. The challenges faced by Pakistan were both economic and political. All the territories that constituted the new state of Pakistan were relatively some of the least developed parts of the Indian subcontinent. The reasons behind the political crisis were even deeper. A constitutional crisis in the newly independent Pakistan was almost inevitable given that the western wing was relatively more developed and was home to the top bureaucratic, military and economic elites while the eastern wing had a bigger population and therefore would hold power in a democratic polity. East Pakistan had virtually no indigenous capitalists, and virtually no senior bureaucrats or army officers in 1947. While West Pakistan was less developed compared to more advanced areas of India, many of the Muslim businessmen and senior bureaucrats from other parts of India who opted for Pakistan settled in West Pakistan as they were culturally closer to that region. The army too was largely drawn from the Punjab region of West Pakistan.

The indigenous elites of the two wings of Pakistan had never been strongly behind the idea of Pakistan and had not worked together prior to 1947 with a shared vision of Pakistan. This may appear to be surprising but their unpreparedness and lack of coordination is in fact easy to understand. The two most important Muslim-majority areas of India were Punjab and Bengal. The western part of Punjab became the heart of West Pakistan and the eastern part of Bengal became the core of East Pakistan. However, the demographic dominance of Muslims in these provinces meant that Muslims already enjoyed substantial power under the electoral system introduced by the British in 1936. As a result, Muslim chief ministers already ruled in these provinces long before 1947 and they had no interest in partitioning the provinces they were already ruling. The dominant Muslim parties in these provinces were not the Muslim League though they were sometimes in coalitions with the latter. The discourse on partition was primarily played out in central India where Muslims were a minority and where Jinnah's Muslim League was trying to negotiate constitutional and political protections for Muslims in these provinces in an independent India. The Muslim League was not organizationally strong in either Bengal or Punjab and it spent much time trying to bring these provinces under its wing to enhance its own bargaining power at the centre.

Jinnah's own commitment to an independent Pakistan was a negotiable one. When the British offered a federal plan (known as the Cabinet Mission Plan) in 1946, Jinnah gave up his demand for Pakistan and was willing to negotiate with the Indian Congress under Nehru on this basis. The Cabinet Mission Plan gave substantial powers to federal units and the fact that Muslims would have real powers in some parts of India gave Jinnah the confidence that this would be sufficient to protect Muslims in the parts of India where they would be a minority (Jalal 1985; Chatterji 1995). It was only when Nehru ruled this out that the Muslims in Bengal and Punjab panicked at the implications of a centralization of power in Delhi which would make them powerless in their own provinces. There was an electoral and political swing to

the Muslim League at the last minute, as a result of which the Muslim League won the 1946 elections in Bengal and was the biggest party in Punjab. The partition of India rapidly became inevitable as a result of this last minute failure in negotiations between Jinnah and Nehru. Only then did it become clear that the partition of India was definitively going to happen and would create a Muslim homeland in the two main Muslim provinces. But the local leaderships and populations in these provinces were unprepared for either partition or statehood and had not spent a long time working out what such a state would look like.

The Muslim League immediately faced serious problems in trying to cobble together a Pakistani state. It had won many votes in the 1946 elections but it had a weak party organization in the parts of India that would now become Pakistan. Moreover, most of its top leadership came from parts of India that would *not* become Pakistan and lacked any political constituency in the new country. However, West Pakistan's largely Punjabi elites soon discovered they stood to become the dominant group in the new state in terms of their relative position in the bureaucracy and army and their relative economic development. The Punjabis also experienced the most significant savagery on both sides during partition and this created a strong demand for a centralized and militarily strong Pakistan, a demand that had little resonance in the East where the experience of partition was less traumatic and bloody. This combination of factors led to the East Pakistani political elites suddenly discovering that they were in a subordinate position of political power in the new state. Thus, the new state of Pakistan began its life with serious conflicts of interests between the politicians and political organizations of the two wings from the outset. A decade of constitutional discussions failed to achieve a power-sharing formula between the two wings that would satisfy both the dominant elites of the west and the aspiring elites of the east. The former were dominant in terms of their links with economic and bureaucratic (including military) organizations, but the latter could legitimately claim political equality if not superiority on the basis of their population numbers.

The central problem was that the relatively poorer and less developed East Pakistan had at that time a bigger population, making the economically dominant West Pakistani elites suspect that they had much to lose in a democratic system. Moreover, even though East Pakistan was relatively underdeveloped, its political organizers were more organized and experienced in mass political mobilization and electoral politics as it had a longer history of colonial rule. Finally, West Pakistan was internally split into four provinces so that it was very likely that votes in the West would be split between several political parties. These asymmetries in the economic, political and organizational capabilities of the two wings made a constitutional settlement virtually impossible. The military coup of Ayub Khan in 1958 was the result.

The imposition of martial law curtailed the formal rights to set up and operate political organizations. The ruling coalition was defined around a core group of bureaucratic and military elites but inevitably West Pakistani economic organizations were close to these groups. Political parties were excluded and initially had very limited organizational capabilities to resist the enforcement capabilities of the military-bureaucratic coalition. However, the history of prior political mobilization meant that the excluded organizations would not remain permanently quiescent. The political subsystem was nevertheless initially a vulnerable patrimonialism and the institutional authoritarianism that was introduced was initially in a moderately

effective operational equilibrium with this underlying distribution of organizational power. For a while, the threat of force did indeed disrupt the ability of excluded organizers to pose a significant threat to the ruling coalition. Till the mid-1960s the operational equilibrium was fairly stable in the political subsystem. But gradually, political organizers in both wings of Pakistan began to organize increasingly effective popular resistance to the ruling coalition, taking the form of strikes, demonstrations and defiant public meetings. In the second half of the 1960s, Bhutto's Pakistan People's Party in the West and even more so, the Awami League in the East led by Mujibur Rahman began to mount an effective challenge to the 'patrimonial' claim of the military-authoritarian ruling coalition to rule in perpetuity.

Economic organizations had low competitive capabilities in both wings of Pakistan but they were almost non-existent in the East. The West benefited from the fact that a number of capable Muslim merchant and industrial capitalists immigrated to Pakistan from western India and chose West Pakistan as their natural home. These capitalists had strong links with the Muslim League from British times and had financed its politics in India (Khan 1999). These political contacts became even stronger now because the military-dominated ruling coalition realized that economic growth was vital for the survival of the country. As a result they fostered strong 'political' links with the West Pakistan-based business elites. Policy-induced rents were now controlled by a ruling coalition consisting of the military-bureaucratic elite and their close business allies. At the same time control over access to foreign exchange, the exchange rate, interest rates and tariffs and quotas allowed the state to create rents for privileged business elites. The initial effect of the new political settlement was not only greater political stability but also a sustained growth spurt that lasted through much of the 1960s. But the location of political power and entrepreneurial capabilities meant that almost all the manufacturing growth was located in West Pakistan.

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

In the end, Basic Democracy was self-defeating for the regime. As the rural basic democrats became more confident and ambitious, they saw obvious opportunities in throwing their lot in with the growing dissent that the traditional political organizations could mobilize. When this began to happen in the late 1960s, not only

did the 'hot house' economic development come under threat, the political stability of the country was fundamentally challenged as there were no easy ways of incorporating excluded elites into the system quickly enough. The PPP in West Pakistan and the Awami League in East Pakistan began to significantly increase their holding power as their number of direct and indirect supporters increased. In the second half of the 1960s the number of strikes, *hartals* (general strikes shutting down cities for a day) and other manifestations of civil protest increased exponentially (Alavi 1971; Ziring 1971; Jahan 1972; Gardezi and Rashid 1983; Zaheer 1994). This evidence can be interpreted as a dramatic increase in the relative power of excluded organizations and an increasingly rapid dissolution of the organizational distribution of power in the political subsystem described as vulnerable patrimonialism.

Under pressure in both wings of Pakistan, the military government allowed elections in 1970. They did not foresee that the East Pakistan based Awami League would gain an absolute majority in parliament. The East did have a majority of seats in the central legislature but the military ruling coalition believed that the vote would be split between several parties. In the end, the superior political organizational skills of East Pakistani politicians led to a resounding victory of a single party, the Awami League. This led to an even more serious constitutional crisis as West Pakistan based elites were unwilling to let an East Pakistan party form the government. The last desperate act of the authoritarian regime was a bloody crackdown on political organizers and their intellectual supporters in East Pakistan in March 1971. As the conflict became increasingly bloody, the political settlement collapsed into crisis. Civil disobedience in the East intensified and transformed into a war for liberation and independence. Pakistan's historic enemy India intervened to assist the Bengali struggle for independence and the independent country of Bangladesh was born in 1971.

The relationship between changes in the political settlement and the implementation of institutions supporting growth is summarized in Figure 11. The combination of changes in the relative power of political organizations and the introduction of authoritarian political institutions in 1958 resulted in a movement outwards of the growth-stability trade-off curve *for institutions and policies supporting of extensive growth*. These were institutions that focused the allocation of resources and subsidies to a small number of economic organizations that could drive growth. They included the licensing rules that allocated scarce foreign exchange to growth sectors, overvalued exchange rate policies that made machinery imports cheap at the cost of the rupee income of peasant exporters of raw jute, provided subsidies for exporters of manufactured products and allocated bank lending to favoured investors in new manufacturing industries. These formal institutions could be enforced to a greater extent because the political settlement prevented those opposed to these policies from organizing effective resistance, while the economic and political organizations that benefited did not have significant incentives to informally modify these institutions in ways that hampered their enforcement. For almost a decade, the institutions supporting extensive growth achieved rapid growth with the development of new sectors that had previously not existed in the country (Khan 1999, 2008b). This is shown in the top half of Figure 11 as an increase in the growth rate from  $A_1$  to  $A_2$ .

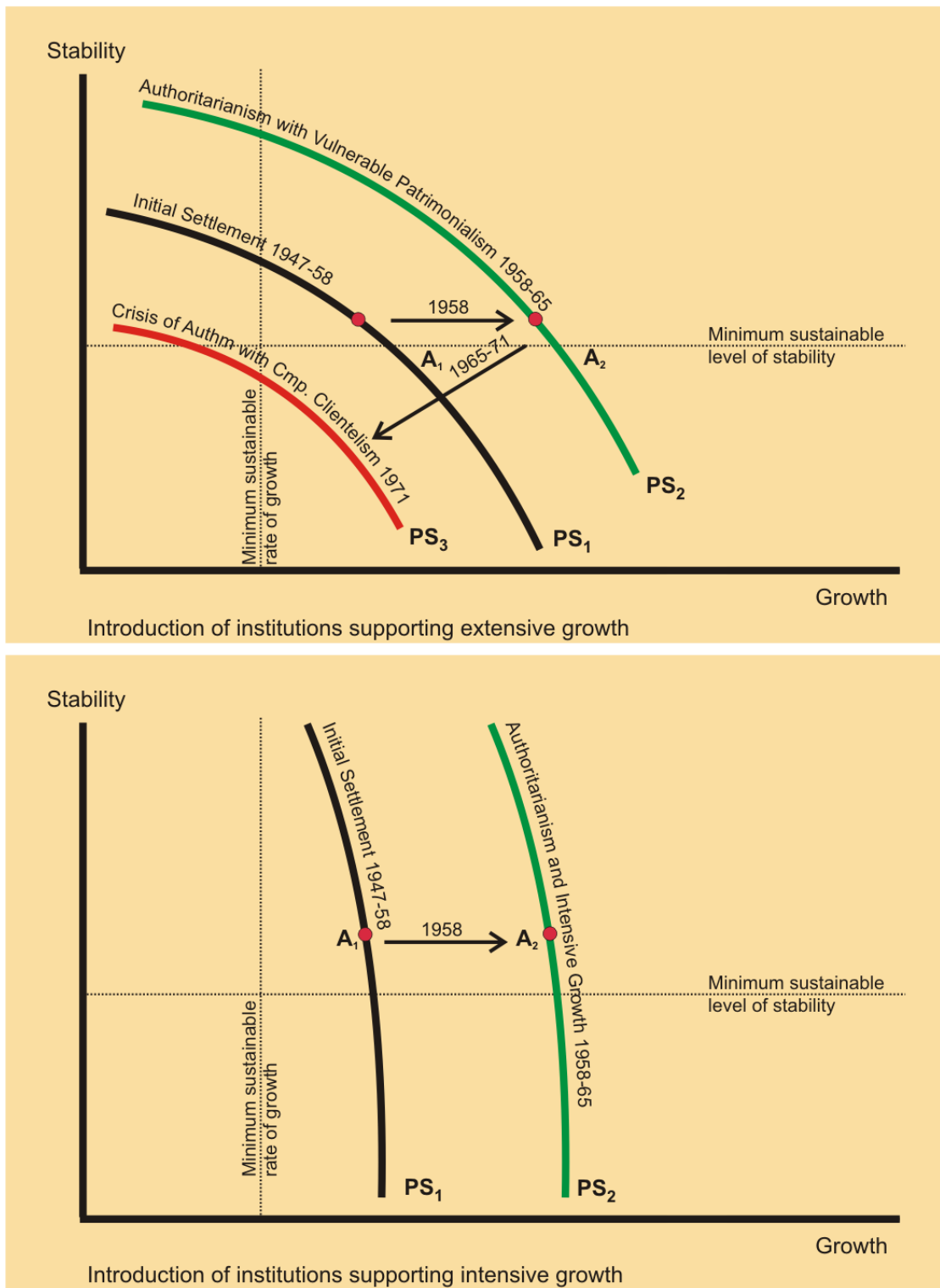


Figure 11 Growth and Crisis under Authoritarianism 1958-71

In contrast, the improvement in the trade-off curve for the institutions that were required for intensive growth was much less favourable, as shown in the lower set of curves in Figure 11. As in the India of the same period, powerful business groups were strongly networked with particular politicians and in the case of Pakistan with particular bureaucrats or generals. This meant that from the growth rate of  $A_2$ , further improvements in growth could not be achieved through learning-by-doing and

productivity growth because the enforcement of discipline faced very steep declines in stability. Alternatively, the institutions responsible for disciplining would be informally modified so significantly that growth improvements would not be achieved. The operation of banks, licensing rules and other institutions that should have enforced discipline on poor performers were informally modified so that growth-enhancing outcomes were not achieved. If these institutions could have been enforced (whether through formal or informal mechanisms) growth could have been pushed significantly beyond  $A_2$  in Figure 11. But more significantly, the extensive growth at  $A_2$  was not sustainable without productivity growth making economic organizations viable without subsidies. The failure to achieve the enforcement of the second type of institution resulted not only in lower growth rate, but also eventually the collapse of extensive growth.

The political settlement was not sustainable for several reasons. First, the failure to make the growth sectors self-sufficient meant that subsidies could not be freed up to spread the growth to new sectors. Economic organizations that failed to achieve competitiveness appeared to be crony capitalists living off public resources. This delegitimized the ruling coalition and its strategy and allowed political entrepreneurs to organize new intermediate class groups who had been left out of the growth and could now be mobilized to organize even broader groups in society. Secondly, the skewed regional pattern of growth had further delegitimizing effects. The absence of an East Pakistani capitalist class and the absence of a sufficiently autonomous ruling coalition that could develop East Pakistani economic organizations as a long-run strategy of stabilizing the polity meant that the major beneficiaries of policy-induced industrial growth were West Pakistani owned economic organizations. There were some attempts to redress the balance both by promoting some East Pakistani capitalists in the 1960s as well as using the public sector to promote industrialization in the East, but these steps were too limited relative to the scale of the problem. The economic imbalance created a ready and legitimate grievance for excluded political organizations in the East to coalesce around issues of economic and political exploitation of the East. The mobilization of political organizations in the late 1960s meant that the distribution of power across political organizations no longer approximated vulnerable authoritarianism. As this happened, authoritarian institutions could not be in operational equilibrium with this underlying distribution of power. The result was a growth of instability and violence within the political subsystem and the consequence was that the political settlement as a whole began to collapse into a broad-based crisis. As the first diagram in Figure 11 shows, the result was a collapse in the trade-off curve for the operation of all institutions including the institutions supporting extensive growth. In fact by the late 1960s the level of instability and violence had reached a point where the minimum economic and political viability conditions for system reproduction could not be met. It was out of this violence that Bangladesh was born.

### **13. The Rise and Fall of Dominant Party Authoritarianism 1972-1975**

The victory of the excluded Bengali political organizers in 1971 created a new crisis. The Awami League, which won virtually every seat in East Pakistan in the 1970 elections, was clearly for the moment a dominant party. The party had also included within its ranks the majority of political entrepreneurs and their organizations. By the time independence was achieved in December 1971, there were few significant

organizations that remained outside the broad umbrella of the party and its related organizations. The patrimonial nature of its subsequent rule was based on this inclusion of all relevant and powerful organizations directly or indirectly within the movement led by the party. In terms of our categories, the distribution of power across political organizations immediately after independence approximated that of constrained patrimonialism.

But the inclusion of so many diverse organizations under the umbrella of the nationalist movement led by the Awami League was not based on a unified ideological position on which a disciplined party had been constructed. Many if not most organizations had joined the Awami League to ensure that they were not excluded from access to power in the new political arrangement that was likely to follow after the breakdown of the authoritarian regime in Pakistan. The incentive to work under the umbrella of the Awami League was magnified after the election victory of the Awami League in 1970 and even further after the breakdown of negotiations in early 1971 that made the independence of Bangladesh inevitable. By late 1971 therefore, only political entrepreneurs who were strongly opposed to the partition of Pakistan and a few ideological parties like some Marxist factions remained outside the broad umbrella of the Awami League and its allied parties. Thus, when Bangladesh was born the ruling coalition consisted of a broad coalition of almost every politically significant organization in the country, but it was also a coalition that was particularly weak in terms of its internal discipline.

Initially, the concerned patrimonial description of the political subsystem meant that the leadership of the Awami League began to believe that they could rule indefinitely as long as the inclusive character of the dominant party could be maintained. But this inclusion was actually not based on shared political objectives but rather on the calculations of a large number of diverse organizations that their opportunities for economic and political advantage were larger within the party than outside it. The political leadership also did not have a disciplined party apparatus that was adequate for maintaining discipline in a context where significant resources were to be allocated to entirely new groups of the social structure that had previously been excluded. How would the political beneficiaries of the new system of power be selected and how would their relative claims be assessed and satisfied? It is not surprising that violence within the party steadily increased. The number of organizations and therefore political entrepreneurs within the party had vastly increased and now almost all powerful political entrepreneurs were within the ruling coalition. Given the limited rents that were available for distribution or capture, the allocation could not be settled to everyone's satisfaction.

Central party control over its own competing political organizers could not be easily established. Individuals and groups who received less than they expected threatened to leave the party and engage in opposition or violence from outside. At the same time, accommodating all individuals and groups on the terms that each thought reflected their bargaining power would add up to more resource redistribution than the economy could possibly sustain. The dissatisfaction within the party was rapidly represented in a number of ideological debates: between those who had fought or claimed to have fought in the war of liberation and those who for various reasons had not or could not, and between slightly different versions of the now dominant 'socialist' ideological consensus. Behind these debates over nationalism and socialism



was in most cases primarily a concern about who would have the power to decide or limit the allocation of rents.

An analysis of the logic of patron-client politics in developing countries can help to explain this crisis. Twice in the last fifty years in East Bengal, massive political victories were followed by the virtually immediate disintegration of the winning party. The Muslim League, which won a landslide in Bengal in 1946 and was instrumental in achieving Pakistan, fell apart in East Pakistan in a matter of months. It lost the 1954 provincial elections to the secular United Front, never to recover (M. G. Kabir 1995: 122-39). Now, once again, the Awami League had won a landslide victory in East Pakistan in 1969 and its victory was instrumental in creating another independent country but now it began to disintegrate within months of independence (M. G. Kabir 1995: 183-95). Some aspects of these disintegrations can be explained in terms of the economic logic underpinning the competition between organizations within a ruling coalition in a clientelist political settlement. The paradox of political success is that when a political organization is too successful in attracting primary organizations to join it, it faces a problem. It achieves significant holding power in contests with other organizations and can potentially win to become the ruling coalition, but in victory it finds it does not have sufficient resources to satisfy all the aspirants who have joined as faction leaders. In East Bengal in 1947, and then in East Pakistan in 1971, the problem was even more dramatic. The coincidence of communal or ethnic identities with factional ones meant that in 1947 the defeated factions preferred to leave the country and in 1971 they were forced to leave. Thus, at the same time as demands for redistribution increased, the resources that could be redistributed shrank. In 1947 the aspirations of East Pakistani political organizers were blocked by new constitutional problems and eventually the imposition of martial law. But in 1971, these aspirations broke out in an intense competition for resources that threatened to tear apart the ruling party.

The situation within the ruling coalition in 1972 was clearly unsustainable and the ruling party, the Awami League, attempted to re-assert central authority over competing political organizations by resorting to authoritarian means. Authoritarian in this context refers to the imposition from above of rules that restrict the activities or choices of political organizations. The Awami League could not impose martial law after having fought so long against it, so instead it tried to use a constitutional amendment to introduce a one-party state and a presidential system of governance that would concentrate powers in the hands of the president. The hope was that this would reduce the intensity of competition between competing political organizations and enable the president to impose discipline from above, if necessary by using repressive enforcement. In particular, the threat of leaving the dominant party and competing with it from outside was removed by requiring that all political activity had to be carried out within the party. This too was expected to reduce the bargaining power of constituent organizations within the party and to assist the president in enforcing a distribution of benefits across organizations from above.

In January 1975 the fourth amendment to the constitution was pushed through despite misgivings amongst many party members. Mujib, the leader of the liberation movement, had to threaten to resign to make his party fall into line on the vote (Karim 2005: 348). The constitutional amendment created a presidential system, with power concentrated in the hands of Mujib who became the president. The amendment also

provided for the creation of a 'national party' with the sole power to engage in political activity, and all members of parliament and the president had to belong to this party. In February all other parties were suspended and the national party launched. This was the Bangladesh Krishok Sromik Awami League (Workers and Peasants Awami League) or BAKSAL (Mascarenhas 1986: 57). The plan had the strong support of the pro-Moscow faction of the Communists as it fitted in with the blueprint of similar one-party experiments in other parts of the developing world then supported by Moscow. Socialist ideology aside, this was clearly also an attempt to reassert central control over rent allocation within a defined dominant coalition, in other words, to create a one-party version of an authoritarian ruling coalition.

The problem for the Fourth Amendment was that this institutional solution could not find an operational equilibrium with the actual distribution of power across organizations as the latter was rapidly evolving. The actual distribution of power across organizations no longer reflected a constrained patrimonial structure. This is because alternative most powerful organizations were formally within the ruling coalition; most organizations within the one-party structure did not perceive themselves to be part of the ruling coalition. The party simply did not have that kind of ideology or discipline to make organizations feel included nor could it offer most organizations the resources that would satisfy them. Many organizations within the party felt that they were excluded and indeed many were leaving all the time, which is why the constitutional change happened. In the absence of the constitutional amendment, the departure of large numbers of organizations would demonstrate that the real distribution of organizational power approximated that of competitive clientelism. The institutional change on its own did not change this fact. It simply meant that excluded organizations formally within the ruling coalition now had less power to bargain for rents *provided* the actual ruling coalition had the capacity to enforce the constitutional rule on the organizations that were dissatisfied. The authoritarianism in this arrangement was therefore not directed at excluding outside organizations but at imposing discipline on organizations that were formally within the ruling coalition. If the enforcement capability of the actual ruling coalition over the other organizations was sufficient to overcome their likely resistance, an operational equilibrium may have been possible. It soon turned out that it did not have this enforcement capacity. On the contrary, a number of individuals from the army with the collusion and support of factions within the ruling party acted to remove the top leadership of the party in an act of violence.

The events leading up to the constitutional amendment and the bloody debacle that followed demonstrate this analysis. The opposition to the constitutional amendment was, of course, not expressed in terms of the implications for the competition over rents between the constituent political organizations of the ruling party. Instead, disquiet was expressed (and some of this was undoubtedly genuine) about the possibility that this was the thin end of the wedge that would convert the country into a planned economy of the Stalinist type with its attendant authoritarian characteristics. No doubt, the pro-Moscow communists also supported the plan on the same expectation that subsequent developments would be likely to favour them. Nevertheless, the failure of this proposal to win the support of many of Mujib's key lieutenants was significant. Many people inside and outside the party saw the move as a logical culmination of steps towards an authoritarian protection of the power of the actual ruling coalition composed of Mujib and his close associates. In the absence of

well-understood and shared rules for sharing rents within the party (which a more disciplined party may have had), many political leaders and their supporters within the ruling party felt justifiably threatened.

Already by 1973, it had become clear that the rule of the dominant party could not be taken for granted and many constituent organizations were threatening to leave. As early as 1972 a significant section of the 'left-wing' of the Awami League left to form the Jatiyo Shomajtantrik Dal (the National Socialist Party), JSD on the grounds that the party was no longer socialist enough. The 1973 elections, though it resulted in a huge victory for the Awami League had revealed the vulnerability of many of the top leaders whose re-election was widely believed to have been achieved through administrative interventions in the electoral process (Karim 2005: 305-8). Many of Mujib's henchmen and relatives were already deeply unpopular for their acts of appropriation and their blatant immunity from all legal restrictions. As the opposition National Awami Party put it: 'Pakistan's 22 families have become Bangladesh's 2000' (Karim 2005: 290). They could have added that the rents of the 2000 were based entirely on expropriation and were not even remotely associated with technology acquisition or industrialization. The paramilitary Jatiyo Rakkhi Bahini (National Protection Force) or JRB was increasingly used to protect Awami Leaguers from attack and also to intimidate voters during elections (Karim 2005: 273). It was in this context that the introduction of BAKSAL and the one-party state has to be assessed.

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

Independently of the secret betrayals and conspiracies, it is clear that the plan to create a one-party state was deeply unpopular with many of the very elites that the party hoped to bring together into an authoritarian one-party ruling coalition. The viability of an authoritarian ruling coalition is only assured if any significant organizers of violence outside the party can be effectively repressed *and* lower-level coalitions within the party are sufficiently satisfied to have no incentive to rebel or can be repressed if they do. The more credible the threat of repression becomes the less likely it is that repression will have to be exercised. From the perspective of credibility, the BAKSAL experiment was demonstrably a failure. The threat to impose discipline and repress those who disagreed was in the end not credible because the underlying distribution of power across organizations already represented a competitive clientelism. There were too many powerful organizations that did not

feel they were part of the ruling coalition and they were too powerful and too numerous to be credibly repressed given the instruments of enforcement available to the actual ruling coalition.

The interesting question is why the attempt to define the ruling coalition in an inclusive way did not find broad support amongst the competing political organizations that it wished to incorporate. The likely answers to this question have important implications for understanding the organizational characteristics of clientelist political organizations in Bangladesh. The essential problem with an attempt to impose order on formal and informal rent allocation in developing countries using a one-party authoritarian structure is that there are no well-defined criteria for allocating resources across organizations of varying size and power. Political accumulation by political entrepreneurs is a dynamic process where sequential layers of political entrepreneurs are continuously emerging at all levels. One way of imagining this is to think of a multitude of patron-client political organizations with conveyor belts in each taking enterprising individuals higher up and with individuals at higher levels occasionally branching off to construct their own factions. A single authoritarian party is simply a coalition of a large number of patron-client organizations which have been brought together in a larger coalition. Attempting to define rent allocation in a coherent way in this context faces two sorts of problems.

The first problem is to determine the distribution of rents between the different factions (or constituent organizations) that are part of the ruling coalition. If each of these organizations was generating its own rents and the question was only about protecting existing rents, the problem would be a lot simpler and the ruling coalition could collectively provide third-party enforcement for its member organizations. This could happen if all factions within the ruling coalition were productive organizations or if the patrons of each faction were only extracting rents from their own clients. But if a significant part of the rents of factions are based on redistribution from elsewhere in society, each faction is targeting the same pool of resources for capture. In this case, the distribution of rents between factions cannot be guaranteed by the factions themselves. Only the supreme leader can do the arbitration of rent allocation between constituent organizations and that too only if the leader has the support of most organizations most of the time. If the distribution of rents between internal factions depends on the decisions of a supreme leader, all factional leaders have to be confident of their access to the supreme leader, and the leader has to have sufficient authority to impose decisions once taken. Clearly, a number of internal factions were already refusing to accept Mujib's decisions within a year of independence and some had already left to oppose and unseat the ruling coalition. Mujib's decision that a one-party system using the authoritarianism of a constitutional amendment could force all these factions back to the fold and force them to accept the rent allocations he offered was a significant gamble. It would only work if most organizations accepted the rent allocation that was offered, in other words, if most organizations were actually part of the ruling coalition. In that case repression would only be required against a minority of organizations outside the ruling coalition, and in the case of constrained patrimonialism, the excluded organizations are of negligible strength. Unfortunately, in the case of Mujib's constitutional experiment many if not most of the organizations formally within the ruling party were unlikely to accept rent allocation from above

and were also sufficiently strong to resist the repression that was available to the ruling coalition.

The second problem for a dominant party is to define the limits of the ruling coalition. In the South Asian context, the number of political organizers who believe they have enough disruptive capacity to deserve inclusion within the ruling coalition and claim a share of political rents is potentially vast. It may have appeared for a moment after the victory of 1971 that all political organizers in Bangladesh were united in one party, but this was an optical illusion. The more organizers the ruling coalition accommodated, the smaller the rents for each organizer. The problem for well-defined ruling coalition as in a one-party state is that it defines insiders and outsiders clearly. Not only is the group of insiders too large as discussed earlier, the outsiders, however defined also have strong incentives to unite against insiders. Successful one-party authoritarian regimes usually have some special features that allow them to keep insiders in, outsiders out, and to absorb outsiders at a manageable rate. For instance, they could have significant natural resource rents that could be used to finance an acceptable distribution of rents for major factions and a credible control of violence at the centre. Some oil rich one-party states provide examples of this variant. Still, the calibration of the frontiers of the party is critical to ensure that the available force is sufficient to deal with potential dissent. Of course, the combination of force and rents required to make a one-party system of this type viable is not defined in absolute terms, but rather in relation to the strength of potential organizations (within and outside the ruling coalition) who demand rents based on their relative power.

The danger of using rents to construct a large single party ruling coalition is that the ruling coalition has to have access to significant rents and the rent allocation is likely to be unproductive. Dominant party states often suffer from this constraint, as well as the constraint that they may be unable to re-allocate rents within the economy that are protected by powerful constituent organizations of the ruling coalition. However, these constraints are not always binding. A possible variant of a one-party ruling coalition that can overcome some of these problems is a disciplined authoritarian party that does not immediately offer significant rents to leaders and organizations lower down the organizational chain, but does offer credible career paths for individual party members to move up the pyramid. The credibility of such a party to offer future rents to individuals implies that it has a developmental strategy that can provide steadily growing rents over time. This may be credible strategy for keeping lower-level clients disciplined if the party is well-organized party and has a credible developmental strategy. Contemporary China provides an illustration of a one-party ruling coalition that does not immediately have to allocate so many rents to its internal supporters that the overall social rent allocation is destructive. On the contrary, the disciplined control over rent allocation at the social level allows the Chinese Communist Party to play a significant developmental role. In contrast, Mujib's party had neither the natural resource rents nor a disciplined party hierarchy running a credible development strategy. Indeed, the party did not even control the army, as Mujib's assassins were dissident young officers who operated with the knowledge of factions within the Awami League.

The relationship of the evolving ruling coalition with economic organizations during this period is also interesting. Most Bengali economic organizations were of low capabilities but the few high-capability Bengali economic organizations were not seen

as allies of the regime in its attempt to achieve economic viability. This is partly because the departure of Pakistani capitalists left behind significant abandoned assets like major factories and these offered significant rent opportunities for the ruling coalition. These assets had to be nationalized by the state because there were no obvious Bengali entrepreneurs who could take them over and even if there were, it would be very disruptive to allocate them to private owners after a long fight against economic exploitation. The nationalizations increased the state's share in modern industry from 34 to 81 per cent. But even this was not enough for the new ruling coalition. The Presidential Order of March 1972 brought the few high-capability Bengali-owned economic organizations in the jute, cotton and sugar sectors into public ownership raising the public sector's share to 92 per cent with a corresponding increase in the rents the state could allocate to its supporters (Sobhan and Ahmad 1980: Table 10.1; K. A. S. Murshid and Sobhan 1987: 3-4). Why this was done has been much debated. To some extent ideology played a part, but more prosaically, nationalization brought more rents under the control of the state which needed rents to keep its fractious coalitions together.

The quality and capabilities of bureaucratic organizations also suffered a significant decline during and after the war. The top echelons of the civil service during the Pakistan period was staffed by an elitist group of mandarins selected by examination. They constituted the Civil Service of Pakistan, the CSP. Very few Bengalis found positions in this elite service and the CSP were generally perceived to be antagonistic to the interests of East Pakistan. The new state opened up employment in the civil service on much easier terms to a new swathe of aspirants, frequently accommodating political clients of the ruling coalition on an informal basis. Employment in the public services witnessed a dramatic expansion at a time when the examination process was in any case informally weakened to ensure the admission of particular individuals and groups. At the time of liberation in 1971, there were 450,000 employees of all grades in the public services, of which only 320 were officers at the level of Joint Secretary or above. By 1973 total employment in the public services had increased to over 650,000, with officers in the higher grades increasing to 660 (World Bank 1984: 109). Some of this growth was due to the change in coverage from the inclusion of new industrial units within the public sector which brought their administrative staff within the ambit of the public services. But the number of white collar staff in Bangladesh's small industrial sector would only account for a fraction of the increase. The informal institutional modification that allowed examinations to be 'fixed' so that clients of the ruling party could achieve easy entry into the civil service proved to be a very difficult informal institution to alter. It achieved a rapid operational equilibrium with the actual distribution of power in the political subsystem because the ruling coalition needed clients in the bureaucratic organizations and had the political power to ensure that these clients could be rapidly created. It is a problem that continues to affect attempts to improve the capabilities of bureaucratic organizations.

The rent and resource capture during this period can be described as intense primitive accumulation. The most important economic organizations that were politically connected and benefited from rent allocation were set up by low capability new entrepreneurs who were closely connected to political organizations. A new class of entrepreneurs rapidly began to emerge rapidly bypassing the handful of older Bengali capitalists who had emerged during the Pakistani period, and whose assets were now nationalized. Interestingly, the new accumulators rapidly went beyond primitive

accumulation and wanted to change the limits of the 'socialist' policy framework that restricted private investment. Pressure from this group had already resulted in a revision of the government's socialist industrial policy. They demanded the legalization of property rights over their potential investments. They would no doubt still prefer to have some types of rents to assist their investments but no longer supported the destructive rent capture of other primitive accumulators. Under pressure from this group in 1974 the ceiling on private investment was increased from two and a half million to thirty million takas. Partnerships with foreign private investors were allowed, and the moratorium on nationalization was increased from ten to fifteen years. These emerging capitalists were not at all excited at the prospect of a 'socialist' one-party state which could reverse these changes.

Nurul Islam, an economist in the Planning Commission at that time describes some of the processes of asset and rent capture: "By 1974 there were a number of factors which had contributed to an accumulation of surplus funds in private hands. For one thing, high profits were earned in domestic and import trading activities, including illegal trade such as trade in contraband goods and in smuggling jute and other exportables across the border. Since these transactions were illegal, the risk premium was high and hence profits, once realised, were high. In addition, many residential buildings and trading or commercial enterprises, abandoned by Pakistanis, were illegally occupied by private persons. The 'caretakers' of such commercial enterprises, hastily appointed by the government in 1972 immediately after independence, made large fortunes through the undeclared sale of assets. Moreover, there were gains to be obtained from rental or sales proceeds of the abandoned houses which were illegally occupied by private persons. Those who had accumulated financial resources were pressing the government to commit itself to a more substantial and permanent role for private enterprise in the economy of Bangladesh" (Islam 1979: 225-6).

The anarchic process of rent capture during this period had the expected negative effects on economic performance. An assessment of 1970-1975 is difficult because of the very real disruptions caused by the war, and the short life of the regime. Productivity in manufacturing was on average less than 50% of the level reached in 1970 and real wages in manufacturing, around 60% of their 1969/70 level (World Bank 1978: Vol. II Annex I.6 p. 173, 1984: Vol. II Table 9.12 p. 118). In addition, in 1974 Bangladesh suffered from a serious famine that took place without any significant decline in aggregate food availability (Sen 1983). The causes were largely state failure in managing distribution and ensuring purchasing power in a context of hoarding and smuggling. More than a million people died in the famine, which according to some estimates was probably more than in the war of liberation (Sen 1983: 134-41; Karim 2005: 335-40). When finally an attempt was made to rein in the unproductive rents through a 'Second Revolution' (the one-party state) many factions within and outside the dominant party had no faith that this would be in their interest. Mujib's assassination ended this experiment.

Overall, however, the types of rents that political organizations were creating in Bangladesh during this period were largely unproductive and purely redistributive rents. The vulnerability of the economy was both a cause and a consequence of the fact that the rents generated by the political process were almost entirely value-reducing (Umar 1980; Ahmed 1986: 27). Formal institutions had collapsed to the

point that informal rent capture was not simply sharing the returns created by productive activities but were in many cases simply asset capture and the creation of monopoly rents through different types of restrictions, over-invoicing opportunities and so on. Faction leaders were involved in grabbing abandoned assets, appropriating public resources through the creation of excess employment, making excessive margins on construction contracts, import contracts, and so on (Islam 1979: 225-6). These rents were zero-sum at best and had no positive effect on productive investments. In fact, they were mostly value-reducing. Major targets of appropriation were the assets of departing Pakistanis and of groups who could be associated with them, such as the (non-Bengali) Biharis. But assets of Bangladeshis were also targeted as were the assets of many Hindus (who had never been supporters of Pakistan) (Karim 2005: 283-90).

Figure 12 summarizes the poor enforcement prospects of growth-enhancing institutions in the context of the collapsing political settlement from 1972 to 1975. The period began with constrained patrimonialism in the political subsystem in the immediate aftermath of independence. The Awami League and its allied political organizations dominated the political subsystem. This allowed for a time an operational equilibrium with democratic political institutions as the latter still ensured the political dominance of the Awami League. However, the internal fragmentation of the Awami League began to lead to the departure of disgruntled organizations from within the Awami League. This began to transform the political subsystem into a competitive clientelist one. The consequence was both a threat for the continuing dominance of the dominant party under the existing institutional rules as well as a worsening trade-off for growth institutions. In particular, the intensification of the competition for rents and of primitive accumulation led to more extensive informal modifications of formal institutions and worsening growth prospects.

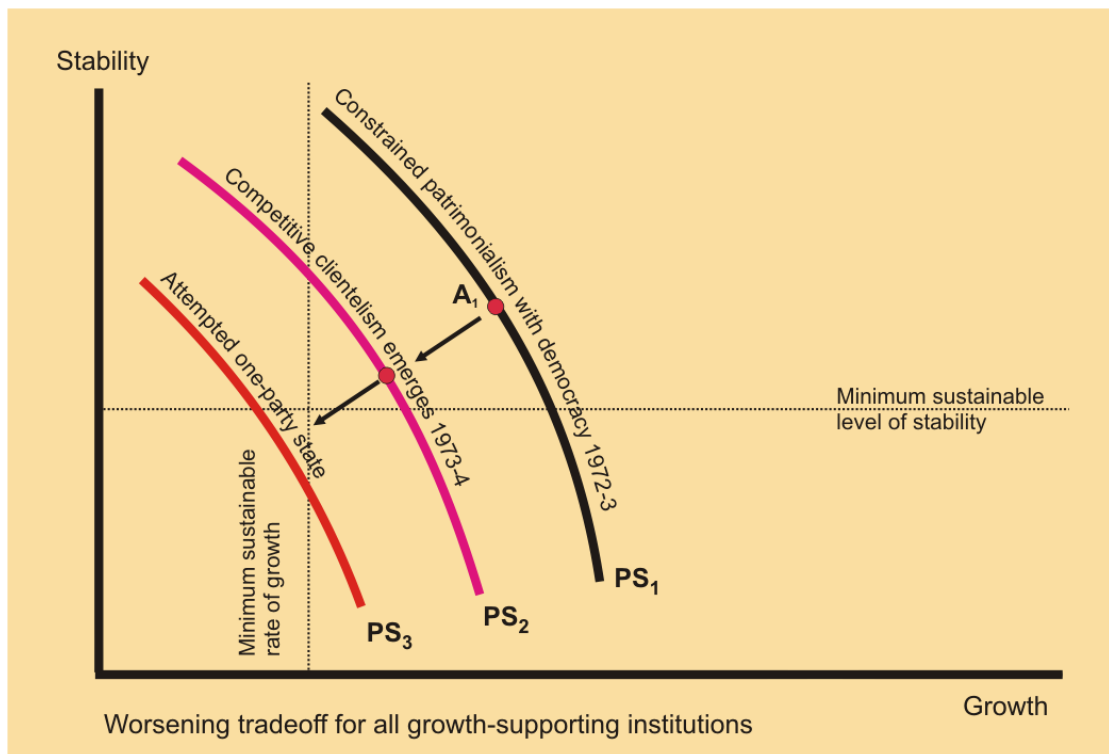


Figure 12 The Dominant Party 1972-5



It was in this context that the Awami League leadership attempted to reinforce its patrimonial claim by changing the institutional rules in the political subsystem to set up the one-party state. However, given the competitive clientelist distribution of power this simply further increased instability and contestation. The incompatibility of these institutional rules with the underlying distribution of power across organizations was the source of a sharp increase in potential violence and a deeper economic crisis. This is shown in Figure 12 as a collapse of the political settlement. With enough instability in politics, the minimum economic and political viability conditions of the system are unlikely to be met. The political settlement effectively collapses under these conditions and some type of discontinuous adjustment is likely to happen. In 1975 this took the form of a revolt by young army officers that wiped out the top leadership of the Awami League.

Some aspects of the emerging crisis in Bangladesh in the early 1970s were unavoidable. The economy had been severely disrupted by war and conflict. The bureaucratic organizations of the state had been thoroughly disrupted as a result of politicization and the departure of West Pakistani personnel. It is unlikely that even a limited developmental strategy could have been properly implemented even in the absence of any organizational resistance. In addition, the hunger of excluded political entrepreneurs and their organizations should not be underestimated and it would be unrealistic to assume that any political leadership could have fully contained the primitive accumulation that was unleashed. The failure of the Awami League leadership to stay on top and manage this social eruption therefore has to be placed in context. But the leadership and its policy advisors also appeared to be entirely unaware of the processes that were going on and took no steps that could ameliorate some of what was happening. On the contrary, some of their steps, like nationalizing Bengali-owned economic organizations, trying to develop 'socialism' defined as public ownership and job creation in a crushingly poor economy, repressing political competition and finally attempting to set up a one-party state against the grain of the evolving distribution of organizational power were a series of avoidable mistakes that contributed to make the problems much worse than they need have been.

#### **14. The Transition Period of Clientelistic Authoritarianism 1975-1990**

The violent end of the first Awami League regime was followed by a period of political turbulence. The distribution of organizational power in the political subsystem now approximated competitive clientelism as a number of competing and powerful patron-client organizations had emerged and none could be excluded for long by any institutional arrangements that strictly attempted to enforce exclusion. At the same time the institutional arrangements for organizing a democratic contest between these organizations could not immediately emerge given the context of violence and the absence of any shared conception of rules of the game to regulate such a contest. A gradual transition towards such an institutional structure did however take place, ironically under military leaderships. The transition period was marked by the creation of first one and then a second alternative party to the Awami League based on the principle of clientelist inclusion of powerful organizers under a dominant leader, initially from the army. Formal multi-party competition was introduced under these parties. While it was clear that informal power would make the ruling party undefeatable, political competition established the relative power of

competing political entrepreneurs and their organizations in a way that they could bargain for inclusion into the ruling party. These principles of inclusion into clientelist political parties based on terms determined by the holding power demonstrated by constituent organizations in turn established the informal rules for the organization of competing clientelist political parties, which in turn enabled the transition to democratic competition under competitive clientelism after 1990.

The re-establishment of a greater degree of political stability took time. The entry of the armed forces into the political arena with significantly greater violence potential compared to the contesting political organizations did impose a truce on the deteriorating law and order situation in the political subsystem. However, initially the violence simply shifted within the army as competing officers vied to establish their leadership within the armed forces which had themselves been politicized by the war of liberation. Mujib's assassination was thus followed by a series of bloody coups and counter-coups led by competing officers and supported by their informal organizations within the army and supporters outside. It was only in November 1975 that General Zia-ur-Rahman, the army chief appointed by Mujib, emerged as the supreme leader. But the military leadership knew by now that neither the authoritarian model of the Pakistan period based on the exclusion of all autonomously powerful intermediate class organizers nor the authoritarian one-party model of Mujib that attempted forced inclusion under centrally determined terms would work in Bangladesh. General Zia was a decorated freedom fighter and enjoyed wide popularity. When he formally became president in 1977 he took care to construct a strong constituency of supporters for his rule by moving swiftly to construct a political party that eventually became the Bangladesh Nationalist Party (BNP). It remains one of the two dominant parties in contemporary Bangladesh. The new strategy for constructing the ruling coalition had a number of important features distinct from earlier phases.

First, the terms on which individual coalition leaders joined the ruling coalition were individually bargained. The terms were effectively to offer inclusion on terms that were proportional to the holding power of the organization that the political entrepreneur could bring into the ruling coalition. The national leader wanted to incorporate the largest number of the most important organizers and their political organizations at the lowest price in terms of the rents that they demanded. A broad ideology of development and nationalism allowed organizers from the far left to the far right to seek terms for entry. The price they could extract in terms of their access to future rents depended on their proven organizational capabilities and therefore the significance of their departure for weakening their erstwhile parties. As alternative parties were no longer banned, organizers had the chance of proving their abilities outside the BNP before negotiating incorporation. Opposition parties were allowed to set up, operate and contest elections. The only (informal) limitation was that the top job was not up for grabs because the dominant party was unlikely to be defeated given its control over the administration. This informal administrative restriction is nevertheless sufficient to define the ruling coalition as authoritarian, even though multi-party democracy was formally reintroduced with the repeal of the fourth amendment that created the one-party state.

Secondly, no attempt was made to define *ex ante* the boundaries of the ruling coalition. The regime maintained the right to calibrate the size of the ruling coalition

through a competitive process of assessment and negotiation. This too ensured that excluded elites had an expectation that they may be included on appropriate terms in the future if they played according to the rules of the game. The combination of these two characteristics ensured that the minimum required rents were competitively allocated to the most important political organizers. Implicitly, this party formation process identified and established the most important principles for constructing effective political organizations in a clientelist political settlement. The coalition that could put together the greatest number of powerful organizations within a feasible 'budget' in terms of rent allocation to client organizations would actually be the most effective coalition to govern within the constraints of maintaining political stability. The transition to a multi-party democracy in a clientelist political settlement could not happen till the principles for constructing a plurality of effective clientelist parties had been established.

Finally, economic viability required that the cost of constructing a coalition that could viably rule should not be too high. This meant that at the same time as encouraging political organizers to reveal their holding power and their terms for inclusion, it was also necessary to check their ambitions by encouraging countervailing political organizations. Both Zia, and General Ershad who succeeded him, attempted to check the claims of established political organizers by creating new rural voices through 'decentralization'. These strategies were quite similar to the Basic Democracy strategy of the Pakistani period, but now they were a complementary part of a broader strategy of competitive party formation and not part of a strategy that sought to permanently exclude established political organizations. Even so, these strategies, particularly Ershad's attempt to create a new class of political representatives in the newly created 'upazillas' (a tier of government constituting a small number of villages), was strongly opposed by urban political organizers. They had a limited effect in enhancing overall political stability, and the attempt to force these strategies of decentralization through possibly had a negative effect on political stability during the Ershad period.

The period as a whole remained one of considerable instability even though the extreme instability of the early years of independence gradually declined. Violence continued for a while, particularly within the army, where coups were frequently attempted. Nevertheless, some signs of a viable political settlement began to emerge and these elements would be built on in the fourth phase. First, the strategy of ensuring entry to political organizers through individual negotiations to determine the 'price' that was demanded in terms of access to rents proved to be a viable strategy for constructing parties as coalitions of organizations. It remains the strategy through which competing political parties in the fourth 'democratic' phase continue to construct coalitions to form governments. By its nature, a ruling coalition put together in this way is likely to be turbulent with constant internal renegotiations and infighting. Violence is likely to sometimes break out, both within the ruling coalition and against factions currently out of power. But in the absence of a better method of determining the distribution of rents for constructing a ruling coalition, this has emerged as the operative default mode for constructing coalitions during the democratic period.

Second, the openness of the boundaries defining the ruling coalition has proved to be extremely useful in managing the perpetual entry of new aspirants into the ruling

coalition and the orderly departure of those who are dissatisfied. The 'clientelistic authoritarian' period allowed new entry into the ruling coalition even if not to the top job. This restriction would of course eventually prove to be unsustainable in a competitive clientelist political structure because eventually a coalition of organizations could hope to challenge it. On the one hand the restriction created strong incentives for ambitious officers within the army to try to violently replace the supreme leader. There were frequent coup attempts against General Zia who was eventually killed in a coup in 1981. On the other hand, the effectively indefinite reservation of the top job for a single individual also resulted in strong opposition from ambitious civilian political organizers from other parties. The futility of elections to replace the top leader became apparent under General Ershad and resulted in a growing mobilization against him. As the BNP (Zia's party) was now in opposition, this mobilization brought together the BNP with Mujib's Awami League against the Jatiya (National) Party that Ershad had created. From 1987 onwards the country was under almost perpetual political instability with street demonstrations, strikes and frequent *hartals* when the excluded political organizations prevented movement on the streets of big cities including the capital. Ershad was overthrown in 1990 by a popular uprising when the army refused to continue to support him if it meant shooting at thousands of demonstrators. The return to 'democracy' kept intact many features of the system that had been established during the clientelistic authoritarian period. The major change was that not only the membership but also the leadership of the ruling coalition was now contestable in a competitive multi-party system. Both would now be determined through competitive demonstrations of relative organizational power.

The transition period also saw a significant change in the capabilities and strategies of economic organizations. The most predatory types of primitive accumulation began to die down after most abandoned assets were appropriated. The beneficiaries of the primitive accumulation and the older capitalists gradually regrouped during this period and established political connections with factions within the ruling parties. As many of the new 'capitalists' were direct beneficiaries of political accumulation, they were closely networked into existing factional structures. While primitive accumulation continued but economic organizations that had accumulated enough now began to invest in capability development and to learn the use of new technologies that would allow them to achieve global competitiveness. The breakdown of full-fledged authoritarianism as well as of dominant party authoritarianism was beneficial for this process in a number of respects.

First, the breakdown of a single hierarchical political structure, whether based on military authoritarian or a dominant party, created more room for manoeuvre for political leaders and economic organizations. In hierarchical political systems where political and economic organizations that matter have a well-defined place in the hierarchy it is often more difficult to change the allocation of subsidies and benefits because the true holding power of inefficient economic organizations (and therefore the political cost of re-allocating resources) is difficult to determine without significant political disruption. Relatively weak organizations can continue to claim resources and block change because most organizations have an interest in maintaining the status quo and threatened organizations can find many allies if their interests are threatened. In addition, the Awami League's dominant party system formally subscribed to the ideology of 'socialism' which made it easy for opponents

of any change in the direction of greater efficiency to present the restructuring as a threat to jobs or a move in the direction of capitalism. The breakdown of the centralized political hierarchy allowed the ruling coalition to pick and choose organizations for support with a greater degree of freedom. In this context, gradual and slow moves towards privatizations began in the late 1970s, as well as policies targeted to support private sector investments in emerging sectors like garments.

Secondly, from the perspective of economic organizations, maintaining their relative position within a centralized political hierarchy of rent allocation became less relevant and this increased the incentive for investments in achieving competitiveness. However, the achievement of competitiveness was only feasible for economic organizations that were relatively close to the frontier because the competitive clientelist distribution of power meant that long-term sustained support from the political system was an unrealistic expectation. Economic organizations could expect to make relatively short-term alliances with political organizations to create and share rents, and if they were relatively close to the competitiveness frontier, it could be a feasible strategy to use these rents to achieve global competitiveness and seek profits in the marketplace. As Bangladeshi economic organizations were of relatively low capability in terms of their technological and entrepreneurial expertise, an economic takeoff could only happen if relatively low technology sectors became available for investment and if rents could be created to support learning and technology acquisition in these areas. Fortunately for Bangladesh, precisely such a conjuncture opened up in the 1980s with the opportunities for investment in the garments industry.

However, business-government links that drive productivity growth to achieve competitiveness are only likely to work if economic organizations are within striking distance of achieving competitiveness and the time scale for which they can feasibly rely on policy-induced rents (given the short-term nature of political commitment in a competitive clientelist polity) is sufficient for them to attempt to achieve competitiveness. Given the initial capabilities of Bangladeshi economic organizations in the 1980s and the types of policy-induced rents that could be created, this was a credible and profitable strategy of rent-creation for sectors like the garments sector. Once such sectors achieve competitiveness, they do not need the support of rents to finance their learning. Thus, when sectors and firms close to the frontier achieve competitiveness, the ones that are left are likely to be further and further away from the competitiveness frontier. Business-government links with economic organizations that are far from the frontier are unlikely to result in favourable outcomes in a competitive clientelist political context. Political organizations are willing to pursue policies that create rents for economic organizations because they need the kickbacks that economic organizations can then provide. But economic organizations that are far from the frontier are unlikely to be able to use rents for productive purposes to achieve market-based profitability. In these contexts, business-government links are likely to result in many types of unproductive rent creation and rent capture that do not add to social productivity. The garments industry takeoff outweighed unproductive rent creation for a while but after the easy low technology sectors had been developed, rent creation under competitive clientelism could not in general create many new competitive economic sectors. This challenge became more severe in the democratic phase that we discuss later.

Finally, the rapid decline in the capabilities of bureaucratic organizations that had happened as a result of the ravages of the war and the subsequent politicization of the bureaucracy and their involvement in primitive accumulation were to some extent stopped and even reversed during this period. To some extent this was driven by the exhaustion of very significant rent capture opportunities as time went on. For instance, abandoned Pakistani assets and industries were eventually allocated and after almost everything had been nationalized it became clear that the next movement would be in the direction of privatization. The entry of personnel from the armed forces into leadership positions within the administration also introduced a semblance of discipline for a time, though the armed forces personnel often became incorporated into the political rent creation and rent capture processes. Finally, the return of political stability allowed normal processes of recruitment and capacity-building within bureaucratic organizations to be resumed.

An important change compared to the Pakistan period was that rents were no longer created or defended on the basis of general policies of development. The state stopped trying to create or allocate rents as part of an explicit formal industrial policy to develop infant industries. At best some general subsidies were temporarily justified on welfare grounds, for instance to safeguard employment in public sector enterprises that were recognized as inefficient. Market failure justifications for infant industry protection or technology acquisition almost disappeared. This was partly because of the memory of the political fight against the statist pro-capitalist policy of Pakistan and against the statist ‘socialism’ of the Awami League, and partly because international economic opinion informing policy in Bangladesh had also changed radically in the 1980s. Not surprisingly, Zia was an advocate of privatization. The rents that public sector industries and some of the newly privatized industries continued to receive was because the state was too weak to remove these rents from powerful organizations, not because the ruling coalition believed that this would accelerate the modernization of the economy.

However, sector-specific and firm-specific rents did not disappear and indeed were unlikely to disappear given the political and economic requirements of organizations in a developing country. A more open and competitive economic and political environment meant that individual capitalists were free to link up with the leaders of political organizations to identify mutually beneficial strategies. An excellent example of this was the policy support that was made available to the garment industry, which played a critical role in ensuring its takeoff. The achievement of competitiveness in this sector required a critical set of international rents and domestic rents based on institutional innovations that Zia undertook in order to support the sector (Khan 2008b, 2009b). The characteristics of the new political settlement, in particular the breakdown of a centralized political structure allowed the rapid introduction of these vital institutional innovations like the back-to-back LC and the bonded warehouse system without strong opposition being fielded by organizations who may have wished that the status quo should be maintained and protected.

The change in the political subsystem also allowed a gradual movement towards privatizations that in turn changed the characteristics of economic organizations over time. The process began very early in General Zia’s tenure. Between 1976 and 1983, a total of 217 public sector enterprises were wholly or partly sold to the private sector or returned to their former Bengali owners from whom they had been nationalized

without compensation in the aftermath of liberation. However, significant denationalizations only began under the regime of General Ershad. Under the New Industrial Policy adopted in 1982, denationalizations of large-scale public enterprises were given priority. Privatization faced substantial political opposition, particularly from the trade unions of white collar workers who benefited most from the over-employment in the public sector (Bhaskar and Khan 1995). Although white collar workers were potentially very powerful and were part of the intermediate classes that provided the political entrepreneurs who led all political organizations, the fragmentation of political organizations had significantly reduced their ability to organize concerted opposition to economic changes. The government was able to divest 110 large units in little more than a year, including jute mills that had previously been owned by Bengalis, after which the programme continued at a slower pace (World Bank 1984: 149).

The privatizations initially had a very limited economic impact on the economy. The large-scale enterprises that had been created under the Pakistani industrial policy of the sixties had never achieved full global competitiveness. After they were nationalized in the seventies they built up vast additional liabilities because of over-employment, looting and mismanagement. This did nothing to help their future viability when they were gradually privatized in the eighties. The new owners took over the liabilities as well, wrongly believing that political arrangements could be worked out to sustain subsidies into the future. Some of the privatized firms limped on and were lucky to become moderately profitable. Many eventually closed down, particularly in the jute and cotton textile sectors. However, the privatizations began to reduce the unproductive rent allocations that the permanent losses of these industries represented, freeing up the state to engage in the ad hoc and sector-specific policy support that had a greater chance of supporting growth in a few sectors.

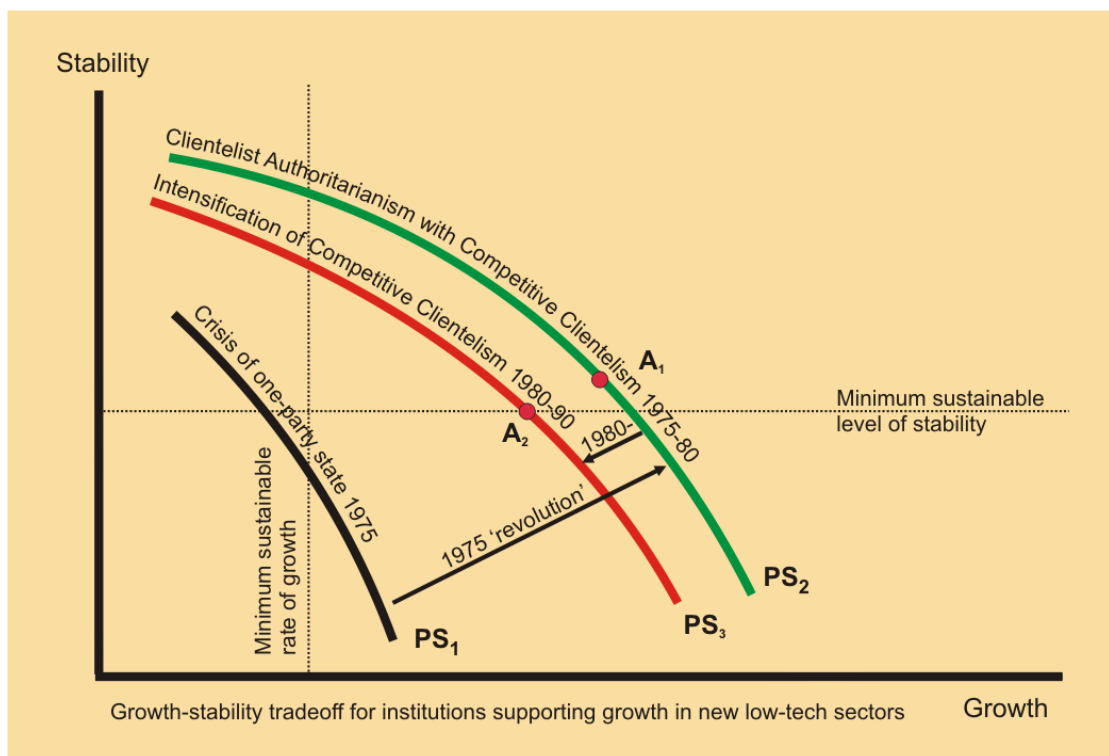


Figure 13 Growth led by new sectors under clientelistic authoritarianism

The growth takeoff under clientelistic authoritarianism was based on new low-technology sectors where the political settlement created the space for new ad hoc institutions and policies of support that could be implemented in growth-enhancing ways. This is shown in Figure 13. The institutions that could be implemented could only provide limited support but this was sufficient in the case of a number of low-technology sectors, in particular garments. Here, the assistance for learning new technological capabilities was significantly assisted by the existence of globally generated MFA rents, which allowed disciplined learning in the garments sector. The political settlement was thus much more promising for growth than before, and for the first time a Bengali-owned capitalist sector began to grow. This is reflected in the growth figures for manufacturing and industry in the 1980, as shown in Table 1. The growth-stability trade-off was favourable for the support and promotion of a limited range of formal institutions supporting specific accumulation strategies. Examples include the rapid implementation of changes in banking laws and customs rules that provided targeted assistance to growth sectors. In a break with the authoritarian military period, there was also a new consensus that policy should not support general industrialization strategies like import-substituting industrialization or general support for exports. There was no general policy that sought to use rents to create more sophisticated organizations or to absorb more sophisticated technologies. Rather, the focus of rent allocation was much more about the management of political stability. However, sector-specific and firm-specific policies did emerge on an ad hoc basis that implicitly created rents for businesses and sectors that were close to the technology frontier and the growth dividends they offered were attractive to political organizations and the political leadership.

At the level of politics, the clientelistic authoritarian period established that brute force to enforce restrictive political rules could not be used to stay in power. The ruling coalition needed to incorporate significant numbers of political organizers. But it could not absorb all potential organizers either. In other words, neither the authoritarianism of the Pakistan period nor that of the Awami League one-party state was judged to be feasible in Bangladesh. The actual practice of the clientelistic military rule established the norm that political stability has to be based on a competitive system of rent allocation to allow the most important political organizers and their organizations to be brought into the ruling coalition at the cheapest price. The links of the supreme leader with the army meant that this position was not available for re-allocation. Competing political organizations could at best expect some of their most important organizers to be incorporated into the ruling coalition on attractive terms. This arrangement provided political stability for a while but eventually the major political parties united to reject an arrangement that deprived them of access to the most significant political job. The growing strength of excluded political organizations can be represented as an intensification of competitive clientelism to a point that the operational equilibrium with clientelist authoritarianism was no longer feasible. By the late 1980s there was a significant increase in political instability, regular strikes and *hartals*. The much more significant political instability in the latter half of the 1980s had significant effects for the enforcement of growth-enhancing institutions, and this too is shown in Figure 13. Eventually General Ershad was overthrown in a mass uprising in December 1990.



## 15. Vulnerable Democracy 1990-

The overthrow of Ershad and the holding of elections under a caretaker government converted the authoritarian clientelistic system into a (weakly) institutionalized democratic one. By now the distribution of power between political organizations described by competitive clientelism had reached a degree of intensity that it could not be in any equilibrium with political institutions that permanently excluded any set of political organizations. The ruling coalition could only achieve stability if it accepted the right of excluded organizations to replace them in power through the democratic process. The problem (in all developing countries) is that the formal institutions of democracy (like any other formal institutions) cannot be fully enforced in a clientelist political settlement. There are bound to be informal modifications of formal rules that powerful political organizations can be expected to make, so there also have to be informal limits to these modifications to ensure that excluded political organizations do not engage in excessive violence because they perceive that state power will be used to exclude them from power. Democracy in Bangladesh remained vulnerable because these complex informal rules did not fully emerge more than two decades after the fall of Ershad. The ruling party periodically attempted to fix the formal and informal rules in a way that would perpetuate their power, in effect attempting to revert back to clientelist authoritarianism as an institutional system under the guise of formal democracy. But every time the result was an outbreak of intense political instability that inevitably led to the replacement of the party in power with an opposing coalition in the next election. Yet, even as late as 2011, the major parties did not appear to have learnt the futility of trying to modify institutional rules of political competition to their advantage in ways that would not be accepted by excluded political organizations.

Economic organizations were by now relatively developed, not only in the garments and textile sector, but in a range of medium-technology manufacturing sectors. Industry overtook agriculture in terms of share of GNP in the 2000s (Table 2). Some leaders of industry were by now rather well-organized and closely networked with political parties, often keeping good relationships with more than one, as parties regularly cycled in and out of power. Collective organizations like chambers of commerce and industry played a part in engaging in the policy process though their formal influence was often far less than the informal access that they sometimes enjoyed depending on the individuals and organizations involved. The Federation of Bangladesh Chambers of Commerce and Industry (FBCCI) played an important role in the political crisis of 1996. The ruling Bangladesh Nationalist Party (BNP) held an election in which the major opposition parties including the Awami League refused to participate. They had demanded a continuation of the caretaker system where a neutral bureaucratic interim government conducts the elections after the term of a sitting government ends. The boycott of the opposition ensured that the first 1996 elections lacked legitimacy.

If the opposition alone had to dislodge the ruling coalition the process may have been protracted and violent. The FBCCI along with a number of other business and professional organizations took the stand that a caretaker system had to be introduced and their open declaration assisted in the rapid introduction of the thirteenth amendment that made the caretaker system mandatory. Ironically, the Awami League that had successfully demanded the caretaker system (and won the 1996 elections under it) felt that it could get rid of the system when *it* was in power. This it did in the

fifteenth amendment of 2011, pushing the country into a new electoral crisis as the opposition BNP immediately made it clear it would not contest the 2013 elections if the caretaker system was not reinstated.

But while the capabilities of some economic organizations were by now fairly sophisticated, the evolution of the political settlement had some adverse implications for industrial policy, infrastructure development and general governance. Competitive clientelism with vulnerable institutions of democracy has, *ceteris paribus*, a relatively adverse growth-stability trade-off for many institutions supporting long-run growth. This is both because the permanent presence of significant excluded factions that are always building up their oppositional strength serves to reduce the time horizons of incumbents and focuses their minds on making quick money to fight the next election. In addition, the competitive context increases the power of lower-level factions within the ruling coalition and makes policy implementation difficult and the enforcement of formal institutions relatively poor. Strong operational equilibria with developmental institutions without significantly damaging informal adjustments are only likely if the institutions a) create enough rents for political organizations for the enforcement of these institutions to be attractive and b) at the same time the institutions create enough rents to create opportunities for learning and investment but not so much that the incentives for learning and investment are destroyed. This combination of conditions is not likely to be satisfied for many sectors, but was satisfied in a few. In Bangladesh these were typically low technology sectors like garments and in these sectors the growth-stability trade-off for growth-enhancing institutions was relatively promising.

On the other hand, institutions required for supporting long-term investments are not likely to provide significant rents to political organizations with short time horizons. As a result, these powerful organizations are likely to make informal modifications to these institutions to extract short-term benefits in ways that are likely to damage the growth supporting aspects of these institutions. Overcoming these informal modifications and enforcing growth-supporting institutions in these contexts is therefore likely to face a significant stability cost, implying adverse growth-stability trade-offs. This is a paradoxical result for many good governance policy recommendations where the assumption is that the introduction of democratic institutions will make it easier to enforce growth-enhancing institutions. In reality, institutions like those supporting industrial policy or infrastructure development are likely to face adverse growth-stability trade-offs in developing countries with vulnerable democracies.

However, this analysis does not necessarily imply that authoritarian political institutions will achieve better growth-stability trade-offs for growth-supporting institutions. Apart from being desirable for itself democracy in developing countries may allow better economic outcomes if we set up the counterfactual properly. If the underlying distribution of power across political organizations resembles a fragmented competitive clientelism with intense competition, the vulnerable institutions of democracy may offer a more stable operational equilibrium in the political subsystem compared to the alternative of authoritarianism or even clientelistic authoritarianism. The latter may result in a weak and contested operational equilibrium in the political subsystem characterized by significant political instability and violence. The instability can directly reduce time horizons across the system so that growth-stability trade-offs for important productive

institutions may be even more adverse than if vulnerable democracy had been introduced. In other words, from a purely economic perspective, authoritarianism or clientelistic authoritarianism can only result in more favourable growth-stability trade-offs if the underlying distribution of power is, or can be changed to become, a patrimonial one (whether constrained or vulnerable). This is why the transition to democracy in Bangladesh in 1990 was marked by reduced political instability and an improvement in the growth-stability trade-off in a few sectors.

Figure 14 shows the changes in the prospects of sectors where growth-supporting institutions were potentially feasible in a context of competitive clientelism. The growth-stability trade-off even for potentially effective institutions had become adverse by 1990 and is shown as PS<sub>1</sub>. The growing operational disequilibrium between the institutions of clientelistic authoritarianism and intensifying competitive clientelism created a crisis in the political subsystem. The sustained political instability of the late 1980s affected the operation of all institutions including potentially growth-supporting ones and the trade-off curve for these institutions became adverse. The growth that could be sustained by potentially effective institutions declined to a position like A<sub>1</sub>. The democratic revolution of 1990 introduced political institutions that were democratic compared to clientelistic authoritarianism because now the top political job became contestable and it became credible for an opposition party to fully replace the ruling coalition.

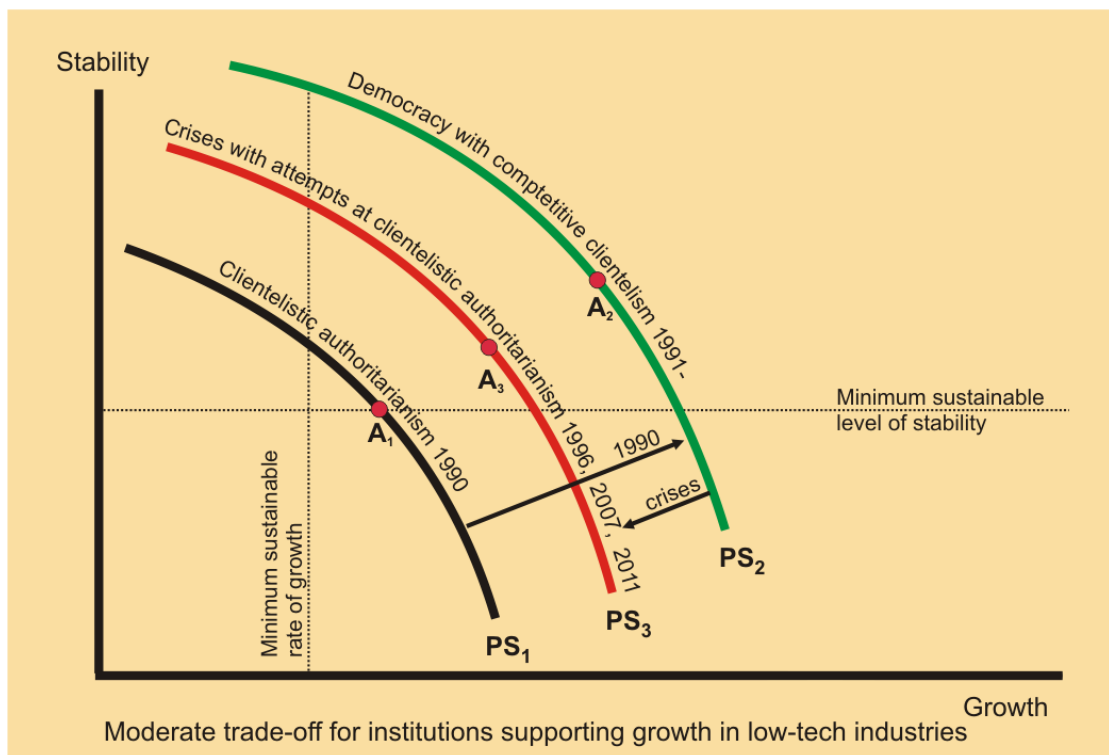


Figure 14 Growth with Vulnerable Democracy 1990-

Democratic political institutions that gave excluded political organizations a realistic chance of becoming the ruling coalition potentially offered a more stable operational equilibrium with competitive clientelism and therefore greater stability in the political subsystem. Greater political stability in turn allowed the enforcement of institutions that supportive of growth provided they were also consistent with the interests of powerful organizations. The result was a more favourable growth-stability trade-off at

PS<sub>2</sub> and the possibility of better growth outcomes shown by A<sub>2</sub> for sectors that were relatively close to the competitiveness frontier and which either did not require any further assistance in learning or required support for very limited periods. The vulnerability of the political subsystem during this period meant that the operational equilibrium was not very stable and was periodically thrown into disequilibrium as a result of repeated attempts by the ruling coalition to fix the rules of the political game to disadvantage excluded organizations. Whenever this happened the result was an upsurge of violence and instability as excluded organizations successfully contested the formal or informal limits that adversely restricted their chances of winning. During these periods of instability, the growth-stability trade-off would once again become adverse, moving to positions such as PS<sub>3</sub> with growth declining to positions such as A<sub>3</sub>.

### ***Bengali versus Bangladeshi Nationalism and Democratic Vulnerability***

If the distribution of power across political organizations is sufficiently dispersed (competitive clientelism is entrenched), an attempt by a ruling coalition to exclude others using institutional rules and enforcement is likely to be met with stiff resistance and instability till the limitations are lifted. Therefore, the achievement of even a moderately stable operational equilibrium in a competitive clientelist polity requires institutions that limit the ruling coalition from constraining the chances of victory of excluded political organizations. The futility of attempting to institutionally constrain excluded political organizations under competitive clientelism was repeatedly demonstrated in Bangladesh after 1990 in the failure of successive attempts by ruling parties to alter institutions in ways that reduced the probability of excluded political organizations achieving political power.

The interesting question is why this experience did not result in a recognition by the two dominant parties, the Awami League and the BNP that the only mechanism for achieving stability and sustained growth (and therefore for sustaining their own long-term interests) was to have shared informal rules that supported 'live and let live' strategies of political competition. Part of the answer lies in the path-dependent development of the antagonistic ideological positions of the two major parties. These differ not on substantive policy issues but on existential questions relating to the origins and fundamental characteristics of the country. These ideological differences served to establish two mutually exclusive claims to be the natural party of rule in Bangladesh. From the perspective of each of the two major parties, the other is portrayed not just as a fraudulent claimant to the right to rule but also a potential threat to the survival of Bangladesh as an entity with the characteristics defined by the party in question. The ideological positions as they have developed are thus inimical for the development of a live-and-let-live set of compromises. Indeed, each is a bid to establish a patrimonial right to rule on an exclusive basis. The ideologies of the parties therefore did not adapt to the new operational equilibrium in the polity and indeed periodically served to disrupt that equilibrium in the direction of new crises.

The history of these ideological positions is important to understand because they explain the path dependent problem that they generated for the post-1990 attempts to institutionalize democracy. Core aspects of the ideologies of both main parties had developed in the context of zero-sum conflicts against a ruling coalition that in each case had attempted to exclude others using ideology, institutional rules and substantial violence. In each of these contexts, excluded organizations had to develop ideological

positions that united them in a life-and-death struggle against the ruling coalition. In the case of the Awami League, its ideology of Bengali nationalism developed in the course of the fight against the ruling coalition in command of the Pakistani state. In the case of the BNP, its ideology of Bangladeshi nationalism developed in the aftermath of the violence unleashed by the attempt by the Awami League's to institutionalize a one-party state. The purpose of this ideology was to unite political organizations that had been excluded by the Awami League in the aftermath of its violent overthrow to ensure that it could not come back to power. In both cases, the ideologies were deliberately constructed to be exclusive and to brook no compromise. Unfortunately informal institutions allowing compromises were essential for maintaining the operational equilibrium of democratic political institutions with competitive clientelism. The path-dependent development of these ideologies provides part of the explanation for the vulnerability of democratic institutions under competitive clientelism in Bangladesh.

Once social forces are mobilized around exclusivist ideologies they tend to get more entrenched because if political strategies of one side are based on exclusion, the other side has no option but to drum its ideological position more stridently. The path dependence follows. One illustration of the problem was that the behaviour of both main parties in the democratic period suggested that the main object of their politics was to save the nation from the opposition. In the 1990s and into the 2000s the zero-sum attitude of the two major parties came to be known in the reflective sections of the Bangladeshi media as the 'battle of the begums', referring to the two ladies who led the rival parties. Sheikh Hasina, daughter of the assassinated President Mujib, led the Awami League, and Khaleda Zia, wife of the assassinated President Zia led the Bangladesh Nationalist Party or BNP. Their implacable opposition to each other was manifested in a range of different ways. The two leaders refused to talk to each other and their political strategy in opposition was generally to boycott parliament and to rapidly call for mass political agitation to overthrow the government, including the use of *hartals* or general strikes. Their mutual attitude often appeared to be that to rid the country of the menace posed by the other party would be the most positive contribution to development.

It is in this context that we have to understand the debate in Bangladesh on the question of nationalism. The Awami League has defined itself as the protector of *Bengali* nationalism, while the BNP emerged as the defender of *Bangladeshi* nationalism. For nationalisms to differ from each other politically, they must each have a different project of state building with different borders and definitions of who is included and excluded in the state project. A close look at the content of the two nationalisms shows that they do not in fact have separate state-building projects. Yet in the political discourse in Bangladesh, these ideologies are mutually exclusive and there can be no compromise between them. Their incompatibility is real but this has to be understood instead in terms of the function these ideologies performed at an earlier period in building coalitions against a particular ruling coalition. The logic of coalition building requires ideologies that can serve as convenient pegs for structuring coalitions though the ideologies themselves may not describe their interests. The definition of two mutually exclusive variants of nationalism for the country served to distinguish two implacably opposed coalitions even if the ideologies did not describe any significant differences in their interests or policies. However, by defining their differences in terms of ideologies that were linked to past struggles where no quarter

was given and no compromise was possible, the parties committed themselves to similar strategies in the future. Connected to these definitions of nationalism was the related position of the two parties on secularism and Islam. Here it may appear that there really are fundamentally opposed positions of the parties, but again a closer examination suggests that this is not the case. No significant material differences exist between the parties in their commitment to secularism or the practice of religion or even on the absolute separation of religion from the state. There are undoubtedly small differences between the parties on these issues but they are hardly significant enough to explain the sharply uncompromising positions they have taken in politics. For that we need to look at other functions that ideologies perform and have performed in the past in the context of coalition-building in a clientelist political settlement.

Many contemporary ideas about the progressive role of secularism can be traced back to the European experience with the Reformation and the separation of Church and state. The conflict between the Church and secular social forces during the Reformation is rightly recognized as one of the defining moments in Europe's transition to modernity. This was because in Europe the Church was blocking the material interests of the classes that would eventually lead the industrial revolution. This was a fundamental reason why the opposition of the progressive bourgeoisie to the Church was implacable until the Church had been significantly reformed (Tawney 1938). The specific features of the Reformation differed from country to country in Western Europe but some broad features were shared in common. Productive capitalist classes were emerging based on long-distance trade, and states were being constructed that could exercise territorial jurisdictions within which capitalism could grow. The social forces that were often opposed to them were organized around the wealth of the Church and the political ambitions of a Church-based empire. The social coalitions organized by the Church often incorporated older elites who were opposed to many of the changes that merchants and capitalists were bringing about because these changes threatened the stability of the old order and in particular the dominance of the Church in the ideological sphere. As a result, there were relatively sharp *economic* conflicts between monarchs, the Church and emerging capitalists that put the Church on one side and a collection of progressive economic forces on the other.

An important economic conflict between reforming monarchs and the Church concerned the vast amounts of land owned by the Church. These assets not only reduced the access of the monarch to revenues but also created a powerful competing political force allied to Rome, which could prevent the centralization of political authority in local states. Secondly, there was a conflict between merchants and the Church over the theological acceptability of income from interest in Christianity. Here capitalist accumulation which was driving growth faced obstacles from a pre-capitalist Church-based system of maintaining social order based on notions of justice that were no longer appropriate. Finally, there was a conflict between Church and state over their respective jurisdictions when it came to appoint officers to lucrative administrative and judicial positions. In this case too, territorially defined emerging modern states faced competition from a parallel set of jurisdictions organized around the Church. Thus the economic interests underlying the ideological conflict between Church and secular social forces were based on radically different ways of organizing production. This is why religion and secularism represented conflicting social interests in Reformation Europe. This in turn ensured that the victory of one side or

the other would have economic consequences for the mode of organizing production in Western Europe over a period of several centuries.

The emergent economic supremacy of the secular interests challenging the Church in the course of the Reformation resulted in stronger local states and an acceleration of economic growth. The material interests of new productive classes ensured that the relevant aspects of secularism defined as the political separation of Church and state began to be reflected in the *practice* of politics across Western Europe. This is despite the fact that in many European countries, including England, the formal constitutional separation of Church and state has not emerged to this day. The Western European story is important because the theoretical association of secular movements with the liberal bourgeoisie and therefore with social progress is based on a reading of this history. But the political economy of religion in contemporary developing countries is very different and the developmental attitudes of different parties cannot be so readily read off from their attitudes towards religion and secularism.

In the Indian subcontinent neither Hinduism nor Islam had an organized church with significant land-holdings and incomes along the European pattern either in pre-colonial or colonial times, or indeed subsequently. Nor has there been any ongoing competition between “church” and state over their respective jurisdictions in appointing office-holders along the European pattern. The weakness of religious control also meant that rules about interest could be ignored altogether, or evaded by defining it as profit-sharing as in many applications of Islamic banking in contemporary Pakistan and Bangladesh. This meant that the restrictions on usury in Islam did not lead to intense conflicts between emerging merchant-financiers and the “church”. In independent Pakistan or Bangladesh, the merchant and capitalist classes have certainly not felt threatened by the anti-capitalist elements implicit in the Islamic ban on usury. Similarly, while some aspects of Hinduism, such as the caste system, appear to be anti-capitalist, emerging Hindu traders and capitalists have not felt threatened by these and have certainly not been in the forefront of secular movements in India.

In the absence of a fundamental cleavage between religion and emerging capitalist economic interests, the political use of religion in Bangladesh has reflected very different interests. Clientelist coalitions have used religion, language, caste and other long-standing beliefs and identities as pegs around which to establish differences between themselves and their opponents or to invite new factions to join particular coalitions. As a result, parties with an apparent ‘position’ on religion have been willing to change their positions far more readily than if particular religious institutions or practices had fundamental implications for their economic interests. The Bengali nationalist movement led by Mujib and the Awami League against the policies of the Pakistan state in the 1960s mobilized against the ostensibly Islamic state backing the policies of the ruling coalition. In this context, the ‘secular’ aspects of Bengali nationalism were highlighted. However, as we have described earlier, the economic interests of the upwardly mobile Bengali Muslim intermediate classes were not blocked by the equivalent of the Church or by Islamic values but by the preeminent position of a non-Bengali ruling coalition unwilling to incorporate excluded political organizations. The victory of the Awami League in 1971 led to Bengali nationalism emerging as the dominant ideology of the country. The break with Pakistan was followed by the adoption of a secular constitution and the

definition of the nation in terms of a secular Bengali nationalism. But because secularism was not essential for protecting any fundamental economic interests of the ruling coalition, the Awami League was ready to ally with Islamic political organizations when this was necessary for its coalition building.

This is best illustrated by the overtures that Mujib made to Islamic groups immediately after the victory of secular Bengali nationalism over the Islamic republic of Pakistan. An important religious party, the Jamaat-e-Islami, had supported Pakistan and opposed Bangladeshi independence. Many of its members, and indeed members of other smaller Islamic parties had fought on the Pakistani side. In this context, Mujib's decision in 1973 to release without trial or investigation the 33,000 alleged war criminals who sympathized with, or were members of, Islamist parties was significant. Shortly afterwards, in 1974, Mujib travelled to Pakistan to attend the Islamic Summit at Lahore and returned home proudly proclaiming Bangladesh to be the world's second largest Islamic nation, bigger than Pakistan (B. M. Kabir 1988: 83-4). In the same year a Madrasah Education Commission was formed to report on how religious education could be improved. And in 1975 the Islamic Foundation was set up to promote Islamic studies and to manage mosques (M. G. Kabir 1995: 188-90; T. M. Murshid 1996: 362-3). Even in terms of the narrow definition of secularism in the new constitution, some of these moves, at least, were suspect.

It is possible to comprehend these actions if we recognize that for the Awami League and other clientelist parties taking positions for or against secularism, the *practice* of Islam or secularism did not have a direct material significance for their organizations or constituents. Reaching out to Muslim political organizations was simply an act of restructuring the ruling coalition. It allowed the Awami League to neutralize or incorporate groups whose members were in any case very similar to those who were already part of the ruling coalition. Religious beliefs are important and clientelist organizers and politicians are likely to have their own preferences and prejudices, but subject to these, their main concern is to maintain the ruling coalition. The ruling coalition is always searching for allies who will join or support them at the lowest cost, and this logic can shed some light on Mujib's possible motivations when he made these concessions to Islamic political organizations. In the aftermath of independence, it was cheaper for the ruling group to acquire potentially powerful organizational allies from amongst the defeated Islamist groups rather than from within the left. The left was growing in mobilizing ability, and its leaders could and were demanding much bigger payoffs for their allegiance. It was already becoming clear that many of these powerful organizers and their organizations would soon leave the ruling coalition to oppose it from outside with the objective of dislodging it. In that context it is not at all surprising from the perspective of the logic of maintaining the ruling coalition that Mujib was making overtures to his old enemies in the Islamic movement, while increasingly using violence on his old allies on the left.

Clearly, Mujib's manoeuvres for sustaining the holding power of the ruling coalition against those who were outside and those who were leaving to join them began to rapidly unwind. The ruling coalition failed to maintain enough support to sustain its patrimonial desire to rule indefinitely. Eventually, the disastrous attempt to stop its decline with the institutional solution of the one party state and the enforcement of this with formal and informal power led to Mujib's assassination in 1975. Those who united against the Awami League at that time did not do so as a normal act of political



opposition but perceived their fight to be a life and death one against a ruling coalition that was organizing to wipe them out politically. This context has to be understood to see why the ideology of the new ruling coalition was designed to signal an irrevocable break with the supporters of BAKSAL, the one party state. This was the context in which Ziaur Rahman and his Bangladesh Nationalist Party or BNP developed the counter ideology of *Bangladeshi nationalism*. This was defined as the nationalism of Bengali Muslims, and distinguished their nationalism from the Indian nationalism supported by the Bengalis of West Bengal. The implicit signal was that the supporters of Bengali nationalism had let down the country because they were pro-Indian as Bengali nationalism implied a close alliance with if not unification with West Bengal.

In fact, *Bengali* nationalism as Mujib had understood it was never about attempting the reunification of Bengal, nor did Mujib's definition of Bengali nationalism deny the Muslim identity of the vast majority of Bangladeshis. The distinction between Bengali and Bangladeshi nationalism was not a division based on different material interests or even deeply felt beliefs about the practice of secularism, or a debate about the borders of Bangladesh. Indeed, the supporters of both nationalisms recognized that reunification with West Bengal was not on the cards, and that while India was a big neighbour, there were many conflicts of interests with the Indians. Moreover, both parties recognized that as a Muslim-majority Bengali nation-state some recognition of its Muslim identity was necessary to justify its borders, and neither camp supported a sharia version of Islamic law. Rather, the real purpose of the vaguely defined distinction between the two nationalisms was really to sharply distinguish the core supporters of the ruling coalition of 1975 who supported a one-party state from those who participated in opposing and overthrowing it to create an alternative ruling coalition in the following years.

Indeed, the military governments which succeeded Mujib and the civilian parties they created absorbed many defectors from the Awami League who saw no contradiction in adopting the new definition of Bangladeshi nationalism. They also attracted old Maoists like Kazi Zafar and JSD socialists like Abdur Rab who argued that the developmental agenda of the ex-military leaders was more in tune with the developmental agenda of their own socialism. Even though constitutional changes *were* introduced which recognized the privileged status of Islam, the left-leaning organizers and organizations that now subscribed to Bangladeshi nationalism did not see any significant difference in the practice of secularism as a result. Nevertheless, the secular agenda of separating religion from the state, to the extent that it was ever implemented, was now somewhat attenuated. By the end of the 1980s the main lines of factional conflict were drawn between the *Bangladeshi* nationalist BNP (the Bangladesh Nationalist Party set up by General Zia) and the *Bengali* nationalist Awami League. While the conflict between the two was often implacable they did occasionally cooperate. The two joined forces in the late 1980s in their fight against the ruling Jatiyo Party of Ershad that was ideologically indistinguishable from the BNP. Indeed in the early 1990s, it was the 'secular' Awami League that entered into an alliance with the Islamist Jamaat against the then-ruling BNP government. Inevitably, over this period the Awami League's secular claims became much more muted. By this stage it had become difficult to identify any important issues of concrete political practice affecting secularism on which the three major parties actually differed. For instance, BNP and Awami League governments were very similar in the 1990s in banning books offending Islamic sensibilities.

The Awami League government that took office in 2009 identified as one of its most important priorities the trial of the war criminals of 1971. This process had been abandoned by Mujib and later governments but the new Awami League government took up a demand that had been voiced by many of its supporters and by a wider constituency for some time. The demand reflected not just a nagging perception amongst many sections of the population that justice had not been meted out to many people who participated in crimes during the war. But the Awami League government was soon criticized by international observers for choosing as targets for prosecution only prominent members of the opposing camp (for instance in a series of articles on the war crimes trials in the *Economist* magazine throughout 2011). The trial process began very slowly and with many questions about procedures but its most salient feature was that by 2011 only a handful of individuals were finally charged and they were all members of the Jamaat-e-Islami party, together with one individual from the BNP. Nevertheless, by then the issue failed to polarize society into supporters and opponents of the trials in the way the Awami League perhaps expected because there was very little underlying difference in the broader society about the desirability of a proper trial.

The Awami League's claim that those who did not support the war crimes trial were opponents of Bengali nationalism and thereby supporters of Pakistan who had aided and abetted the Pakistanis no longer rang true. The repeated pronouncements of the ruling party that many people were trying to disrupt the trials suggested that they actually expected the trial to be implacably opposed by the opposition. In fact the BNP's electoral alliance with the Jamaat-e-Islami was an opportunistic alliance, no less than the Awami League's alliance with the same Jamaat against the BNP in the mid-1990s. Nevertheless, the Awami League probably expected a much more spirited opposition by the BNP based on their refusal to adopt Bengali nationalism which in their mind should have made the BNP protectors of war criminals. In fact despite the government's attempts to portray all opposition to its policies as a hidden attempt to disrupt the war crimes trials, these claims soon began to lose credibility amongst the general public. Opposition to the trials was actually almost non-existent except for occasional criticisms levelled in Bangladesh and in the international press that pointed out that the procedures were not as transparent and robust as they should be, and that the choice of the first batch of accused was politically motivated. There is perhaps hope that whatever the outcome of the trials, it will become more and more difficult to sustain the myth that the parties represent truly irreconcilable positions on secularism, nationalism or the sovereignty and independence of Bangladesh. That can only be for the good for any attempt at enabling a stable democracy.

Thus, despite the absence of any significant differences in practice or in their real interests as revealed by their practice, the conflict between the *Bengali* nationalism of the Awami League and the *Bangladeshi* nationalism of their rivals defined irreconcilable differences between competing camps in the democratic political arena of Bangladesh after 1990. The reference to nationalism was obviously misleading because a substantive difference between Bangladeshi and Bengali nationalism would really imply different views on the desirability of the reunification of Bengal. But in fact, the supporters of Bengali nationalism in Bangladesh, and in particular the Awami League, have no political intention of redrawing the borders of India and Bangladesh. This should have made the debate between Bengali and Bangladeshi

nationalism politically redundant but it did not. Going back even further, the ‘Bengali nationalism’ of the 1960s in East Pakistan was about autonomy or independence for the part of Bengal that was East Pakistan, not about the reunification of Bengal. In that sense, it was indistinguishable from what later came to be known as Bangladeshi nationalism. The later constitutional debate in the 1990s about the role of religion was an important debate but here too there were very few irreconcilable differences between the parties because they were actually agreed on most issues and their practice of secularism was very similar. Nor was there any significant difference between the parties on the desirability of the independence of Bangladesh in 1971, and both parties had similar numbers of freedom fighters within their ranks.

The misrepresentation of the differences between them as irreconcilable issues about nationalism and secularism is significant because it is a manifestation of the fact that Bangladesh’s political leaders still want to talk in the uncompromising language of decisive battles appropriate to a different context. As a result, the development of the informal institutions that would enable democratic politics in Bangladesh to ‘mature’ into a sustainable equilibrium with competitive clientelism has been slow to happen. Instead, the ruling coalition claims, and from its actions apparently also believes, that the opposition is not only troublesome but also dangerous. The ruling coalition is therefore justified in taking upon itself the task of blocking the opposition or even attempting to politically wipe it out. The perpetual confrontation between the two uncompromising parties in the 1990s and 2000s was organized with the same life-and-death intensity that marked the conflicts of 1971 and 1975. However, the real context was now entirely different and what was required was the emergence of a series of informal rules that would allow the coalitions to cycle into and out of power smoothly through democratic contests where their relative holding power was revealed. Unfortunately, the division of parties into mutually exclusive “nationalist” coalitions recreated two implacably opposed camps locked in a life-or-death battle. While clientelist coalitions do need distinguishing characteristics, the ways in which the two dominant parties sought to define their differences appears to be the result of a misreading of their own history and a misunderstanding of what a substantive debate about nationalism or secularism today should mean. The repeated descent into zero-sum games has prevented a stable operational equilibrium in the polity and as a result the growth-stability trade-offs for all institutions have been affected.

### ***The Absence of (Informal) Rules for Live-and-Let-Live Cycling***

The intransigence of the two parties during the 2000s appeared most directly during elections when it repeatedly threatened the viability of the democratic system under competitive clientelism. A fair election in a clientelist political settlement means that the political outcome reflects the balance of power between organizations on the ground without ‘excessive’ interference from bureaucratic or military officials. While all interference in the administration of elections cannot be ruled out in a developing country, for viable democratic institutions, the interference cannot take place to the extent that the electoral outcome fails to reflect the balance of forces. If that happens, the outcome of the election will not be stability but more intense contestation and perhaps eventually violence by the losing side. A sustainable solution requires that the voting outcome roughly reflects the balance of organizational power and the object of the electoral campaign is to reveal this. The primary objective of a fair election in competitive clientelism is therefore not to discover the true preferences of the electorate, partly because true preferences may not exist given the absence of serious

differences in the policies that the parties are likely to implement. Rather, elections are processes through which the organizational strengths of competing coalitions are revealed. For stability to be achieved, a coalition of factions with significantly greater holding power has to be allowed to form the ruling coalition.

The critical requirement therefore is that no party should be able to artificially leverage its strength by using the administrative apparatus to repress or limit other organizations to give it an electoral advantage that is unrelated to its real relative organizational power. If a ruling coalition uses administrative power or institutional rules to disadvantage the opposition, this is effectively a return to the institutional system of clientelistic authoritarianism with the inevitable conflict it generates in the context of competitive clientelism. Thus, Figure 14 shows that democratic institutions did generate greater stability and therefore better growth-stability trade-offs for some growth-supporting institutions but only when the democratic institutions were perceived to be fair by opposition political organizations. Whenever the ruling coalition attempted to change institutional rules or implement them in ways that the opposition perceived would disadvantage them, this amounted to a *de facto* introduction of clientelistic authoritarian institutions. An upsurge of instability inevitably followed with a corresponding collapse of the growth-stability trade-offs for institutions from PS<sub>2</sub> to PS<sub>3</sub> in Figure 14.

A solution to this problem appeared to have emerged in the aftermath of the overthrow of Ershad's 'authoritarian' rule (clientelistic authoritarianism in our classification) in 1990. As Ershad's government had effectively fallen, the elections had to be held under a caretaker government led by a Supreme Court judge. The outcome was an election where the charges of rigging and repression were relatively muted. The victory of the BNP in this election led to demands from the opposition Awami League to institute the caretaker system for future elections. It was at this time that the Awami League was in alliance with the Jamaat. Initially the BNP did not accept this demand, but as a result, the 1996 election was boycotted. It had to be re-run after a constitutional amendment was passed by the BNP that institutionalized the caretaker system for conducting elections. The 13<sup>th</sup> Amendment set up a Caretaker Government system to organize elections. It was to be set up at the end of every government's term with the last Chief Justice of the Supreme Court becoming the interim head of government. Its sole task would be to organize the elections to determine the next ruling coalition. This was a unique formal institutional experiment to create a credible electoral process for selecting a ruling coalition. If it had been sustainable this could have created a stable operational equilibrium of democratic institutions with competitive clientelism.

However, this institutional arrangement was clearly not buttressed by a deeper set of informal political agreements that would ensure that the formal arrangements would not be informally modified as they can always be in a clientelist political settlement. The balance of power between the two parties had not yet established in their collective minds the fact that the cycling of their parties was now the normal state of affairs. Their subsequent actions suggested that both parties harboured a desire for a decisive victory that would establish one of them as the natural party of government and lead to the unravelling and disappearance of the other. The caretaker government system worked for two subsequent elections, despite minor attempts by both parties to interfere. However, the constitutional arrangements collapsed in the run-up to the

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

The emergency caretaker government turned out to have been a significant wasted opportunity. The emerging system of democratic institutions and competitive clientelism had clearly not yet acquired a stable operational equilibrium to be fully self-sustaining. The emergency could have been an opportunity for delivering a political shock to the system that may have helped to establish that the army could be deployed as third party enforcement by a caretaker government to enforce an implicit rule of law for governing elections. But instead, the caretaker government headed by an ex-World Bank bureaucrat and backed by the army took a 'good governance' perspective on how to solve the problem. Their interpretation (no doubt strongly influenced by dominant international policy perceptions) was that the political instability in Bangladesh was caused by the involvement of political elites in corruption and by the personalization of politics.

The Emergency Government drew on the argument that the opportunity for political corruption created distorted incentives for politicians to interfere with electoral outcomes. This suggested that if political corruption could be rooted out and if parties could be made to compete on the basis of alternative manifestos of delivering public goods the problem of electoral violence and standoffs could be rooted out. The second argument was that the monopolization of the leadership of the two parties by the families of the dead presidents was damaging and was the source of the implacable hatred between the two parties. So they also sought to change the leadership of the two main parties (the so-called '*minus two*' strategy). Both strategies dismally failed.

On anti-corruption, the two-year emergency caretaker government took a series of radical steps to achieve a large number of convictions for high-level corruption. The underlying thinking was that the source of political violence was the engagement of political leaders in corruption. Hundreds and possibly thousands of political activists were arrested and incarcerated, including the leaders of the two main parties, on charges of corruption. Hundreds of businessmen were also arrested and some of them handed over millions of dollars to the new government as 'ill-gotten gains' under pressure (which later on turned out to include torture and extortion). Based on evidence that was itself dubiously and hurriedly collected, thousands of cases of corruption and extortion were introduced in the courts. The whole exercise was deeply flawed not only from the perspective of its flawed understanding of a clientelist political settlement but even in terms of the formal legal procedures that were followed. In the end, almost all the cases had to be abandoned on the grounds that evidence was missing or inadmissible. Many witnesses who came forward (perhaps under pressure and perhaps under promises of protection) during the Emergency period disappeared and refused to continue to give evidence when the cases were continued under the democratic government which eventually took over.

More significantly, the caretaker government and its international advisors had failed to understand the nature of a clientelist polity. Political leaders running mass clientelist coalitions do not have sufficient resources from formal sources to finance the organization of politics and the redistributions that are required. A significant degree of informality in financing and in redistributive arrangements is therefore a characteristic of clientelist political settlements. Effectively, the caretaker government was trying to replace a clientelist political settlement with a Weberian-type capitalist one without changing the material conditions that have generated clientelist political settlements in every developing country. This was a failed enterprise in the way it was set up. Not surprisingly, the military caretaker government's attempt to address this problem failed dismally. The two arrested leaders of the main political parties eventually had to be released, and one of them was elected prime minister in the 2009 elections.

The strategy to replace the two leaders (*'minus-two'*) also failed and this too represented a failure to understand the nature of clientelist politics. The leadership of clientelist parties is not based on a choice between different policy positions represented by different leaders. The most appropriate leader of a clientelist party is someone who has the best credentials for being able to construct the biggest coalition for the party by organizing a distribution of benefits that is both economically viable and acceptable across all factions and organizations within the party. Who is the person that all party factions are likely to trust the most? If a leader of an organization internal to the party were to become leader of the whole party, their own organizational or factional supporters would be likely to benefit compared to supporters of other internal organizations and factions. The promotion of such an individual therefore would be strongly resisted by other organizations and factions within the party. In contrast, the wife or daughter of a dead president could be expected to have the best interests of the legacy at heart and be the most fair in adjudicating the relative power and therefore the claims of competing organizations and factions when disputes break out. If one of the most important tasks that the leader of a clientelist party plays is the regulation of the rent distribution across factions, 'the family' is likely to have an advantage over other individuals in gaining trust across factions. In the absence of a better alternative the parties may well have sought and identified an alternative leader, but as long as a 'natural' leader existed, the experiment of the interim government was almost doomed to fail. Indeed at the end of the experiment, the two ladies retained control over their own parties.

Not surprisingly, family control of clientelist parties is very common across the Indian subcontinent, including India and Pakistan. This does not mean that all developing country parties are of this type. More disciplined ideological parties can achieve greater internal discipline and can select their leaders through rule-following procedures. On the other hand, disciplined parties based on ideologies like Marxism or Islam are likely to remain relatively small in terms of their following because most people in poor countries prefer to belong to parties that can provide them with immediate material benefits, however small. Clientelist parties can gather large followings based on a pyramidal absorption of client organizations but the price is that there are no external criteria like seniority or commitment to an ideology that can determine the relative benefits for different constituent organizations. Leaders of powerful groups within the party can threaten to leave and join other parties unless

they can be offered benefits proportional to their power. Sometimes Communist or Islamist parties in developing countries can become mass parties but usually this requires very special circumstances like prolonged wars against colonial powers as in the case of the Communist Parties of China and Viet Nam or the FIS in Algeria. The emergency caretaker government in Bangladesh did not understand that clientelist parties will not convert into internally disciplined ideological parties if only their leadership could be changed.

An interesting feature of this caretaker government period was that it demonstrated a significant change in the organization and aspirations of the Bangladesh army. In the past a political crisis of this magnitude would have provided ambitious generals an opportunity to organize a coup, perhaps with a genuine desire to salvage the situation but no doubt also to pursue their own ambitions. This time they stayed in the background but actively backed a civilian caretaker government, making it clear that they were the power behind the scenes. And unlike previous interventions where the justification was to pursue economic development, this time the army joined forces with civil society champions to justify their indirect intervention in terms of promoting good governance. A significant change in the resource base of the army as an organization could explain some of these changes. It was now closely tied to the 'international community' through its lucrative involvement in international peacekeeping missions. It was dependent on formal international rents and did not want to jeopardize them with a domestic adventure to generate informal rents for the army through the political process. Its own recent history had also demonstrated the limits of authoritarianism and clientelistic authoritarianism. However, the army as an organization was not as centralized and coordinated as it would like to be. There were allegations from businessmen and politicians that different groups within the army acting in the name of the high command used the opportunity to arrest individuals in uncoordinated ways, often to extort payoffs in exchange for their release. These experiences suggested that the army too was no longer a centralized and coordinated organization. This was a problematic message for the political parties as the most important potential 'third-party' mediator and enforcer who may have been relied upon to intervene in the case of a real impasse was shown to be itself fragmented and relatively weak.

The main effect of the two-year experiment was a collapse in investor confidence. The two main parties whose intransigence and violence had caused the problem in the first place did indeed receive a shock, but the abject failure of the strategy of anti-corruption and leadership change had a negative effect on the impetus for reform. Even more important than the problem of political corruption (which is unlikely to be eradicated as long as the informal aspects of the clientelist political settlement are reproduced) was the failure to develop a credible mechanism for organizing elections. The core activity of the emergency government was to improve the formal aspects of the electoral process such as creating a much better voter list and identity cards. These were necessary but not sufficient requirements for enabling a democratic system to operate in a clientelist polity. The critical missing element was of course the absence of the informal limits on the activities of the ruling coalition that is essential to make the electoral process a credible one in these contexts. The caretaker government appeared to have no conception of how to bring about what the Bangladeshi media described as a necessary change in the 'political culture' and which we would describe as the informal understanding of the limits to the modifications in formal

rules beyond which the system is likely to descend into violence and instability. After two years in office the overall legacy of the caretaker period for developmental reform and institutional change are very likely to have been negative.

The Awami League won a resounding victory in the elections of late December 2008, winning 230 out of the 300 parliamentary seats. The landslide gave the Awami League more than two-thirds of parliamentary seats (though with less than half the votes cast). It was in a position to carry out constitutional amendments on its own and soon proceeded to do so. In 2011 it won a Supreme Court judgement that the 13<sup>th</sup> Amendment that had introduced the caretaker system of governance for conducting elections was itself unconstitutional. The brief judgement that was initially delivered said that the caretaker system may be continued for a further two terms given the time it would take to build confidence in alternative arrangements. However, without waiting for the full judgement to be delivered which would have shown the arguments the court considered in recommending the caretaker system for the next two elections, the Awami League rushed through the 15<sup>th</sup> Constitutional Amendment to remove the caretaker system with immediate effect. The opportunistic nature of this move and the possible opportunities it would give the Awami League in the next election was not lost on the BNP, which immediately announced that it would boycott the elections unless the caretaker system was reintroduced. The absence of informal limits to the use of power by the ruling coalition could not have been more robustly expressed. In early 2012 negotiations were continuing between the Awami League and the opposition BNP on this issue. A possible compromise that was under discussion was to have a 'political' caretaker government to oversee the elections, composed of elected nominees from both parties, possibly headed by the President. But the formula would have to convince the opposition that administrative power would not be used during the elections to give an excessive advantage to the ruling coalition.

### ***Economic Organizations under Vulnerable Democracy***

As Figure 14 summarized, the failure of democratic institutions to achieve an operational equilibrium can result in a spike in instability and violence and a more or less serious collapse of the growth-stability trade-off facing potentially growth-enhancing institutions. The possibility that the approach of elections will result in a crisis is likely to disrupt the normal operation of the economy. The failure to organize an election or an election that achieves a stable result can lead to violence and strikes that inflict broader economic costs, attacks on the economic interests of opposition supporters and finally retribution against the economic interests of supporters of the current government if and when it is finally deposed. All of these possibilities can obviously reduce the time horizons of investors and politicians in a competitive clientelist system. The enforcement of growth-enhancing institutions becomes much more difficult at times of crisis as does contract-enforcement, particularly contracts involving the government. Thus, the electoral crisis is likely to result in a collapse in the trade-off curves of different institutions and sectors, but the effects are likely to be different across sectors and institutions.

Long-term investments are likely to suffer if electoral uncertainty is likely long before any instability actually emerges because the expectation of future instability is sufficient to make investors procrastinate. Institutions supporting long-term investments are likely to suffer, particularly where government contracts involving significant sums are involved. For instance, it has proved to be very difficult to raise



private financing for investments in the power sector in Bangladesh. This is an area where future income streams depend on governments honouring contracts made by previous governments. But if the opposition is being constrained by the incumbent government, and are eventually likely to have to force the incumbents out, investors are likely to be wary that the opposition may challenge the legality of some contracts if they come to power. At least they can expect further demands for payoffs on top of the first round that they have probably already paid to the incumbents, and this can significantly increase the cost of doing business. Thus, vulnerable democracies under competitive clientelism can face high transaction costs for some types of contracts and some investments may not be possible at all. Since infrastructure and power sector investments do require government guarantees for future payments, a vital set of investments are adversely affected on which the economic performance of other sectors ultimately depends.

For sectors that have already achieved competitiveness, the failure to enforce growth-enhancing institutions is likely to have less adverse effects compared to sectors like power and infrastructure or compared to sectors where global competitiveness is yet to be achieved. In established sectors like garments, competitiveness has already been achieved through the investment of significant time and effort in learning-by-doing. In garments, learning opportunities were created by a combination of rents together with strong incentives created by fortuitous conditions and institutions that ensured high levels of effort in learning. Once competitiveness was achieved, the need for special institutional support is no longer required. In already competitive sectors, political instability affects growth in more usual ways: by delaying investments, by disrupting exports when ports and transport systems are affected by strikes and *hartals*, and ultimately persuading risk-averse buyers to move their business elsewhere. Much of the contract enforcement in competitive export sectors involves the banking system and these formal institutions are unlikely to be significantly modified as a result of political instability unless the latter reaches very high levels. Business organizations that are export competitive and stand to lose orders have periodically organized collective action to campaign against *hartals* and to bring political instability to a rapid end. These collective organizations have included the Bangladesh Garment Manufacturers and Exporters Association (BGMEA). While some of these initiatives have had some marginal effect on the intensity of conflicts, their interventions have not had any decisive effect. Ultimately, the resources that the business sector could generate were insufficient for this sector to dominate the political system and to set the conditions for acceptable political conduct.

More serious have been the effects for sectors that have not yet achieved competitiveness but are close enough for learning-by-doing to be a potentially effective strategy. These sectors require more specific institutional support to reduce the costs of the loss-making period when learning-by-doing needs to be financed. This requires institutions that can regulate the provision of financing and the enforcement of conditions that create incentives for high levels of effort during the learning process. But the provision of financing and the enforcement of conditions for ensuring effort are both particularly difficult to ensure in a context of instability and political fragmentation. The financing required for investing in new sectors and then investing in the learning-by-doing process is likely to involve a cycle longer than one or two years. The institutions providing the financing and defining the conditions for recipients of the financing have to remain effective over the lifetime of more than one

government and this cannot be ensured under these conditions. The collapse of the trade-off curve for institutions supporting learning is likely to be quite steep. The garment industry developed as a result of a fortunate conjuncture of rents created by the Multi-Fibre Arrangement (MFA) organized by the USA, domestic political support in Bangladesh at the highest level, the availability of domestic investible resources for driving these investments and strong incentives for foreign technology providers to transfer the appropriate technologies to Bangladesh. This conjuncture also happened during the earliest phases of clientelistic authoritarianism when the time horizon of investors and institutions financing the learning process could be long given the stability of the new regime. The lesson that emerges is that the extension of this success to new sectors and under conditions of vulnerable democracy requires developing new institutions and governance capabilities. A necessary condition is that democracy at least achieves a moderate operational equilibrium with competitive clientelism so that the probability of electoral crisis is reduced.

The agencies and institutions that could assist Bangladesh to move up the value chain in new areas could take a variety of forms ranging from direct government policies of support for critical sectors to the development of a new generation of industrial banks. However, given the weak operational equilibrium of democratic political institutions it is not surprising that no significant institutional measures were taken to develop new sectors during the period of vulnerable democracy. A few new sectors did begin to emerge, like electronics manufacturing, but investments and financing for learning in these sectors were driven by enterprising entrepreneurs who took huge personal risks in financing learning on their own. The challenge for the future is to develop both the institutions that can support these initiatives as well as initiatives to develop specific governance capabilities to ensure that institutional support is not captured by politically connected but inefficient entrepreneurs. Neither the ambitious industrial policies of the East Asian countries nor the 'good governance' agenda set by western development partners provides a feasible set of governance reform targets for countries like Bangladesh. But even a limited and very specific set of governance targets that are aimed at building competitiveness in progressively more sophisticated sectors faces an adverse growth-stability trade-off in the context of short time horizons and periodic political crises. Provided that a moderate operational equilibrium of democratic political institutions can emerge with the emergence of the appropriate informal institutions, the challenge for Bangladesh will be to devise institutions that can support catching-up in new sectors. A more stable operational equilibrium requires the acceptance of informal and perhaps some formal limits on the powers of the ruling coalition to limit the chances of excluded organizations in the competition for power. It is surprising that this has not emerged despite the repeated failure of every ruling coalition that attempted to limit the organizational capabilities of excluded organizations. Perhaps a few more salutary failures will be required before the voluntary adoption of limits by the major parties to emerge.

Finally, the collapse of time horizons and the slow development of competitive profit-making opportunities can also have adverse effects on the incentives of powerful entrepreneurs. By the end of the first decade of this century a number of economic organizations in Bangladesh had emerged with significant technological and entrepreneurial capabilities. The problem that faced many economic organizations was that apart from areas like garments, pharmaceuticals and ceramics where significant capabilities were built, even high capability business houses lacked

competitiveness in many sectors, including relatively low technology areas. For cash-rich big business groups like Salman Rahman's Beximco the problem was even with their relatively high entrepreneurial and technological capabilities in some sectors they could not competitively enter most areas of production. For big business houses, this created incentives for unproductive and speculative investments in areas outside their usual areas of competitiveness. Big business houses were likely to have close political ties with at least one major party and sometimes with several. These connections are mutually beneficial, providing the political party with economic resources when needed and providing business houses with politically created profitable opportunities to recoup their outlays with significant profit. As political uncertainty reduced the time horizons of both economic and political organizations and made it more difficult to develop competitiveness in new sectors, it increased the attractiveness of creating unproductive profit opportunities. We would expect business-government relationships to move towards the creation of value-reducing rents. There was indeed evidence of politically-assisted profit-making by big business houses close to ruling parties in ways that were not in the public interest and were not driving learning-by-doing in new sectors.

The democratic competitive clientelist period after 1990 has thus had a mixed record. Paradoxically, in Bangladesh, the introduction of institutions of political democracy did not even achieve sustained political stability despite the existence of a fragmented competitive clientelism that made the institutions of clientelistic authoritarianism unviable (Figure 14). The difficulty lay in the failure to evolve credible formal but primarily informal rules for the removal of the ruling coalition. This made the operational equilibrium of democratic institutions vulnerable because the result was repeated periods of intense conflict and instability. The instability reduced time horizons and raised the transaction costs facing some types of vital long-term investments, in particular in the power and infrastructure sectors, and thereby directly harmed growth. On the other hand, economic activities in other sectors where competitiveness already existed, and significant public institutions for enforcing complex contracts were not required, were not so significantly constrained. More damaging was the effect on sectors that needed institutional support for addressing the market failures constraining their learning-by-doing and their technology adoption. The immediate challenge for sustaining democracy under competitive clientelism is to achieve more credible and less violent methods of ensuring the replacement of the ruling coalition. If this can be achieved, the longer term challenge is to transform the organization of coalitions to the extent that this is possible (for instance through the organization of more disciplined parties) and to devise institutions that are compatible with this political settlement so that investments in new sectors and the financing of learning-by-doing can be institutionally supported.

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