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**CAPITAL ACCUMULATION,  
STATE INTERVENTION AND  
PRIVATISATION**

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## **CAPITAL ACCUMULATION, STATE INTERVENTION AND PRIVATISATION**

The debate over privatisation is essentially the debate over the relative efficiency of the state versus markets and private property in the allocation of resources. Where state intervention was previously justified on the grounds of market failure and other problems faced by developing countries in particular, privatisation theory has viewed the state as the cause of inefficient allocation due to the vested interests of bureaucrats (or the possibility of states or public policies becoming ‘captive’ to the special interests of influential or powerful groups) and the lack of incentives in the absence of clearly designated property rights. The state can play a part in privatisation by ensuring that resources are allocated efficiently, not just to the best candidates but also to the most productive sectors. That is to say, privatisation can be undertaken as part of a state’s development strategy and can be an important part of a development process. In these circumstances, privatisation needs to be examined against state theory. The sources of state capacity and capabilities as well as factors which constrain state policy then become important in determining the success of privatisation.

### **STATE THEORIES**

The sources of state capacity, particularly in view of the success of the East Asian developmental states, have been well documented. Apart from various institutional attributes (e.g. an insulated, autonomous and technocratic bureaucracy), there is general recognition of the political context in which state industrial policies were formulated and implemented, specifically state-society relations. The class character of this ‘political settlement’ and ‘development alliance’ – or ‘growth cum distributional coalition’ – shapes the capital accumulation strategy and determines whether it is growth enhancing or growth reducing. While the presence or absence of pro-growth state-business relations explain different accumulation strategies and outcomes, growth-reducing state-society relations have the converse effect. Whether the ruling coalition is ‘efficient’ or ‘inefficient’ depends on historical factors, including pre-existing class relations. In societies where certain powerful, but unproductive groups emerge, and where the power of these groups is greater than the state’s, then the nature of state-society relations will not lead to efficient outcomes<sup>1</sup>. As privatisation can facilitate both capital accumulation and greater efficiency, its success depends on the effectiveness of state policy and state strength in relation to various groups in society (and not just its relations to business).

The ability of the state to promote efficient capital accumulation (through privatisation) depends ultimately on state capacities rather than the presence of information problems or institutional failure. Apart from supporting a capitalist class (through rents – which privatisation allocates – and other state support), while disciplining this group, the state must also be able to overcome potential resistance from other groups in society. Thus, the efficiency of privatisation reflects the ability of the state to efficiently allocate resources.

The economic success of (East Asian) late industrialisers, despite evidence of rent-seeking and corruption, highlights how rent allocation can result in efficient or inefficient outcomes. Rather than dismiss all rents as inefficient, unproductive and welfare reducing, it is more useful to recognise differences in the efficiency of rents, and thus, the important role the state plays in determining the allocation (and deployment) of rents. Given that all states intervene in economies for various reasons, the issue is not whether states intervene, but how they intervene and for what purpose (Johnson 1982: 17-18). As the process of capitalist development essentially requires efficient capital accumulation where investment is channelled to productive sectors, the state can play a part in promoting and coordinating investment. Here, state intervention is necessary to promote development, and not merely correct for market imperfections.

Historically, the state has played a central role in the development of capitalism. State intervention is seen as necessary (even more so in developing countries), given the problems of bounded rationality and market failure; weakness or absence of an entrepreneurial class, risk-taking or capital markets; failure to exploit economies of scale; and where there are positive technological externalities. The state can then be crucial in coordinating complementary investment decisions (as people will not invest in new industries because they do not know if complementary investment will come along)<sup>2</sup>; financing industry; creating learning rents; providing “entrepreneurial vision” and “calling forth and enlisting for development purposes resources and abilities that are hidden, scattered or badly utilised” (Hirschman 1958, cited in Chang 1999: 194; Chang 1999: 182, 194). State intervention is also crucial in promoting the process of capital accumulation through transfers which include the creation of new property rights and the provision of rents. The creation of rents can be a convenient and powerful policy instrument for eliciting business cooperation and support for government policies and also for increasing capital formation by redistributing income from consumption to investment activities (Choi 1993: 23). In the

case of privatisation, the under-pricing of initial public offerings (IPOs) can serve, not merely to broaden private share ownership and foster the development of liquid domestic capital markets (Dewenter and Malatesta 1997), but more importantly, to aid capital accumulation by selected capitalists by providing windfall super profits, i.e. rents.

### **The Developmental State**

The success of Japan, South Korea and Taiwan renewed interest in the role of the state and introduced the concept of the developmental state which took on developmental functions (i.e. led the industrialisation drive) in late industrialisers (Johnson 1982: 19). The East Asian developmental state was based on the notion that economic development involves a combination of steady high rates of growth and structural change in the productive system, both domestically and in relation to the international economy, and requires a state which can create and regulate the economic and political relations that can support sustained industrialisation (Castells 1992: 56; Chang 1999: 182-3). This included redistributing agricultural land; extracting capital; controlling finance; generating and implementing national economic plans; manipulating private access to resources; coordinating individual business efforts; targeting specific industrial projects and assisting particular industries; insulating domestic economies from competition and excessive foreign capital penetration; improving productivity; and promoting exports and technological acquisition (Pempel 1999: 139; Wade 1990). The East Asian developmental states 'encouraged' or directed companies into higher value-added, higher wage and more technology-intensive forms of production; legislated to discourage short-term speculative domestic or overseas investments (indirectly ensuring more flows to manufacturing); created industrial sectors that previously did not exist; invested heavily in the creation and refinement of new technologies; protected domestic markets; consistently monitored world markets for export opportunities; and subjected companies receiving credit to rigorous performance standards (Henderson and Applebaum 1990: 21-22).

Where public choice theory extends the neo-classical assumption of utility maximisation to explain the behaviour of bureaucrats and politicians, the idea of the developmental state is partly based on Weber's concept of an autonomous bureaucracy, which is meritocratic, technically competent and committed to wider social goals. Common to all three countries was the presence of strong states (with state actors relatively free from populist pressures) as well as the absence of a sharp dichotomy between state and

society; land reforms (which accelerated capitalist transformation); egalitarian domestic power structures based on individual merit; “hegemonic projects” (that entailed enhancing national economic competitiveness through internationally marketable goods); and the rejection of Western concepts of “the market” (in favour of market enhancing manipulation) (Pempel 1999: 160).

The importance of combining market rationality with state planning in the form of a ‘capitalist guided market economy’ (White and Wade 1988: 5, cited in Lubeck 1992: 178) is a common thread in the developmental state literature. Weber viewed the complementary nature and role of the marketplace, on the one hand, and the rational and rule-bound state bureaucracy, on the other, as “necessary components and complementary preconditions of modern capitalism” (Vartiainen 1999: 201). With reference to Japan, Johnson (1982: 18) describes this as ‘plan rational’ – as opposed to ‘market rational’ and the Soviet-type command economy’s ‘plan ideological’. “The plan rational state pursued not blind ideological goals but enhanced economic competitiveness” (Pempel 1999: 140). Rather than creating market distortions, ‘soft authoritarian’ state intervention sought to augment market rationality in the long term by reducing risk and uncertainty (Johnson 1987: 141, cited in Lubeck 1992: 178) through augmenting the supply of investible resources, spreading or socialising long-term investment risks, and steering the allocation of investments by combining government and entrepreneurial preferences. This has been variously described as ‘governed markets’ (Wade 1990) and ‘disciplined markets’ (Amsden 1989), where the key is a “synergistic connection between a public system and a mostly market system, the outputs of each becoming inputs for the other” (Wade 1990: 5, cited in Pempel 1999: 142). The developmental state thus defines its mission primarily in terms of long-term national economic enhancement, and regularly intervenes to improve international competitiveness by creating competitive advantages, rather than comparative advantage (Pempel 1999: 139). It is this combination of incentives (i.e. rents) and (international) market discipline which has been largely responsible for the success of the East Asian economies.

There are thus many determinants of success: long-run incentives for private entrepreneurship must not be weakened; a competent and meritocratic bureaucracy sets state policy independent of organised interest groups, and does not aim to maximise the revenues of its individual members; the state can manage a coherent and balanced corporatist network of organised interests; and the state and its various corporatist partners are endowed with tools for allocating finance and regulating the functional

distribution of income (Vartiainen 1999: 218). In essence though, the success of the East Asian economies can be attributed to the state's ability to promote successful capital accumulation by selecting and supporting a capitalist class, directing investment into strategic sectors, and ensuring performance.

State supported capital accumulation involved the transfer of land and other assets, as well as subsidised loans to selected individuals in South Korea in the 1950s and 1960s, where property and assets (including state-owned banks), and later, subsidised loans, were selectively distributed on the basis of political connections, with loans closely tied to the allocation of investment licenses and conditional on economic performance (Koo and Kim 1990: 123-128). Financial subsidies were also critical for spurring investment and overcoming particular costs associated with export promotion (Amsden, cited in Haggard and Lee 1993: 10). By channelling savings away from consumption and other non-productive investment options to the manufacturing sector and by regulating interest rates, developmental states reduced the cost of capital for producers (Cheng 1993: 56). Control and manipulation of the financial system (e.g. interest rate ceilings, controls of bank lending portfolios, through the extension of loan guarantees and other regulations) can thus be used to influence the behaviour of private financial intermediaries to achieve developmental policy goals (Haggard and Lee 1993: 6). In Japan, capital was mobilised through the public postal savings system, while government intervention increased financial savings in Taiwan for domestic investors, allowing the state to direct capital to desired sectors (Wade 1985, cited in Haggard and Lee 1993: 10; Pempel 1999: 149-150). The Bank of Taiwan extended preferential interest loans to SOEs and ISI industries in the 1950s, while the state promoted ISI and nurtured a crop of capitalists through the allocation of foreign exchange, control of industrial permits and securing development loans from abroad (Cheng 1993: 62-64). State control of banks and import licenses in Taiwan geared the economy for import substitution (Castells 1990: 42).

Rents have thus been crucial for both the early stages of capital accumulation and learning. In so far as privatisation confers additional income above what recipients would otherwise have received, it involves allocating rents. It is the 'efficiency' of this rent seeking which is most relevant to the discussion of privatisation in developing countries, in particular the question: what determines the ability of the state to promote efficient capital accumulation? As has been discussed, resource misallocation can come from rent-seeking pressures from social groups, but this does not explain why

some countries have managed to industrialise despite equally high rent-seeking as in stagnating economies. One explanation is that allocation decisions (including privatisation) were made without appropriate incentives and information.

### **ASYMMETRIC INFORMATION**

According to theories of asymmetric information, the ability of the state to ensure efficient allocation is constrained because the information needed to make correct decisions is often incomplete. This means that the state is unable to select appropriate candidates for economic tasks nor is it able to monitor the performance of selected candidates. In the context of asymmetric information, the benefits of private over public ownership are not as clear as thought. This is because principal-agent problems affect both public and private enterprises where managers are not themselves owners and which involve substantial delegation of authority (Stiglitz 1996: 174). However, assigning property rights not only does not guarantee economic efficiency, but it is also difficult to define property rights in terms of 'residual control' (ownership) and 'residual returns' (profit)<sup>3</sup>. For example, stockholders are normally considered to be owners of the company in that they get residual returns (e.g. through dividends), but have only limited residual control (i.e. they can fire the directors, but have virtually no control rights over the firm). Here, the control or management of assets is in the hands of professional managers (directors, mainly executive directors) who act as agents for the shareholders' interests (Martin and Parker 1997: 402). Directors thus have residual control rights in law (e.g. they can decide on the level of dividends, to hire and fire senior executives, to accept merger offers, etc), but do not get residual returns. While in theory, shareholders vote on how profits should be allocated, by and large, it is the executives who propose and allocate profits either for dividends or more investments, thus having effective control of the pool of funds accruing to shareholders. Furthermore, control in public limited companies can be achieved with a significant minority share (Tan 1982: 139, 190), and cannot be determined by simply assigning an absolute percentage of stock ownership to it, as ownership does not automatically bring corporate control. Because property rights cannot always be clearly defined, economic efficiency cannot be assumed to follow as private firms also face monitoring problems.

The ability of principals to monitor managerial discretion in the private sector is said to be more efficient than through the political process due to capital market discipline, competition among managers, the threat of takeover and bankruptcy, and company law, which requires regular independent

audits and financial statements (Martin and Parker 1997: 394; Plane 1997: 357; Fama and Jensen 1983 and Jensen 1983, cited in Martin and Parker 1997: 403; Millward and Parker 1983: 537-538). However, the discipline of the capital market is based on the assumption of perfect information and a frictionless capital market in which shareholders have perfect knowledge (see e.g. Williamson). Instead, shareholders suffer from bounded rationality and the capital market from information ‘impactedness’, leading to significant transaction costs which allow management to deviate from policies which maximise shareholder utility (Millward and Parker 1983: 533). Sub-optimal monitoring can also occur owing to the pursuit of short-termism, lack of viable (or hostile) takeover threats, and lopsided shareholder distribution. Where there is the threat of takeover, this can produce short-termism – at the expense of long-term investment and dynamic efficiency (Martin and Parker 1997: 407). And given that only a fraction of improvements in productivity go to managers in public or private firms who are principally remunerated by their salaries (Mansfield and Poole 1991, cited in Martin and Parker 1997: 403), “neither has the incentive to design good incentive structures” (Stiglitz 1996: 174), leading to managerial discretion.

The presence of asymmetric information in privatisation means that even with the best designed auction process, the state will be unable to distinguish between potential bidders who are efficient producers and speculative buyers. The producer bidding the most, and promising to conform most closely to government objectives, may neither carry out those commitments nor find the asset most valuable due to limited liability and imperfect enforceability of commitments. A willingness to bid higher may simply reflect a higher probability of defaulting on promises (Stiglitz 1996: 194). In the context of asymmetric information, it is difficult for the state to successfully select and monitor candidates due to the problems of adverse selection (owing to hidden information) and moral hazard (hidden action).

But privatisation does not only involve divestiture. Where government functions are ‘subcontracted’ out to private companies, the relationship between state and capitalist may be compared to that of principal and agent where the state retains residual control and the capitalist retains residual returns. Here, the government engages the private sector in privatised projects, usually involving construction, through build-operate-transfer (BOT), build-operate-own (BOO) or build-operate (BO) contracts. These contracts can be very lucrative as they often confer guaranteed revenue and profits (e.g. toll highways) and thus function as rents. As they can serve to promote both capital accumulation and economic



growth, it is important for the state to carefully allocate such rents and monitor performance. The state also retains ultimate control, given the often strategic importance of such contracts and as a quid pro quo for capitalists to receive the benefits of these 'rents'. In return, capitalists are expected to deliver. However, aside from the problem of 'adverse selection', the ability of the principal to specify conditions and monitor the agent's performance is also constrained by incomplete information. Not only is the state unable to write a complete contract specifying all possible contingencies, it also cannot monitor the performance of the agent since information problems similarly afflict both (large) public and private enterprises.

But the ability to monitor agents merely informs the principal if the agent is performing and does not, in itself, guarantee that agents will actually 'deliver'. In other words, even if it is aware that the agent is not performing, the state must be able to enforce discipline. While imperfect knowledge has been identified as a cause of stagnation (North 1990: 8, cited in Khan 1997: 80), this does not explain why state failure should persist (Khan 1997: 80). This means that where privatisation may result in the allocation of rents, the efficiency of this rent depends not only on the ability of the state to successfully select the best candidates and monitor performance, but also to discipline capitalists who fail to perform or deliver. While monitoring is affected by information available to the state, enforcement depends on political constraints facing the state, and by extension, the strength of the state in relation to capitalists.

### **POLITICAL CONSTRAINTS**

As experiences in Eastern Europe have shown, privatisation is confronted by political constraints both before and after its introduction. *Ex ante* constraints are feasibility constraints, where proposals for privatisation may be blocked by various groups which stand to lose out; *ex post* constraints relate to 'backlash' and the possible reversal and adjustment of policy following the uncertainties of transition and restructuring (Roland 1994). It is precisely because privatisation confers huge benefits for successful bidders that it is potentially very conflictual, with losers likely to contest or resist. In short, privatisation is a highly politicised process (see Fine 1997).

This highlights the second role of the state in the development of capitalism – to politically manage the economy to ease conflicts inherent in the development process. The development process itself involves rapid structural change, and the transition from low to high productivity economic activities inevitably

results in obsolescence as certain factors of production are not mobile (Chang 1999: 196-197). In the case of non-capitalist economies, the transition or development phase usually involves rapidly evolving or changing property rights, not unlike the process of 'early accumulation' in England's transition to capitalism, characterised by the creation of new wealth-owning classes (Khan 2000: 15-16; Khan 1998: 16). In either instance, there is often intense conflict as losers contest the outcome and related changes. Hence, arguing that privatisation depoliticises distributional issues (Boycko *et al* 1996; Bienen and Waterbury 1989) actually merely ignores the potential political conflict which is part of any process of change with both winners and losers.

As the ultimate guarantor of property rights and other rights in society, the state is inevitably involved in such conflicts and thus must not only be able to regulate economic and political relations that can support sustained industrialisation (e.g. coordinating change, providing ['entrepreneurial'] vision, and institution building), but also mediate potential conflicts between winners and losers in the process of growth and structural change where losers accept the need for adjustment and gainers compensate them (Chang 1999: 183; 192-7; Vartiainen 1999: 202). Privatisation thus ostensibly involves state economic intervention, rather than its negation. "What is privatised and how represents the state's continuing intervention within the economy, favouring certain capitals at the expense of others" (Fine 1997: 376).

### **State Capacity**

The developmental state has been defined by its autonomy from societal forces (i.e. the ability to develop and implement long-term economic policies without undue interference from private interests) and its capacity and capability to implement economic policies effectively (i.e. the state can exercise a large measure of control over the behaviour of domestic as well as foreign capital) (Koo and Kim 1990: 121). The capacity of the state -- to manage these relations, allocate resources to the most productive and strategic sectors, and enforce discipline -- determine the success of capitalist transition. This depends on the state's political capacity, which is circumscribed by political processes (Castells 1992: 64; Koo and Kim 1990: 122).

The success of the East Asian economies has been attributed to a strong state (characterised by the relative autonomy, corporate integrity and capabilities of technocrats and their commitment to market conforming planning) and synergistic interactions between government and business (Johnson 1982).

The developmental state required a bureaucracy effectively ‘embedded’ in society through “a concrete set of connections that link the state intimately and aggressively to particular social groups with whom the state shares a joint project of transformation” (Evans 1995: 59, cited in Woo-Cummings 1999: 15). Here, economies are neither self-constituting nor autonomous, but always ‘embedded’ within political processes and institutions; just as states ‘rest’ on economic bases, economies in turn ‘rest’ on certain political bases (Weiss and Hobson 1995: 55). It is this ‘embedded autonomy’ – the combination of an autonomous bureaucracy and ‘thick’ external ties to the economy’s organised agents – which are key to a developmental state’s effectiveness (Evans 1994: 96). State capacity thus largely rests on the character of the distributional alliance, which is, in turn, determined by the distribution of power between state and society (i.e. the ‘political settlement’).

The character of this developmental alliance (between the state and segments of capital) shapes capital accumulation and thus determines a state’s ability to pursue its objectives (Koo and Kim 1990; Pempel 1999: 156; Vartiainen 1999: 219). The close relationship between East Asian states and industrial capitalists enabled the state to pursue an industrialisation programme which led to economic growth and benefited both parties. The social character of the developmental alliance is, in turn, determined by historical factors such as earlier social relations, state institutions and the state’s relations with business. The balance of power between the state and capital also determines state capacity.

The success of the development project depends not only on the ability of the state to discipline capitalists, but also on an appropriate balance of forces between state and capital, where both feel that their own progress depends on the success of the other partner (Vartiainen 1999: 219). This ‘strategic interdependence’ involves mutually dependent relations between government and big business (Barzelay 1986, cited in Choi 1993: 23-24). “The concept of the developmental state means that each side uses the other in a mutually beneficial relationship to achieve developmental goals and enterprise viability” (Johnson 1999: 60). In the case of South Korea, “both business cartels and state economic bodies were committed to high growth, realising that they would have to sink or sink together” (Pempel 1999: 164).

But because the state “can structure market incentives to achieve developmental goals” or “structure them to enrich itself and friends at the expense of consumers, good jobs, and development” (Johnson

1999), for developmental states, “connections with society are connections with industrial capital” which “enable state elites to incorporate these powerful groups in the state’s economic project” (Evans, cited in Woo-Cummings 1999: 16; Evans, cited in Kohli 1999: 132). Developmental states are thus characterised by the implementation of strategies by a comparatively autonomous technocratic elites and the institutionalisation of close relations between business leaders and state officials in forming a dynamic export-oriented regime of capital accumulation (Johnson 1982, cited in Lubeck 1990: 177). Here, states must be able to construct economic rules that advance long-term capital accumulation and technological dynamism, and thus promote growth (Pempel 1999: 142). State capacity can thus be defined as the ability to mobilise social resources and allocate them to desired ends (Weiss and Hobson 1995).

Differences in state strength and sources of state capacity partly account for differences in economic performance. The diversity in state structures, state-economy linkages and inter-state relations shape the autonomy, strategies, capacities and capabilities of modern states to facilitate industrial change (Weiss and Hobson 1995). The constellation of political priorities, state structures and government-business relations (i.e. the state’s ‘transformation capacity’) determines the ability of the state to coordinate industrial change to meet the changing challenges of international competition (Weiss 1998: xii, 7). Such state-business coalitions are thus reflected in a strong pro-business policy bias. In the case of South Korea, the state’s nature and relations allowed it to implement policies in the 1960s and 1970s, which were in favour of big capital<sup>4</sup>, which in turn ensured business confidence and a favourable investment climate (Koo and Kim 1990)<sup>5</sup>. The success of the Korean developmental state thus lay in its new production-oriented alliances with the dominant classes, which buttressed the state’s capacity to both control and transform, which led to sustained economic transformation (Kohli 1999: 96, 108). In addition, the willingness of the state to punish recalcitrant firms was vital to the overall acceptance and success of state-led, macro-level initiatives (Pempel 1999: 165). State capacity is not about strong or authoritarian states, but depends on the state’s ‘negotiated power’ (Weiss and Hobson 1995). This ‘infra-structural power’ is the “ability to shape incentives through coordinated decision-making and elicit desired behaviours, distinct from the coercive power to forestall political challenges” (Mann 1991, cited in Felker 1998: 87).

But there is also a potentially negative side to the relationship between the state and business, not only because losers are involved, but also because “all countries have accumulated politically organised groups which have developed ways to modify certain market outcomes ‘politically’” (Chang 1999: 191). While a mutually beneficial relationship enables the state to undertake development policies which benefit both capital accumulation and economic growth, it must also be able to do so without disruptive political constraints. While focusing largely on the willingness of the state to discipline capital, the literature on the developmental state has tended to ignore the political problems posed by other groups in society. Here, state capacity not only depends on the state’s relationship with segments of capital, but also on political constraints posed by groups outside the ‘developmental alliance’. Some of these groups can be easily removed, but others may be so entrenched that this will be at a very high political and economic cost.

Arguments for state intervention implicitly assume a competent, informed and ‘strong’ government whose motives are “to maximise social welfare by offsetting and correcting market imperfections” (Haggard and Lee 1993: 7-8). Rent-seeking models, however, suggest that government intervention reflects “pressures emanating from powerful groups capable of extracting policy favours”. While developmental states have been characterised by strong states, the efficiency implications of economic policy are determined by the relationship of the state with these ‘powerful groups’.

In a way, public choice theory has recognised the problem of political pressure from interest groups to extract policy favours. However, its solution of reducing state intervention fails to account for variations across countries in terms of the nature and effectiveness of state intervention. It also forgets that powerful groups remain in society regardless of state intervention. It also fails to address the question: did state intervention result in rent-seeking by interest groups, or did the existence of interest groups lead to or shape state intervention? Rent-seeking models do not explain the direction of causality. By assuming that reduced state intervention will automatically reduce rent-seeking, and that privatisation depoliticises distributional issues (Bienen and Waterbury 1989: 618), such arguments ignore political realities in developing countries and transitional economies.

As these groups are potentially destabilising politically, the state must be able to either accommodate them (i.e. pay them off) or constrain their actions. In the case of India, labour – fragmented and

dominated by adversarial political parties – had the power to bend and block policy and to thwart capital selectively, but lacked the cohesion or independence to pursue corporatist strategies or enforce social compacts. Similarly, the social power of propertied classes was reflected in the failure of land reform and the ability of landlords to overcome development policies. As capital funded the government, “the big business houses got rich in protected markets collecting rents on sub-competitive quality at supra-competitive prices” (Herring 1999: 323, 331-334). The result is the allocation of rents without any benefits in growth or efficiency.

Just as the balance of power between the state and capitalists determines the nature of the ruling growth and distribution coalition (and thus, the capital accumulation strategy), the ability of the state to implement policy, e.g. by allocating and withdrawing rents, depends on the political context in which economic policy is conducted, namely its relationship to economic actors. State capacity thus does not merely depend on the state’s reach (its connections with capitalist groups or other productive relations), but also its ability to overcome political constraints (i.e. resistance by losers and other interest groups) (Chang 1999: 191-198)<sup>6</sup>.

### **Institutional Failure**

Institutional explanations for state failure focus on the interests of politicians and the structure of government as determinants of the ability of rent-seeking groups to get their way (Haggard and Lee 1993: 12). Institutions can be described as “the social rules, conventions, and other elements of the structural framework of social interaction” (Bardhan 1989: 3). New institutional economics (NIE) combines (neo-classical) assumptions of human behaviour (e.g. wealth maximisation) and problems of asymmetric information, with transaction (and enforcement) costs (North 1990)<sup>7</sup>. At its core is the notion of transaction costs and bounded rationality, where “the capacity of economic agents to uncover and incorporate all potentially relevant information is bounded” (Fine 1997: 380-381). State failure is due to the failure of efficient institutions to emerge and is related to the costs of changing institutions.

Rent-seeking is attributed to policies and institutions which create the wrong incentives for individuals (e.g. extensive state intervention; weak monitoring and regulation; low public service salaries; inadequate judicial system) (Khan 2000: 8). As such, the most important institutional prerequisites for successful industrial development are: security of property rights; an effective and impartial judicial

system; a transparent regulatory framework; and an institutional framework that promotes and permits complex impersonal exchange and interaction (North 1990, cited in Martinussen 1997: 254).

Institutional change can include the designation of new property rights (in the case of privatisation) or other economic transfers which are part of structural change.

According to North, changes in relative prices or relative scarcities leads to the creation of property rights when it becomes worthwhile to incur the costs of devising such rights. This leads one or both parties in an economic or political exchange to renegotiate agreements or contracts to improve one's position. As institutional change involves winners and losers, the latter must be compensated through 'side-payments' or 'participation bribes' (Libecap 1989; Dow 1993, both cited in Khan 1997: 80). Political transaction costs are thus the costs of organising the side-payments which allow institutions to be changed through a process of voluntary contracts (North 1990, cited in Khan 1997: 80). The failure to introduce more efficient institutions (and to industrialise) is due to the high levels of political transaction costs for changing institutions and prevailing institutional conditions (Martinussen 1997: 255).

However, most of the time, institutional changes are resisted politically by losers because compensation is not offered or, if offered, not accepted (Khan 1997: 81). Furthermore, efficiency-improving institutional change is linked to the political process, which means that NIE solutions, such as property rights, cannot be separated from redistributive institutional change (Bardhan 1989: 11). In the absence of alternative influences on policymaking, the political struggle becomes central to the redistribution process, and conflicts between groups over economic policy tend to get played out in the political arena (Cook and Minogue 1990: 27).

In the privatisation debate, decisions to "establish, retain or divest a public enterprise are not made in a political vacuum" and "ownership and control of economic units are instruments for advancing certain interests and frustrating others" in the struggle for power among various interest groups (Jones and Mason 1982: 16). As public enterprises can be used to further the interests of the state elite, "deregulation threatens the 'rents' accruing to various groups" (Cook and Kirkpatrick 1988: 121). It is precisely because it functions as a rent that "privatizations may be implemented in the absence of a

commitment to market forces, but where the state seeks to redefine the instruments and scope of its intervention” (Bienen and Waterbury 1989).

The success of policy change such as privatisation thus depends on the political dynamics of market liberalisation, which groups stand to benefit or lose, and their relative political power to resist change. For a reform to be successful, it must thus be politically desirable, feasible and credible (Shirley 1997: 41). These, in turn, depend on whether political benefits (efficiency gains) outweigh political costs, if there is a change in regime or coalition shift (i.e. the balance of political power in society), and the leadership’s ability to compensate losers or enforce compliance (Campos and Esfahani 1996: 193; Cook and Minogue 1990: 29).

### **Patron-Client Networks**

The character of groups resisting change, and their relationship with the state, determines the distribution of power in society – the ‘political settlement’ – which either enables or constrains state actions (Khan 1997; 2000). This is, in turn, shaped by historical factors, specifically pre-existing distributions of political and organisational power in society, and how these affect accumulation strategies (Khan 2000: 12). Resistance can be traced back to specific and powerful social and political groups (Hood 1979, cited in Cook and Minogue 1990: 28), usually public sector employees who fear job losses, and government officials whose authority and opportunity for patronage will be reduced<sup>8</sup>. Resistance may be greater if potential losers are located within the state and public enterprise bureaucracies themselves, and where public enterprise agencies often constitute patron-client networks which lead directly back into the political and bureaucratic elite groups responsible for policy reforms (Pendse 1988; Sandbrook 1988; both cited in Cook and Minogue 1990: 29).

The potential for privatisation is tempered by the nature of coalitions of vested interests, and the attention of the leadership to the control of economic resources and patronage (Bienen and Waterbury 1989). These dominant coalitions are usually seen to comprise the political elite, the military, state managers, organised labour, civil servants and large sections of the professional middle class closely involved in the (import-substituting) programmes of an interventionist state (Bienen and Waterbury 1989: 11). But privatisation creates both winners and losers. Just as there is resistance, there will also be political support, particularly where privatisation potentially benefits the very same groups that may



oppose its introduction. Or, more realistically, privatisation may be designed to accommodate such groups which are usually party to (costly) social pacts in which they trade political support (or silence) for protection of their standard of living and privileges, e.g. through a continued state commitment to redistribution. Different political coalitions of interests will thus produce different political responses to pressures for privatisation (Cook and Minogue 1990: 29).

In many developing countries, the colonial legacy and the struggle for independence created intermediate 'non-capitalist' classes which later became influential in post-colonial states. While Northeast Asian developmental states effectively restructured society, eliminating the landlord class, and emphasised the training of technicians, engineers and businesspeople, many developing countries were burdened by "a well-educated but economically unproductive professional class" (Pempel 1999: 169-170). The political role of the educated salaried middle classes in such societies is of considerable importance (Alavi 1982: 299) and resistance has typically been organised by emerging middle class groups left behind or marginalized by the development process (Khan 1998: 19). The allocation of rents in this context is not only crucial for economic development, but also, for political stability, for which it may be necessary to 'purchase' the support of these groups. The efficiency implication of such political transfers is that "the state allocates resources to those with the greatest ability to create political problems rather than those who have the greatest ability to pay" (Khan 1998: 19). Unfortunately, "the groups whose accommodation is necessary for political stability may be very different from groups who are likely to lead economic growth" (Khan 2000: 19).

The ability of these groups to resist or demand pay-offs explains the differences among different state capacities, and hence, economic performances in East Asia and South Asia (Khan 1998). Rather than NIE transaction costs, the intensity and extent of resistance is the real 'cost of change' faced by its initiators (Khan 1997: 81). This 'transition cost' is "the political cost which potential losers from proposed institutional change can impose on the proponents" (Khan 1997: 82). This can take several forms and depends on the balance of power between the state and economic actors, which are in turn determined by the political settlement. More than institutional strength (e.g. strong states with meritocratic and autonomous bureaucracies, etc), it is the power relations between the state and economic actors which determine state capacity (see e.g. Vartiainen 1999; Pempel 1999).

Due to the problem of excess demand for resources in developing countries, resources are usually allocated in personalised and partisan ways, and through patron-client networks, rather than through transparent processes, invariably leading to rent-seeking and corruption (Khan 1998; 2000: 20). (Patron-client relations are repeated relations of exchange between specific patrons and their clients [Khan 1998: 23].) The nature of such patron-client relations – in terms of how it is likely to influence economic decisions – depends on: the objectives and ideologies of the patrons and clients; the number of potential clients and their degree of organisation; the homogeneity of clients; and the institutions through which patrons and clients interact, including the degree of fragmentation of institutions (Khan 1998: 24-26). More critically, the relative power of patrons and clients can determine how resources are allocated.

In East Asia, rents were allocated on the basis of strict economic criteria. “Government programmes were often generous to favoured industrial sectors, but international competitiveness was expected in return. Poor performers were penalised; good performers were rewarded” (Pempel 1999: 173). So although the transfers of large subsidies from the state to capitalists inevitably involved rent-seeking, where rents were allocated in exchange for ‘payoffs’ or ‘kickbacks’ to the political leadership, the state was able to extract maximum rents while, at the same time, ensuring economic performance. Here, the bribes offered indirectly correlate to the capability of the client: the highest bribe will come from a client who is most confident of recouping this cost by using the rent allocated most efficiently. The more efficient the entrepreneur, the bigger the bribe they will be willing to offer. This enables even the corrupt state to pick more successful entrepreneurs and to weed out less successful ones (Khan 1998: 32). Because the state can extract a quid pro quo from the private sector in the form of sustained high investment levels to maximise net rents (Haggard and Lee 1993: 12-13), the end result is that the rent is efficiently allocated<sup>f</sup>.

This was possible because the client was weak, allowing state actors to extract the maximum economic payoff, including bribes reflecting the value of the right being transferred or created. However, where the patron is politically weak, the client may instead offer political support (or reduce political opposition), rather than an economic payoff. Such political corruption may be necessary to ensure stability, but can also be growth reducing. Patron-client networks in South Asia reveal the substantial political power of clients from intermediate ‘non-capitalist’ classes whose accommodation has resulted

in interlocking patron-client transactions, making it difficult for the state to re-allocate rents more efficiently, which partly explains the persistence of inefficient rents (Khan 1998: 28; Khan undated: 17, 19).

Apart from the differences in the power of patrons and clients, the pattern of rent flows is crucial. The absence of “competing and decentralised centres of political power which could demand rent-distribution to themselves” has important consequences for the efficiency of rents, and accounts for South Korea’s efficient outcome compared to India (Khan undated: 21).

### **POLICY IMPLICATIONS: PERVERSE INCENTIVES AND MORAL HAZARD**

The changing nature of patron-client networks raises several important questions, not least over whether state intervention is conducive to efficiency in the long run given the problems of perverse incentives and moral hazard. In the South Korean case, by fostering the growth of *chaebols*, the state created perverse incentives. Where NIC states assumed the role of ‘gatekeeper’ to finance and export markets, local capitalists became entirely dependent on bureaucratic licenses and government-sponsored credit (Castells 1990: 65). Financial regulation, for example, led to big business depending for too long on debt financing (Choi 1993: 24). While this was necessary in the early stages of Korea’s economic development, and while the economy boomed, this was not a problem. But in a slowdown, debt-ridden firms fell back on the government for relief and the government had no choice. Financial relief only nurtured continued dependence on debt.

The state thus faced the problem of moral hazard where it could not allow large conglomerates to fail. Generalised bailouts of banks are usually seen to reduce incentives in all firms and to lead to widespread moral hazard (Roland 1994). But as the state was responsible for credit allocation decisions and the accumulation of NPLs in the banking system, banks could not be held accountable for bad loans, and the state could not avoid rescuing banks in the 1980s (Choi 1993: 41, 53; Woo-Cummings 1999: 12) or poorly-managed companies between 1969 and 1971 (Koo and Kim 1990: 131). Because the state could not afford the political costs of massive layoffs, it was never fully able to enforce the threat of terminating credit or relief loans (Choi 1993: 41). This places the system in a “state of permanent receivership” where the state has to socialise risk by manipulating the financial structure to meet industrialisation objectives (Woo-Cummings 1999: 12-13). The *chaebols* were well aware of this, and

their expansion in the 1970s was precisely to ensure that they were large enough so that the state could not afford to let them fail. This business strategy also allowed *chaebols* to strengthen their position in relation to the state, and thereby influence policy (Choi 1993: 24, 36, 41, 53; Koo and Kim 1990: 136). As a result, the relative autonomy of the state vis a vis conglomerate capital, and its ability to control the behaviour of the *chaebols*, declined considerably (Koo and Kim 1990: 145). State intervention thus not only depends on the political settlement, but in turn also affects the balance of power.

## **CONCLUSION**

The efficiency of rents from privatisation can be crucial to the success of a growth strategy. This, in turn, depends on the ability of the state to select appropriate candidates for the job, monitor their progress, and enforce discipline. Where privatisation is mainly undertaken by contracting out development projects, the relationship between state and capitalist is that of principal and agent. Here, the ability of the state to select the appropriate candidate and monitor progress is constrained by asymmetric information, leading to adverse selection and managerial discretion. However, access to information in itself does not guarantee that agents will deliver and the state must also have the capacity to enforce discipline.

This state capacity depends not just on state institutions (or perfect information), but also on political constraints facing the state, which can be traced to the 'political settlement', i.e. the distribution of political power in society. This not only includes the nature of the state-society developmental alliance, but also the strength of the state in relation to capitalists, as well as other non-productive groups in society, in particular, the intermediate classes, who may resist or disrupt change. It is the nature of the state's relationship to these groups which can account for differences in the economic outcomes of rents. As rents are usually allocated through patron-client networks (given the limited resources available and excess demand), the type of patron-client network can explain the efficiency of rents. Where the state is strong enough to dictate economic policy, the allocation of rents is centralised and based on economic criteria. On the other hand, a decentralised allocation process is usually indicative of a fragmented patron-client network where independent clients compete for resources. Where these groups involve unproductive middle classes, the results are political payoffs not based on economic criteria which can therefore be growth reducing.

The nature of the patron-client network, however, is not static, and state intervention which creates conditions for successful capital accumulation and growth, may inevitably benefit a particular group or class who are then in the position to influence state policy. This highlights the problem of perverse incentives and moral hazard in state intervention, where incentives (in the form of privatisation or other rents) for learning or capital accumulation make it difficult for the state to withdraw support in the long run. Rather than asymmetric information or institutional failure (or for that matter, seeking 'good governance' or 'political will'), the study of the changing balance of power in society and how this constrains state policy, is of crucial importance to understand variations in state intervention, and the success or failure of privatisation.

This, in turn, requires examining the political economy and economic history of a country to determine the nature of the political settlement, and how this affects the ability of the state to allocate resources. Of particular interest will be the types of groups that have emerged, and the nature of their relations with the state, including their relative strength. Such a historical perspective allows not just the examination of the quality of state institutions (Vartiainen 1999: 219; Koo and Kim 1990: 144), but also political dynamics and varying performances in the context of a variety of colonial pasts. Different state capacities can be traced back to the colonial experience: South Korea's dynamism can be located in part in the state-society relations created under Japanese colonialism; India's slow growing economy due to British colonial strategies resulting in 'distributive politics'; and the predatory states in much of Africa, the result of 'incomplete states' (Kohli 1999: 135-136).

## *Notes*

<sup>1</sup> Productive activities can include sectors which contribute directly or indirectly to economic growth (e.g. manufacturing) as opposed to speculative or wasteful activities. However, not all productive activities are necessarily efficient.

<sup>2</sup> The state's commitment to heavy industrialisation in South Korea and control of actual investment decisions, for example, aimed to reduce 'strategic uncertainty' involved in heavy industry investments (Choi 1993: 36).

<sup>3</sup> The clear designation of property rights, by combining 'residual control' and 'residual return', is said to provide incentives to improve efficiency (by introducing the profit motive) and reduce managerial discretion (through capital market pressures and the threat of bankruptcy). This is because incomplete information, bounded rationality, opportunism, 'information impactedness' and uncertainty result in the failures to write, monitor and enforce complete contracts which cover all possible contingencies (Hart 1995 cited in Martin and Parker 1997: 396; Millward and Parker 1983: 531, 536).

<sup>4</sup> It has even be argued that as the capitalist state is, by necessity, developmental, the successful state must be able to understand the needs of capital as a whole (and not fractions of capital) and act against particular capitals in the interest of capital as a whole (Herring 1999: 331).

<sup>5</sup> Kohli (1999: 120-123) provides examples of the state-business alliance which were "so intricate that it is difficult to tell where the public efforts ended and private efforts began". This is in contrast to India's failed developmental state where the bureaucracy was autonomous of (and antagonistic to) capital as a class, and where this autonomy was reinforced by the disunity of capital (Herring 1999: 323, 331-334).

<sup>6</sup> Whether government policy is more or less efficient and growth-promoting will depend on the strength of the groups which stand to benefit, and the political influence they yield, relative to other groups, as well as the 'disciplinary capacity' of the state (Haggard and Maxfield 1993: 294-295, 298, 308). Here, the interests of domestic actors and domestic political changes cannot be wholly disentangled from international financial market incentives. States are more likely to intervene where growth, rather than macroeconomic stability, is more important.

<sup>7</sup> Transaction costs and transformation costs are affected by problems of coordination due to the motivation of players, complexity of the environment, and ability of players to decipher and order the environment.

<sup>8</sup> It may also be politically unacceptable to sell enterprises to specific ethnic groups or to foreign interests (Cook and Kirkpatrick 1988: 125).

<sup>9</sup> For example, the size of NPLs in the Taiwanese banking sector remained small because bankers collected kickbacks from firms with collateral (Cheng 1993: 82).

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