Mushtaq Khan. 1995. *State failure and weak states: a critique of new institutionalist explanations.* in J. Harriss, J. Hunter and C. M. Lewis (editors). **The new institutional economics and Third World development.** Routledge: London and New York.

Definitions

Institutions are the set of formal and informal rules that constrain and govern the interaction of agents subject to that institution. The formal institutional structure includes conventional property rights but also any other enforceable constrains such as taxes and subsidies. State regulation creates or attenuates property rights, and the state is also responsible for the enforcement and protection of all property rights. Hence, the state is part of the formal institutional structure. (pp. 71-2).

"State failure" is a descriptive term involving only a judgement about the potential benefits of alternative institutions, if institutions can be changed. It does not necessarily mean that the state decides which institutions to protect and how. The state or parts of it can under some circumstances act autonomously, in others it simply responds to pressures from competing classes and groups. (pp. 72).

Types of institution and state failure (pp. 72-3):

> *Type I (structural) failure* – refers to performance of existing institutions (or existing structure of rules and constrains) compared to an alternative set of institutions. Type I institution failure occurs when a particular formal institutional structure results in lower net benefits for society compared to an alternative structure. The lost net benefit indicates the magnitude of Type I failure. NIE uses transaction cost and rent-seeking analysis to compare alternative sets of institutions and measure Type I failure.
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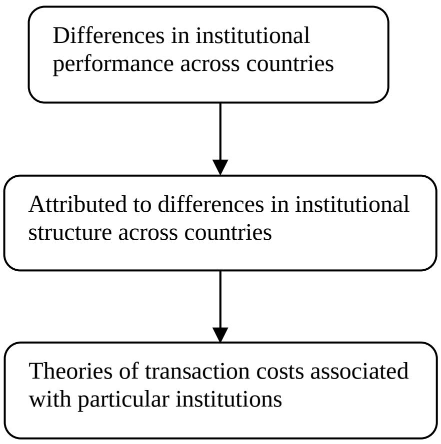
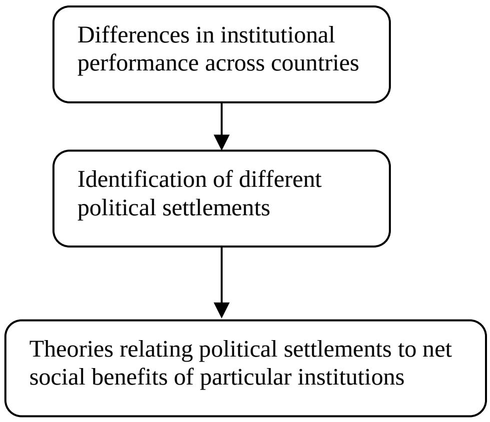
> *Type II (transition) failure* – refers to failures in the process through which institutions change compared to alternative processes. Type II failures are failures of transition. If Type I failures exist, then it is instructive to compare alternative paths to a better structure. Type II institutional failure occurs when the process of changing the structure of institutions attains a lower cumulative set of net benefits (the structure attained, the speed of transition, the costs of transition, whether Type I failure increased or decreased, etc) for society compared to an alternative process over a given period. For Type II failure, NIE relies on transaction costs (such as political transaction costs) and the costs of organising collective action.

Type I (or structural) state/institution failure

NIE Analysis	Political Economy Analysis
Drawn on rent-seeking analysis extended by using transaction cost analysis. Both add costs to the *traditional static costs* associated with state/institutional failure: Static costs of state intervention = p≠mc *Rent-seeking*: unproductive use of resources for creating and capturing rents made possible through state intervention: Costs = resources used unproductively.	The rent-seeking argument may be one-sided since: - all property rights confer privileges, which have the character of rents; - rent-seeking can therefore be associated with any structure of rights in which people would seek the rent (or property rights allocation); - rent-seeking only results in Type I failure if lower rent-seeking costs are attainable; comparing the current state with the unattainable laissez-faire, contest free world is irrelevant; - state intervention can save transaction costs by changing incentives and enabling coordination; - intervention with rent-seeking may have overall lower transaction costs than laissez-faire (ex, if ISI allows cheaper coordination of technology acquisition). Rent-seeking shows that there may be a real social cost associated with contests, but ignores improvements and net benefits that are associated with changes in institutions that the contest may bring.
Transaction costs: costs of agreeing and enforcing a contract: Costs = contract costs + gainful transactions prevented Rent-seeking results in Type I failure by increasing transaction costs of doing business.	Transaction costs include the possibility of improvement associated with contests, but: - its early analysis of costs is based on assumptions about the political system; - alternatively, jointly analysis of economic and political institutions to mapping from institutions to outcomes, but this can be easily overturned because it abstracts fro the political settlement; - introduces politics through informal institutions, while retaining the analysis of formal political institutions in which the choice of institution is independent of polity – this would either render the choice of formal and informal institutions indeterminate, or prevent the mapping from institutions to outcomes independently of the polity. Hence, the political balance of power conditions both the problems institutions have to solve and the costs of solving them. This may explain why different NIE studies have identified & ranked very different institutions as been crucial for success or failure.
Explaining institutional Performance  	**Explaining institutional performance** 

Type II (or transition) state/institution failure

NIE Analysis	Political Economy Analysis
Why wouldn't a government introduce growth improvement rights? Even a predatory state would benefit from increasing growth. So, why wouldn't it change the institution setting in the presence of type I (structural) institutional failure? Three explanations emerge under the NIE.	The same questions could be answered alternatively by focusing on two related issues: the costs of transition (resistance costs), and the fact that institutional performance depends on political settlement, not on the institution per se.
Objectives of the leadership, particularly with respect to *time preferences*, are different from that of society: revenue maximising state is unwilling to introduce growth-increasing institutions if these lower short-term tax revenues.	Predatory leaders may not have short-term horizons. Even if some predatory leaders/states have high discount rates, this may be endogenous, in the sense that their time preference is determined by the political settlement (ex, the Kuomintang, predatory in China, developmental in Taiwan).
Errors of calculation: wrong models of the world and imperfect information are the cause of stagnation since policy-makers may either make wrong decisions, or have no clear idea of the whole impact of their decisions.	There is no evidence that leaders of less dynamic countries have lagged behind in wanting to learn from successful experiences and their own mistakes, not that these countries have incurred systematically in more mistakes than the others. But they do find it more difficult to correct mistakes, what may be associated with the costs of change. In the case of firms which share the same environment, differences in the subjective creativity of entrepreneurs may be fairly important in explaining differences in relative performance; but in the case of states, it is more likely that differences in the environment (which includes not only technical possibilities but also the political settlement) may be relatively more important than subjective differences between leaders.
Political transaction costs: if growth-enhancing institutions do not emerge, there must be resistance to change. Similarly to market exchange, NIE models institutional change as a series of voluntary contracts that may or may not happen because of the relative political transaction costs, or costs of side-payments (compensation to losers). The efficiency of the market is the key issue.	If all institutional changes were voluntarily negotiated, all type II failure would be due to failures of knowledge alone, and the costs of change would become irrelevant in explaining type II failure. Losers resist most important institutional changes because compensation is not offered or, if offered, is not accepted. Thus, the intensity and extent of resistance is the real cost of change, or transition cost (not the political transaction costs). With full information, the best institutional world attainable through individual negotiation can be realised, apart from transitory blips – this is, when agents have not caught up yet with new knowledge. Only persistent failures of knowledge can result in political transaction costs, and this collapses into the knowledge failure discussed above (where transaction costs are irrelevant). However, real world institutional changes (even minor changes like tax cuts) are rarely a result of negotiation, nor involve any compensation to losers. These institutional changes involve path changes, which are not negotiable through compensation. Since compensation is not on offer, its costs are irrelevant. Hence, political transaction costs are a very deficient way of analysing failure of institutional change. Transition costs are not economic costs, but political ones: the cost opponents groups can inflict on one another is the balance of power between them as described by the political settlement. The feasibility of each project is decided by the ability of the proponent group to absorb transition costs. If the political settlement favours opposition to change, low transaction costs may increase the strength of opposition; if the political settlement favours proponents of change, transition costs may be low and changes may occur irrespectively of transaction costs. The analysis of type II failure involves political judgement about the desirable transition path and location, and the mapping from institutions to outcomes is not sustainable.