Introduction

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The rapid economic development of a number of Asian countries over the past three decades lulled many observers into taking excessively complacent positions about the new 'emerging markets'. The financial crisis of the late 1990s, which brought this period of growth to a temporary halt, resulted in an equally dramatic change of mood about the prospects of these countries. Led by the International Monetary Fund (IMF) and many academics, there was a widespread feeling that rent-seeking and corruption underpinned the crisis, and that without uprooting the institutional structure of 'crony capitalism', the prospects for the region were dim. The period as a whole thus provides a rich source of evidence with which to examine the role of rent-seeking in economic development. How important have corruption, patronage, lobbying and kickbacks been in developing countries? Have they been responsible for slow growth or the reverse? What determines the magnitude and effects of different types of rents, of corruption and of patron–client exchanges? How did Asian countries grow so rapidly in the 1980s despite an apparently widespread problem with rent-seeking? To answer these questions, we start by examining theoretical models and asking how they need to be amended and extended. Corruption, clientelism and other forms of rent-seeking were widespread during Asia's high-growth period and it is this experience which most of our case studies address. Understanding the role of rent-seeking in the period of growth is critical for assessing the adequacy of explanations of the subsequent crisis in terms of crony capitalism which many commentators were quick to offer *ex post.* The main thrust of our story is that rent-seeking was, and is, endemic in both developing and developed countries. The difference is that in developing countries the rent-seeking can be more extensive, can include illegal forms and is more often damaging for growth. At the same time, many types of rents and rent-seeking played a key role in processes of development and are likely to do so again in the future. Understanding this paradox is of great importance for policy-makers.

The book is aimed at audiences across the social sciences, in particular, economists, political scientists, development professionals and political economists. The interdisciplinary approach was motivated by a convergence in the types of questions being asked and the types of explanatory variables being identified across social science disciplines to explain related phenomena. We feel very strongly that further progress is contingent on active cross-fertilization across disciplinary frontiers. The authors contributing to this book are economists and political scientists working on the effects of rent-seeking, corruption and patron–client exchanges. But rather than being a collection of pieces addressing similar questions in different disciplines, the authors have addressed this interdisciplinary audience. In addition, the book is distinctive in that all our authors have regional specializations in one or more of the Asian countries discussed. As a result, our theoretical questions have been motivated by historical observations to a much greater extent than is typical in the analytical literature.

Chapters 1 and 2 provide an overview and critical extension of the analysis of rents and rent-seeking. The mainstream economic analysis is shown to be far too narrow. Advances in information economics and in institutional economics as well as insights from classical political economy are used to extend and amend the standard model to make it more appropriate for analysing the historical evidence. Chapters 3 to 8 address the experience of rent-seeking, corruption and related processes in a number of Asian countries. These chapters are interesting in their own right as an analysis of rent-seeking in these countries, but, in addition, they also test the validity of the narrow rent-seeking framework and our claim that this framework has to be radically amended and extended.

The mainstream framework used for analysing rent-seeking has (a) focussed on some very specific *types* of rents, and (b) assumed very specific political and institutional conditions under which rent-seeking (the competition over rents) takes place. There are two possible responses to the limitations of these theories. One is to abandon the rent-seeking framework altogether and to derive analytical generalizations about the effects of processes like corruption and patronage from the empirical evidence. This approach is often adopted by critical political scientists. The other is to preserve the overarching analytical framework of the rent-seeking approach but to extend the range of rents and types of rent-seeking which are analysed. These two approaches are actually complementary because, if the rent-seeking model is to be extended, it has to incorporate the insights coming from political science and political economy.

Chapter 1 shows that, while many rents are harmful for developing countries, others are essential for both efficiency and growth. As a result, Chapter 2 shows that the rent-seeking which seeks to preserve or destroy particular rents can be growth-promoting or growth-retarding, depending on the circumstances. To have an effective analytical approach we need to look not only at the determinants of the rent-seeking *cost* but also at the determinants of the *types of rents* which are being created or preserved. Since institutional change almost always involves the creation or destruction of rents, and since distributive conflicts can also be described as conflicts over rents, rent-seeking *can* provide an overarching framework for examining many questions which have concerned institutional economics and political economy. By drawing on the insights of these disciplines, we see that the outcomes of rent-seeking must also depend on institutional and political variables. Although conventional rent-seeking theories have not significantly borrowed from these disciplines, the first two chapters show that an analysis of political and institutional variables is essential for making sense of rent-seeking in the real world. Chapters 3 to 8 provide detailed case studies of rent-seeking processes in a number of Asian countries. The experiences of the Philippines, Thailand, Malaysia and Indonesia receive particular attention. The theory chapters draw on the experience of South Korea and the Indian subcontinent as well. Each of these chapters focusses on particular economic, political and institutional variables which the authors think are essential for explaining the effects of rent-seeking in that country.

The economic theory in Chapters 1 and 2 aims to be accessible to social scientists with an interest in economics. But as these chapters also challenge the standard rent-seeking model by incorporating results from institutional economics and political economy, they will be of interest to economists as well. Similarly, the case studies in Chapters 3 to 8 should be of interest both to economists working on rent-seeking and to political scientists and area specialists with an interest in these countries. In addition, graduate students and advanced undergraduates across the social science disciplines are likely to find the book useful for its critical development of the theory of rent-seeking and as a source of case studies of rent-seeking in Asian countries.

The Asian financial crisis of the late 1990s intensified the debate over how governance structures and political processes need to be reformed in developing countries. The contributors to this volume ask how substantial rent-seeking could have coexisted with high growth for so long, indeed how rent-seeking appears to have driven growth in some cases. Our authors suggest that rent-seeking describes a wide range of processes which are sometimes critical for growth and sometimes severely growth-retarding.

The link between crony capitalism and the financial crisis which was frequently made in the aftermath of the 1997 crisis seemed compelling at the time, but was certainly too simplistic in view of the longer historical record. The significance our authors attach to the financial crisis for the analysis of rent-seeking varies. The consensus, rather, is that a policy response to rent-seeking cannot be developed by looking at the financial crisis in isolation. Looking at the rent-seeking process historically confirms the need for a more sophisticated analysis if future policy responses are to be appropriate.

The longer-term Asian experiences which this book draws on challenge many of the established models of the effects of corruption and rent-seeking. Corruption, patron–client exchanges and other forms of rent-seeking have been rife in many of these countries. All of them have also had periodic ups and downs, but more interesting is the variation in their *long-run* performance. In many cases, long-run performance has been dramatic, in other cases quite poor. It has ranged from the relatively poor performance of the Indian subcontinent and the Philippines to the very high growth rates of Northeast Asian countries, such as South Korea. Most Southeast Asian countries, such as Indonesia, Malaysia and Thailand, fall somewhere in between. Even allowing for other factors explaining differences in growth rates, this range of experience raises questions about the adequacy of the standard economic models of rent-seeking.

Not only was there no simple correlation between the *extent* of rent-seeking and long-run economic performance, there was also little correlation between the intensity of rent-seeking and the country's vulnerability to the financial crisis of 1997. Chapter 2, in particular, looks at the analytical implications of these puzzles. With comparable amounts of rent-seeking and corruption, many East and Southeast Asian countries did significantly better than the South Asian countries of the Indian subcontinent. Moreover, while corruption increased much more rapidly in the 1990s in the Indian subcontinental countries, the financial crisis hit only the Southeast Asian countries with ferocious severity. Clearly, the interaction of short-term capital flows, problems of political legitimacy as well as problems related to some *types* of rent-seeking produced a particularly severe crisis in some Asian countries. But it is also important to understand rent-seeking as a longer-term process, with implications and effects which should not be read off from a single shock.

Comparisons of the extent of rent-seeking and corruption across countries are, to say the least, not a precise science. The contributions to this volume are a response to the observation that corruption and political transfers have been significant in virtually all Asian countries. They challenge the interpretation, widely shared among policy-makers, that developmental success is related to the *absence* of rent-seeking and the conditions which give rise to it. A common theme running through the contributions in this volume is that this view is unrealistic. The effects of extensive corruption, clientelism and other forms of rent-seeking *differ* across countries, and the analytical task is to identify the determinants of these differences. By examining rent-seeking processes in greater detail, the volume questions many widely held conceptions about rent-seeking which have gained uncritical currency. The next three sections summarize, in turn, a number of issues in our discussion of rent-seeking, corruption and patron–client exchanges which recur throughout the book. The fourth section provides a plan for the subsequent chapters and an outline of the main arguments.

Rents and rent-seeking

The term 'rent' is used to describe (not always very precisely) incomes which are above normal in some sense. But what is a 'normal' return? Often the benchmark used is the income which an individual or a firm would have received in a *competitive* market. But since the competitive market of theory does not usually exist, a more useful definition is an income which is higher than the minimum which an individual or firm would have accepted given alternative opportunities. However defined, a moment's reflection should tell us that a very wide range of critically important real-world incomes have the character of rents. Rents include not just monopoly profits, but also subsidies and transfers organized through the political mechanism, illegal transfers organized by private mafias, short-term super-profits made by innovators before competitors imitate their innovations, and so on. Some rents are legal while others can be illegal. Some, such as monopoly rents, may signal inefficiency; others, such as rents for innovators, subsidies to infant industries or the rents earned by owners of scarce natural resources, *may* signal either efficiency or the successful exploitation of growth opportunities. The wide range of incomes which have the character of rents raises questions about the usefulness of the term. A broad definition does have the advantage of allowing us to focus on common features relevant for an analysis of all rents. On the other hand, differences between rents are also very important, as we will see in Chapter 1.

Since rents loosely represent incomes which are higher than would otherwise have been earned, they create incentives to create and maintain these rents. These activities can range from bribing or even coercion at one extreme, to perfectly legal political activities such as lobbying or advertising at the other. Collectively, these activities are known as *rent-seeking* activities, and they raise a further set of questions. Rent-seeking can be broadly interpreted as activities which seek to create, maintain or change the rights and institutions on which particular rents are based.

However, once we define it in this way, we see that rent-seeking describes a significant part of social activity. This is because almost all institutional change involves creating or destroying rents and almost all distributive conflicts can be described as conflicts where one or both sides are seeking rents. Thus, much of the subject matter of institutional economics and political economy can inform a broader and more encompassing rent-seeking approach. If we take this route, the rent-seeking approach can provide a framework for incorporating theories of institutional change as well as the political economy of distributive conflicts. It can also provide a framework for incorporating the insights of theories of state performance.

The encompassing approach to rent-seeking suggested in the last paragraph is a far cry from early rent-seeking theory. Rent-seeking theories were initially constructed by liberal economists who wished to show that state intervention induced additional rent-seeking costs by artificially creating rents (Krueger 1974; Posner 1975; Buchanan 1980). These arguments were meant to strengthen the case for free markets where, in theory, no-one would earn any rents. While other economists challenged these conclusions, their responses in turn enriched the rent-seeking literature (Mueller 1989: 229–46). Statist economists supporting intervention had to explain how the damage due to rent-seeking could be limited by interventionist states. The use of the rent-seeking framework by competing schools to reach widely different conclusions shows that the rent-seeking approach can only have relevance if it makes explicit the institutional and political assumptions on which radically different conclusions can be based. Chapter 2 lays the foundations for such an extended approach to rent-seeking.

Like rents, rent-seeking can refer to a wide range of expenditures and activities. And as with rents, the broad scope of what can be incorporated within the rent-seeking framework can be a strength if used properly but a serious weakness if used loosely and without refinement. Chapter 2 discusses the variables and conditions which can determine whether rent-seeking is value-enhancing or value-reducing for society. The framework is then used to compare rent-seeking processes in the Indian subcontinent, South Korea, Malaysia and Thailand. The chapter brings together approaches developed quite separately by economists and political scientists, and shows how they may be integrated in a broadly defined political economy framework.

There is clearly an overlap between rent-seeking and processes such as corruption and patron–client exchanges which have long attracted the attention of political scientists. The resources spent on corruption, or spent within patron–client networks, are sometimes (but not always) expended to capture rents. If so, these expenditures too are variants of rent-seeking. This has led to fruitful exchanges between political scientists who have studied different types of corruption and patron–client exchanges, and economists who have been interested in incentive structures and their implications.

While the rent-seeking argument was initially developed within neoclassical economics, it has striking similarities with the analysis of unproductive activities in classical political economy. The classical concern was that some activities used up resources as inputs without adding to the net value of the outputs produced. For Adam Smith the service sector was unproductive in this sense, while for Marx it was a number of sectors including the financial sector (Boss 1990). The sectors identified as unproductive by the classical economists were too broadly defined, but their analytical concern has been rediscovered by modern economists. In much the same way, the rent-seeking literature has identified sets of activities which are unproductive. These are typically 'political' activities which seek to protect, maintain or change rent-generating rights. Nevertheless, the problem of determining which of these activities is unproductive is very similar to the classical problem. Just as some service sector or finance sector activities can add to net value even though they use up inputs, some rent-seeking activities can add to net value even after allowing for the cost of the inputs they use up. This is because some rent-seeking may be about creating or protecting 'useful' rents. This possibility makes the analysis of rent-seeking much more challenging, and also much more policy relevant.

Despite the growing sophistication of the rent-seeking analysis, the mainstream policy discussion is often based on the earliest and simplest models. These early models assumed that rent-seeking entailed large wasteful expenditures to create or protect value-reducing rents. If rents are always value-reducing and if the effects of rent-seeking are also negative, rent-seeking must, on the whole, have seriously bad effects. Not surprisingly, the rent-seeking models used in policy prescriptions generally predict that the existence of rents will result in inefficiency and low growth. This policy consensus is strengthened by an overwhelming but partial set of observations from low-growth economies in Asia and Africa. The evidence is drawn from countries which suffered from substantial amounts of rent-seeking and were poor economic performers. The conclusion that rent-seeking is a major cause of poor performance is based on this evidence.

This is why the East Asian and, more recently, the Southeast Asian experiences are important. They suggest a more complex story about the efficiency and growth implications of rents and rent-seeking. They show, first, that the simplifying assumption that all rents are always bad is questionable. In a world where learning and innovation have to be rewarded, distributive conflicts dealt with, where incentives have to be created to deal with asymmetric information and where scarce natural resources have to be conserved, many types of rents are socially desirable. While many of these rents are recognised as useful in neo-classical theory, redistributive transfers have not been adequately analysed within the mainstream economics tradition. Redistribution is often involved in 'creating' the concentrations of wealth on which capitalism is based and may also be essential for maintaining the social order necessary for growth. On the other hand, some redistributive rents can be particularly damaging in developing countries. The theoretical challenge is to identify the conditions which determine whether value-enhancing or value-reducing rents are created and the magnitude of the rent-seeking cost.

Corruption

The study of corruption has a parallel literature, with obvious overlaps with the literature on rents. The interest in corruption as a factor affecting development has a long history (Heidenheimer et al. 1997 provide a collection of some of the classic articles). Corruption is usually defined as the transgression of formal rules governing the allocation of public resources by officials in response to offers of financial gain or political support (for a discussion of alternative definitions of corruption, see Nye 1967 and Khan 1996b). From the outset, this literature too has been concerned with whether corruption could be beneficial and under what circumstances. In an early contribution, Leff (1964) argued that corruption could have beneficial effects in developing countries suffering from oppressive state intervention. By allowing entrepreneurs to side-step restrictive rules, corruption could induce faster growth and higher efficiency. This perspective has become increasingly unpopular as the evidence of beneficial corruption has been very scarce. In the African countries which Leff was interested in, the beneficial effects of corruption have been least apparent.

In contrast, Myrdal (1968) argued that the possibility of corruption may induce bureaucrats to deliberately introduce legislation which creates new obstacles. Myrdal's argument anticipated the early rent-seeking literature of the 1970s and 1980s. The possibility of taking bribes could create incentives to *seek* bribes by creating new restrictions. Bureaucrats and politicians could be creating new hurdles to maximize their bribe take. While this qualifies Leff's argument, it does not necessarily overturn it. If some rents are socially useful, one can imagine circumstances under which a bribe-seeking bureaucracy could increase growth by creating value-increasing rents to collect bribes. Indeed, when one looks at the few examples of successful developmental states in the second half of the twentieth century, one finds that most of them were also very corrupt. Explaining the differences in the effects of corruption in different countries is thus closely related to our suggested extension of the rent-seeking framework to take into account differences between types of rents and rent-seeking processes.

The modern economics literature on corruption also includes a parallel literature which looks at how institutional and incentive structures can determine the magnitude and effects of corruption (Rose-Ackerman 1978; Shleifer and Vishny 1993; Bardhan 1997). These authors share with the rent-seeking school an interest in modelling the incentives which determine the extent of expenditures on corrupt transactions. As in the rent-seeking models, the key questions are: what determines the magnitude of the rent-seeking expenditures (in this case, bribes), and does the corruption result in value-enhancing outcomes (as in Leff's argument), or the reverse (as in Myrdal)? Shleifer and Vishny's (1993) contribution is particularly important because it suggests that states with a very centralized institutional structure and those with a very decentralized institutional structure may suffer less from the damaging effects of corruption than states with an intermediate level of institutional centralization.

The interest in corruption has increased as Cold War alliances no longer protect developing country governments from scrutiny. In addition, a number of econometric studies have shown the negative effects of corruption, using subjective corruption indices as explanatory variables (Ades and Di Tella 1996; World Bank 1997). Correlations of these corruption indices with development indicators such as investment and growth rates tend to show that corruption has a negative effect on development (for instance, Mauro 1996). While providing useful empirical results, these regression results have to be interpreted with care, and we would argue that they are not a substitute for historical analysis.

The regression approach assumes that there is an underlying invariant relationship between the degree of corruption and economic performance. Corruption across countries in these studies is measured in terms of the subjective assessments of international businesspeople. These subjective estimates raise problems of objectivity and comparability which are fairly serious (Khan 1999a, 1999b). They do not distinguish between corruption per transaction and total corruption, between economic and political corruption, and businesspeople may subjectively assess corruption to be less serious if the system works and they are making large profits. Leaving these measurement issues aside, the econometric approach has a more serious problem. The regression results are based on comparing countries to see if more corrupt countries are, *on average*, doing better or worse. In general, they find that more corrupt countries do perform less well. But suppose that high levels of corruption are associated with low growth in some countries, but with high and sometimes *very* high growth in others. In this case, the relationship picked up in the cross-section regression may depend on the selection of corrupt countries in each category.

The first and most numerous group of countries in any sample is likely to consist of developing countries, most of which have, by and large, not done too well in terms of development over the last three decades. Most are very corrupt, and the corruption seems to have had very damaging effects on growth. But there is a second and smaller group of developing countries where growth has been very high despite the presence of substantial corruption. But these countries are few in number simply because very few countries have been successful developers. Finally, there is a third group of relatively more advanced countries where corruption is low and economic growth is moderate.

It follows that, in a cross-section study, the second group is typically swamped out as a set of outliers because of their small numbers (though not necessarily their population size or significance in terms of what we can learn about development). The strong negative relationship picked up between corruption and low growth is then effectively based on a comparison of the first and third groups. This book concentrates on the countries within the critically important second group, many of which happen to be in Asia. It compares them with each other and with the less dynamic Asian countries in the first group. A case study approach is used to understand the mechanisms through which corruption and other forms of rent-seeking can affect growth *differently* in different countries. If we are right, it makes no sense to conclude, as the regression analysis does, that a 1 per cent reduction in corruption will result in an x per cent increase in the growth rate, *irrespective of the country*. Finally, the direction of causation is not revealed by correlation. In the long run, development and social maturity are very likely to result in declining corruption, but this does not mean that reducing corruption by any means right now will increase growth rates (Khan 1999a, 1999b). We believe that the case study approach is important to complement and challenge some of the effects of corruption identified by regression analysis which now widely influence policy-making. This is not to condone corruption or to suggest that it can be 'useful' in the way Leff did, but to come up with a better understanding of developmental processes and policy responses which may actually work.

Patron–client exchanges

Patron–client exchanges are another set of transactions which overlap with both rent-seeking and corruption. Patron–client relationships are