The Capitalist Transformation

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(*published in* Jomo, K.S. and Reinert, Eric S. eds. 2005. *The Origins of Development Economics: How Schools of Economic Thought Have Addressed Development.* New Delhi: Tulika Books and London: Zed Press pp. 69-80)

The transition of a small number of developing countries to high living standards over the last four decades has brought to the fore debates on the content and conditions of the capitalist transformation. What are the necessary and sufficient conditions for sustained and rapid improvements in living standards that have historically been achieved in countries going through successful capitalist transformations? The capitalist late developers were different in many respects from the early developers, but they are recognizably capitalist given the important role of private sector capitalists in these transitions. But in late developers, states played a bigger role in ensuring and maintaining high rates of investment and the shift to higher productivity technologies.

Beyond these very general observations, there is little agreement about the institutional preconditions, economic policies and state capacities that are needed to achieve this transformation. The earlier debates about the definition of capitalism, the key features that made it the significantly more dynamic in generating productivity growth compared to previous systems, and the preconditions for the transition to capitalism, connect in interesting ways with these more recent controversies about the conditions of late development.

For non-Marxist neoclassical institutional economists, capitalism is defined by the private ownership of assets and market coordination of all activities that are not organized within firms (Williamson 1985). But for Marxists, capitalism is much more than this: capitalism is a specific relationship between classes of owners and non-owners of the means of production such that not only do capitalists own the means of production, workers are systematically separated from the ownership of these means of production and are forced to work for capitalists to survive. Both non-Marxist and Marxist definitions of capitalism are trying to capture the key institutional features of the system that can explain the much higher productivity and productivity growth of the capitalist system compared to all previous (or in the non-Marxist view, all alternative) systems. An important problem for the neoclassical definition of capitalism is that many pre-capitalist systems also had extensive private property ownership as well as extensive markets. Here, the Marxist definition does identify something distinctive about the new capitalist system that began to emerge in England from the sixteenth century onwards, because the separation of working people from the means of production *was* something new.

Another merit of the Marxist approach to capitalism is that while Williamson and the new institutional economics can explain why any private property system can be *efficient* in terms of reducing transaction costs, the Marxist definition aims to explain why successful capitalist economies enjoyed historically unprecedented rates of productivity *growth*. The neoclassical definition of capitalism derives from the analytical argument that well-defined private property rights reduce transaction costs and allow markets to reach their full efficiency potential. The Marxist definition focuses instead on capitalism as a system of compulsion. Thus, Wood (2002) argues that capitalism is characterized not just by the presence of market *opportunities*, which have always been present in societies with markets, but also by a hitherto unknown introduction of market *compulsions*, which ensured that both capitalists and workers continuously had to strive to improve their performance just in order to survive.

The distinction between these two views is relevant for understanding the limitations of the dominant view in contemporary economics that the necessary and sufficient conditions for constructing dynamic economies in developing countries is to create the conditions for markets to work well. This perspective has venerable precedents going back long before its current neoclassical incarnation. It is supported by part of the classical economic tradition going back to Adam Smith. Some versions of the Marxist argument, while they strongly distinguish capitalism from the market as such, nevertheless also appear to support the claim that removing restrictions on markets was the critical feature of the transition to capitalism.

On the other hand, there are powerful challenges to these views coming from within Marxism, including from some of the most interesting work done by Marx himself. These arguments point out that not only was capitalism a fundamentally different system of property rights and class relationships, its dynamism has to be understood as being brought about by a *change* in the market logic to one of market compulsion rather than an *extension* of the pre-existing role of the market as a provider of profit opportunities. This points out the importance of institutional and property right changes that were required for the emergence of this compulsion in what we know as early capitalism. If these changes are not equivalent to market-enhancing reforms, then identifying what they are, and the class and political constraints preventing their emergence, is likely to be of paramount importance.

Doing this, however, does not necessarily tell us much about conditions for capitalist transformations in contemporary developing countries. There are important differences between early capitalism and late capitalism. The historical evidence of late development coming mostly from East Asia over the last four decades suggests that there are important institutional differences between early and late developers, particularly in a much bigger role of the state in providing part of the compulsion for productivity growth in late developers. Why was the system of compulsion that was sufficient to drive productivity growth in the early developers apparently inadequate for late developers? If there are indeed significant differences between early and late developers, the capitalist transformation raises yet another question that we have to answer. First, we have to decide whether the market-enhancing view of capitalism is appropriate, or whether the distinctive feature of capitalism is a set of institutional, property right and class relationships that create capitalists and workers and compel rapid productivity growth. Secondly, if capitalism is a productive system that is more than just a market economy, we have the equally important challenge of explaining why the property rights and institutional structures that have been necessary for compelling productivity growth in late capitalism may be different from those in early capitalism, and identifying what these differences may be.

These issues are critically important regardless of whether or not we believe that a capitalist transformation would be in the interest of poorly performing developing countries. There is a strong position within Marxism that has argued that meaningful socialism cannot be constructed in poor countries that have not gone through a period of capitalist growth. But even if we believe a non-capitalist path to development is possible and desirable in poor countries, very similar questions arise about identifying the institutional and property right structures that can accelerate productivity growth in this non-capitalist or socialist economy, as well as the process of transformation through which these rights can come about. The worst situation is arguably one where the conventional wisdom about how to create "market economies" in developing countries persists despite having produced remarkably poor results in the countries most in need of transformation.

We will look first at the debate between the claim that removing restrictions on the market created capitalism and the claim that the emergence of capitalism was a social transformation involving fundamental changes in property rights and class relationships. Secondly, we will look at the reasons why late development may require significantly different institutions and rights from early capitalist development. We then conclude by examining the implications for current debates within development economics about reforms to accelerate development in developing countries.

The conditions determining the transition to capitalism in Western Europe have been debated for a long time, going back to debates amongst historians, both Marxist and non-Marxist. This is an important question because capitalism as a new and radically more dynamic economic system first emerged in England, and then in some other parts of Western Europe. Yet, for a long time, these areas had been relatively technologically and commercially backward compared to other parts of Europe such as Florence or the Dutch Republic, and indeed compared to many areas in Asia and the Middle East. Two sorts of explanations have been put forward, and the divide between them is still relevant for understanding contemporary debates on the determinants of and obstacles to the transition to high-productivity economies in developing countries today.

The first type of explanation argued that capitalism emerged through the freeing up of further market opportunities. According to this position, the transitions to capitalism happened in those countries where the obstacles to the market were first removed.

These obstacles included political obstacles set up by feudalism, which included many barriers to the movement of labour and capital, and barriers that prevented land being freely sold. Other obstacles to the market were ideological or religious barriers that prevented markets from becoming the main regulator of resource allocation in society. This position then argued that these obstacles were first overcome in England and then in other parts of Western Europe because changes in internal and external factors weakened feudal restrictions and ideologies and allowed the market to grow. The group of historians and economists making this case often differed on the obstacles they thought were more important and the mechanisms through which they were overcome, but they agreed that capitalism emerged because of the *removal of obstacles to the market*. Despite many important differences between them on other critical issues, Marxist historians such as Maurice Dobb (1946) and Paul Sweezy (1950) shared the view that the distinctive feature of capitalism was that it removed many of the fetters that had constrained the market economy under feudalism.

This strand of Marxist thinking argued that in the absence of specific constraints, there were powerful forces operating in the form of technical progress, accumulation and profit-seeking activities in the pre-capitalist market economy that created systemic pressures towards capitalist production. The difference between Dobb and Sweezy in this debate was about the process that weakened feudalism and reduced its ability to restrict the market so that capitalism could emerge. For Dobb, the process that began to remove obstacles to the market was a class struggle between lords and peasants *internal* to the feudal economy. This weakened the political ability of feudalism to restrict markets, and allowed the growth of petty commodity production, that in turn grew into capitalism. Sweezy's debate with Dobb was essentially about whether these internal forces were sufficient to dissolve feudal fetters.

Sweezy was not convinced, and argued that the growth of long-distance trade played a key role in weakening feudalism and allowing capitalism to grow. For Sweezy, the removal of fetters constraining the growth of internal markets depended on the incorporation of the feudal society into systems of external markets. Thus, for Sweezy, not only is capitalism the removal of fetters in the internal market, but moreover, the removal of these internal fetters is assisted by the growth of long-distance trade, which created a market logic that the political power of feudalism could not constrain. The growth of long-distance trade in turn weakened the ability of feudalism to restrict internal markets.

The Dobb-Sweezy debate was very sophisticated and had many aspects (for a fuller discussion see Hilton 1976) but it did not address some critical questions. If Dobb was right, why did class struggles of different types in other pre-capitalist societies not weaken internal restraints within those societies sufficient for petty commodity production to expand to the point that modern capitalism began to emerge? After all, feudalism was quite weak in many parts of the world that were fairly commercialized, including non-European areas like India, but capitalism did not emerge there. On the other hand, if Sweezy was right, why did commercialization and long distance trade not act as a solvent that allowed capitalism to emerge in other trading areas, including China, India, the Italian city-states like Florence or the Dutch Republic?

Without many of the subtleties of this early debate within Marxism, the modern neoclassical position is similar only in that it also believes that economic takeoff in developing countries also depends on removing or at least reducing restrictions on markets. From a very different analytical perspective, non-Marxist economic historians such as Douglass North (1990) argued that capitalism emerged in Western Europe through changes in property rights that allowed the market economy to work more efficiently. They conclude that if obstacles to the operation of markets can be removed, productivity growth and rising living standards will follow. In earlier versions of the neoclassical position, the emphasis was simply on liberalization of markets and the reduction of state restrictions.

More recently, the neoclassical position has been enriched by inputs from the New Institutional Economics that has argued that for markets to work efficiently, transaction costs in the market also have to be reduced, and this requires a number of institutional changes. This has added a number of other requirements for the takeoff to take place, including the stabilization of property rights, which requires lowering expropriation risk and reducing corruption (North 1990). It has also suggested the necessity of democratization, to reduce the ability of states to engage in ex post expropriation (Olson 1997, 2000).

All these reforms are essentially motivated by the desire to make markets work better. Implicitly, the neoclassical position argues that the main difference between advanced capitalist countries and poorly performing developing ones is that markets do not work effectively in the latter. If restrictions on the proper working of markets could be removed, these countries too would rapidly begin to resemble advanced capitalist countries. In other words, they would in fact become capitalist.

In contrast to these positions, the conventional Marxist position has been not only to distinguish the market from capitalism, but also to point out that removing market restrictions was not *sufficient* for this transition. (Later we will discuss a number of reasons why removing restrictions on the market may not even be *necessary* for the transition to capitalism.) After all, markets had existed for thousands of years without leading to capitalism. Moreover, areas that were relatively more commercialized, such as Florence or the Dutch Republic did not make the first transitions to capitalism. Nor was there any sign of capitalism in India or China despite the presence of widespread long-distance trade within these empires and between them and the rest of the world. Since differences in the degree of marketization did not correlate with the degree of capitalist development in the pre-capitalist era, it is more consistent to argue that capitalism was not just about extending market opportunities, but rather about the imposition of a completely new structure of property rights and institutions that introduced radically new compulsions for productivity growth.

Marx pointed out that capitalism was indeed a unique system of property rights where for the first time, the market operated in such a way that productivity was rapidly enhanced and technological progress happened in a sustained manner. The reason was the property rights and class relationships of capitalism were such that both capitalists and workers were continuously *compelled* to improve their productivity simply in order to survive. This market compulsion had never existed before, and was a sharp break from the role of the market in earlier societies, where the market provided *opportunities* for greater profit. Robert Brenner (1976, 1985) and Ellen Meiksins Wood (2002) have powerfully represented this position, and it can be argued that this was much closer to the position of Marx himself in his detailed analysis of how class structures changed in the run-up to the capitalist transformation, including through processes of primitive accumulation.

The transition to these specific structures happened largely through political and social processes rather than through extensions of the market. The internal configuration of class and state power was most conducive for this transformation in England, and this is why the transition to capitalism first happened in English agriculture. The processes through which this happened included the forced transfer of land to an emerging class of agrarian capitalists that was essential for the creation of capitalism in England. Market opportunities were important, and indeed, the new large landlords needed to have markets to sell their products, but the presence of markets alone did not lead to similar transitions in other countries where the class configuration between landlords, tenant farmers and the state was different (Brenner 1976, 1985).

This analysis says that the reason why capitalism emerged in England did indeed have a lot to do with internal class struggles and state strategies (as Dobb had suggested). But these struggles were important *not* because they led to the weakening of feudal restrictions on the market, but rather because they led directly to changes in property rights and class relationships that were necessary for a capitalist economy to emerge. The historical evidence can be read as being strongly in favour of this second interpretation of the conditions under which capitalism emerged in the West (Brenner 1976, 1985; Wood 2002).

If this view is correct, it has enormous significance for current debates on the institutional conditions for rapid productivity growth in developing countries. Dynamic capitalist economies are unlikely to emerge simply by removing obstacles to the market and trying to make their markets more efficient. Rather, we have to identify the rights and institutions that are necessary for rapid productivity growth in the context of the contemporary world economy and we need to identify how these can be introduced in different contexts. This perspective suggests that the construction of capitalist societies in developing countries where capitalism is not fully developed may require a *social transformation*, and this may in turn require, or be held up by, specific balances of power between internal classes and the state (Khan 2002). Moreover, this social transformation may involve substantial internal conflicts between different sections of existing propertied classes as property rights and class relationships are altered.

The huge social transition from pre-capitalist or largely pre-capitalist societies, where markets created opportunities but not an overriding set of social compulsions, to capitalist societies where markets operated to *compel* the maximization of profit and continuous productivity growth was described by Polanyi (1957) as the *great transformation*. However, Polanyi, like Dobb, argues that the transition was driven largely by technological developments within pre-capitalist society, which necessitated the development of large-scale production. This, combined with the weakness of internal constraints within feudalism in Western Europe, allowed the great transformation to happen in Europe.

If we ignore, for a moment, the debate over the process through which capitalism is set up, Polanyi makes the important observation that once capitalism has emerged, the *retention* of some market restrictions can be necessary for political purposes, to make capitalism politically palatable. If markets became completely unfettered, society may disintegrate, given the very powerful forces of social dissolution set in train by the capitalist market logic. This was the first time that the political necessity of states mediating capitalist markets and easing some of the pain of continuous market restructuring was pointed out. Polanyi's argument suggests that once capitalism has been set up, fully unrestricted markets may be damaging for capitalism, and may indeed result in its political collapse. Thus, some degree of market restriction may paradoxically be politically *necessary* for the survival of capitalism.

A more powerful set of reasons why some specific types of market restrictions may be necessary for capitalism emerges when we look at late capitalism. In early developers, the creation of a propertyless class of workers and a class of asset owners who were competing amongst themselves to survive was sufficient to ensure relatively rapid productivity growth through market competition. It is not clear that a similar structure of rights in contemporary developing countries would have the same effect, given that now developing countries have to *catch up* with advanced countries that already have higher productivity and better technologies than they do. A catching-up country that had free trade would very likely be stuck with low-technology production.

In theory, if a market exists, and a country has cheaper labour than its competitors do, capital should flow to the cheap labour country. But this theory ignores that competitiveness and productivity are only high in some countries because their social structures impose compulsions for high productivity. If productivity is low and does not grow, low wages by themselves will not attract investment. This is simply a matter of arithmetic. Even if wages in the developing country are 1/20th that in an advanced country, if productivity is 1/40th, unit labour costs will be *twice* as high in the developing country.

Productivity differentials between advanced and developing countries are likely to be particularly high in high technology industries, and less so in low technology industries. Given the wage differential, this would make it profitable for capitalist owners to shift the location of some low-technology industries to developing countries, but not necessarily shift high-technology industries. This, rather than the relative cost of labour and capital is a more powerful explanation of why only low-productivity industries are likely to migrate to developing countries that rely simply on markets, with no internal strategy of social transformation. But now we are referring to a social transformation towards property right, institutional and class structures that can enforce productivity growth in a context of catching up.

The developmental state literature (Aoki, Kim and Okuno-Fujiwara 1997, Woo-Cumings 1999 and many others) and case studies of catching-up countries such as South Korea (Amsden 1989) and Taiwan (Wade 1990) show that successful catching up has required a range of institutions and interventions that are quite different from classical capitalism. It is important to understand in outline why this might be so.

A critical problem with setting up high-productivity industries in developing countries is that learning how to use sophisticated processes, and setting up the internal and external systems that are required to achieve the potential productivity of high-technology industries *takes time.* This very simple point was made a long time ago by Kenneth Arrow who introduced the term *"learning-by-doing"* to describe the fact that productivity was always initially low when workers (and managers) have to work with new machines, and only gradually improved as workers learned how to use them. This means that unless there is some institutional system that can both allow this learning to take place, and *ensure* that resources are not wasted if learning fails, successful investment in high productivity sectors is unlikely to happen.

The conventional answer to this in developing countries has been to support infant industries through conditional subsidization policies. But conditional subsidization requires not just appropriate intentions on the part of the state, but also, and critically, it requires a power structure that allows the state to withdraw support when performance is poor, and indeed to restructure and re-allocate assets rapidly when required (Khan 2000a). Thus in late developers, the social transformation does not just have to create a working class with the imperative to work, and a capitalist class that owns property. There also has to be a distribution of power between state and capital that allows different strategies of catching up to be organized and implemented, because market competition between capitalists will no longer suffice to ensure rapid productivity growth. In short, specific systems of state-led compulsion are required to complement market compulsion in late developers.

This approach can help to explain why different systems of state support of technology acquisition played a key role in late developers. Although outright infant industry subsidization was not always used, in all successful late developers, the state evolved some system of carrots and sticks to attract high technology industries while retaining the ability to withdraw this support or otherwise sanction non-performers if performance in bringing in high productivity technologies was poor. Not all late developer states were equally good in achieving these goals, but they were all substantially successful and this explains their relative success compared to the vast majority of developing countries that performed rather poorly. Because very different institutional and property right structures can be used to create incentives and compulsions for technical progress, the internal power structures that are required to implement and police these strategies have differed quite significantly. This means that the internal power structures and class conflicts that may allow a viable capitalist economy to emerge are not very narrowly defined, and more variants of capitalist transition may emerge in the future. On the other hand, this does not mean that every developing country has an internal power structure that is suitable for the rapid implementation of new institutional and property right structures that would be appropriate for capitalist catching-up strategies. In many poorly performing developing countries, there may indeed be internal conflicts that are blocking social transformation to economies that are more productive (Khan 2002).

This analysis helps us to evaluate the mainstream consensus that a perfectly working market *is* capitalism, and that bringing about the conditions for a well-working and efficient market *is* creating the conditions for a capitalist transition. What is required (in the conventional wisdom) for such a market-driven transition?

First, we require stable property rights, defined by low expropriation risk. Note that we do not require any specific *structure* of property rights, all we need is that *all* existing rights should be well defined and non-expropriable. It does not matter if existing rights are peasant rights over land or the land rights of large unproductive landlords, or anything else. The assumption is that as soon as we have property rights with low expropriation risk, transaction costs will fall, and efficient allocations will follow. The point made by Brenner and Wood that markets did not lead to capitalism emerging for thousands of years till forced changes in rights created capitalism in England in the sixteenth and seventeenth centuries has to be answered by these theorists.

Second, it is argued that well-working markets require no intervention by states, so a well-working capitalism requires the virtual absence of state intervention. Intervention creates rents (incomes above opportunity incomes) and this impedes the operation of competitive markets. This claim contradicts the role of the state as an agency of social classes pushing the social transformation that creates versions of capitalism. It also ignores the role of the state in managing the politics of capitalism, in the way Polanyi pointed out.

Third, the mainstream view argues that well-working markets require the absence of rent seeking and corruption since these processes create rents and destabilize property rights. So, it is argued that creating the conditions necessary for a takeoff involves fighting corruption and rent seeking as well.

Finally, it is assumed that since rent seeking benefits a minority, the majority will use democracy to ensure that rent seeking does not happen. The majority will also ensure that the state does not expropriate resources from investors ex post. Therefore, it is argued, we need to have democracy to make a market economy work. These reforms add up to the so-called good governance agenda, which is now recognized as a set of preconditions for market-led (capitalist) growth.

But what is the evidence that good governance was necessary for generating economic dynamism in any developing country? While a lot of cross-sectional evidence is presented in support of the conventional models, the regression exercises do not actually support the claims that are made (see Khan 2002 for a critique). Figure 1 plots Knack and Keefer's Property Right Stability Index (incorporating corruption, rule of law, bureaucratic quality, government contract repudiation and expropriation risk) for 1984, the earliest available year, against GDP growth rates for the decade 1980-90. We can treat 1984 as the index for the beginning of the period in question. The interesting observation is that while the regression line has the positive slope expected by the mainstream approach to development, (although the statistical fit is very poor), the countries in our sample separate into three quite separate groups. Most countries belong to either group 1 (low-growth developing countries, defined by a growth rate below the advanced country average) or group 3 (advanced industrialized countries, defined by their high per capita incomes).

The first group has low growth (by definition) and poor governance characteristics, while the second has higher growth and the best governance characteristics. The (weak) slope of the regression line depends on most countries being in one or other of these two groups. But the most interesting group is group 2 (developing countries that are catching-up by virtue of having higher growth rates than the advanced countries). This group is interesting because though the countries in it are not numerous enough to make a difference to the slope of the regression line, they were the only ones that were actually catching up. A visual examination of the data shows that while their growth was significant, their property right and other governance characteristics were *not* significantly different from the developing country average.

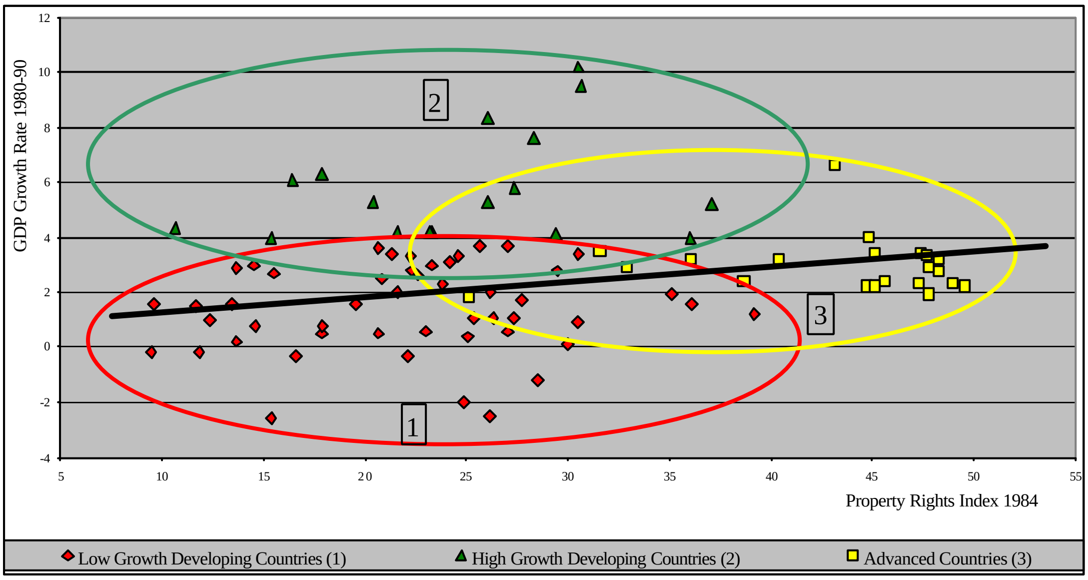

Figure 1 The Relationship between Stable Property Rights and Growth

This evidence raises a very important question for catching-up policies in developing countries. Do group 1 countries try to reach group 3 by *first* emulating the market and governance characteristics of group 3 countries, or do they look at history and try to attain the governance characteristics of group 2 countries, as these are the only countries that are actually catching up? The route to group 3 may be through group 2, in which case, the required institutional, market and class characteristics of group 1 countries should be sought in group 2 rather than group 3. The first route can be described as the attempt to create capitalism through creating the conditions for efficient markets. The second route is the route of constructing a capitalist transformation, which in late developers involves not just the transformation of property rights to create a capitalist and a working class, but also the development of different types of state capacities to push technological progress through systems of conditional incentives and compulsion.

The debate on how the capitalist transformation of poorly performing developing countries is to be organized has acquired very significant implications. The marketization strategy, with its focus on stable property rights and the creation of a well-working market is clearly the dominant strategy. But while stable property rights and well-working markets are important characteristics of an advanced capitalist economy, creating a capitalist economy always requires substantial restructuring of pre-existing property rights and incentives for emerging capitalists to acquire new technologies as rapidly as possible. During this transition, the condition of stable property rights is therefore an odd one to aim for; particularly since the existing structure of rights and production systems are by definition generating low productivity and productivity growth. The real question is whether we can ensure that the economic and social restructuring that is taking place in every developing country is taking the country in the direction of a viable capitalist economy or not. The danger is that the good governance approach allows us to bypass difficult questions about the social transformation and instead focus on reforms that would at best work if the aim were to make an already existing capitalist market economy work better. This assumes that a capitalist market economy exists in the first place; when in most developing countries the problem is to organize the capitalist transformation itself.

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