Institutional change and the political economy of development: some conceptual and analytical propositions regarding property regimes and foreign investment

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Introduction

This paper elaborates a conceptual and analytical framework to study institutional change in developing economies under external pressures of internationalization, focusing on property regimes as crucial variable. The framework considers different analytical dimensions that describe the co-evolution process of change and continuity in property regimes, following path-dependent patterns due to social and political inertias.

This paper takes property, specifically varieties of industrial ownership regimes (i.e., ownership of firms) as a key institution for economic governance. Property regimes not only provide a legal framework to protect ownership rights but constitute a political non-market entry-and-exit tool, which also delimits the role that firms and individuals may play in a national economy. It is considered that property regimes are political institutions because they define the participation of economic agents in the market. Changes in property regimes can reduce or enhance the capability of national economies to integrate economic agents (i.e., multinational firms) and their capacities. Despite reforms in property regimes in response to external (or domestic) pressures, domestic business practices tend to show frequently signs of continuity because of political economy legacies and mental inertias given by routines at various levels of social and business interactions.

In the literature the establishment of private formal property rights seems to lead automatically to a stronger long-term growth (Acemoglu etc.). But the relationship between these variables is not as clear as many economists have argued, and it is important to have a better understanding of the process of changing property regimes.

Property regimes

For this paper, most property rules might be found in the formal variety as legal concerns; however, being ownership a component of social interaction which has become part of our most basic social instincts, informal rules to govern certain interactions are also embedded in our understanding of behavioural limits. Property is a subject to unwritten codes of conduct which constrain others to take away things that are not their own. Most social customary practices are well rooted on this essential fact of life, especially under scarcity conditions. Not-so-scarce

resources or common property could present a different story for individual and collective action though, but it is also a problem which involves property issues (see Ostrom 1990).

The coexistence and reinforcement of formal and informal institutions through normative, pragmatic, and cognitive functions guides economic and political life along a complex articulation of rules, purposes, and understandings. The role of institutions in such interaction is to constrain and/or enable action, and to shape individual and collective preferences. Institutions constrain or enable action because they construct the shared meanings that establish the patterns of conduct within a society.

Property regimes, as institutional sets, are very much related to this type of socio-economic cognitive process. The rules governing industrial property issues (who owns what firm, how much is allowed to own, how the ownership is protected from other players, and what is the criteria for granting ownership) also produce routines, habits and a common understanding of the political and economic game, which shape the business practices of a certain locality. For instance, selective industrial policy that protects certain industries from foreign firms may encourage a particular behaviour from local firms which operate in a more or less predictable institutional environment and is subject to the enforcement mechanisms established by the central authority. Rules and the behaviour of the capital owners tend to synchronize into a set of practices and understandings that may be ultimately effective for the economic performance and the goals of the political and economic elite, at least for a period of time. Such convergence of rules, purposes and understanding –and the creation of habits as a consequence-- is what we will call institutional harmonization further on.

Continuity and change: the institutional harmonization process

Institutional harmonization is not a concept that refers to a static condition but to a *temporary circumstance* of social life. This means that alignment between formal and informal rules is not necessarily an end in itself, but a process of continuous struggle, search, and experimentation. The struggle refers to the attempts of different interests within society to preserve or modify the distributive outcomes of a particular institutional framework. Search refers to the constant self- and world-exploration that subjects carry out to validate or update their perceptions about reality. Experimentation is the ultimate motor force that turns curiosity and the sense of need into action for change. Institutional harmonization is therefore transitory in nature although the extent of institutional change will be confined to previous power differentials, beliefs, and technological conditions (both physical and social (Nelson and Sampat 2001)). In this

sense, alignment is a process of co-evolution that includes a permanent institutional selection and behavioural adaptation to the external environment, which implies both continuity and change.

It is now relevant to raise the question of what accounts for institutional continuity and change. Following the ideas sketched above, it might be clear by now that any sort of institutional harmonization, if reached, is never permanent because of changes in the balance of power or in economic (or technological) environment. However, it may also be true that too many changes or too often would "undermine predictability and thereby impose social losses" (Nabli and Nugent 1989: 25). For instance, from a rational choice perspective, the uncertainty about the costs of organizing collective action towards institutional change and the concerns about the impact on equilibrium outcomes "is enough reason to stabilize institutions and prevent continuous institutional change" (Eggertsson 1990: 72), an idea developed earlier by (Olson 1965, 1982). Another useful insight to grasp a better understanding of the difficulties of institutional change is that one must consider the differences between 'slow-moving' and 'fast-moving' institutions (Roland 2004: 109). Roland classifies culture as an example of slow-moving institutions and political institutions as fast-moving, meaning the former change in gradual and continuous fashion whereas the latter change much quicker but perhaps irregularly.

Institutional systems are rules interconnected with or embedded in the ongoing structures of social relations (Granovetter 1985) and present different degrees of complementarities (Roland 2004), so that a change of one implies the partial or whole modification of the others. Nelson and others (2002; 2001; 1982) have argued repeatedly that physical and social technologies are bounded into an institutional set or governing (organizational, behavioural) structure that support, moulds and standardize their interaction and underlies their co-evolution. Ultimately, institutions become the embodiment of standardization of human interaction and technological co-evolution building up a pathway for further interactions which becomes a 'collection of procedures' (the recipe) that may admit choice, but "within a limited range of alternatives" (Nelson and Nelson 2002: 267; Nelson and Sampat 2001: 42). Roland (2004: 113) observed that "replacing one institution by another can in some cases dangerously disrupt this systemic consistency." Campbell (2006, 2010) makes similar observations. This is a problem when a political elite wants to transplant an institutional 'module' that might not be compatible with the cultural context. As in the case of biological organisms, institutions adapt to the socioeconomic internal and external environment, that is to say, to relations of production, to technological change, and to power distribution. This means that, although a characteristic of the institutions is to promote continuity and certainty, they also must be regarded to be dynamic. Institutional transformations can be imperceptible if they are observed in short periods (Pierson 2004). The change in the external

environment through technological innovations, severe changes in prices of key commodities, or wars, invasions, natural disasters, etc., can provoke changes in certain institutions and eventually drag the subsidiary structures into disarray.

Mark Tool (1994) identifies three paths of institutional change, which he classifies as path-independent, path-dependent and path-determinant. The first one is by intentional agent-driven establishment of new 'universal' rules selected consciously and independently from institutional, cultural, and historical backgrounds. This path is contrasted with the second and more gradual approach of path-dependency in which ongoing frameworks derive from previous orders with slight adjustments but still presenting elements of predictability (Pierson 2004: 20-2). The driving forces of path-dependency are technology and the institutional background that enables or inhibit societies to accumulate knowledge (Ayres 1978: 177). The path-determinant approach to institutional change is a combination of the previous two in which external conditions (economic and political) force powerful interests to make an 'artificial selection' of rules which are eventually adapted into the internal order. In the following section we discuss five historical settings which normally are believed to provide momentum for important institutional changes.

Five scenarios for radical institutional change in developing countries

Although a combination of spontaneity and rationality can bring about change, three related assumptions should be noted here: one, institutional change produces losers; two, there will always be a reaction against change; and three, resistance will depend in the collective action capabilities of affected interest groups (Johnson 1966; Olson 1963, 1982). With that in mind but with no intention to be exhaustive, we identify and briefly discuss five scenarios that often seem appropriate or conducive to institutional changes: favourable environment, adverse environment, continuous growth, sudden environmental change, and change of ruling coalition. Each situation suggests that incentives to pursue reforms are based on the perception of 'critical historical junctures' (Krasner 1984: 240-4; Thelen and Steinmo 1992: 15`, 17).

A *favourable environment* associated with stability of domestic and international environments supposedly encourages risk-acceptance behaviour. For instance, it can be thought that promotion of formal institutional change is possible "when the government will not be held accountable for their actions by the citizenry for a considerable period of time" and external economic conditions are promising (Garrett and Lange 1995: 633). This possibility, however, would not assure a change in conduct from political or economic actors. From a wider perspective, even if risk is or could be minimized, large masses of population may not engage in

collective action in support of change (i.e. assume the costs), precisely because of the favourable environment. Such conservatism will be enhanced by individual and collective expectations that the current circumstances will continue in the future. Then, why should anyone bother to engage in (and bear the costs of) any attempt to change the state of things?

Another scenario is the *adverse environment*. Although negative circumstances such as economic decline, stagnation, or evident degradation of the political system could give incentives to carry out major reforms to institutions which appear obsolete or inadequate, a deficit on clear outcomes that distinguishes poor external and internal conditions could prompt indecision and lack of confidence. In such a case, mobilization towards change may not be likely because uncertainty induces the adoption of non-risk strategies, which normally signifies inaction. As an alternative, agents would rely on 'safe' and conservative habits and standard patterns of behaviour (Eggertsson 1990: 56; Hodgson 1988: 157), or even compromise on minor reforms at best.

Small but continuous *economic growth* and social *stability* also seem to create an appropriate mood for reforms. Yet again, psychological factors may preclude costly adjustments on rules and behaviour, especially when status quo serves well the entrenched interests (Olson 1963, 1965). Societies do not get interested in questioning the system and there is no point in investigating alternative options. Shared beliefs and practices 'encapsulate' and constitute "an obstacle to the absorption and diffusion of the new knowledge in the form of technological innovation. Consequently, a new discovery in the arts or sciences will be incorporated into behavioural patterns only to the extent that the community believes that the previously existing degree of ceremonial dominance can be maintained" (Bush 1988: 143).

The *shock scenario* is also a condition believed to be appropriate for radical changes. Sudden economic collapse, severe political unrest, massive violence, coup d'état, physical invasion or wars are sources of instability and may unveil the inconsistencies of formal rules with the political and economic reality. The aftermath of political crisis is usually a regime vacuum and ideological disarray. This is characterized by periods of adjustment and trial-and-error efforts to establish a new workable governance structure. Another type of shock that may trigger radical institutional change is natural disasters. Great physical losses and the impossibility of recovering normal life in the short run may lead people to recognise the inadequacy of their institutions regarding practical problems, consequently feeling motivated to transform them. Notwithstanding these scenarios of sudden institutional collapse, practices tend to remain as before because mental frameworks and value systems might not change so abruptly, although sometimes their validity could also be reassessed.

The last scenario, the *change in ruling coalition*, is when central power is overtaken by a different party or group after the prolonged rule of a dominant party or a dictator. The new rulers can be either an opposition political party or a reformist faction within the former ruling elite. After a new group takes power, it temporarily produces expectations based on a desire to improve the material conditions of life, reduce the obstacles for business, and increase the chances of political participation. However, radical changes are difficult and unlikely to be achieved at the promised speed and rate. This is normally due to the several forces of resistance, which are often underestimated. Under these circumstances, substantial frustration produces apathy in the political system. As substantial reforms cannot be realised the momentum for change fades away.

As economic history shows, all five scenarios do not exclude one another. Some common elements appear at first sight. Each case shows a sense that the perceived equilibrium between institutions has been broken leading to the alteration of loyalties and trust on the status quo; the turbulence generates an increasing isolation and division of social sectors due to inefficient coordination, exacerbating policy inconsistencies and ultimately uncertainty. The problem of flawed coordination may be a signal of institutional inconsistencies and a source of instability. Nevertheless, combinations and overlapping processes can be identified among the scenarios described above and, despite pessimistic predictions, dramatic institutional change can indeed occur. It is important to recognise, however, that institutional change is a progressive and gradual process punctuated by events that alter the external environment, such as critical technological innovations. This may indirectly affect the mental frameworks developed within the previous environment. The extent that mentality will change and assimilate the new tools and skills of problem-solving processes is contingent upon the permissiveness of 'ceremonial dominance' which, according to Bush (1988: 149-53), will determine the extent of 'progressive institutional change'.

In our view, institutional change is a continuous process of accumulation of small and apparently unimportant changes. The changes can be whether in rules, belief systems, value systems, perceptions, and world views. Moreover, it is often hard to detect which was the event that led the "mutation" of the rule or the perception. It could be the aggregate of little accidents that provoked an innovation or technological adjustment, or changes in laws and regulations, or the result of an academic or industrial research. Sometimes, a great discovery can be unveiled or rejected by the society if it was economically unviable or was contradictory to the customs or patterns of understanding reality. In these cases a lot of time may pass before its usefulness is spread and completely accepted by the society in organisational and/or national levels. The advance on industrialisation paths accentuates the complexity of the productive processes by

incorporating new technologies and having intensified the interaction among a greater diversity of agents. This provokes the redefinition of priorities, so much on the part of the government as of the economic actors due to the modification of preferences, value systems, and mental structures. In consequence, what is likely to come about is the admission of new practices and expectations.

The external environment changes slowly but progressively. The intuition or consciousness of the changes is accentuated by the internationalisation of the national economy, whether given by the factors of production endowments or, especially, by the intensity of capital and technology (Keohane and Milner 1996). Nevertheless, it can be that those in dominant positions inside the local or national structures do not perceive the change or fail to determine its magnitude or simply believe that the existing institutions do not need any significant alteration, especially if this implies the need to modify the conditions that benefit them.

It is now necessary to ask the following: What are the factors for which a society can adapt its institutions to the external changes? Partly following Bush's (1988) reasoning, the response offered here is that the capacity of adjustment is contingent upon the permeability of the informal institutions. This assumes that the set of values and patterns of thought are flexible enough to accept variations in the system. On the one hand, when the change is gradual, such a process happens imperceptibly and probably it does not turn into a matter of public debate. On the other hand, it is possible that the acceptance happens after the ruling elite and other relevant actors in the society make a conscious evaluation of the practices with regard to the formal settings and recognise the need for change, leading to the search and adaptation of the appropriate patterns to meet the new challenges.

It is important to observe, therefore, two complementary factors: the existing mechanisms to filter the preferences of the existing interests and the government's leadership. The first factor refers to the political institutions that grant voice, vote, and veto (Garrett and Lange 1995). In this sense, the rules that give exclusivity rights in the economic field –i.e., property regimes– are also political institutions. Through them, certain agents are vested with exclusive rights to execute their activity within a frame of protection and certainty. Political institutions also allow them to express their preferences and use the available mechanisms to see their needs attended. This implies the habit of developing harmonious relations between the beneficiaries of the exclusivity rights and those who grant them, since they can also cancel such rights. In the case of the property systems, these become the instrument of the authority to establish cooperative behaviour among the economic actors and they operate as 'selective incentives' (Olson 1965, 1982), either allowing entry or forcing exit (Campbell and Lindberg 1990). It is in this respect that the capacity

of monitoring of the government and its leadership entail a critical importance both for the stability of the institutions and for the change: to police with credible mechanisms the economic actors as well as to guarantee the property rights and to extend them when it is economically and politically viable.

The analytical framework

We propose an analytical framework which may contribute to the understanding of institutional change. It identifies property systems as the connecting institution between the international and domestic political economy (Figure 3). Therefore, the independent variables are the external environment and the institutional legacies of the previous models. The external environment includes factors such as FDI, new ideas, and globalisation. By institutional legacies we mean the formal political institutions and the informal collective habits of thought developed domestically.

The framework takes property as the key institution for economic governance, specifically the industrial ownership regime, and studies the political economy implications of its transformation. The property regimes are part of the state's institutional fabric; they are understood here as the system of rules that define and regulate the entry and exit from the market and grants rights of ownership –exclusivity of control– in certain economic activities. From a political economy perspective, property regimes shape the behaviour of domestic agents; therefore they can be used as instruments to control, stimulate, and protect national industries. We assume that the change of property regimes may perhaps alter the conditions of governance. However, the underlying argument here is that even if changes in property regimes transform the structure of power relations, the adaptation process is not mechanical. In this sense, the hypothesis is that even though a sudden change in the environment may produce a major shock to a socio-political system, the domestic political economies tend to show many signs of continuity. Therefore, changes in industrial ownership regimes to liberal standards do not always bring about expected patterns of behaviour from government and economic actors[B1].

The aspect of property regime change explored in this paper is the opening of the foreign investment regime, which means the possibility to assign decision and management rights to outsiders, and the inclusion of foreigners in domestic politics. The framework consists of a dynamic multilevel institutional set, in which political and economic activities are embedded.

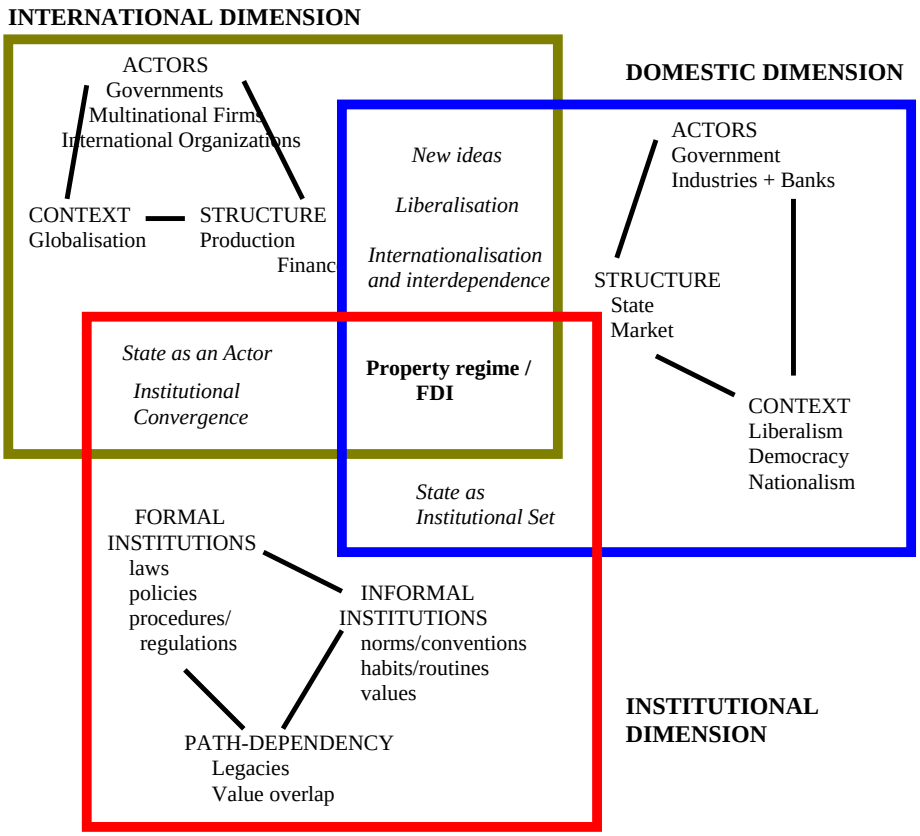

Figure 3. Analytical framework

The domestic dimension

The notion of development here signifies the co-evolution of formal and informal institutions that enhances economic growth and wealth distribution subject to the cultural background and welfare aspirations of the society. It is worth noting here that economic growth is not equivalent to development but is one of its basic components. Nabli and Nugent (1989: 22) point out that economic development is "economic growth accompanied by 'efficient' institutional change". For these authors, the connection between institutions and economic growth is dynamic and interdependent. It is a reciprocal dynamic between the types of institutions and the economic operation: economic growth leads to institutional adjustments and institutional framework affect economic performance (Nabli and Nugent 1989: 22-3; North 1990).

The process of development is not unrelated to the difficulties of deciding the direction a society and its economy should take. The weight of the pressure of existing economic agents is often at issue, and it varies according to the development stage (landowners, manufacturers, bankers, heavy industry capitalists, etc.). Initially, the old sectors are powerful in terms of resources, market share, collective action capabilities, and links with government officials. However, as new industries start gaining economic and political presence, the policy-making process has to recast the balance of power and orientation of existing institutions. In this sense, "the state has a relative advantage in supplying required structure" (Eggertsson 1990: 320), for instance, when a different set of rules is needed due to technological changes that increase the complexity of exchange and production processes. The success of the regime in coping with new contingencies will depend on the capability of its society and the political institutions of the state to incorporate or marginalize the new forces without disrupting economic performance.

The state is the principal organisational and governance structure within which other socioeconomic arrangements are nested. In this sense, the main function of the capitalist state *as an institutional framework* is to link the mediation mechanisms (institutions) to manage the tensions from division of labour (Aglietta 1998: 53) and to solve or minimize collective action problems (Cerny 1995). The set of formal rules establishes the procedures for the distribution of power, the incentives to generate predictable behaviour, and the sanctions to those who violate the limits. The economic performance and the reproduction of the society depend on the adherence and compliance of the socioeconomic agents to such procedures, incentives and sanctions. To regulate and govern the activity of such agents, the government will determine and orchestrate policies, though other actors may also take part in their design.

The state as an institutional vehicle deals with the coexistence of divergent interests and policies are programmed according to the arrangement of political institutions. Such arrangements are meant to establish a system to solve the conflicts derived from the distribution of resources and power. A key factor is the autonomy of state agents from societal pressures. This is important not only for the formation of policies, but also for the institutional design overall. However, if it is agreed that both the market and resource distribution mechanisms are in essence political processes (Chang 2000), then the dilemma concerning property rights and democracy becomes a difficult one to solve, where "a strong state is required to protect property from encroachments but a strong state is a threat itself" (Przeworski and Limongi 1993: 53). In other words, the activity of individuals and private groups depends on the permeability of the state

agents[1] and on the means to regulate the costs and benefits associated with the activity of the private interests (Przeworski 1990),[2] being these centralised or decentralised structures (Boyer and Drache 1996; cf. Weingast 1995).

Social and political institutions have the faculty to dictate appropriate behaviour and constrain individuals or groups (even those in power). Moreover, institutions discriminate and exclude in favour of dominant social groups. Discrimination and exclusion leads to a problem of competition and distribution, thus to the search for the factors that determine how distributional conflicts are solved throughout societies (Knight 1992). By recognizing the issue of discrimination or exclusion it is possible to introduce the idea that an established authority has the power to enforce the rules of entry and exit. The property regimes are the general and specific rules that establish who owns what and how much of particular industries and firms. Such a system delimits market shares and establishes guidelines for resource allocation. Property regimes institutionalise or formalise the extent of economic power. Alterations in the formal relationships of agents towards the means of production determine the new conditions of power distribution and reflect the emergent values; as a result, changes in property regimes bring into being the dynamic development of capitalist alliances and the variety of coordination mechanisms (Klein 1988; Przeworski 1990).

Markets play a similar organizing role as a set of institutions that support systems of production and exchange creating a particular type of competition, which is allegedly self-regulated by market principles.[3] When markets cannot coordinate efficiently the systems of production and exchange to reduce transaction costs, capitalist economies create firms to resolve such problems (Coase 1937; Williamson 1985). The state's structure recognises the legal status of firms (Hodgson 2002) through property rights and protects them from other firms by a complex matrix of sanctions and incentives (regulation) to which firms respond in relatively expected ways. Taking regulation as a sort of public good helps to explain its role in establishing 'workable market frameworks' for the operation of the economic system as a whole (Cerny 1995: 609). This leads to the idea that the first and most important association of the market with the

[1] Simultaneously, the permeability or the degree of autonomy is contingent to the political institutions as the voting systems and the cohesion of the administrative apparatus. A government divided in terms of overspecialisation of political and administrative functions or divided by ideological preferences is probably less independent from private pressures whether national or foreign.

[2] In the economic area, the state's distribution power is normally in the fiscal and competition policies. The political distribution is founded on the recognition of people's right to "express preferences about allocating resources that they do not own", which are distributed more equitably than the property rights over the means of production (Przeworsky 1990:1).

[3] Rules of competition do not forbid the possible harm inflicted from one actor to another, but regulates the extent of the damage and the retort (see Coase 1960; Furubotn and Pejovich 1972).

state is the legal system that supports formal contracting (Hall and Soskice 2001; Rapaczynski 1996).

Polanyi (1957: 3) argued that the market cannot be left alone without the risk of transforming the surroundings 'into a wilderness' by "annihilating the human and natural subsistence of society". On the one hand, the intervention of the state in the market through its agencies in coordination with the parties involved is then as legitimate as its role as warden of law, order and security –factors that are highly valued by economic forces. On the other hand, the sustainability of production and exchange activities is also decisive for the viability of the state; that is so because most administrative apparatus depend on the revenues extracted from such process as a mechanism of wealth distribution. Therefore, states and markets are institutions that reinforce each other and they do not always move in opposite directions. However, as both are ultimately manifestations of human activity, they are also exposed to coordination problems, uncertainty, deficient information, conflict of interests, power asymmetries, etc.

Therefore, instead of taking state and market as rival entities, a more accurate view of reality is to regard them as complementary to social activity (Aglietta 1998: 50-1; Aoki 1997; Hollingsworth and Boyer 1997). A frequent matter of discussion is if whether the market is a product of the state (Polanyi 1957) or if the evolution of market as a web of contractual exchanges contributed to the emergence of property regimes and consequently to the creation of the state. Notwithstanding the importance of such debates, we assume that the evolution of each institutional structure has been intertwined to the other, the result of a constant process of interdependence and co-evolution. In other words, there is no primacy of one institutional structure over the other, but their current forms are very much shaped by the particular aspects of each society, which include a variety of relationships and forms of institutions, many of them interconnected and influencing differently human agency (Aglietta 1998; Chang 2000).

Considering the state-market relationship as a reciprocal interaction, institutionalists' viewpoint about market freedom is of moderate importance. As Chang (2000) points out, what matters is the institutional context that supports the 'rights-obligations structure', including elements such as the formal and informal rules that govern the way in which interests are organised and exercised; the 'ideologies' that prevail in the society; and the formal and informal institutions that determine how the rights-obligations structure could be changed.

In this respect, the very notion of capitalism is precisely a representation of one type of market-state relations in the context of rules, ideas and procedures. Such a relationship is defined by the property systems which outline the contracts and connections between the state apparatus and the business groups (Chibber 2003; Eggertsson 1990; North 1990). One of the main sources

of variation among capitalist countries is the centrality of private ownership to the exchange and production activities. Two variables are important for the argument: one is the allocation of property rights within the economic structure and the other is the proclivity of governments to manipulate economic variables.[4] A number of combinations regarding these variables define the type of social contracts or sociopolitical structures. With no intention of being exhaustive, Table 1 identifies four sorts of arrangements.

Table 1 Institutional arrangements of property structures and state-market relationships

Exclusively state ownership: managers of state firms seldom have freedom to allocate resources or decide over production output. **State-market relationship**: central planning economy	**Private property rights**: not "free" enterprise as private owners follow government's plans and development projects. **State-market relationship**: highly planning economy
Combination of private and public ownership: private firms may have liberty to invest but are heavily constrained by regulation. **State-market relationship**: intensive regulation in the economy	**Mostly private property**: free enterprise rules over prices, production and investment decisions. **State-market relationship**: low government activity in economy

Economic, legal and political systems are closely related in each pattern and although multiple combinations can be formulated, each corresponds to specific categories of state-market-society schemes. For example, the top-left quarter would undoubtedly match with what we knew as socialist states; the top-right pattern will be normally found in the so-called developmental states; the model at the bottom-left is closely related to welfare and corporatist states; and the bottom-right sector is the neo-liberal model.

We are not evaluating whether state intervention –also in terms of economic planning– is efficient or predatory, since there can be either case in whichever composition. We only intend to pinpoint the possible property structures, which except for the top-left variant, the rest are mainly capitalist systems according to the classical definition.[5] What we want to do is to identify the interrelation among state and private agents and the mediating mechanisms that make possible any kind of order. Those mechanisms, as we hope our writing has shown so far, are the institutions.

A major factor that differentiates one state from another is the kind of relationship between the socioeconomic agents and the government; in other words, the degree of political autonomy between the government-administrative apparatus and the socioeconomic agents

[4] The modes of intervention vary in degree and intensity regarding price controls, allocation of resources from public budget, trade barriers, monopoly rights; R&D financing, monetary policy, FDI requirements, nationalisation; fiscal incentives, state-own enterprises, etc.

[5] Capitalism is the system of production characterized by private property of the means of production and the free labour.

(Evans 1992, 1995; Leftwich 1995). The degree of autonomy between one actor and the other is contingent upon the configuration of political institutions that permits certain agents to participate wholly or partially in the development strategy.

At issue is what kind of commitment can be exerted from state agencies and economic actors to abide to the rules and to what degree the evolution of economic activities (marked by technological and cultural changes) can make the rules change. Moreover, some distortions may occur as regulation falls behind the actual process of economic growth and technological advance. In that case, the original articulation of state agents and public entities with the private agents may develop in predatory and pernicious activities –like rent-seeking– which can, if not quickly adjusted, undermine the state agents' capabilities of coordination and enforcement. This becomes apparent when external influence, including foreign capital, new "imported" ideas, and new technologies penetrate into the domestic political economy processes.

The international dimension

Despite several claims that the forces of globalisation –e.g., capital, technology– are debilitating the state and rendering it a meaningless entity in the world economy, like many others, we do not see that happening. On the contrary, the state is a fundamental figure of the global political economy (Weiss 2003, 2005). The state has a double function: one as *regulator* of the national political economy impinging on the existence and operation of firms and the political participation of firms, and the other as a *filter* of external forces. The point is: the institutional setting shapes the ways that the domestic and the international dimensions affect each other. It starts from the principle that the political and economic interaction does not occur in an institutional vacuum. Therefore, the partial or integral change of the structure of rules would suppose so much the alteration of the domestic political economy as of the eventual penetration of external forces at different degrees and types depending on the sector. The viability of institutional structures and practices is constantly tested by changes within the society and the external environment.

Having said the above, this section discusses the international dimension of institutional change. It focuses on the relationship between national governments and multinational companies (MNCs) and complements the topic by arguing that the evolution of such relationship is linked to the context and international structures. Most of the literature on the relationships between governments and MNCs focuses on the positive and negative impacts that the activities of multinational firms have in the host country through foreign direct investment (FDI) (Moran 1986; Moran, Graham, *et al.* 2005). Either way, it is worth considering MNCs activities as a

relevant factor for institutional change precisely because of the implications in terms of power and wealth distribution.

Multinational firms are the main vehicles of foreign capital, which normally is accompanied by organisational and technological capabilities that are considered superior to those of local firms. For that reason, the activities of MNCs "inspire both awe and fear" (Grunberg 2001: 346). This applies to both developed and developing countries' manufacture (light and heavy) as well as financial industries. On these grounds, governments have reacted in different ways according to their perceptions about the economic and political benefits of opening the development strategies to FDI.

The common thread between most political economy perspectives is the contention that MNCs have a substantial impact on national economies; the perspectives differ, however, on the significance and quality of implications to distribution of gains, on the autonomy of ruling elites and on the long-term prospects of development. Evidently, each perspective measures differently the magnitude of the political consequences of FDI and shapes the perceptions of benefit and harm. So the question of how much MNCs really affect policy-making and policy choices of governments is relative to the shared meanings and collective habits of thought, at least from the most powerful members of the society. As a particular set of ideas dominate the political arena, it can be expected that the attitudes of national elites towards MNCs will be influenced accordingly. Therefore, the role of ideas is an important factor for institutional change.

An important assumption here is that FDI always implies the issue of property and hence the interests of capital owners. Therefore, FDI has important implications for the political economy of institutional change. From the MNCs side, as private self-interested actors they will predominantly prefer environments that reduce uncertainties and costs to their transactions. Such firms will establish operations in economies with secure and stable legal frameworks, which also provide substantial freedom to control their own network of subsidiaries –or use existing local suppliers under their own criteria–, and to reinvest or repatriate their gains as they see fit. In addition to those institutional factors, FDI will look for places with environments in which political and economic leaders' as well as general people's attitudes towards MNCs do not radically oppose their presence. If MNCs expectations are not met by ongoing institutional and environmental factors, then they may threat to leave or simply shut down and go to more favourable locations, thus exercising the fearful 'structural power' of exit (Scholte 1997: 443`, 447-9).

From the side of governments and the institutional infrastructure they administer, their response to development challenges and the role of private foreign capital can be observed from

various fronts. One perspective is to see governments as proactively promoting and welcoming FDI, almost regardless of their nature (productive or financial). Another is to see governments competing to attract more FDI into their countries by giving MNCs numerous incentives and a favourable environment. A third way is to observe governments engaging in collective action to harmonize institutional frameworks among other states. In none of these views are governments indifferent to the implications of FDI, although mostly the attitudes are favourable to MNCs. In the first perspective, the government response is to induce inward FDI in proactive ways. Governments arrange packages of incentives such as new investment laws, tax cuts, subsidies, minimal performance requirements, upgraded physical and human infrastructure, etc. Governments may also set up promotion agencies to provide legal and environmental information, which may assist foreign investors to reduce search costs (Loewendahl 2001; Moran, Graham, *et al.* 2005: 378-81). In some cases, e.g., East Asian countries, governments have adopted more holistic strategies to enhance the long-term competitiveness of their indigenous resources and capabilities (Dunning 1998), and investment promotion agencies have been increasingly vested with faculties to coordinate other government branches and allocate resources to support specific projects, regions, or special zones.

However, despite the allegedly universal character of globalisation, foreign capital in the form of investment is rather scarce and it is concentrated mostly in the developed countries. Moreover, MNCs interests are narrow. In that sense, countries have to compete to attract foreign capital. Competition among countries to invite FDI is often used as an explanation for the trend toward unilateral liberalisation and the associated consequences of reducing governments' power in economic management (Walter 2000: 51). One of the negative aspects is the 'race-to-the-bottom' phenomena referring to governments' attempts to match the incentives offered by other countries in similar stages of development to attract FDI. This process, it is argued, is visible in income polarization, and in labour and environmental standards (Sklair 2003). Additional consequences of liberalisation are the reduction of government's abilities to control foreign investors, extract fair revenues from MNCs activities, and probably eschewing welfare policies and programmes (Gereffi 1985). In some cases, optimists argue, liberalisation may also trigger a 'race-to-the-top' in regulatory and policy standards (Walter 2000: 51) producing spill-over effects thus raising countries' technical capabilities (Moran, Graham, *et al.* 2005: 379-81).

Cooperation between countries to set rules governing competition for FDI and to standardize incentives and controls for potentially 'harmful' FDI –e.g., short-term capital flows– is a prime concern between developed and developing countries. However, collective action has

not been easy as the Uruguay Round on TRIM and the OECD's MAI negotiations demonstrate (Walter 1998).[6]

In this section we argue that the context and the international political economy structures are relevant factors that shape government-MNC interaction, and, by extension, the process of institutional change. The connotation given to the "context" is based on a particular combination of historical facts. However, in our view, the connection of facts and the identification of trends is a matter of interpretation, which at the same time involves the selection of a particular criterion for judgment. The context is, therefore, a mental construction that can be shared by those under similar habits of thought, so one might argue that the force of ideas is relevant to shapeperceptions of the reality. On this regard, the idea of globalisation is a powerful one.

During the 1980s, many governments in developing countries started to incorporate new generations of bureaucrats graduated from U.S. and European universities. The background of debt crises and the difficulties to sustain economically and politically the welfare and nationalist regimes made ruling elites pay more attention to macroeconomic stability policies implementing shock measures to halt further economic deterioration. The role of the International Monetary Fund and the World Bank were crucial in dispensing those policy packages and the new technocracy was instrumental in promoting the economic policy reforms preached by the 'Washington consensus' (Williamson 1990). Gradually, political leaders became *aware* of the magnitude of the forces and their political survival was increasingly associated with a change of attitude towards FDI. The next step was to persuade the population about the benefits of FDI, disregard its potentially harmful consequences, and promote the inflow of foreign capital. Such change in attitude from economic and political leaders occurred in both developed and developing countries.

In such a *context*, national governments felt impelled to seek deeper connections into the structures of trade and finance in order to improve their economic development strategies. Thus economic policies gave special attention to the domestic regulatory environment in which MNCs operated. The usual response was to liberalise, privatise and deregulate, leaving behind the domestic institutional frameworks that were functional to the domestic industrial status as well as the international post-War and Cold-War contexts. However, the process of reform was not exempt from political pressures and different –sometimes conflictive– understandings of reality, driving to diverse responses to globalisation and liberalisation of FDI.

Ultimately, the governments have to operate simultaneously at two levels: the domestic and the international. In the domestic level, governments must deal with local players under the

[6] *Financial Times*, "Bye-bye, MAI?", February 19, 1998.

diverse constraints of formal and informal rules that operate within the state (Keohane 1984; Mo 1994; Putnam 1988). With regard to the international level two factors are salient: the limits imposed by the international rules on the one hand, and the foreign governments with their own domestic constraints and 'win-set', on the other (Putnam 1988). Therefore, it is important to observe the organisational capacity that certain domestic agents have developed to respond to external challenges as well as the heterogeneous institutional evolution and preferences of different economic sectors (Atkinson and Coleman 1989; Milner and Yoffie 1989). To grasp a better understanding on how the domestic processes are really affected by the external forces it is convenient to observe the ways governments and private agents articulate their preferences in relation with external interests.

The formation of coalitions through the formulation of foreign economic policy is an internal process and therefore related to domestic politics (Dent 2002; Gourevitch 1978; Katzenstein 1977, 1978; Milner 1988). For instance, as Gill and Law (1988: 49-50) argue, "the policies which might help sustain an open international economy are most likely to be pursued when an 'internationalist' coalition of interests gains sufficient control over foreign economic policy". Therefore, it is worth considering the abilities of local capital to internationalize by integrating into the structures of global production and finance, whether as a strategy or a consequence of evolution and increasing sophistication of production processes. And, in such a process, local and foreign capital (productive or financial) may find internationalisation and interdependence to be relevant countervailing forces to gain voice and presence in policy making (Haggard and Maxfield 1996: 37).

The institutional connection between the domestic and international dimensions

The initial sections offered a conceptual outline mainly clarifying what we mean for institutions, their types and functions, as well as some ideas about the process of institutional change. Following the conceptual account, the two preceding sections sketched out the domestic and international dimensions that constitute the proposed analytical framework. This section puts forward the analytical framework with which we explore the political economy of institutional change. With the institutional, domestic, and international interlinked spheres as a background, We consider three interrelated processes: a) the formation and control of the economic agents by the property system; b) the economic liberalisation that reduces government's capabilities to command the market and the economic interests; and c) the increasing importance of international capital and neo-liberal ideas along with the internationalisation of domestic firms. The institutional connection between these processes is the foreign investment regime (Figure 3).

The property regime is one of the most important institutional factors in the political economy of development because it *affects the formation and control of firms by governing entry and exit mechanisms*. Therefore, property systems are a function of power and governance. From a developmentalist perspective, property regimes determine *who* participates in the market and benefits from industrial policy incentives; for such political implications, *property regimes can be considered as political institutions.*

Because property regimes filter economic interests, the change of such set of rules necessarily implies the alteration of the domestic political economy. This applies to the emergence of new domestic firms as well as to the entry of foreign companies. The access of new or independent financial agents –domestic or foreign– will deepen the gaps. Under those circumstances, governments are encouraged to adopt different coordination roles. Consequently, opening property rules may constrain the government's ability to affect economic performance.

The second process refers to the connection involving *economic liberalisation –including privatisation– and change in political institutions*. In this case, liberalisation is a process of institutional change in which, supposedly, the rules of the market would establish an impersonal, politics-free, entry and exit mechanism –i.e., replace the role of the government and its directing agencies. As suggested above, the relationship concerning liberalisation and political openness is that the reduction of controls to domestic and foreign firms leads to the independence of economic agents and the reduction of government selective capacity. However, this can create mixed outcomes in the national political economy: on the one hand, if domestic industrial actors are weak, foreign economic interests are likely to penetrate and dominate the national economy. On the other hand, if economic power is concentrated in strong business groups, economic liberalisation may lead to further concentration because the new expansion opportunities could be seized by those domestic interests in the absence of significant counterbalance from foreign capital. The problem is more acute in developing countries that forged capitalist institutions under centralised planning but then embarked intentionally on the quest to become a market economy. This brings with it inconsistencies between the conservative nationalistic interests and the institutional memory of the developing model vis-à-vis liberal foreign economic policy and the internationalisation of economic activity. The conflict between nationalistic and liberal mindsets may produce institutional disharmony between formal rules and practices, which could create confusion and inefficiency but also exacerbate harmful inclinations towards risky and unchecked ventures.

The third process that affects the evolution of property regimes is the impact of *international forces*. Two of them are particularly important: the MNCs and new ideas. The logic

implies that the more advanced it is the industrialisation process, the more exposed to international economic forces because of the increasing size of the market and the deeper integration into the regional and international economy. MNCs and other actors may feel attracted to enter such a market or seek to secure and expand their activities. Once foreign companies have gained substantial market share or have acquired controlling stakes in domestic firms they might directly or indirectly influence the business environment. The influence of MNCs may be whether by pushing regulators to create or modify the institutions or by setting best-practice standards or by establishing intra-firm networks that alter the industrial organization. With regard to new ideas as an international force, their role is to foster paradigm change which eventually re-shape the mental frameworks. The new value systems would affect collective and/or elites' perceptions and, consequently, the content of economic policy. The channels of transmission of new ideas and the historic and cultural conditions in which they are introduced may vary depending on the case.

The importance of the international factor rests on the perception of the governing elite about its ability to maintain the political stability of the regime and sustain the process of transformation. Neo-liberal-minded reformist leaders pursue unilateral liberalisation and seek to link the national economy with the international through active participation in multilateral organisations and other legal agreements. Initially, reformists undertake the economic opening as a complementary disciplinary force to keep control over socioeconomic agents, including the big companies. From this point onwards, the formal links with the multilateral organisations would serve to confine the choices of domestic forces to the "global standards". Such a strategy does not necessarily seek to cede the power to external structures of governance, but to influence the popular perception that the adoption of new practices will ensure competitiveness and long-term economic survival. Thereby, economic reforms are intended to renovate incentives and expectations with subsequent reduction of transaction costs and uncertainties. At issue is how existing –remaining– formal and informal institutions can provide a viable framework to keep control over the distribution of power and wealth.

The nodal point between these three factors –the property regime, economic liberalisation, and the international forces– is the foreign investment regime. The opening of property regime implies that the participation of external agents would lead to a reconfiguration of policy choices. Foreign investment is also supposed to be instrumental in changing the collective mental structures to a favourable one for foreign capital. Figure 4 outlines the political process in two diagrams.

Before liberalisation **After liberalisation**

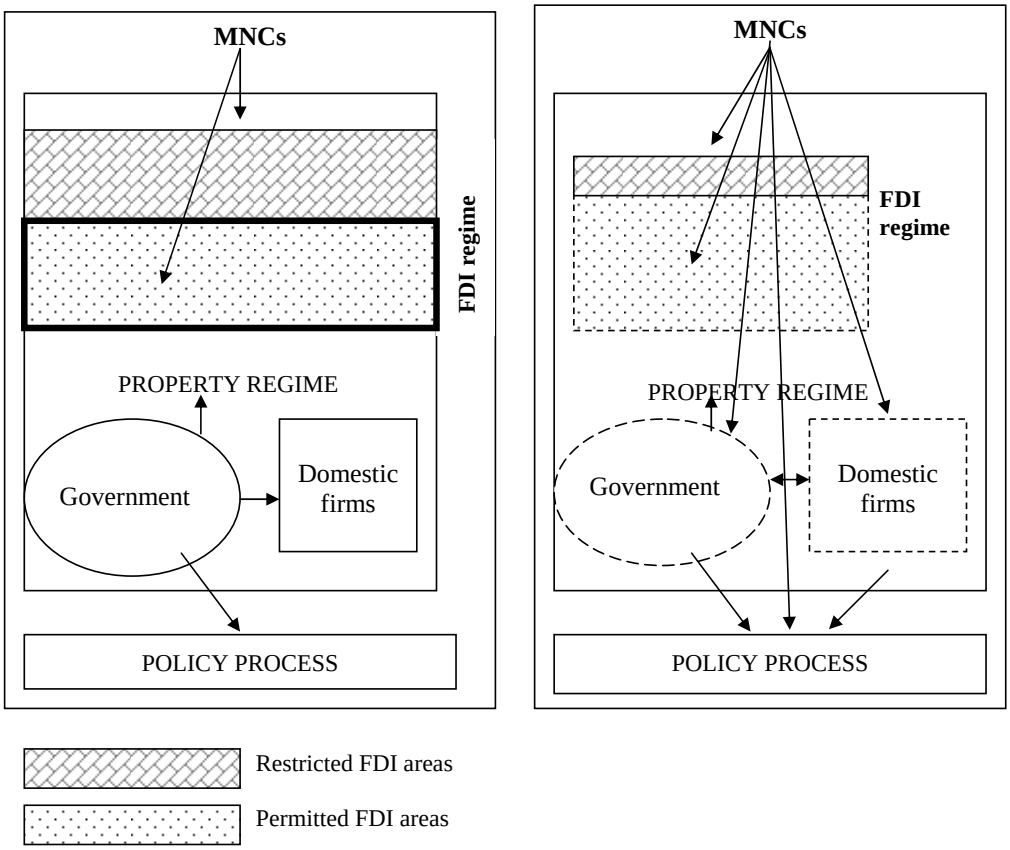

Figure 4. Property regimes, FDI and policy process

Conclusions

The preceding sections have elaborated the conceptual and analytical frameworks. To sum up, institutions are dynamic structures developed deliberately or unconsciously by humans to facilitate interaction. Formal institutions are always created and modified with a purpose, so they are generally accompanied by concrete expectations. Informal structures normally change gradually under the subtle pressure of external environment or due to emulation, influence of new ideas, technological innovation, etc. Whatever the source, institutional change seldom takes unidirectional trajectories. As shown in the first part of this chapter, it is hard to determine when the time is propitious for radical institutional changes and even harder to harmonise new formal rules with the habitual mental frameworks.

Since their origin, all states have developed economic and political regimes that allowed them, as socio-political entities, to survive and maintain order among relevant actors. In general, institutions survive without severe changes; endurance is enhanced as dominant elites secure the

rule-compliance from constituencies or simply because the society finds it convenient and suitable to abide indefinitely by customs and collective habits. For example, property regimes may serve as guidelines for custom and routine; eventually, customs and routines become the main source of expectations and references for judgment that shape the informal determinants of the state-market relationships. The efficiency of the system would depend on the harmonization between formal and informal rules, and not so much on the type of institutional arrangements of property structures and state-market relationships. This does not mean that ownership structures must be homogeneous throughout national economic systems let alone globally. The issue is how governments in developing countries manage general economic reforms with differentiated property regimes according to the development needs and the nature of each economic sector. For this reason it is convenient to rely on case-study inquiries and consider the possible differences within the system, which may help to understand the complexity of the processes of change.

The chapter also emphasized that, notwithstanding the liberal influence of market-efficient models, the role of government is still central in resolving the tension between domestic and international forces. After all, the government embodies the ultimate political institution of the state to filter domestic and international interests. However, liberalisation alters the institutional setting –including property systems–, thus bringing market competition and foreign investors into the domestic political arena. An obvious consequence is that local agents are forced to adapt to the new institutional environment and adopt new practices. Moreover, liberalisation may be introduced not only as the elimination of formal barriers to market entrance but also as a mental model that includes particular value systems.

As governments and socioeconomic actors perceive a change in the external environment, they may feel compelled to adapt but not to change radically the structures that have created comfort, status, and power. Therefore, the response to liberalisation generally is mixed: on the one hand, mobilizing resources to modify the ongoing structures and, on the other, adhering to the habits of thought and practice. The outcomes of such evolutionary process vary. For instance, governments that open the property regime to outsiders (FDI regime) to foster the competitiveness of domestic firms will confront new distributional pressures across the different national levels and sectors. Furthermore, changes in property regimes enable the creation of new sectors or industries, and, potentially, are conductive to the disappearance or restructuring of old ones. Such institutional change will alter the power relations inside the state, yet the modification of the foreign investment regime is a domestic process in which too many interests are at stake and ideas about the role of foreign capital might be difficult to change. For instance, domestic

economic actors that gain from closed property systems may have an incentive to resist or oppose changes.

If external forces are able to influence the modification of the property regimes, they will be in a better position to accommodate their interests in the economic agenda. The way that the private external actors accede to the political system is by generating stakes within the domestic economic system and that can be done by means of FDI and the acquisition of assets. The role of political institutions is to allow or prevent that from happening, but those structures can also be influenced by domestic actors either in search of new distributional outcomes and buttressed with a renovated mindset, or seeking to defend and extend the status quo.

To reiterate, the speed of transformation is determined by the flexibility of the collective habits of thought and the skill of the dominant coalition to introduce new paradigms and profit from it. Nevertheless, although the momentum seems to be propitious and the government possesses the political legitimacy and conceptual clarity in the content of its vision, the intended neo-liberal reforms do not always lead to the expected outcomes. Notwithstanding that the new formal rules are “in place” according to so-called “international standards”, these seldom consider the legacy of previous policies, power relations, traditional practices and ways of understanding reality. If these aspects are not compatible, then the institutional amalgam might fail to produce a new clear-cut paradigm.

The analytical framework was built upon the underlying argument that institutional change is not a mechanical but an evolutionary process that involves some sense of purpose (adaptation to a new environment), legacies of political institutions (power relations and habits), and also the external environment (MNCs presence, context, ideas and structures) (Figure 5). This paper asserts that one institutional connection between domestic and international dynamics is through industrial property regime.

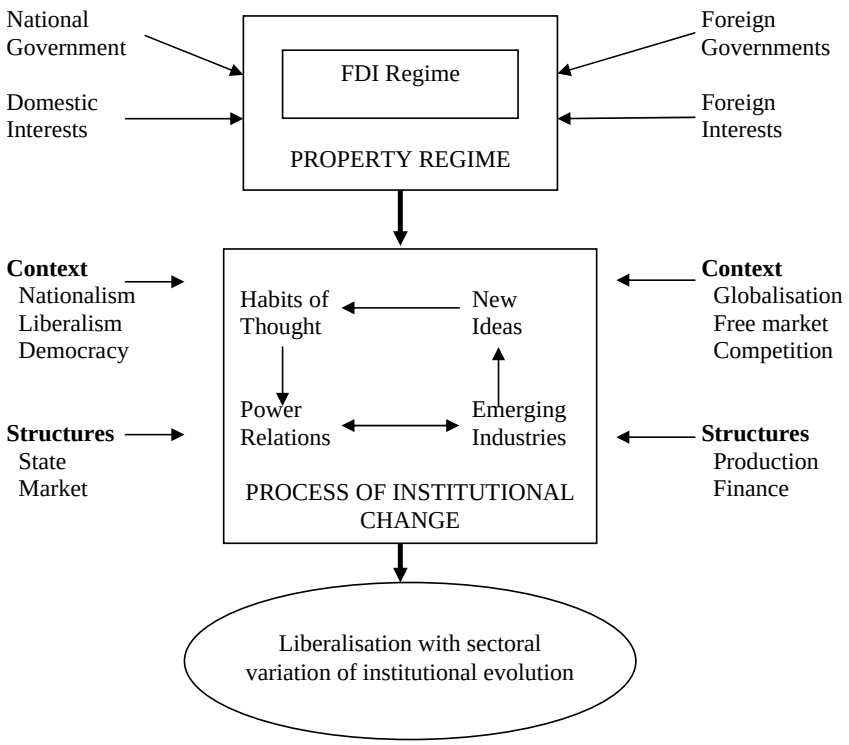

Figure 5 Political economy of institutional change

Certainly, the historical analysis can shed light upon the social processes that overlap with the external circumstances, inferring results from certain combinations of events and decisions. The historical study of institutions helps to elucidate how and why the political institutions differ between and within national economies that are exposed to similar pressures and shocks.

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