An Institutional Approach to Understanding Success and Failure in Economic Development: The Cases of South Korea and Bangladesh

Md. Dulal Miah ※
Ritsumeikan Asia Pacific University

Abstract

South Korea and Bangladesh were parallel in terms of economic development at least until the 1950s, if not later. However, the former enjoyed unprecedented economic growth during the latter part of the last century, which has enabled it to join the ranks of richer nations. In contrast, Bangladesh has clearly failed to realize any such noteworthy economic progress. This raises a question: what has enabled South Korea to accelerate its economic growth while Bangladesh fails to do so? This paper examines differences in the determinants of growth between these two nations and argues that strong institutions that provide proper incentives can explain the "mystery" of South Korean economic growth, whereas economic underdevelopment in Bangladesh can be attributed to its failure to direct resources towards productive efforts through creation of proper institutions. Colonial experiences are analyzed briefly through the existing literature to identify the nature of institutions which the two countries have inherited from their respective colonizers.

Keywords: economic growth, institutions, colonial experience, incentive, South Korea, Bangladesh

Introduction

The conclusion by Thomas L Friedman (2005) that the world has converged into what he terms *the flat world*, is invaluable for understanding how technology and other "world flatteners" shape the trajectory of economies in the twenty-first century. However, historical interpretations of growth as accounted by measures such as per capita income and GDP growth rate show us that the world has diverged. It is, indeed, true that the world is being transformed into a global village and that the pace of this trend has increased markedly in the recent past owing to the technological revolution. In spite of this, very few would deny that we live in a world of inequality and diversity, where

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some spend a lot to reduce their weight while others can hardly manage a meal for a day. Vivid examples of which are myriad in the present-day Africa and parts of Asia.

Income per capita in the richest industrial countries is about 400 times that of the poorest countries. Just how "unflat" the world is will be more apparent when we take into account the astonishing fact that 250 years ago, the gap between the richest and the poorest was perhaps 5 to 1, and the difference between Europe and East or South Asia was around 1.5 or 2 to 1 (Landes, 1999). Not only has the income per capita gap increased over time but the growth rate in this gap has also increased. Helpmen (2004) analyzes the growth rates of 104 countries for two distinct periods, 1960-1972 and 1974-1990, and finds that more countries experienced higher income growth in the former period than in the latter.

Similar trends of income per capita and growth rate can be found in Asia. Some newly industrialized economies (NIEs) such as Hong Kong, Singapore, Taiwan, China, and South Korea have clearly accelerated the pace of their economic prosperity. The per capita incomes of these NIEs have increased nearly sixteen-fold in the past forty years (Quibria and Dowling, 1996). In contrast, many countries in Asia and the majority in Africa are still struggling with much lower levels of economic development. For example, income per capita in Bangladesh is US $400 whereas the same figure for South Korea is US $12,030 (2003 price). Surprisingly, the absolute GDP base of South Korea and Bangladesh were very similar during the 1950s, and at times the GDP of Bangladesh may have been higher. Kuznets (1994) reports that the GNP per capita of South Korea in 1963 was US $143 (at current price) while for Bangladesh the average GDP per capita from 1961 to 1970 was US $163 (1985 price). This anomaly leads us to ask: why has South Korea grown so rapidly while Bangladesh has failed? Or more generally, why do some nations grow but others do not?

Many factors such as technology, innovation, population, governance, savings, investment, geography etc. can influence country's growth at a certain time, meaning that there is no definite and straightforward answer to this question. However, traditional new classical growth models have paved the way for identifying growth instruments. For example, Solow (1956) attributes difference in income per capita to differences in savings rate (capital intensity), technology, or other factors such as total factor productivity (TFP), whereas Koopmans (1965) explains that the difference is due to either preferences, or other exogenous parameters including TFP. Mankiw, Romer, and Weil (1992) examine different implications of the Solow model. Assuming that each country experiences the same technological changes and the same rate of capital depreciation, they find that cross country variation in income per capita is a simple function of variation in savings, rate of population growth, and the initial level of labor productivity. In contrast, the Romer (1986) model attributes the difference in prosperity between two countries to differences in allocation to innovation.

Factors that motivate people to save, to invest for innovation, and to undertake productive initiatives are not included in those neoclassical models. North and Thomas (1973) conclude that innovation, economies of scale, education, and capital accumulation are not the cause of growth, but rather they themselves are the growth. For North and Thomas the fundamental cause of growth difference between countries can be attributed to differences in institutional settings which divert the choice of the people towards productive efforts. In the traditional growth models, these institutional variables are assumed either neutral or ignored. Or, "they were taken as given and then specified in so perfunctory a way as to suggest that institutional influence was not of

much importance" (Furubotn and Richter, 1991: 2). Thus, even though the theoretical tradition of neoclassical models is seemingly persuasive and has provided an important insight into what causes growth difference between countries, they are unable to provide a fundamental explanation of the issue in question.

This paper aims to shed light on the major determinants of economic growth, focusing two distinct cases – South Korea and Bangladesh – to explore the forces that have led the former to enjoy unprecedented success in accelerating economic growth, while the latter has apparently failed to manage any significant development since her independence in 1971. This paper has been organized as follows: following this introduction, section two describes some general notions that are frequently assumed causes of economic underdevelopment in many countries, particularly in Bangladesh, and how useful they are for explaining the prevailing situation. A theoretical framework is developed in section three, while section four explains succinctly the causes of economic underdevelopment in Bangladesh starting with its colonial origins. South Korean economic success is the subject of section five, which is followed by a brief conclusion.

The Mystery of Economic Growth

The customary belief that countries with vast reserves of natural resources should grow faster than countries with low levels of natural resource endowment is no longer a valid proposition. Natural resources are undoubtedly crucial factors of production, since they are the sources of supply for both raw materials and energy requirements. However, anecdotal evidence suggests that it is unlikely that natural resource endowments can accelerate economic growth. South Korea and Japan are good examples. Economic growth in these two countries skyrocketed, especially during 1970s and 1980s, despite their poor endowment of natural resources. In contrast, most Middle East countries have an abundant stock of natural resources but are functioning poorly, with a few exceptions, and the resulting sluggish economic growth is noticeable from Table 1.

Table 1 GDP growth rate of seven oil producing countries

	Bahrain	Iraq	Kuwait	Oman	Qatar	Saudia Arabia	UAE
GDP growth rate (in %) Period	-0.75 1975-88	-1.88 1970-87	-5.39 1970-89	0.69 1970-89	-7.7 1980-90	-0.76 1970-89	-4.60 1973-89

Source: Sachs and Warner (1997).

Sachs and Warner (1997), analyzing a sample of 97 developing countries for the period of 1970-1990, find that resource-poor economies vastly outperform the resource-rich countries. They argue that in the seventeenth century resource-poor Netherlands clearly outperformed resource-rich Spain, in spite of the fact that Spain accumulated vast amounts of gold and silver from its colonies. Moreover, in the nineteenth and twentieth centuries, a resource-poor country like Switzerland, for example, surged ahead of a resource-abundant economy like Russia. Therefore, natural resource endowment cannot explain the differences in economic growth and development between countries

Most underdeveloped countries including Bangladesh are, without a doubt,

densely populated – one factor which can be considered a cause of underdevelopment. Overpopulation means higher levels of consumption an a consequent low level of savings available for investment, which in turn leads to low investment and hence limits production. Moreover, a large population may create unemployment because low levels of investment cannot provide sufficient jobs. This cyclical process may persist if outside variables do not interrupt it. Although the process may sound logical, scholars hardly accept this proposition on the grounds that population is a resource rather than a liability. However, systematic methods of accounting for human resources have yet to be developed. Countries like Singapore, Hong Kong, Japan and even South Korea are more densely populated than many underdeveloped countries. As per Table 2, population density in Singapore and Hong Kong was much higher than that in Bangladesh, India, and Malaysia over the entire observed period. However, the rapid GDP growth in Singapore implies that overpopulation can not explain economic underdevelopment in many countries.

Table 2 Demographic and economic indicators of some Asian countries (unweighted average)

	Singa-pore	Hong Kong	South Korea	Japan	Bangla-desh	India	Malaysia
GDP growth rate (in %)							
1961-1970	9.88	9.87	8.26	10.47	4.06	4.11	6.49
1971-1980	8.92	9.38	7.30	4.50	1.04	3.08	7.87
1981-1990	7.44	6.48	8.74	3.95	3.73	5.81	6.03
1991-2000	7.68	4.59	6.19	1.46	4.8o	5.51	7.23
2001-2004	2.94	3.42	4.64	1.36	5.12	6.19	4.21
Population growth rate (in %)							
1961-1970	2.32	2.52	2.44	1.03	2.53	2.30	2.88
1971-1980	1.51	2.46	1.78	1.13	2.51	2.27	2.38
1981-1990	2.33	1.24	1.17	0.56	2.53	2.12	2.80
1991-2000	2.77	1.56	0.92	0.27	1.75	1.79	2.46
2001-2004	1.90	0.67	0.60	0.18	1.74	1.52	2.00
Population Density/Sq. km.							
1961-1970	2839	3524	292	271	457	166	29
1971-1980	3391	4267	359	305	589	209	38
1981-1990	4129	5236	414	331	757	261	49
1991-2000	5371	5984	458	344	932	316	64
2001-2004	6299	6519	484	350	1052	355	75

Source: Author's calculation based on World Bank data

Corruption is now a widely discussed phenomenon, especially in Asia, because it is believed that corruption hampers a country's economic progress through the various complex networks at the core of the country's political system. Bangladesh, according to Transparency International, is one of the most corrupt countries. Though the measurement criteria are quite subjective, it is undeniable that corruption does have some serious negative effects on economic performance. But is corruption an independent variable, elimination of which will substantially improve country's level of economic performance? How far can different levels of corruption be used to explain the fact that South Korea experienced accelerated economic growth before the

Asian financial crisis and Bangladesh did not? Table 3 provides some insights into the relationship between corruption and economic performance.

Table 3 Growth rates and corruption levels in some Asian countries

Country	GDP Growth Rates (in %)				Corruption Index*	
	1970-80	1980-90	1990-97	2003	1980-83	1996
Bangladesh	2.3	4.3	4.5	5.3	4.0	2.3
India	3.4	5.8	5.9	8.6	5.3	2.6
Pakistan	4.9	6.3	4.4	5.1	4.0	1.0
South Korea	9.6	9.5	7.2	3.1	7.7	5.0
Malaysia	7.9	5.2	8.7	5.3	6.0	5.3
Thailand	7.1	7.6	7.5	6.9	1.5	3.3

Source: Khan (2000) except growth rate for 2003 collected from World Bank data
Note: * On a scale of 0 to 10 from the highest to the least corruption

This table does not provide data from another important country, Indonesia, which has had a long experience of autocratic rule and numerous scandals arising from high levels of corruption. Nevertheless, economic growth in Indonesia during the autocratic regime was impressive, with the country experiencing a remarkably good rate of sustained growth. Table 3 shows that South Korea enjoyed a tremendous rate of GDP growth at 7.2 percent on average between 1990 and 1997, while the corruption index indicates the existence of a moderate level of corruption. The case of Thailand has more anomalies than any other case in the table. This country grew at an average of 7.1 percent during the period 1970-1980 with a remarkably high level of corruption, more than 3 times higher than that of Bangladesh which experienced a meager GDP growth in the same period. These facts, however, do not legitimize corruption, and neither do we intend to; however, the central importance of these anomalies is that corruption cannot explain why Bangladesh, for example, is economically poor while South Korea on the other hand is rich. This forces us to look for some other mechanisms to explain what leads to differences in economic growth.

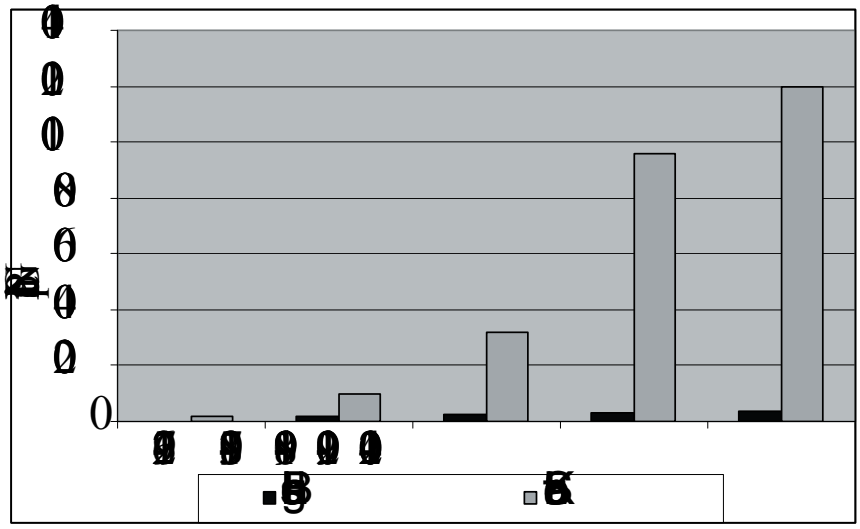
Most underdeveloped countries are technology-poor and lag far behind the developed and even developing countries in respect to innovation and the employment of technology, undoubtedly an important tool for enhancing productivity. The productivity of an employee who works in a printing press in Bangladesh with technology invented in the 19th century is in no way commensurate with the productivity of a US worker handling a similar job with frontier technology. Similarly, a farmer in Cambodia who cultivates land aided by an ox produces many times less than a farmer in Sweden who using modern agricultural technology, despite the fact that the land in the former case is more fertile. Therefore, it does appear that technology can explain why farmers in Cambodia are poor while they are very rich in Sweden.

The effect of technology change on economic performance is examined by Solow (1956, 1957), who is considered to be the founder of the neo-classical growth model. Analyzing US private non-farm GNP for the period 1909 to 1949, Solow finds that gross output per man hour doubled over this time interval, with 87.5 percent of the increase attributable to technical change and the remaining 12.5 percent to increased use of capital. The basic theme of his model is that capital intensity (the ratio of capital to labor) is the growth driver which functions according to the law of marginal

diminishing returns. This means that at the initial level of capital intensity, the output of a country rises at a faster rate than when it approaches to a higher technological frontier. According to this model, a country like Bangladesh that operates with very low capital intensity initially grows faster than a country like South Korea which operates with high capital intensity. Therefore, the growth rate of Bangladesh should converge with that of South Korea in the long run and they reach an equilibrium where growth rates are equal to technical change, which is the growth driver according to the Solow model.

Similarly, if incomes per capita were driven by capital accumulation and a common rate of technological progress only, then growth rates between the poor countries and the rich would have converged. But the reality deviates significantly from this ideal situation. Our data in the previous section and figure 1 provide us with sufficient grounds to argue that technical change alone cannot provide a satisfactory explanation. Olson (1996) however, argues that South Korean growth certainly supports the view that the productive knowledge is available to the poor countries of the world, and at very little cost. This means that poor countries are not far away from in catching up with technology that is developed in the industrialized countries. But many poor countries remain poor.

Figure 1 Unweighted average of Gross National Income (GNI) per capita



Source: World Bank

This evidence implies that technical change cannot explain income differences to a very large extent, hence turning the focus towards the possibility of human capital which might fill the gap. But as long as the accumulation of human capital is subject to the law of diminishing marginal productivity, including it in the function does not change the basic premises of the model. The above circumstances lead us to conclude that other factors must have played crucial roles in shaping economic growth patterns and differences among countries.

In economics parlance, this mysterious factor of economic change is described as "total factor productivity" (TFP). It includes all unmeasured improvements in the quality of inputs, for instance improvements in technology, improvements in the organization of production and distribution, the reduction of distortions, and improvements in

government policies (Helpman, 2004). An example will make this clear. Suppose the initial GDP of a country is 100 units with a combination of 60 percent labor input and 40 percent capital input in the production process. We can write a simple production function such as Q= f(K, L, P) where Q stands for output, L for labor input, K for capital input, and P for TFP as usual. Therefore, the production function in this case is 100= (0.4K*0.6L*P). One year later, GDP increases to 105 units with increased capital input of 1 percent and labor input of 2 percent. Under these conditions, the increase in both labor and capital combined can explain 1.6 percent of the total productivity increase of 5 percent and the remainder can be contributed to TFP. Helpman (2004) argues that more than 60 percent of per capita income variation across countries can be explained by TFP. Thus, determinants that we call here institutions help many countries to nurture high levels of TFP and are likely to be vital factors in explaining growth differences.

Theoretical Framework

What are institutions and why do they differ

'The rule of the game' definition of institution is widely preferred and cited in the literature of institutional economics, even though the spectrum of this definition is fairly broad. This broadness is likely preferable to a narrow one, because narrowing it down might lead to some basic apparatus for analysis being ruled out. Nelson and Sampat (2001) propose that "the rule of the game" is important because well defined rules set baseline conditions for human behavior, which in turn create a predictive possibility of how the interacting parties in a transaction are likely to behave in a particular situation. This interpretation fits with North's intention in proposing that the generic function of institutions is to reduce uncertainty to risk. This "rule of the game" is a set of constraints comprising regulations, culture, perceptions, societal norms and other similar elements that shape human behavior responding to society's numerous demand. North and Thomas define institution as "An arrangement between economic units that defines and specifies the ways by which these units can co-operate or compete" (1970: 5). Since institutions define and limit the set of individual choices, their presence in society would govern and set the directions of human behavior – for example, what they ought or ought not to do. From this perspective, a good institution is developed when a country adopts a set of rules that promotes and encourages value-enhancing activities at the same time as constraining rent-seeking and individual empire building through irrational and unethical means, which are unproductive and wasteful of the society's scarce resources.

Institution comprises both formal constraints such as rules and regulations, and informal constraints, for example conventions, codes of conduct, and norms of behavior. Such institutions affect performance fundamentally by fostering better policy choices such as favorable tax regimes that encourage production, independence of the central bank where it has been ceded power to oversee financial markets, government commitments to protect the private property as well as to deter extortion, ensuring participation of citizens to voice against or in favor of government policy and the like. Differences in institutions may create different incentives and behavior among the people. For example, corporate takeovers are more frequent in the US and UK than in Japan and Germany, a fact which can be attributed in some degrees to the formal institutions such as legal rules and procedures, and in some degree to informal

constraints. The implications and manifestations of democracy differ fundamentally between countries because of considerable variation in institutional settings informing the behavior of society, corporations and the state.

Organizations including political, social, economic, and educational bodies can be perceived as the players of the "game". They process or produce information and make decisions that reflect the capacity of the players within the institutional framework (North, 1990). The inherent tendency of the players is to maximize their utility within the existing constraints. Therefore, those constraints would ultimately decide whether value maximization is taking place to ensure efficiency of the society in question. The Soeharto government in Indonesia could allocate more than one trillion rupiah for off-budget expenditures (McIntyre, 2000), simply because the customary institutions either allowed it to conceal the colossal pecuniary benefits legitimized by the cabinet, or the institutions were unable to create a framework that could check this expenditure effectively. In contrast, the parliament in seventeenth century England curtailed the crown's power – a power which allowed the crown suddenly to disband parliament by dint of the "divine rights of king" in his own interests, undermining social and individual liberty – and subordinated this power to common law (North and Weingast, 1989). It is further argued that this circumstance paved the way for modernization of England. The quality of present-day laws to protect investors' rights and the quality of their enforcement are stronger in the common law countries than that they are in the French civil law countries, and for this reason, inter alia, the economic performance of many French colonies is worse than British colonies even today (Helpmen, 2004 referring to La Porta and colleagues, 1998)

Establishing property rights are, perhaps, one of the most visible examples of institutions. Potential setbacks evolving from property rights and their lax enforcement harm motivation of would-be entrepreneurs. Moreover, the ruinous effects of this weak protection of private property increase uncertainty as well as transaction costs, thereby thwarting innovation and development. Transaction costs of land transfer stemming from this uncertain nature are prohibitive in many underdeveloped countries, including Bangladesh. The provocative findings by Soto (2000) are the case in point. He finds that capitalism triumphs in the West but fails everywhere else because formal institutions can to some extent be adapted from former to the latter, but informal institutions retard the proper functioning of those imported formal institutions as opposed to complementing them. This research shows that a taxi driver who wants to obtain official recognition of his route faces twenty-six months of red tape in Peru. In order to obtain legal title for a small piece of land requires 728 steps which take from eleven months to six years to complete in Peru, thirteen to twenty five years in Philippines, five to fifteen years in Egypt, and nineteen years in Haiti. Given these bureaucratic complexities as well as underlying transaction costs, investment to develop land and other physical assets is unlikely to take place and therefore, factors of production are restricted from their efficient allocation.

Whose interest is served by these prolonged and tiresome institutions that skyrocket transaction costs as well as retard economic growth? Or putting it differently, why do the institutions not approach the efficient frontier in the long run? These concerns are also raised by Nelson and Sampat (2001: 36):

Much of the early "neoclassical" institutional writing following Demsetz on

> property rights, and the law and economic traditions in general, presumed that the law was efficient, and that changes in the law reflected changes in the rules that are socially optimal….Recently there has been a noticeable breaking away from this position. The intellectual movement of Douglass North from an early position that institutions evolve in a way that assured they always were close to efficient….to his present belief that societies that possess relatively efficient institutions are very lucky.

Why does this happen, who blockades change? As we have already pointed out, analyzing constraints leaves us roughly two components: cultural constructs and formal constraints. The former is preoccupied to a good extent with what might be called beliefs and values which change at a snail-pace, if at all, and are also shaped by past history. In this respect, frequent change of formal constraints is expected in order to lead a society to long-run equilibrium. But the incumbent interested groups always prefer to stick with the current situation if it benefits them, even if at the cost of society. Alternatively, they will seek to change the prevalent institutions through changes to laws, regulations, legislatures, and government bureaus that would further their opportunistic behavior. This situation is theorized in many guises in the economic literature such as 'interest group theory' (Eggertsson, 1990), 'theory of vested interest group' (Krusell and Rios-Rull, 1996) or more broadly 'theory of rent seeking' (Buchanan 1980, Tullok 1989, Krueger 1974, Khan and Jomo 2000).

Individual preference in institutional settings varies depending on distributional aspects of the resources, which in turn generates conflict of interest among various groups. Suppose there are two groups competing for a monopoly to produce or supply a product and both parties would incur costs for lobbying to seek a decision in their favor until the present value of the monopoly is greater than the cost of lobbying. Personal gain for the single monopoly, which each group will take into account in deciding how much lobbying cost should incur, is undoubtedly higher than if the monopoly is granted to both. Thus, the combined lobbying costs would be higher than the socially optimal ones. Moreover, the incumbent would attempt to impose restrictions on potential entrants by creating various financial and non-financial barriers which would make transaction costs huge for potential entrants. Even so, it is not unlikely that the margin of the monopoly privilege would be large enough to induce other disadvantage groups striving to pursue the authority to change the decisions. Thus, the potential entrants will invest efforts, time and other productive resources in a variety of attempts to shift the decision in their favor. This process of rent seeking on the parts of potential entrants in a situation where entry is blocked must generate social waste in the sense that resources applied to the attempt could be used to produce valuable goods elsewhere in the economy, whereas nothing valuable is produced by rent seeking except redistribution of it (Buchanan, 1980). Conversely, if competition is allowed, constraining the power of the monopoly-granting authority by enacting appropriate institutions such as legislation, all competing groups would take into account their small market share which yields them a much smaller competitive edge to bid for the opportunity, and thereby saves a lot of scarce resources. Hence, economic efficiency is the likely consequence.

Institutions and economic performance

Theoretically, the proposition that institutions matter has already been well documented in the existing literature. Empirically, however, the fact has not been established to a degree which enables agreement among economists. Disagreement has occurred because it is very problematic to sort out the exact institutional variables that can be attributed to the fundamental cause of economic growth. Sometimes the debate develops like a chicken-and-egg problem, i.e. whether institutions cause growth or the causality runs the other way around. For example, Acemoglu, Johnson and Robinson (2001, 2004) show that institutions cause economic growth whereas Glaeser et al (2004) document that economic growth is caused not by institutions but by human capital, which is then followed by institutional development. These results vary mostly because of the different elements they consider to be variables for growth.

In addressing the problem of why a worker in the United States produces as much output in ten days as one worker produces in a year in Niger (1988 account), Hall and Jones (1999) conclude that differences in physical and human capital attainment can only partially explain this huge difference in per capita output, and that it is driven by differences in institutions and government policies which they call "social capital". They conclude that the 35-fold difference in output per capita between the two countries can be attributed by a factor of 1.5 to differences in capital intensity, 3.1 to differences in educational attainment, and the remaining 7.7 to productivity residuals or institutional variables. This concept of social capital is supported by Knack and Keefer (1997). Their definition of social capital such as trust and civic norms conforms mostly to the informal institutions, and they find that those elements of informal institutions are stronger in countries where formal institutions are well placed. On the other hand, democracy as an institutional variable is polemic because even if it appears that democracy has a strong positive relationship with growth, few studies result in disapprobation of this hypothesis (Levin and Renelt 1992, Dollar and Kraay 2000, Butkeiwicz and Yanikkaya 2006). In contrast, Barro (1997), Rodrik (2000), Knack and Keefer (1995) find that democracy has a positive effect on growth. However, along with most scholars, Knack and Keefer (1995) agree that the rule of law is a better proxy than democracy of an institution which has a strong and positive relationship with growth.

One hypothesis might be that people living in the tropical region are less productive than those living in more temperate zone, in the sense that tropical environment tend to have poor crop yields, more fatal diseases, and endowments that cannot employ production technology effectively developed in more temperate zones. For example, South Asian countries are poor because their tropical environment is unfriendly to crop production, and excessive heat may enervate the workforce and thus reduce productivity. Similarly, it could be argued that many African nations are poor because they are landlocked, far from the richer states and have low levels of openness, as well as a disease-prone environment with high mortality rates. This problem is addressed in the work of Easterly and Levine (2002) who conclude that tropics, germs and crops affect a country's economic growth, not directly, but through institutions. They state that despite its lush agricultural endowments with three growing seasons in a year, abundant rainfall, and fertile volcanic soil which are suitable for many crops, Burundi is poor because institutions have manifestly failed to protect peoples' lives and property or establish any law and order. Further, they cite Nkurunzizi and Ngaruku (2002) who conclude that rulers have looted the economy using such mechanisms as heavy subsidies for public enterprises controlled by the rulers, substantial taxes on cash crops

and the appointment of clans in the state's lucrative and susceptible positions to further strengthen their expropriations.

Olson's (1996) example is representative in this regard. He argues that, according to the 1980 US census, salaried migrants to the US from Haiti, one of the world' s least successful economies, earned half as much as their German counterparts did. Therefore, if Haitians, with their working habits and other personal traits, were to work in German institutional settings, their income per capita would have been half than that of Germans. But the actual level of earnings, which was one tenth, cannot be justified simply by attributing the gap to sheer productivity. Rather, it is a clear indication that the institutional arrangements of the country fail to direct resources towards maximum utility. From this vintage point, Olsen concludes that the poorer countries do not have a structure of incentives that brings forth productive cooperation. Similar findings are substantial in the existing literature, but the empirical study of Acemoglu, Johnson, and Robinson (2001) is particularly noteworthy. Taking into account institutional coefficients derived by their model helps them to explain that improving Nigeria's institutions to the level of Chile could, in the long run, reduce the gap between them, which is currently eleven times, to seven times.

In order to resolve the conundrum of whether institutions cause growth or the causality runs conversely, Acemoglu, Johnson, and Robinson (2001) use colonization patterns as an instrumental variable to explain the divergence in institutions between countries. They find a strong negative relationship between settlers' mortality and European settlement to colonies, a significant positive relationship between European settlement and early measures of institutions, and positive correlations between early measures of institutions and institutions today. European settlers helped formulate different sets of intuitional structures in their former colonies depending on the suitability for their settlement. For example, places where colonizers were more susceptible to local diseases such as malaria, and yellow fever were not feasible for their permanent settlements. Resultantly, it was likely that the colonizers would develop institutional settings that enabled resources to be extracted from the colonies. In the case of Burundi, Easter and Levine (2002: 1) report

> During the colonial period, mortality among the European settlers was a frightful 280 per 1000 per year. The Belgian colonialists, thus, did not settle but exploited the colony through forced labor on coffee and other cash crops plantations and compulsory food crops quotas. The Belgian ruled indirectly through Tutsi chiefs, to whom they seriously attributed 'racial superiority'…. The Tutsi military dictators…have ruled Burundi 32 out of 38 years since independence, which have been marred by massacres of civilians, recurrent civil war, and as noted, economic decline.

In Congo, extractive institutions were introduced by Belgian settlers which neither imposed restrictions on private property nor provided checks and balances against government expropriation, because the main purpose of the extractive states was to transfer as much wealth as possible from the colony to the colonizers (Acemogly, Johnson and Robinson, 2001). In contrast, many Europeans migrated and settled in countries like Australia, New Zealand, Canada, and the United States and modeled local institutions after European institutions which protected their private property and also

provided check and balance mechanisms against government expropriations. Therefore, colonial experiences provide with a very good insight to help explain institutional differences between countries previously colonized and also help elucidate their current situations. The next two sections, therefore, will attempt to examine the sources of institutional divergence in South Korea and Bangladesh. In so doing, a brief explanation of colonial experiences as an exogenous factor of growth differences, and their persistence in the post-colonial periods, will be provided. It is to be noted, however, that the discussion will be confined to economic aspects of colonial experiences rather than examining brutality, which might be reflected by other variables.

The Case of Bangladesh

Colonial exploitation and institutional change

Europeans were tempted to the Indian subcontinent by her rich natural resources, notably arable lands, raw agricultural materials and fine manufacturing goods. Because of military prowess, the British East India Company had established its stronghold in many parts of India before its European counterparts began to develop their prowess in these lands. At that time, Bengal was assumed to be the wealthiest state in the Mughal Empire because of her rich textile industry, which brought substantial revenue for the sustenance of the Empire. Thus, the Company's aspiration to conquer the land of Bengal reached an astronomical level. However, conquest was not achieved until 1757, when a coup led by Robert Clive ended the tenure of Bengal's last emperor and hence established the British East India Company's reign of despotism and exploitation.

The mortality rate of European settlers in the Indian subcontinent was very high (Acemoglu, Johnson, and Robinson, 2001). Settler mortality theory, therefore, suggests that the institutional structures were likely to be fashioned after the extractive state model. Bayly's (1988) conclusion supports this hypothesis. He documents that capturing Bengal was very fortuitous for the Company in the sense that the control of the courts was instantly ceded to the Company and that this power was later used for the Company' s greater interest.

Conquering Bengal was a great sigh of relief even at the beginning of the colonial regime, since stable land revenues collected from Bengal state could offset the deficits the Company was already incurring in other parts of India such as Madras and Bombay. In 1765 when the Company took administrative apparatus under its full control, a monopoly regime over valuable products such as salt, betel nut, indigo etc. was established. Furthermore, the Company's servants, who helped in numerous ways to gain control over the state, had unbridled power for brigandage under the auspices of the Company and had also been freed from Mughal customs dues. For example, European officials were assigned in the hinterland for revenue collections in 1772, and they were thereby able to exploit the markets in rights and privilege to the full (Bayly, 1988). Under the Company's direct patronage, a local bourgeois class emerged, facilitating revenue collection through various oppressive means.

The practice of squeezing revenues from farmers and cultivators was so severe that the situation has been characterized as a man standing permanently up to the neck in water, so that even a ripple is sufficient to drown him. On the other hand, prices for the produce were astoundingly low because of the Company's established monopoly on crops trading. When oppression reached at an unbearable limit, some institutional

structures were put in place to curb it. For example, Lord North's Regulating Act of 1773 and Pitt's India Act of 1784 attempted to bring the Company's administration under the supervision of parliament through a board of control. But this did not halt the despotism and corrupt practices of the Company's servants. Because India was far from the metropolis, the Governor-General and his bureaucratic clans had enormous supremacy over day-to-day operations of the Company. Bose and Jalal (2004) argue that this colonial bureaucracy became more racially exclusive and also distant from lower levels of Indian society. The Company's purpose was to build its edifice by any means, not to contribute to the equity or improvement of local society. An uninterrupted stream of revenue was their principal aspiration, and institutional arrangement were made in a way which would best realize this aspiration.

One such arrangement was the Permanent Settlement of 1793, by which a private property right was assigned to the Zamindars (landlords) of Bengal, as opposed to the real cultivators of the land. The system empowered Zamindars to collect revenue from the cultivators by any means, and a substantial proportion of the revenue was sent to the company. This initial allocation of private property rights to those who neither possessed the lands physically nor cultivated them exacerbated the peasants' situation and left many of them destitute. A sunset law was attached to the bundle of the rights, by dint of which property was auctioned off if the revenue did not fill the Company's pocket before sunset on the appointed day. Zamindars were not beyond the claw of Company repression, either. Sunset laws along with high ceilings of revenue left many of them bankrupt. Consequently, what happened in the early period of Permanent Settlement was not a great revolution in landholding or increase in productivity but a great circulation of title. Because of the dismal performance of revenue collection and frequent bankruptcy, Zamindars were subsequently empowered with extra-economic coercion. One such arm was inauguration of Regulation 7 in 1799, which came to be known as Law of Distraint. This granted Zamindars the right to distrain crops for arrears of rents. Furthermore, eviction of tenants from land was legalized by the Law of Eviction in 1812. Bose and Jalal (2004) report that the entire period from the late eighteenth century to the mid nineteenth century was marked by revenue and rent offensives both by colonizers and Zamindars.

Economic malaise stemming from this tenuous property rights arrangement left peasants with no options but to raise their voices against the Company. On the other hand, rapid expansion of commodity production for capitalist markets compelled government to redefine the previously lopsided agrarian law to the cultivators' favor. The result was the enactment of the Rent Act of 1859 and the Bengal Tenancy Act of 1885, which provided tenants moderation of rent and secure tenure subject to the payment of controlled rent. This move seemed fairly sound in the sense that at least real cultivators had some rights over their property. Behind the scenes, however, the motto of the Company was to extract the surplus income from the tenant not directly through rent, as was implemented previously, but rather through credit mechanisms. Tenants had the land but obviously lacked capital, which was more pronounced because gradual commercialization of agriculture products encouraged them to cultivate cash crops such as cotton, jute leaving aside labor intensive crops.

Company servants had a monopoly over money-lending, enabling them to set lofty interest rates – a new form of expropriation. Bose (1993) reports that annual interest charges in the Dhaka district amounted to over Rs. 21 million, which was about

a fifth of the value of the total products and five and half times the rental demand. Interest rates varied from district to district, ranging from 12 percent to 300 percent. During the great depression in the 1930s, the price of crops plummeted. This, along with the decrease in agricultural raw material exports to the world market, worsened the peasants' indebted situation. Conditions were further worsened by the lack of availability of new credit from international financial sources, and thereby the whole credit system collapsed. The subsequent series of debt legislation – the Agricultural Debtors' Act of 1936 aiming at dwindling debt burden by scaling it down to ability to pay system, followed by Bengal Moneylenders Act of 1940 to lower interest rate ceiling and reduced-absolute debt burden – formally ended surplus expropriation through debt burden.

Pressure to remodel the trading system in India was also brought to bear by outside lobbying groups. The Company's established monopoly over trade in India brought them lucrative margins which were further boosted by commercialization of agricultural products. This became an eyesore to the newly emergent capitalist class in Britain, who wanted the opportunity to sell their products, especially textiles, in India. In the face of their harshly criticism of the existing monopoly practices, the Charter Act of 1813 was passed, bringing and end to the end of single monopoly over trade in India. Consequently, the Company lost a great deal of its moneymaking capacity and started devising a new way of exploitation in order to offset this lost privilege. By this time, China tea had proved to hold very good potential for trade, enough to help compensate for other lost opportunities. In order to finance China tea, the Company established a government monopoly over opium cultivation in India. Remittance requirements were met by forcing farmers into indigo cultivation. This proved to be one of the most oppressive mechanisms the Company ever imposed on farmers.

Besides outright coercion, initially the cultivators were enticed to indigo production by the availability of finance funded by agency houses during the first quarter of nineteenth century. This sort of financing pattern dominated by few firms paved the way once again for monopolistic control over the indigo trade. The vulnerability of the indigo trade, however, was acute because the major portion of production was traded with international markets. Resultantly, the economic depression in Britain in the 1920s adversely affected the Indian market and most of the agency houses went bankrupt, being unable to collect the credit already doled out to the peasants (Bose, 1993). Bose further contends that the indigo planters were unparalleled for enforcing coercion. On the other hand, indigo cultivation had already proven to be unremunerative, and increased population along with rent offensives created pressure on cultivators to seek alternative, more productive and labor intensive products. In this circumstance, planters who invested heavily in indigo plants sought special regulations from the Company to enforce contracts against helpless peasants. The outcome was Regulation 6 of 1823 giving the planters linen, and Regulation 5 of 1830 prescribing imprisonment of peasants who were unable to stick to their indigo contracts. This brutality, along with the non-availability of advances for cultivation, left peasants no option other than to revolt. Finally after long and untold suffering, the arrangement was ruled out in Bengal by the so-called "Blue Mutiny" of 1859-60.

It is an infallible truth that even if the Company appropriated all the vital resources from the states on which the then Indian economy was based, it initiated hardly any mechanisms to facilitate the state's economic growth and social welfare to

compensate. Moreover, it constrained the peasants' movements and imposed restrictions on their economic activities through instituting various formal and informal constraints. Bose and Jalal (2004: 57) thus conclude

> The weavers were squeezed by bringing production more directly under the state control….The peasants found their earlier mobility restricted and were emaciated as a direct consequence of the state revenue and rent policy…. Whereas earlier there were some restraints on the exploitation of labor by wealthier social groups such as landlords and merchants, the company's obsession with the doctrine of private property, together with more direct state control over production and distribution, removed the safeguards that had shielded the peasants and the weavers. And in northern India, where proto-proprietary forms had a prior existence, small-holding peasant families and artisans came under relentless pressure from the newly empowered class of property owners, aided by the state' s legal enactments.

The "Blue Mutiny" symbolized a setback for the Company which forced it to wake up to its horrible bureaucratic malpractice and repression. Soon after, the Company reorganized the political economy of India, modeling the company system after the Crown Raj, meaning that instead of Governor-General, the state would now be ruled by the Crown Viceroy. It is evident that restructuring of the institutions of state brought good fortune for the Company ever since it colonized the state. India had a deficit balance of payments only with Britain and a surplus with all other industrial countries, whereas Britain had surplus trade only with India and a deficit with all others. India was strategically crucial for financing Britain's deficit balance of payments. Under colonial rule, the metropolis had to be paid by an annual transfer from the colony to meet home charges including guaranteed railway interest, military expenses, interest on debt, purchases of government stores and pensions. Substantial investment in the railway that took place during colonial period proved to augur ill for the economic prosperity of the state. The aim of the railway construction was not to mobilize economic activities within the states, but rather nearly five thousands miles of railway were laid to facilitate troop movement as well as dispersal of the British manufactured goods and extraction of agricultural raw materials from the hinterlands of the port. The project did not help to build up ancillary industry at all, because most of the parts necessary for construction were imported from Britain. Moreover, the great fallacy was that private investment was undertaken at public risk. A fixed 6 percent interest on invested funds had to be paid regardless of railway income. In the 1870s the total amount of interest paid was higher than the inflow of fresh capital into India (Bose and Jalal, 2004). The situation had been exacerbated further by a drastic devaluation of Indian currency, which brought the value to almost half of current standards. Instead of boosting exports, the Indian burden of annual payment to the metropolis surged almost to double as a result.

The almost two hundred years of British occupation in Bengal were marked by excessive oppression and offense exercised not only by colonial oppressors but also by their patrons such as local landlords, indigenous merchants and money lenders, rich peasants etc. Expropriation, however, was legalized by formulating formal and informal rules and thereby ultimately transforming the empire into an extractive state.

The legacy continues

Following colonial rule, the Indian subcontinent split into two separate states, India and Pakistan, and in 1971 Bangladesh became independent from Pakistan. Since then, it has experienced many ups and downs due to political disputes before finally establishing democracy in 1991. Although the country has experienced a moderate rate of GDP growth of little more than 5 percent in the last few years, meager absolute GDP coupled with this paltry growth rate is unlikely to push the economy from Rostow's "pre-take-off" to "take-off" stage of development.

Even if initial administrative and bureaucratic constructs between India and Pakistan were almost similar though not thoroughly alike, the later day policies, however, diverged between them in what Jalal (1995) calls the political economy of development versus defense. India was more eager to focus on economic development, utilizing little industrial infrastructure and administrative mechanisms developed during British tenure while in Pakistan and Bangladesh, military prowess diverted the attention from development to defense strategy at the outset. This new polarization of state bureaucracy through militarization took place to protect the interest of the emerging bourgeois class using government jobs as ladders for private fortune. Jalal (1995: 143-4) continues

> Its (Bangladesh) external aid dependent political economy has done more to promote the interests of senior defence and civil officials than the development requirements of its teeming millions. This is born out by the fact that already in 1975 most of the key public corporations were being run by members of the non-elected institutions of the state, the civil bureaucracy, the police and the military.

The process, *per se*, is not clear enough to conclude whether military regime or democracy is more growth oriented. Barro (1997) finds that democracy is unlikely to succeed in a country at low-level of economic development. On the contrary, he argues, it is non-democratic places that have experienced substantial economic growth which tend to become more democratic, as shown by Chile, South Korea, Taiwan, Spain, and Portugal. But the fact to be considered here is that the underlying institutional settings to distribute scarce resources will determine the pattern of growth. If the institutional choices are such that the system prefers monopoly to free competition, kinship to meritocracy, and government expropriation to private property, the country' s development will certainly be impeded. Bangladesh is a quintessential case where neither autocracy nor democracy has made any significant difference in respect of institutional settings that facilitate economic prosperity.

Table 4 Governance Indicators of Bangladesh

Variables	1996	1998	2000	2002	2004
Voice and accountability	-0.37	-0.17	-0.34	-0.57	-0.69
Political Stability	-0.53	-0.43	-0.55	-0.65	-1.24
Government Effectiveness	-0.67	-0.38	-0.47	-0.55	-0.72
Regulatory Quality	-0.54	-0.08	-0.16	-1.05	-1.15
Rule of Law	-0.68	-0.72	-0.65	-0.74	-0.86
Control of Corruption	-0.47	-0.40	-0.60	-0.95	-1.09

Source: Kaufman, Kraay, and Mastruzzi (2005)

Note: All variables range from -2.50 to 2.50 with the highest scores corresponding to better outcomes

Table 4 represents many institutional variables such as protection of private property, government expropriation risk, executive constraints, efficiency of bureaucrats, freedom of judicial authority etc. This table shows no sign of improvement, rather the situation has deteriorated over time in Bangladesh. The whole economy is entangled with complex political polarization. A strong link between political parties and capitalist groups persists, whereby the former grants property rights and other favorable opportunities to the latter in exchange for protection of power. Khan (2001: 119) postulates

> Once the interlocked networks had developed, allocation of subsidies proved very difficult to change … The eventual result was the emergence [and] persistence [of] subsidies for poorly performing industries which were difficult to change in response to performance failures or changes in technologies and markets.

According to the account of a recent Parliamentary Standing Committee on Land Administration, more than 20 thousand acres of government land in a few districts are in possession of 30 thousand land grabbers who are believed to be directly or indirectly linked to political organs. An unofficial estimation shows that more than Tk.700 billion worth of government land is currently under the illegal control of land grabbers. The panorama in other sectors is not much different. Breaking that interlocking network is unlikely unless prevailing institutions can change. Institutional economists emphasize the separation of the judiciary from the executive. The judiciary is assumed as a prime source of institutional change: it revises existing formal constraints where they act as a constraint on welfare-enhancing activities. Such revisions help facilitate economic progress. Since its pronouncement in 1999, no significant progress towards the move of separation of judiciary from executive is visible, for the very reason that political organs derive their strength from the current institutional arrangements.

Consequently, resistance to change towards better institutions is forthcoming from those who are beneficiaries under current institutions. Major banks are recording a huge proportion of classified loans (47%, according to IMF report 2000), due mainly to those in the bourgeois class. Surprisingly enough, some of the loan defaulters are parliament members as well as major lawmakers of influential political parties. Even though collateral can resolve this default culture to some extent, the prevailing institutional setting exacerbates the situation further because it takes couple of years to transfer title over property to the lenders, and more than 4 years to resolve insolvency. According to recent World Development Indicators, it requires 29 procedures and 365 days to enforce a contract and 11 procedures and 365 days to register a property, while as high as 85 percent of GNI per capita accounts for the cost of business start-up procedures. Thus, the economic sluggishness of Bangladesh can be attributed to this seemingly inefficient institution which facilitates illegal empire-building at the cost of the nation.

The South Korean Case

The miraculous success of South Korea in economic development undoubtedly offers many lessons for developing and third world countries. Among those NIEs that achieved remarkable economic growth, the South Korean case is representative because it has many characteristics that are commensurate with those of many underdeveloped countries. For example contribution to GDP by agriculture was very high, with a large percentage of the population employed in this sector and the majority of the population living in rural areas. However, within two decades of high-speed economic growth (1962-1980) averaging 8.5 percent per year, South Korean GNP reached a peak of $57.5 billion from $12.7 billion (1980 prices). Acemoglu, Johnson, and Robinson (2004) attribute the success of this economic growth to institution building, which is typified by paralleling the North and South Korean cases. The North followed the model of Soviet socialism, abolishing private property of land and capital, whereas the South maintained private rights over property and capital and thereby created incentives towards productive activities. The diverging trajectories between them given the geographic, cultural and other common characteristics are due mainly to different sets of institutions.

Colonial experience and institutional change

Japan's colonization of Korea can be divided into two phases. The first phase was the establishment of the Japanese protectorate from 1905 to 1910. The second began with the final annexation that took place in 1910, by which Korea formally became a Japanese colony. The political economy of Korea during the colonial period was remarkably different from that of British colonies in South Asia. Of course the strategic importance of Korea to Japan was different to that of India to Britain in the sense that Britain's aspiration towards the colonization of India predominantly marked by the economic motives, while to Japan's purpose in capturing Korea was ascribed to security reasons more than mere economic ones. Conroy (1960) addresses the question of whether there were economic reasons behind Japan's colonization of Korea, and concludes that there were not. He states that "Economic matters…. had no important effect in determining the Japanese course toward the annexation of Korea" (pp. 485). The Korean peninsula was a buffer against continental aggression and a strong base for expansion into Manchuria. From this vintage point, the institutional settings in Korea during the colonial period were expected to be more constructive and enduring. McNamara (1990: 1) states

> During the thirty-six year annexation period, Koreans were never allowed to participate in any political activities in a modern sense. However, in the fields of thought, literature and religion, they had access to the trends of the times to some extent; in the economic aspects, although they lived under a capitalistic economic system, the Japanese had complete control over the Korean economy. And in social aspect, Korean society, whether compulsorily or spontaneously, was gradually growing into a modern society (Cited from Kang, 1963).

Even if the colonial authority controlled everything with a stringent hand, country's progress was hardly impeded by the process. The theory of settler mortality also supports this hypothesis, even though settlement was not the dominant motive

for the colonization of Korea. However, this was an opportunity for the Japanese government to resettle a part of the already booming Japanese population. Consequently, in the decade following Russo-Japanese war, the Japanese settler population in Korea swelled. Gragert (1994) reports that by 1915, a total of 303,659 Japanese nationals emigrated to Korea, and the process continued because of Japanese government encouragement and financial subsidies extended to those who wanted to emigrate. This was followed by the formation of institutions in a way which encouraged private investment.

The first such move of the colonial authority in Korea was to make land ownership legally secure and reliable for both Japanese and Korean nationals. A system of private ownership of land had already been instituted to some extent by the Yi dynasty. To strengthen the system further, the Japanese authorities initiated a comprehensive nationwide cadastral survey from 1906 to 1915, aiming to distribute currently uncultivated land among newly settled Japanese and also to Koreans. However, some criticisms have been made regarding the pronounced purpose of the cadastral survey, pointing out an ulterior motive to lands to Japanese nationals rather than distributing them efficiently. For instance, Ho (1984) argues that lands without properly documented titles were discovered by this survey and were taken over by the colonial government. Many Koreans lost their land as a result. Ho also contends that most of the crown land became government property and was sold to large Japanese corporations. In contrast, a thorough survey of five Korean villages by Gragert (1994) finds that no major transfer of landownership from Korean to Japanese owners took place at the outset of the colonial period (1910-1918). He further argues that a comparison of records from the last survey of the Yi dynasty with those produced after the cadastral survey reveals a clear and striking continuity of landownership patterns from the late nineteenth century.

This draws a sharp contrast in agriculture policy between the Japanese colony, Korea, and the British colony, India, in that the purpose of the British colonizers was to expropriate surpluses whereas Japan maintained a balance between growth and expropriation in Korea. Agriculture output grew 2.21 percent on average between 1912 and 1937, coupled with average annual GDP growth rates during the period of 4.15 percent (Ho, 1984). Strengthening ownership rights did not encourage outright expropriation because it brought many uncultivated wastelands in Korea into Japanese farmers' possession, filling the gap between settlers' demand and supply. Moreover, a condition was attached that those lands should be made productive within a certain time period. This carrot-and-stick agriculture policy undoubtedly facilitated the increase in agricultural output on the peninsula.

The colonial state in Korea can thus be characterized as growth-oriented even though interventionist in economic affairs. The aim was to promote the peninsula as a base for mineral, agriculture and manufactured exports thorough administrative legislation. During the period of 1912-1937, mining production and manufacturing production increased annually at 11.82 percent and 7.81 percent respectively (Ho, 1984). Substantial investment from both the public and private sectors helped achieve this sizeable growth. The state provided various incentives such as subsidies and tax incentives to tap private investment. Its own initiatives for investment concentrated on large infrastructure projects such as railroads, harbors, roads, warehousing, banking etc., and continued throughout the entire colonial period. This paved the way for transforming the colony into more integrated market system. At the same time, the

expanded economic infrastructure lowered transaction costs and thereby boosted the profitability of private investment in agriculture, commerce, and industry.

The colonial state was modeled after home. Many giant corporations in the colonial state were alleged to function under government auspices which paralleled the home state's zaibatsu models. These giant corporations had monopoly power over production and distribution. In order to realize their economic motives, colonizers often granted monopolies to some corporations. Unlike the state-sponsored monopoly in British India, corporate monopoly in the Korean peninsula emanated almost naturally from certain competitive advantages these large corporations possessed. The corporations had financial strength owing to control over their own banks or influence over other banks, and easy access to supply of raw materials. They were also able to take advantage of employees' preference to join large corporations to attract a more talented workforce. For example, Mitsui Honsha had affiliations with Mitsui Bussan, the Teikoku Bank, Mitsui Mining, Mitsui Chemical Industry, and Mitsui Steamship. Other large *zaibatsu* which invested heavily in the peninsula were Mitsui in trade and later industrial ventures, Mitsubishi in heavy industrial investments, and Nichitsu in hydroelectric and chemical projects.

Leading Japanese *zaibatsu* adapted to the strategic interest of the colonial state and gained state support for undertaking profitable private investment in the peninsula. The major zaibatsu interests in colonial Korea designed a pattern that has strongly influenced business-state relations among Korean entrepreneurs (McNamara, 1990). Therefore, adjustment to state priorities and access to state incentives were important for indigenous Korean entrepreneurs as well. Although it was not possible for Koreans to compete in sectors that require enormous investment such as mining, power, chemical and heavy industry, they were not absent from finance and banking, retail and light industry. McNamara (1990) reports that due to the advantages of prominent aristocratic status and close government ties, a few wealthy Koreans succeeded in investing in banking at the later stage of colonial regime. The shining examples were the success of Min Tae-sik in finance, Oak Hung-sik in commerce, and Kim Yon-su in industry. It is likely that they had to confront awesome tasks and difficulties to succeed as Korean nationals in these sectors, but it was clearly not totally impossible to flourish being Korean during the Chosen dynasty. At best, they had to grow up under the guise of "shadow Japanese".

Hardly any examples of this sort can be found during the British tenure in Indian subcontinent. As has already been mentioned, any move toward this end by the natives during the British regime was curtailed either through legislating new rules or other coercive mechanisms. Britain's philosophy towards colonial rule was to delegate supreme authority to the Governor-General and thereby rule the colony with very little interfere from the metropolis except in monetary aspects. This process left almost no room for the colonial natives to benefit from the legislation. Japanese legal policy toward colonies was little different from that of Britain. In case of Korea, the Japanese government possessed exclusive sovereignty over the peninsula, meaning that it was under the direct jurisdiction of the Meiji Constitution. Thus, legislation of colonial laws by the colonial government was unconstitutional unless the Imperial Diet authorized it. This process yielded substantial de jure status for the colonial people, paralleling that of residents of the metropolis. This necessitated a prohibition on the kind of fatal expropriation from the colony by the divine power of colonial authority, as was seen in

British India. However, in the later period Imperial Diet delegated some authority to the chief executive officer of the colony.

It is obvious that the goal of Japanese colonial policy was to create a strong, centrally controlled empire within the legal framework of the Meiji Constitution and governed from Tokyo. Similar to the British Dominions, the Japanese government never contemplated a self-governing colony. The delegation of authority to the colonial government at the later stage was not intended to result in a self-governing colony, but rather to replace colonial rules gradually by the laws and regulations of the metropolis. The ultimate design was to replace all colonial laws with Japanese laws and to eliminate any distinction between them.

It is noticeable that even if the paramount purpose of the Japanese colonial authorities was not to materialize economic benefits, once the colonization process gained momentum it was accompanied by huge private and public investment. Given that those investments took place for the greater interest of the Japanese settlers and the metropolis, development of the peninsula driven by those forces was inevitable. These economic forces, coupled with a strong military base during the colonial period, played a very significant role in making Korea what it is today we call "a strong state". Cummings persuasively concludes "it is more correct to emphasize that Korea' s capitalist revolution began – and got a long running start – during the colonial period, and, like capitalism everywhere, it moved forward in waves of creation and destruction that transformed old Korea" (1984: 481)

Colonial legacies and the modern Strong state

Prior to the Korean War (1950-53) the institutional settings were similar in both North and South: economic development was fostered through the strong state model, first instituted by the colonial regimes. After splitting into two, different sets of political and economic institutions were established in the two Koreas – soviet socialism in the North, and free wheeling capitalism in the South. The economic consequences were, therefore, different. Given the newly independent Koreas' similar characteristics, the divergence in economic consequence can be attributed to their respective institutional settings. The core of institutional theory is to deal with incentive mechanisms, without which the central importance of institutions will be undermined. South Korean development has been mainly government-led, with the state providing sufficient incentives in various ways to initiate productive effort. In contrast, Glaeser et al (2004) document that between the end of the Korean War and 1980, both North and South were ruled by dictatorship. Therefore, any difference in performance is due to the choice of the dictator rather than constraints. This argument, persuasive though it is, can be extended.

It is true that formal constraints were alike at the outset in both North and South but informal institutions acted as severe constraints for the rulers in South Korea. Rhee Syngman, who ruled the peninsula from 1948 to 1960, was the first democratically-elected President. However, his tenure was characterized by mismanagement and rampant corruption among politicians, government officials, and businesses (Kim, 1997). This led the economy towards high rent-seeking, monopoly and oligopoly rights on property, and foreign aid-dependent fiscal policy. This regime ended following the student revolt of 1960. The next regime of Chang Myon also failed to realize his two formidable goals – democracy and economic prosperity. Social unrest again reached a

peak. These circumstances facilitated the coup in 1961 by military leader Park Chung Hee. The social unrest and chaos that necessitated the coup, and later enabled it to be accepted it by the people, left Hee little choice other than to concentrate on economic emancipation of the people. From this vantage point, it can be concluded that informal constraints emanating from civil society coerced Hee to make the choice that ultimately led to economic prosperity.

Between 1965 and 1978, South Korea had the lowest capital to output ratio in the world (2.2) demonstrating the country's surprisingly high productivity. Secure property rights along with proper incentives urged people to employ their talents and efforts for development. State formulated policies and reforms initiated after the 1950s by President Park Chung Hee supported export-led growth. His aim at "nation building through exports" can be seen as the beginning of Korea's modern development. This strategy was implemented through various institutional mechanisms such as setting export targets and monitoring whether firms complied with them or not, allocation of credit for export purposes, effective policies of technology acquisition, and most importantly maintenance of export-friendly tax and trade regimes. Consequently, exports increased from 7.4 percent of GNP in 1967 to 37.7 percent in 1987 (Kim and Leipziger, 1993). For materializing complete advantage from those initiatives, the Korean government relied heavily on private enterprises and market mechanisms but never forgot to bring them under strong state supervision and control.

Underdeveloped countries are constantly blaming lack of foreign direct investment (FDI) for their meager economic growth. If that is so, firstly they fail to design institutions in a way that will create incentives for foreign investors. Secondly, placing importance on FDI undermines the use of indigenous resources. Rhee's tenure following the Korean War can be featured as highly dependent on foreign aid since 52 percent of national budget was comprised of United States aid, loans, and agricultural products (Kim, 1997). But the regime failed to accelerate the economic development. Olson (1996) refers to Koo (1982), who analyzes data for South Korea from 1973 to 1979 and finds that royalties and all other payments for disembodied technology were minuscule, often less than 0.1 percent of GDP. If the profits of all FDI are assumed to be solely a payment for knowledge and added to royalties, the total is still less than 1.5 percent of the increase in Korea's GDP over the study period. This suggests that FDI is not as important as previously thought; rather economic development can be propelled by encouraging local entrepreneurs, for which proper institutional design is of utmost importance.

Another noteworthy change of institution came in the aggressive land reforms that took place after the Second World War. Land left by Japanese owners – around 23 percent of the total arable land – was distributed relatively equally. The process provided a powerful incentive for the landless farmers and tenants to make private arrangements toward attainment of self-sufficiency. This was followed by a tremendous amount of private investment in agriculture. Lee (1995) points that land reform helped bring about equality of opportunity and the possibility of economic and social upward mobility because it caused the incomes of the lower 80 percent of the population to increase by 20 to 30 percent while the top 4 percent lost 80 percent of their income. This was undoubtedly a bold step because corruption in underdeveloped countries emerges mainly from these circumstances. When claims on property or subsidies are greater than the available distributive resources, lobbies emerge to reap major benefits from the

process (Khan, 2000). This process of lobbying ultimately generates an involution of the bourgeois class and results in greater corruption as well as rent seeking, which are both common phenomena in underdeveloped countries like Bangladesh.

It is understandable that South Korea had a large savings rate and it invested at an extremely high rate. These huge savings came from increases in productivity which meant increasing returns on investment, and therefore a high rate of capital accumulation. Consequently, investors found it very attractive to invest. But the credit for these increased savings is due in large part to education policy. Amsden (1989) argues that the rate of return on higher education in Korea tends to be the greatest. This higher return on education tempts people to save since a large part of the expense, almost two thirds, is to be born personally. These savings are the generic source of heavy investment which is accredited by many scholars as the driving force of GDP growth in Korea. On the other hand, in order to attract educated human resources from foreign countries, especially engineers and scientists, it sets up proper institutions by providing up-to-date technology, repatriation allowances, high salaries, and also considerable power (Kim and Leipziger, 1993). Those institutions, along with free competition, recruitment and promotion based on merit have functioned as incentives for government-led development in Korea.

Table 5 Governance Indicators of South Korea

Variable	1996	1998	2000	2002	2004
Voice and accountability	0.71	0.68	0.76	0.63	0.73
Political Stability	0.16	0.24	0.49	0.50	0.45
Government Effectiveness	0.64	0.50	0.63	0.91	0.95
Regulatory Quality	0.69	0.30	0.47	0.84	0.69
Rule of Law	0.81	0.82	0.64	0.83	0.67
Control of Corruption	0.54	0.11	0.37	0.36	0.17

Source: Kaufman, Kraay, and Mastruzzi (2005)

Note: All variables range from -2.50 to 2.50 with the highest scores corresponding better outcomes.

Institutions reduce uncertainty of risk through imposing various constraints on variables that deter development. This in turn lessens exchange and production costs. A strong state can effectively provide safeguards against uncertainties such as sudden policy changes, government expropriation, high rent-seeking and monopoly power of a certain quarter of the population. Starting from the Park government, the South Korean manifestation of the carrot-and-stick policy in general has transformed it into a strong state. National policies were directed away from the politics and towards economic growth to a great extent. Penalties, the regime used as leverage in order to gain close cooperation of major private enterprise, along with successful efforts to investigate and prosecute collusion in business-state relations, were the embryo of modern strong state. Today's strong state undoubtedly inherits a great deal from traditional values, and the synergy of these values with modern ideas has transformed the country into a modern state.

Conclusion

There are different sets of institutions which can emerge and evolve in different ways in a certain time period. For example, some institutions are spontaneously grown such as habit while others are man-made. Institutions are sustainable when they complement each other and produce some derivative effects. Consequently, the trajectory of economic development of a country is determined by its prevailing institutions. Many economies are underdeveloped and are unable to improve their status from generation to generation because they fail to experience the benefits brought by so-called globalization. This failure cannot be attributed merely to their lack of human capital and technology –traditionally thought to be growth engines – but the prevailing institutions which fail to drive those resources towards productive and growth-enhancing activities. It is the state that has the ultimate responsibility to address the mismatch between underlying institutions and economic growth where the institutions lack self-correcting mechanisms. Stopping automobiles at red traffic lights does not require much state intervention given the potential danger emanating from violations. However, legislation that safeguards private property from potential expropriation needs stringent policing, because any perceived net benefits to the transgressors would ultimately thwart realization of the purpose of such legislation. Thus, the state has to find ways to curb violations of the spirit of laws and contracts with minimum outlay of money and time. It also has to develop further constraints to prevent any recurrence of such events. If economic advancement of the state is placed second to political interests, this is unlikely to take place. Bangladesh today is characterized by this problem. Extractive characteristics which the country has inherited from the colonial regime are still conspicuous in many instances. Most activities are motivated by political benefits and therefore, political affiliation is routinely sought at the expense of concentrating on productive efforts. In contrast, South Korea has overcome many of these difficulties to a good extent, by developing sound institutions which have enabled it to become a member of OECD, the club of advanced economies.

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