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WHY DO “GOOD INSTITUTIONS” FAIL? A POLITICAL SETTLEMENTS CRITIQUE OF NEW INSTITUTIONAL ECONOMICS¹

Summary

Purpose | This article critically assesses New Institutional Economics (NIE) and its policy-oriented counterpart, the “good governance” agenda, which have been central to development economics for decades. The paper highlights the limitations of this mainstream approach, particularly the frequent failure of NIE-inspired reforms in contexts of political instability. It proposes the “political settlements” framework, developed by Mushtaq Khan, as a more effective alternative for analyzing development processes.

Research method | The study is based on a critical literature review and a comparative analysis of competing theoretical frameworks. It synthesizes insights from NIE, including the work of North, Wallis, and Weingast (NWW) and Acemoglu and Robinson, and contrasts them with the political settlements approach to identify the shortcomings of the dominant paradigm.

Results | The analysis concludes that NIE and the “good governance” agenda often fail because they promote the transfer of institutional models from developed countries without adequately considering the local distribution of power and informal norms. In contrast, the political settlements approach offers a more realistic framework by

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focusing on the actual balance of power, termed “holding power”, and its role in shaping institutions as mechanisms for distributing benefits. While acknowledging the evolution within NIE and the criticisms directed at the political settlements approach (e.g., its tautological nature and difficulties in operationalization), the authors find Khan’s framework to be a superior tool for understanding political and economic realities in developing countries.

[Originality/value/implications/recommendations](#) | The paper’s value lies in its direct juxtaposition of the idealized, rules-based perspective of NIE with the power-centric realism of the political settlements approach. It provides a critique of the dominant development paradigm, arguing that grounding the analysis of institutions in the actual distribution of power is essential for understanding why “good institutions” often fail. This provides a crucial alternative perspective for researchers and policymakers engaged in analyzing development and institutional change.

Keywords: institutions, political settlements, new institutional economics, economic development

JEL classification: B25, B51, O43

1. Introduction

The recent Nobel Prize in Economics awarded to Daron Acemoglu, James Robinson, and Simon Johnson symbolically affirms a thesis that has gained wide acceptance in mainstream economics: institutions are of fundamental importance for the long-term economic development of nations. This consensus is reflected in development policy practice, where the “good governance” agenda has dominated for over three decades, particularly in developing countries. However, its primacy persists despite the mixed success of this strategy, which is often premised on the assumption that implementing a specific set of formal rules is the primary key to prosperity.

This article critically analyzes this dominant institutional approach, derived from New Institutional Economics (NIE), and the associated “good governance” agenda. It highlights their limitations in explaining complex development processes, especially in countries with unstable political and economic structures. Methodologically, the paper relies on a critical literature review and

a comparative analysis of theoretical frameworks. By synthesizing insights from different schools of thought, it identifies the shortcomings of the dominant paradigm and evaluates the analytical value of an alternative perspective.

As an alternative analytical framework, this article proposes the political settlements approach, pioneered by Mushtaq Khan [2010, 2018]. This approach centers on analyzing the actual distribution of power and its impact on elite incentives and the strategic choices that shape developmental trajectories. The paper is structured as follows: it first critiques the assumptions underlying NIE and the “good governance” agenda. Subsequently, it provides a detailed discussion of the political settlements approach, highlighting its potential for analyzing development and transformation processes, including post-communist contexts.

2. “Institutions matter” and the “good governance” agenda

In the mid-1990s, the “good governance” agenda established itself as the dominant paradigm in development policy. The theoretical foundations of this approach are primarily derived from New Institutional Economics (NIE), particularly the work of Douglass C. North [1981, 1990, 1995, 2005], but also from the work of other economists such as Mancur Olson [1982, 1993, 2000] and Daron Acemoglu and James Robinson [2005, 2006, 2012, 2019]. The key thesis of NIE is that “institutions matter” for long-term economic development, as they shape the behavior of agents and influence transaction costs within the economy. Institutions, understood as a set of formal (e.g., property rights, constitutions) and informal rules (e.g., social norms, conventions), create a specific framework for functioning in the economic system, a kind of “rules of the game”. Their effectiveness determines, among other things, the predictability of economic interactions, the protection of property rights, and a decrease in transaction costs (i.e., the costs of concluding and enforcing contracts, obtaining information, etc.), with the aim of stimulating economic activity and promoting national income growth. The “good governance” agenda is an application of this approach, assuming that sustainable development is possible due to specific features of the institutional system, such as the rule of law, effective public administration, low corruption, and

political stability. Promoted by the World Bank², the International Monetary Fund, and other international organizations, this agenda is often linked to a mechanism of “institutional conditionality”, whereby access to financial support is conditional on the implementation of specific reforms, thereby promoting a particular set of so-called “good institutions”, which in practice are geared toward liberalization, privatization, strengthening the rule of law, and reducing corruption.

Despite their dominant position, the “good governance” agenda and NIE generally have faced growing criticism, especially from researchers focusing on the Global South [Khan, 1995; Rodrik, 2006; Chang, 2011; Gray, 2016, 2018]. This criticism concerns, among other things, the difficulty of empirically confirming the effectiveness of the proposed reforms and methodological limitations, such as problems with measuring the quality of institutions or the questionable reliability of econometric data on the impact of “governance” on development [Glaeser et al., 2004]. Critics also point to excessive universalization and the failure to adapt the recommendations of the “good governance” agenda to the local social and political context and historical conditions [Khan, 2004; Rodrik, 2006, 2007]. NIE is also accused of overlooking the intricate relationships between institutions, politics, and the economy during the transition process. This leads to an excessive focus on institutions while neglecting the role of economic policy [Sangmpam, 2007; Chang, 2011; Leftwich, 2011]. Furthermore, critics argue that NIE treats institutions as static entities; in practice, they are dynamic and shaped by internal political processes. Critics also emphasize that the development successes of East Asia, achieved under different institutional conditions, undermine the thesis of a universal model of “good institutions”. Heterodox critics argue that while NIE claims to prioritize institutions, it remains fundamentally rooted in the neoclassical paradigm, as evident in its promotion of a limited state role [Gray, 2018; Reinert, 2019].

² The World Bank’s promotion of the “good governance” agenda is evident in two key areas: its publication of numerous annual reports emphasizing the importance of institutions for development [World Bank, 1997, 2002, 2004, 2011, 2018; Zagha et al., 2005], and its development of special indicators measuring institutional quality, such as the *Ease of Doing Business Index* and the *Worldwide Governance Indicators*.

In response to such criticism, representatives of NIE express skepticism about how the “good governance” agenda implements their concepts. They point out that complex elements of institutional theory, including the work of Douglass North, are often simplified and distorted [Shirley, 2011; Wallis, 2011; Dellepiane-Avellaneda, 2012; Ménard, Shirley, 2014]. They criticize, among other things, the instrumental treatment of institutions and the neglect of informal norms, subjective mental models, and the phenomenon of path dependence – the influence of earlier choices on the subsequent trajectory of institutional development. Furthermore, they argue that the term “governance” is an imprecise catch-all term that is difficult to operationalize and measure [Dellepiane-Avellaneda, 2012]. They also emphasize that the so-called post-Washington Consensus simplifies the institutional approach and that policy recommendations based on econometric models often fail to account for the complexity of real economic processes [Legiedz, 2020]. Proponents of NIE stress that its framework, by design, does not offer a complete theory of development that would allow for universal prescriptions [Wallis, 2011]. They argue this is because institutional development is a historically conditioned and difficult-to-control process, where reforms can strengthen the position of privileged groups or lead to destabilization. Consequently, popular indicators of “good governance” often mistakenly measure outcomes rather than the underlying “rules of the game,” thereby creating a risk of incorrect conclusions and the formulation of inappropriate policies. As a result, a disconnect exists between NIE research and development practice, with the latter often adopting a technocratic, universalist approach that overlooks local and political conditions.

The failures of reforms inspired by NIE, coupled with sustained external criticism over the past decades, have prompted a significant reevaluation of the role of institutions in development. This has led to an evolution in thinking both within NIE itself, as seen in the later work of Douglass North [2009], and in mainstream economics more broadly. This intellectual shift has translated into changes in the “good governance” agenda. Since the so-called neoclassical counter-revolution of the 1970s, three distinct periods can be identified in the mainstream perception of institutions. Each of these periods has had significant implications for the policies and activities of the World Bank and the International Monetary Fund.

TABLE 1

The evolution of the mainstream development paradigm

	The 1980s and early 1990s	From the mid-1990s to the first decade of the 21st century	From the second decade of the 21st century to the present
The dominant development paradigm	The Washington Consensus	The post-Washington Consensus	The current consensus
The role of institutions in development	Neoclassical (neoliberal) counter-revolution – institutions are treated as exogenous or secondary.	Institutions matter	Violence and social order
Development policy	Night-watchman state – the main development problem is the limitations of the state.	A strong state whose primary goal is to enforce property rights and create the foundations for the rule of law, but without direct involvement in the economy (no industrial policy). Promotion of a democratic system, fight against corruption, and rent-seeking.	Developing countries operate under different conditions, and copying institutions may be ineffective. However, the ultimate goals remain the rule of law, democracy, and a market economy.

Source: own elaboration.

Recognizing the discrepancy between institutional theory and development practice, Douglass North, John Wallis, and Barry Weingast (NWW) proposed a new conceptual framework [North et al., 2009]. The starting point for this approach is the assumption that no entity, including the state, has a monopoly on violence; it remains dispersed and requires institutional control. The authors also point out that social stability depends on the structure of institutions and material incentives that limit potential violence between influential groups. This is because the escalation of violence is associated with increased uncertainty, which negatively affects production, thereby threatening the interests of the

elites. The theory distinguishes between three types of order: the foraging order (characteristic of hunter-gatherer societies), a limited access order (LAO), which is characteristic of developing countries, and an open access order (OAO), which is found in developed countries. In LAOs, violence is controlled by limiting access to existing organizations and their creation, and by redistributing rents (i.e., income exceeding opportunity cost) within the so-called “dominant coalition” of the most powerful organizations. Political stability depends on whether the distribution of benefits reflects the strength of individual factions within the coalition, rather than on formal rules. Furthermore, politics in such orders is often personalized and based on patron–client relationships. LAOs can evolve from “fragile” (high violence) to “basic” (managed violence) to “mature” (more stable, with more diverse organizations). In OAOs, violence is minimized through competition, open access to forming organizations, and the impersonal rule of law. Elites maximize their interests by adhering to formal, impersonal rules that limit violence and centralize its legal use within the state. Once established, this system becomes self-reinforcing, promoting stability and economic growth through competition. The transition from an LAO to an OAO requires the fulfillment of “doorstep conditions,” such as the rule of law for elites, the durability of public and private organizations, and the centralization of the monopoly on violence. However, this process is not automatic and requires the active involvement of a broad spectrum of actors. As a result, NWW question the validity of universal institutional reforms promoted by the “good governance” agenda in LAO contexts, pointing instead to the need to manage rent distribution and build stable agreements between elites as preconditions for development.

An alternative, yet complementary, perspective to the framework of NWW is offered by Acemoglu, Robinson, and Johnson, whose work has gained significant popularity for its accessible explanation of institutions’ role in economic development. At the core of their theory is the distinction between two types of political power: *de jure* power, which is derived from formal institutions like constitutions, and *de facto* power, which stems from a group’s ability to impose its will through collective action, such as protests or the threat of revolution [Acemoglu et al., 2005]. The dynamic interplay between these two forms of power shapes the country’s institutional and economic trajectory. For instance, democratization often results from a non-elite group leveraging temporary

de facto power to secure lasting *de jure* power through institutional changes, thereby resolving the “commitment problem,” where elites cannot credibly promise future concessions. The interaction between these forces determines whether a society develops “inclusive” institutions, which protect property and promote growth, or “extractive” institutions, which concentrate power and wealth in the hands of a narrow elite. Extractive systems hinder development by blocking the “creative destruction” process, as elites fear innovation that could threaten their dominance [Acemoglu, Robinson, 2012]. In their “narrow corridor” concept, Acemoglu and Robinson argue that liberty and prosperity flourish only under a delicate balance between a strong state and a mobilized society. The ideal is the “Shackled Leviathan” – a state strong enough to provide order but simultaneously and effectively controlled by society. They contrast this with the “Despotic” or “Absent” Leviathan, where either the state or anarchy dominates, hindering long-term development.

Despite its influential contributions, the conceptual framework of NWW has faced significant criticism, particularly regarding its treatment of violence and its underlying theoretical assumptions. Critics argue that the theory reduces violence primarily to a transaction cost tied to the material interests and rent-seeking calculations of elites, while saying little about the diverse forms and experiences of violence, such as wars, revolutions, or ethnic conflicts. Furthermore, the framework focuses on violence between elites and their accumulation strategies, marginalizing the actions and motivations of non-elite groups and potentially justifying elite violence against the rest of society in the name of stability. The theory is also criticized for overlooking the international political and economic system, minimizing the role of violence in OAOs, and failing to analyze the historically changing relationship between violence and power sufficiently [Bates, 2010; Gray, 2016, 2018].

Hazel Gray [2016, 2018] expands on these points, contending that the NWW theory and the Acemoglu and Robinson approach, despite some modifications, remain rooted in a neoclassical paradigm. Their models prioritize rent-free, competitive markets as ideal for economic progress, and are based on methodological individualism and optimization assumptions. By focusing on exchange and transaction costs – including the cost of violence – these theories overlook the structural dynamics of production, capital accumulation, and the complex

economic interdependencies. According to Gray [2016], the OAO is presented as an idealized system of competition in which the role of powerful economic actors, such as corporations, is marginalized, reminiscent of the neoclassical ideal of a perfect market. Ultimately, a central criticism is that by focusing on violence control, the NWW theory fits into a broader trend of defining development primarily as security. These risks sideline other crucial development goals, such as socioeconomic justice, redistribution, social struggles, and the protection of human rights. In this view, while the NWW framework offers a valuable critique of the “good governance” agenda, it remains limited by its simplified understanding of violence and the risk of legitimizing authoritarian forms of power in the name of stability.

3. Political settlements approach

The political settlements approach, developed since the 1990s by Mushtaq Khan [1995], offers an alternative to NIE, especially for analyzing developing countries [Behuria et al., 2017]. In his work, Khan criticizes NIE for ignoring the political context of the functioning of institutions, a failure that, he argues, explains the collapse of reforms inspired by the “good governance” agenda. He defines a political settlement as a combination of power and institutions that is mutually compatible and sustainable in terms of economic and political viability [Khan, 2010, 2018]. Unlike the NWW framework or the concepts of Acemoglu and Robinson, Khan describes power more broadly as the result of interactions between various organizations, rather than simply as the effect of controlling violence. The key concept here is “holding power”, defined as an organization’s ability to impose costs on others and to absorb costs inflicted on it. This power is derived from factors such as economic resources, the ability to mobilize supporters, organizational capabilities, and the use of ideology and symbols of legitimacy. Significantly, the actual centers of power often lie outside formal government structures. Thus, if a reform threatens an organization with significant holding power, that organization can leverage its influence to make enforcement of the reform costly and complex, often leading to its failure.

In the political settlements approach, institutions are seen not only as decision-making frameworks but primarily as mechanisms for distributing benefits

that perpetuate the existing power structure. The distinction between formal and informal institutions is key. NIE recognizes the importance of informal institutions, pointing out that their weakness can hinder the functioning of formal rules by increasing enforcement costs, often leading to the failure of reforms that involve transplanting norms from developed countries [North, 1990, 1995]. Furthermore, NIE proponents often view informal institutions as exogenous, slow-changing factors like cultural values [see Williamson, 2000]. Khan [2010, pp. 15–16], while acknowledging that informal institutions help maintain patterns of behavior at lower costs, emphasizes that their evolution is often endogenous and dependent on the enforceability of specific formal rules. Therefore, he defines them not primarily as cultural norms, but as informal enforcement mechanisms based on power that align the actual distribution of resources and rents with the real balance of power, especially when formal institutions are weak or do not reflect this balance [Khan, 2010, p. 18]. Informal institutions, such as patron–client networks, are often deliberately personal and tailored to the interests of influential groups, providing an alternative mechanism for rent redistribution. Instead of focusing on “missing norms” or “cognitive abilities” (as suggested by North [2005]), Khan suggests analyzing the organization of power to explain differences in the costs of enforcing and creating institutions. Power-based informal institutions may explain the persistence of ineffective formal ones: the informal structures that benefit from this ineffectiveness would not be the primary beneficiaries of modern, formal capitalist institutions. Khan [2010, p. 18] warns against hastily concluding that culture or values are the main problem when formal institutions fail. In many developing countries, the formal sector does not generate sufficient benefits for all powerful actors, making informal institutions necessary for stability. Therefore, the cost of enforcing an institution depends on its compatibility with the interests of dominant groups; the greater the resistance, the greater the risk of its ineffectiveness, regardless of its potential benefits.

Introducing new institutions can lead to destabilization if they infringe on the interests of influential groups. This creates what are known as “transition costs”: social burdens resulting from political resistance to reforms, often manifested in declining political stability. Governments must therefore balance the pursuit of economic growth with the maintenance of political order. The nature

of this compromise is shaped by the existing political settlement, the type of reforms, and the strategy for their implementation. The political settlement must support a minimum level of stability to ensure the cohesion of the ruling coalition and at least a minimum rate of economic growth, thereby preventing influential groups from mobilizing to protect their interests; failure to meet these conditions results in instability. Therefore, Khan's approach suggests that evolutionary, conflict-limiting reforms are usually more effective in developing countries than radical "big bang" changes.

Khan [2010, p. 49] proposes a typology of political settlements based on the extent to which holding power is linked to formal institutions and whether those institutions support economic growth. He distinguishes four main types. The first one is the "capitalist" political settlement, where power is primarily tied to formal, productive capitalist property rights that are dominant and effectively enforced. While this may create conditions for the rule of law, its existence is not guaranteed. The second type, and the primary focus of Khan's analysis, is the "clientelist" political settlement. Here, significant power sources lie outside formal institutions, and rules are often applied in a personalized manner, constrained by informal power structures. This is typical of many developing countries, where outcomes can range from developmental success to state failure. The third type is the "pre-capitalist" political settlement, in which power has historically been linked to formal institutions that did not promote growth, such as feudalism. Finally, what is a political settlement in crisis is a situation where the existing political order has collapsed, formal institutions have broken down, and power is often exercised through violence and illegal activities.

In developing countries, holding power often comes not from formal authority but from the organizational capacity of elites, which they use to mobilize society during political confrontations. Therefore, the political settlements approach focuses primarily on analyzing clientelist political settlements. Although formal institutions in developing countries – such as courts, property rights, and democratic institutions – often resemble those in developed countries, their functioning is limited by informal, personalized power relations. There is a structural discrepancy between formal rules and the actual distribution of power. Elites maintain their position through patron-client networks based on

the exchange of material benefits for organizational support. These structures, often pyramidal and factional, constitute the basic mechanism of informal power and rent redistribution [Khan, 2010, pp. 53–57].

Another key aspect of the political settlements approach is the structure of the ruling coalition, which Khan assesses along two main dimensions. The first one is the horizontal distribution of power – the strength of opposition factions relative to the ruling coalition. A weak opposition, for instance, tends to favor longer political horizons. The second dimension is the vertical hierarchy within the coalition, referring to the degree of control higher levels have over lower-level factions. A strong vertical hierarchy enhances the coalition’s ability to implement decisions. On this basis, Khan [2010, p. 65] distinguishes four types of coalitions: potential developmental (weak opposition, strong vertical hierarchy), authoritarian (weak opposition, weak hierarchy), dominant party (fragmented power within the ruling coalition), and competitive clientelism (strong opposition, weak vertical implementation). For example, a potential developmental coalition offers the best prospects for sustained growth (e.g., South Korea in the 1960s–1980s).

What is the final element of the analysis is entrepreneurs’ political power and technological capabilities. Entrepreneurs with high capabilities but low political power can be effectively guided by a developmental state. Conversely, those with strong political connections but low capabilities can use their influence to seek rents and block productive reforms [Khan, 2010, pp. 69–74].

4. Discussion and conclusions

Despite its growing influence, the political settlements approach has been criticized for its conceptual clarity, methodological rigor, and empirical validity. A fundamental point of contention is the definition of a “settlement”. Kelsall et al. [2022], who advance their distinct framework of political settlements, argue that for the term to be valid, it must imply a conscious agreement, or pact, among powerful groups that ends or prevents widespread conflict. This contrasts sharply with Khan’s view of a settlement as an emergent “interactive order” resulting from a sustainable balance of power. This definitional

ambiguity, which Dressel and Dinnen [2014] describe as “conceptual chaos”, creates significant methodological challenges. Key concepts, such as Khan’s “holding power,” are difficult to operationalize and measure objectively. As van de Walle [2016] noted, this lack of clear indicators leads to a more severe charge: the theory is tautological and unfalsifiable. Suppose a “productive” settlement is identified only by economic growth. In that case, the theory merely states that growth is caused by the conditions that cause growth, creating a circular argument.

Further criticism targets the framework’s explanatory scope and its practical utility. Several scholars argue that the approach is overly elite-centric, often overlooking the agency of non-elite groups, whose influence can be decisive through elections [Behuria et al., 2017]. This critique is significantly deepened and systematized by Clare Cummings [2025]. Cummings argues that what is the foundational limitation of Khan’s political settlement theory is its narrow, materialist conception of power. While scholars like Gray [2018] rightly contend that the focus on clientelism is too narrow by ignoring ideology, Cummings proposes a more fundamental shift. Drawing on cultural political economy, she posits that power is not merely a material capacity for conflict but it is co-constituted by cultural and ideational factors. This means that political mobilization and institutional change are driven by struggles for resources and demands for social recognition, status, and dignity, which are rooted in shared identities and moral beliefs. From this perspective, non-elite actors are not just passive recipients or occasional voters; they possess agency to challenge institutional arrangements on moral grounds, creating counter-hegemonic narratives that can delegitimize the existing order. The theory’s explanatory power is also questioned for its alleged structural determinism and inability to explain anomalies, such as the slow growth in post-apartheid South Africa despite a clear settlement, or the rapid growth in Rwanda in its absence [van de Walle, 2016].

Consequently, the framework’s value for policymaking is contested. Its limited predictive power and difficulty translating its analysis into firm recommendations, beyond the general advice to consider the context, make applying it practically challenging. This raises the risk that the approach could be used to legitimize ineffective or authoritarian regimes, preserving “stability” while

ignoring the influence of transnational factors, such as the interests of foreign aid organizations. Although Khan’s approach partly coincides with the concepts of North, Wallis, and Weingast (e.g., emphasizing the role of rents), it differs significantly in its theoretical foundations. NIE is based on neoclassical assumptions, while Khan draws on heterodox traditions such as Marxism and old institutionalism. Unlike NIE, which often sees clientelism as a universal tendency, Khan interprets it as a historically conditioned phenomenon resulting from the limited development of capitalism in the Global South. Consequently, while NIE often prescribes universal best practices to eliminate clientelism, Khan advocates for context-specific solutions that manage rents to maintain stability.

This challenge of translating theoretical concepts into actionable and predictive policy is not unique. Ironically, it is a limitation that Khan’s approach shares with New Institutional Economics it seeks to critique. Nevertheless, despite these practical shortcomings, the political settlements framework remains a valuable analytical tool, particularly for understanding the complex realities of developing and post-communist countries. Its true strength lies in serving as a crucial, realistic alternative to the often-idealized perspective of NIE. By grounding the analysis of institutions in the distribution of power rather than in abstract efficiency, Khan’s framework offers a more sober perspective. This realism seems particularly vital today, not only for analyzing the challenges of the Global South but also for understanding the complex problems that developed nations face in the contemporary world.

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