INSTITUTIONAL TRANSITION AND TRANSITION COST: A METHODOLOGICAL CONSIDERATION

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Institutional Transition and Transition Cost : A Methodological Consideration

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Abstract

This paper attempts to explain why institutional changes, whose direction look obvious at the beginning, arouse controversies and, more often than not, face 'setbacks'. It starts from critically assessing North's (1981; 1990) analysis of relating transaction cost and economic performance and argues for considering 'transition cost', separately from transaction cost, in designing institutional change. The 'reformers' are often interested in possible transaction cost reducing effect of institutional transition. But an institutional transition can be justified only if the reduction in transaction cost more than compensates for transition cost involved. It seems that many institutional reforms face problems because they ignore or underestimate the aspect of transition cost, the size of which is specific to institutions concerned.

Key words

Institutional change; transaction cost; transition cost; economic reform

JEL

L50; O10; O53; P00

1. Introduction

After the financial crisis in South East Asia, there have been numerous calls from international organisations and researchers for overhauling their malfunctioning institution, and some countries have actually carried out a broad range of institutional reforms. For outside observers, however, the pace of institutional changes in these countries often looks too slow and there are concerns that the 'will' to reform is diluted. On the other hand, there are also growing dissents from several sections of these countries over the direction and pace of institutional changes already set in motion.

This paper attempts to explain why institutional changes, whose direction look obvious at the beginning, arouse controversies and, more often than not, face 'setbacks'. It starts from critically assessing North's (1981; 1990) analysis of relating transaction cost and economic performance and point out the fallacy of connecting transaction cost, i.e, static system management cost, directly to the need of institutional change.

The paper then argues for considering 'transition cost', separately from transaction cost, in designing institutional change. The 'reformers' are often interested in possible transaction cost reducing effect of institutional transition. But an institutional transition can be justified only if the reduction in transaction cost more than compensates for transition cost involved. It seems that many institutional reforms face problems because they ignore or underestimate the aspect of transition cost, the size of which is specific to institutions concerned.

The paper also expands on Khan's (1995) concept of political transition cost and highlights the need to analyse economic 'transition cost' with the case of the economic reform after the financial crisis in 1997. It argues that, as differences in 'political

settlements' across countries call for different strategies for transition, different risk-taking mechanism at the national level also necessitates to take different approaches to reforming an economy.

2. Transaction Cost Economics and Economic Performance

Transaction cost economics, often categorised under 'new institutional economics', has drawn broad interest among economists and economic historians because of some new aspects in its approach. A long tradition of institutional economists had failed to produce common conceptual framework to analyse institutions: the consensus among them stopped at agreeing on the importance of institutions in economic activities and the need for incorporating institutions in economic analysis. But the novelty of transaction cost economics lies in its attempt to explain institutions with a common concept, i.e., transaction cost, and analyse them with the tools employed in conventional economics.[1] Its principal message is that the existence and changes of institutions can be explained in terms of transaction cost economising behaviour of individuals. For instance, Williamson (1985: 1) argues that economic institutions "have the main purpose and effect of economizing on transaction cost". North also maintains that a country's successful economic performance can be attributed to its institutional structure that keeps its transaction costs low.

In understanding transaction cost economics, it is important to note that it started basically from an attempt to rectify deficiencies of the concept of production cost in the

[1] For discussion of different strands of institutionalists, refer to Langlois (1986: 1-25); Hodgson (1991); Matthews (1986); Boulding (1957); Dorfman *et al* (1963).

standard neo-classical economics. According to Williamson, "[p]retransaction-cost economics [i.e., neo-classical economics] takes the organization of economic activity as given and characterizes firms as production functions with a motive of profit maximization" (1985: 199) whereas "transaction cost economics maintains ... that organizational variety arises primarily in the service of transaction cost economizing" (1985: 387). North also separates transaction cost from transformation cost which is almost identical to Williamson's production cost. For both of them, the total cost related to economic activities is the *sum* of production (or transformation) cost and transaction cost.

However, by taking the neoclassical production function as its reference point, transaction cost is defined as costs related with 'frictions' (Williamson 1985: 18-19), or those involved in 'economic exchange' (North 1990: 27), which do not appear in the standard production function. The contents of transaction cost are therefore specified as a *residual* of those of production cost.[2] For Williamson (1985: 20-22), they are the costs related to a contract both *ex ante* and *ex post*. For North (1990: 28), they are all the costs incurred in "defining, protecting and enforcing the property rights to goods (the right to use, the right to derive income from the use of, the right to exclude, and the right to exchange)", as compared to the costs incurred in "transforming the physical attributes of goods (size, weight, color, location, chemical composition, and so forth). And North emphasises the importance of transaction cost in the national economy with a

[2] In this context, Khan (1995: 74) points out "the gap between the neoclassical production function and reality can always and tautologically be attributed to transaction cost".

calculation that more than 45 percent of the U.S. national income is currently devoted to transacting activities.

Apart from considering this 'hidden cost', transaction cost economics is based on rational choice of individuals as same as neo-classical economics: what drives its system is cost minimising (or utility maximising) behaviour of individuals. In this regard, North (1990: 83) asserts that "[t]he agent of change is the individual entrepreneur responding to the incentives embodied in the institutional framework". Institutional change is therefore understood as a consequence of voluntary contracts and a major impetus here is changes in relative prices.[3] Like in the neoclassical world, it is also assumed that institutional change driven by rational choice of individuals would lead to an ideal institution, if free negotiation over contracts is ensured.

In the real world, however, there are many obstacles that hinder institutional change towards efficiency improvements. North refers to the force behind those obstacles as 'path-dependence' and argues that institutional change occurs 'incrementally' or 'at the margin' due to the path-dependence. For North, the most important factor in determining the path-dependence is the political 'market' because "[t]he polity specifies and enforces the property rights of the economic marketplace ..." (1990: 109). Then, he boldly concludes: "The condition [for political market to approximate to the zero transaction cost model for efficient economic change] is *easily*

[3] North (1990: 86) argues as follows: "A change in relative prices leads one or both parties to an exchange, whether it is political or economic, to perceive that either or both could do better with an altered agreement or contract. An attempt will be made to renegotiate the contract... Over time, the rule may be changed or simply be ignored and unenforced. Similarly, a custom or tradition may be gradually eroded and replaced with another".

stated" and this "is a modern democratic society with universal suffrage" (1990: 109, emphasis added). He supports his argument with a comparison between the British-North American path and the Spanish-South American path of economic development. He also applies this conclusion to a comparison of economic performance between the First World countries and the Third World countries.

How successful is the project of transaction cost economics? Let me answer the question by probing its methodological underpinnings.

First, although transaction cost economics originated from dissatisfaction of neo-classical economics, it accepts the inherent efficiency of the neo-classical world. This is mainly in order to compare economic performance of different institutions with an *absolute scale.* By measuring the size of frictions from this reference point, transaction cost aims at an *ordering* of economic institutions. This attempt may be all right for those who believe in the long-term efficiency of the neo-classical world.

However, even in the neo-classical framework, a world with one distortion is not necessarily more efficient than the one with two or more distortions, as the second-best theorem in welfare economics shows.[4] The size of 'friction' does not give a definite efficiency implication here. Also the issue of *dynamic* efficiency has yet resolved in the neo-classical framework because there is no guarantee that the pursuit of allocative efficiency will bring about 'growth effects', although it has 'level effects' (Lucas 1988:

[4] For discussion of the second-best theorem, see Bohm (1987); Boadway & Bruce (1984: 131-36).

12).[5] A short-term friction-minimising institution is thus not necessarily the best performing one in the long term. Moreover, for those who do not accept the efficiency of the neo-classical world, the size of frictions from the neo-classical world does not give any efficiency implication. North's analysis of institution and economic performance is advanced without providing plausible criteria for dynamic efficiency, but with merely assuming the dynamic efficiency of the neo-classical world.

Secondly, transaction cost economics resorts to a *residual analysis*: the focus of the analysis is the residual of production function on the supposition that determinants of production function are separate from those of the residual. North (1990: 27) argues that changes in transformation cost are basically affected by technological change whereas changes in transaction cost are influenced by institutional change. In this way, efficiency of institutions can be analysed by exclusively focusing on transaction cost and explained in terms of 'approximation' from the idealised institution. In the same context, he contends that, if we 'add' a theory of production to his theory of transaction cost, "we can then analyze the role of institutions in the performance of economies".

However, North neglects the possibility that transaction cost can be inter-related with production cost in his supposition that institutions only affect transaction cost. But institutions also critically affect production function, i.e., technology, as neo-Schumpeterian studies of national innovation system demonstrate (refer to Freeman 1987; Lundvall 1992; Nelson 1993). If we take this view, the crucial issue becomes

[5] Level effects refer to once-and-for-all changes that raise or lower balanced growth paths without affecting their slope, whereas growth effects refer to changes in parameters that alter growth rates along balanced paths.

developing a theory that deals with both production and transaction cost at the same time, rather than adding one theory to the other.

Thirdly, transaction cost economics adopts a *reductionism* in its actual analysis: Complex factors determining the efficiency of institutions are progressively reduced to certain ultimate factors. As I pointed out above, they are reduced to transaction cost, separated from production cost in the first place. The determinants of transaction cost, especially those of path dependence, are then reduced to 'political market'. North again reduces determinants of the efficiency of political market to the possibility of free negotiation over contracts.

However, there is also path dependence resulting from economic variables and this has important implications in comparing economic performance across countries as well as designing institutional change, as I will show later (section 4). This aspect is neglected in North's analysis because he excludes production function from his institutional analysis. It is also the case that, even in the most democratic polity, compensations to losers are not sufficiently made, or efficiency-enhancing institutional changes are blocked by interest group politics.

Considering the deficiencies discussed above, the only support given to North's conclusion is his comparison between the British-North American path and the Spanish-South American path of economic development. However, since his case study is not exhaustive, it not difficult to find cases to contradict his conclusion merely by looking outside his comparative setting. For instance, the economic recovery of France after the end of World War II was carried out with a sweeping nationalisation, i.e., by limiting

individuals' freedom to negotiate over contracts.[6] Chang (1994) argues, by employing the very concept of transaction cost, that state intervention in South Korea contributed to reducing, rather than increasing, transaction costs. Elbaum & Lazonick (1986: 11) also attribute one reason for the long-term decline of British industry from the late nineteenth century to the British state's "reluctance to break from *laissez-faire* traditions".

Unfortunately for North, the introduction of a new concept like transaction cost does not bring about any definite efficiency implication of institutions. As Matthews (1986: 907) points out, transaction cost economics therefore "has been invoked in support of both market pessimism and market optimism". This is fundamentally because there is no such thing as the most efficient institution in the real world, by deviations from which we can gauge relative efficiency of other institutions. Any institution has its own merits and demerits in itself. And its net efficiency is indeterminate without considering the context in which it operates.

As we shall elaborate further below, the main difficulty as well as significance of institutional analysis lies in the lack of absolute reference point and the importance of context in comparison. By ignoring this fundamental aspect, North attempts to provide a *universal* theory of institution and institutional change, and inevitably relies on reductionism and residual analysis.

3. Transition cost and system transition

[6] See Kuisel (1981)

Although we are not able to define the most efficient institution in absolute terms, it is not impossible to compare relative efficiency of institutions at a given time and among limited number of countries. For instance, when the Japanese economy outperformed the U.S. economy in the 1970s and 1980s, we can trace reasons for the different economic performance between the two countries to their differences in institutions. Likewise, in understanding the resurgence of the U.S. economy and the stagnation of the Japanese economy during the 1990s, we may find some institutional reasons for the different performance between the two countries. Similarly, it also makes good sense to compare institutions of East Asian NICs with those of Latin American countries if we want to investigate the reasons behind their differential economic performance during last couple of decades. Most studies on institutions and economic performance are actually undertaken in this manner.

What should be noted is that this kind of institutional comparison is basically static one. During a given period, it is assumed, implicitly or explicitly, that major institutional features of countries in question remain same and those features are attributed to explaining performance. If those features are fluid, it is difficult to characterise institutions and to attribute them to performance. This static analysis is the beginning of any institutional analysis and there are certainly great utilities in it. Through relating institutional features to performance, we can draw meaningful implications on what are important aspects of well-functioning institutions, how a system can reduce its maintenance cost, what can be potentially improved on less-well-functioning institutions and so on.

However, in designing institutional change, this consideration of static aspects is not sufficient, though it may be necessary. Let us suppose that a system (S1) performed

better than another system (S2) in certain period. We may 'explain' that S1 had lower maintenance cost than S2, or conclude that S1 was 'superior' to S2. But the superiority of S1 itself does not necessitate for S2 to make a transition to S1. This is mainly because an additional cost consideration is required in 'changing' a system. If the cost involved in shifting S2 to S1 more than offsets the expected benefit of lowering maintenance cost of S2, it is not desirable to make such a transition.

Khan (1995) names this cost involved in institutional transition as 'transition cost' and argues that it should be given a separate treatment from transaction cost. North does not seriously consider transition cost because, in emphasising the importance of 'path dependence', he conceives institutional change predominantly as changes 'at the margin'. Path-changing institutional changes, i.e., changes in characteristic features of institutions, are precluded in this perception. As regards forces influencing path dependence, North (1990: 95) vaguely refers to 'increasing returns' and 'market imperfections', citing Arthur (1989), but he does not elaborate on them except saying that changes in paths "will typically occur through changes in the polity" (1990: 112). Overall, transition through changes in the polity is not considered seriously in North's analysis.

Khan rejects this North-type view of institutional change through voluntary negotiations as following:

> "But in fact important real world institutional changes are rarely accompanied by the compensation of losers. Human history may not be a history of class struggle alone but it is certainly not a history of negotiated institutional change. Modelling institutional change 'as if' it were a negotiated process with compensation allows the importation of

> sophisticated tools ... but makes the analysis seriously deficient. Real-world institutional change involves path changes. These are discontinuous breaks in the paths ... Even relatively minor institutional changes such as changes in tax rates are typically not negotiated through compensating side-payments" (1995: 82).

And he defines transition cost as "the political cost faced by initiators of new institutions" (1995: 81), or "the political cost which potential losers from a proposed institutional change can impose on the proponents" (1995: 82), and argues for placing the concept of transition cost at the centre of the analysis of institutional change.

For Khan, the most important determinant of transition cost is 'political settlement', which is "the balance of power between the classes and groups affected by ... [given] institution" (1995: 77), because the cost depends critically on the 'intensity and extent of resistance' by losers. But it is difficult to measure the cost quantitatively because they are often "inflicted on a specified group by political events such as physical violence or defeats in elections" (1995: 82). The size of transition cost is also institution-specific because political settlement is diverse across countries and therefore costs arising from resistance to proposed institutional change are different according to differences in the existing political settlements in question.

In this situation, the best an initiator of a transition can do is "the [subjective] ranking of composite bundle of costs" associated with alternatives in hand, and chooses a strategy for transition accordingly (1995: 83). In this process, some strategies considered to incur too high transition costs are eliminated from feasible options. Khan (1989; 1995) illustrates this point with the case of the unsuccessful attempt by the Pakistan government in the 1960s to establish a developmental state. The Ayub Khan

regime was a ‘strong state’ equipped with the oppressive power comparable to its counterparts in East Asian countries like South Korea or Taiwan and instituted a similar developmental strategy. However, “[t]he experiment was abandoned after the uprising of 1969-71 and a civil war in which possibly a million people died” (1995: 85). For Khan, this failure was mainly due to attempting an institutional transition without fully considering costs from ‘resistance’ to the proposed change. And he argues that other strategies of transition must have been preferable for Pakistan to attempting to establish an East Asian type developmental state.

4. Economic transition cost: The case of Korea

While Khan proposes the concept of transition cost mainly in relation with *political costs* involved in institutional change, I would add an *economic dimension* of transition cost. That is, even if there are no serious political costs, there may be significant economic costs in institutional transition. This is mainly because economic institutions of a country are also produces of its own historical development, and therefore closely intertwined with other related components of the economy such as composition of industries, developmental stage and other historical heritages of the country, which cannot be changed overnight. When a radical institutional change is attempted, it is therefore possible that it conflicts with the related components of the economy and results in economic costs. I will illustrate this point below with an analysis of institutional transition in South Korea after the 1997 financial crisis under the stewardship of the International Monetary Fund (IMF).

On the allegation that the close 'state-banks-*chaebols*' nexus, which had been a central institutional feature of the economy, was the root cause of the crisis, the Korean government and the IMF attempted to shift it to an idealised Anglo-American system, following the 'Washington consensus'. But the result so far is disappointing on a closer look though the macroeconomic recovery of the country may look impressive. This was mainly because the 'reformers' neglected or at best under-estimated economic costs involved in the systemic transition and simply demolished the previous risk-taking mechanism without building a new one in their lopsided concern for possible benefits of the reforms.

The previous risk-taking system in the Korean economy can be described as a state-mediated bank financing system, in which the state drafts industrial policy and the policy is implemented largely through the banking system, the main beneficiaries of which are the *chaebols*, family-owned business groups. The mechanism of close consultation between the state, banks, and the *chaebols*, reduced financial risks involved in high-risk projects at the national level. The internal transaction within the business group also helped further creation of credit.

A main strength of this system lies in its capacity to enable a high-pitched economic growth through maintaining high rate of investment, as Korea's industrial history evidently shows. On the other hand, its potential weaknesses lie in the possibility that the economy may go wrong if the state does not effectively play its role as the ultimate system manager. In particular, given the fact that the economy is characterised by a relatively high reliance on foreign and corporate debts, a failure in the system management can easily turn into a financial crisis, as the Korean experience in 1997 testifies.

The post-1997 economic reform was principally geared at 'fundamentally' correcting the potential weaknesses of the system and consisted of the following elements: (1) The role of the government was confined to supervising financial institutions and maintaining competitive market order, in the process of which financial supervision standards and fair trading regulations were strengthened substantially; (2) The financial sector was assigned to take over the role of the nerve centre of economic management; (3) Companies were required to compete as independent units, rather than as members of business groups, and corporate governance was strengthened; and (4) External liberalisation, both in the product and service market, progressed in full. Along with these reform measures, a radical reduction of corporate debt-equity ratio was enforced and new engines of growth were sought from foreign capital and venture businesses. Thus seen, the IMF programme applied to Korea was the deepest and broadest one ever experimented in any crisis-hit countries, often called as the 'IMF plus' by local press.

What are the benefits of this institutional transition? It seems to me that the actual benefits are minimal so far. The only positive result of the reform programme was the establishment of a strong 'check and balance' system between financial institutions, companies and shareholders, which may help reduce some of the worst abuses of the system. Financial institutions are no longer allowed to keep accumulating non-performing loans (NPLs) as they are now forced to close or merge if they do not maintain minimum BIS ratios. It has also become difficult for the *chaebol* 'owners' to make 'excessive diversification' due to the increased transparency in accounting and the strengthening of the right of minority shareholders.

However, the reduction in financial risk of the system, the very aim of instituting this new 'check and balance' system, was not quite realised. For instance, even with a radical reduction of corporate debt-equity ratio,[7] the problem of 'thin profit margin' in the corporate sector transformed only into that of 'thinner profit margin'. The ratio of ordinary income to sales (ordinary profit rate) for the manufacturing sector recovered to 1.68% in 1999, from negative figures in 1997 and 1998, but it slipped again to 1.29% in 2000. The average ordinary profit rate for the two years of vigorous economic recovery after the crisis, during which the Korean economy expanded at the annual rate of 9.8%, was only around half of the historical average before the financial crisis (2.8% during 1973-1996). If we include the figure for 2001, the year of sharp economic slowdown, the average is even worse at 1.12% (BOK website). As far as the balance sheet of the corporate sector is concerned, its financial vulnerability has actually become worse even after the structural reform.

Some benefits claimed by the IMF and the Korean government as the results of the reform are also misplaced. For instance, the short-term economic recovery in 1999 and 2000 is more a consequence of adopting aggressive Keynesian policy than that of implementing economic reform. Similarly, the return of FDI from late 1998 was less due to the 'restoration of investors' confidence' encouraged by Korea's commitment to reform than due to the increasing prospect of the economic recovery. Inward FDI was also already on a trend increase from 1995, i.e., before the crisis, thanks to the relaxation in FDI regulations and strong growth of the domestic economy, contradicting the claim that Korea needed a fundamental reform to increase FDI. Moreover, most of

[7] The average debt-equity ratio of the manufacturing sector fell from 396% at the end of 1997 to 214% at the end of 1999 and further to 210% in 2000.

FDI after the crisis was related with asset sales at hugely discounted prices that may eclipse the possible long-term benefit from introduction of 'advanced' management skills and technologies (For details, refer to Shin & Chang (2002, section 3.3)).

On the other hand, the costs involved in this transition were very high. Above all, the amount of NPLs *in the national economy* has kept increasing.[8] The accumulated total of NPLs, which includes those driven out of the financial system through purchase by public funds or through disposition by financial institutions in the form of sales to private investors, liquidation and so on, increased from 97.4 trillion won at the end of 1997 to 232.8 trillion won at the end 2000. During the three years after the financial crisis, 135.4 trillion won (US$112.8 billion) of *new NPLs* was created in the economy. And the increase in NPLs continued in 2001.[9]

It is impossible to determine objectively how much of this increase in NPLs in the economy was due to *ex post* realisation of the latent troubles within the corporate sector accumulated before the crisis or due to the difficulties created by the new economic system. However, if we look at the financial flows from the financial sector to the corporate sector, the importance of the latter becomes clear. As table 1 shows, a remarkable trend in corporate financing after the crisis and subsequent reform was an

[8] The Korean government and the IMF often emphasise the reduction of NPLs as a major achievement of the reform programme. But this applies only to those *within the financial sector*, which shot up to 136.3 trillion won (US$113.5 billion), or 21.8% of total loans, in June 1998, was reduced to 66.7 trillion won (11.3%) at the end of 1999, and 59.5 trillion won (9.6%) in March 2001. This reduction was mainly due to unprecedented injections of public funds and pressure from the government over financial institutions to improve their short-term balance sheets by disposing their assets.

[9] For instance, according to BOK (2001b), companies with lower than 100% of interest coverage ratio, that is, whose operating profit falls short of their interest payments obligations, have increased to 36.3% of listed manufacturing companies during the period of January to September 2001 from 27.6% during the same period in 2000.

abrupt depletion of external funds available for the corporate sector. Even during the period of rapid economic recovery in 1999 and 2000, the external funds for the corporate sector was only around half of that available in 1997, and the situation became worse in 2001.

The main culprit here was the fall in 'indirect financing', i.e., the borrowing from financial institutions. In 1998 when the country was in the depth of the crisis, financial institutions *withdrew* 15.8 trillion won of loans from the corporate sector. Although indirect financing slowly began to recover, its level fell far short of the pre-crisis level. The amount of external financing available in 1999, at 2.2 trillion won, was only about 5% of the 1997 level (43.4 trillion won). In 2000, it was still only 26% (11.4 trillion won) of the 1997 level. As the economy began slowing down sharply in 2001 along with the recession in the world economy, indirect financing shrank dramatically again to 2.5% (1.2 trillion won) of what was available in 1997.

Why has the credit crunch continued even after the Korean economy got over the initial shock of the financial crisis? It was mainly because the institutional transition created a vacuum in the risk-taking function of the economy, rather than re-establishing it. In the new institutional framework, the role of the state and the *chaebol* in the risk-taking mechanism was diminished substantially and the financial sector became the major agent to assess and take risks in loan provisions. But its capability to do so was severely constrained in the context of the Korean economy.

First, since commercial banks were in the process of ongoing re-organisation and many of them were placed under the ownership of the government, their primary concern was to meet newly-introduced supervision standards like BIS ratios and

forward-looking criteria (FLC), which are in general penalising corporate lending. They had little incentive to take high risks in corporate lending.

Secondly, related with the above, managers in financial institutions had little incentive to resolve problems of bad loans by reviving the troubled companies. If they let those companies fail now, the failure will be considered as a result of poor lending decisions by their predecessors, whereas they will be held responsible if the firms they extended loans fail. They therefore tend to underestimate the value of currently ailing firms and prefer selling them, often at a highly discounted price, or liquidating them to putting in efforts to turn them around. And this incentive becomes stronger if the assets related with ailing firms are already classified as NPLs and therefore provisions against them have been made.[10]

Even if commercial banks are privatised, which is in my view unlikely to happen in the short run, it is difficult to expect that the financial sector's risk-taking capability will soon be enhanced sufficiently to provide the corporate sector with necessary funds, because of the extremely conservative financial supervision standards that have been introduced following the crisis and the continuing lacklustre performance of the corporate sector.

One reason why Korea has been able to pay the huge transition costs so far without serious social conflicts is that its public finance was one of the soundest in the

[10] This was well reflected in creditor banks' preference of selling Daewoo Motors and Hynix to foreign buyers than turning around them with their own initiatives.

world.[11] In a sense, Korea bought out large part of potential conflicts in institutional transition with public money at least until now, unlike Khan's original perception of transition cost. However, analytical implications of economic transition cost are similar to those of political transition cost. The economy works in quite diverse ways across countries and the size of economic transition cost resulting from the imposition of a new institution is also very different. When one attempts an institutional transition, this diversity should be considered. There is no absolute institution towards which any institution should make a transition.

5. Conclusion

Like the concept of transaction cost, acknowledging and considering the aspect of transition cost is disconcerting to researchers: It makes our analysis more complicated rather than simplified, and it becomes harder to draw 'general' implications. But this is the fact of life we have to counter rather than to avoid. North's analysis of institutions avoids this complexity by resorting to residual analysis and reductionism, therefore provides little help in advancing our understanding of the process of institutional change.

A main reason why we need an institutional analysis is that diversity is often very important. There are certainly common aspects across institutions, which are important in explaining institutions and designing institutional transition. However,

[11] Despite the substantial increase of budget deficits in the process of buying NPLs and recapitalising financial institutions, Korea's ratio of public debt to GDP was only 23.4% at the end of 1999, still one of the lowest among the OECD countries.

institutional analysis is more than finding common factors and drawing general implications out of them. We need institutional analysis because looking for commonality is not enough in understanding the reality and drawing meaningful implications for action. While acknowledging the recurrence of common factors over time or across countries, we need at the same time to see diversity resulting from peculiar characteristics of time and space.

When one considers institutional changes in South East Asia, this aspect of diversity in institutions and paths of institutional change should be given a due consideration. A useful programme for institutional transition can be derived only from careful analyses of what are real challenges each country faces, what alternatives are available, what are costs and benefits involved in those alternatives, and so on, rather than accepting what are presumably 'good' regardless of specific institutional context.

The only universal lesson that we can draw from our discussion above would be that there is no panacea for institutional management and institutional change. 'One-size-fits-all' solution often results in huge transition costs, as we saw above. The reality is full of grey areas which suggests us that there are many 'middle roads' for institutional transition. What is important is to find what middle roads are suitable to countries in question.

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Table 1. External Financing of the Corporate Sector

(billion won)

	1996	*1997*	*1998*	*1999*	*2000*	*2001*
Total	118,769	118,022	27,664	51,755	66,531	51,939
Indirect Financing	33,231	43,375	-15,862	2,198	11,391	1,185
From Banks	16,676	15,184	259	15,525	23,348	3,381
From NBFIs	16,555	28,191	-16,550	-13,267	-11,997	-2,377
Direct Financing	56,097	44,087	49,496	24,792	18,996	36,838
CPs	20,737	4,421	-11,678	-16,116	-1,133	4,210
Stocks	12,981	8,974	13,515	41,137	20,806	16,504
CBs	21,213	27,460	45,907	-2,827	-2,108	11,761
Foreign borrowing	12,383	6,563	-9,809	11,537	15,765	2,283
Others	17,059	23,997	3,839	13,228	20,380	11,633

Source: Flow of Funds, BOK website
Note : CP is corporate paper. CB is corporate bond. Others include corporate loans, government loans and so on