# Institutional Dissipation and Private Efficiency: A Comparative Theory of Political Economies

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**ABSTRACT**

This paper develops a theoretical framework explaining how robust private efficiency can coexist with aggregate inefficiency through a process we term institutional dissipation. Drawing on comparative political economy, we integrate insights from Hall and Soskice (2001), Iversen and Pontusson (2010) and Mazzucato (2018). We argue that institutional configurations mediate the translation of firm-level efficiency into broader social outcomes, thereby shaping national differences in the relationships among productivity and collective welfare. Our theory combines institutional and behavioural mechanisms to explain how economies exhibiting high private efficiency may nonetheless produce lower aggregate welfare when institutional architectures fail to sustain social investment.

**Keywords:** Political Economy; Institutions; Efficiency; Comparative Capitalism; Welfare Dissipation

## 1. INTRODUCTION

Political economies are complex adaptive systems. They translate political legitimacy into economic coordination, producing both collective order and private opportunity. Yet, as historical experience repeatedly demonstrates, the very institutional arrangements that once propelled prosperity may later become self-defeating.

The central question of this paper is straightforward: *Why do political economies persist in states of organised inefficiency even when actors within them remain privately efficient?*

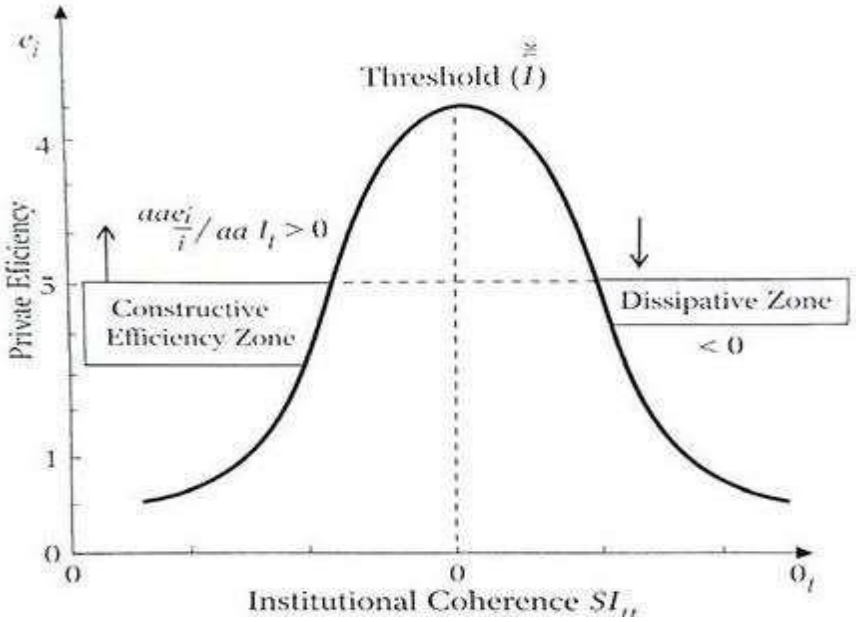


**FIGURE 1 MECHANISM LINKING PRIVATE EFFICIENCY AND INSTITUTIONAL DISSIPATION**

*As shown in figure 1, institutional predictability reduces private efficiency.*

We argue that the standard distinction between inclusive and extractive institutions, as articulated by Acemoglu and Robinson (2012), is insufficient. Such classifications categorise systems statically by structure but neglect temporal feedback. What matters instead is the dynamic alignment between institutional coherence and private efficiency. As systems mature, this alignment can reverse: private actors may adapt so effectively to institutional imperfections that they lose interest in reform.

We term this process *institutional dissipation*. It describes the endogenous erosion of collective efficiency through the very mastery of institutional dysfunction.

### 1.1 Situating the Argument in the Literature

Our framework engages with several established traditions in political economy. The *varieties of capitalism* (VoC) literature, inaugurated by Hall and Soskice (2001), emphasises how national institutional configurations—particularly labour market institutions, corporate governance structures, and vocational training systems—produce distinct comparative advantages. Liberal market economies (LMEs) rely on competitive markets and flexible labour, whereas coordinated market economies (CMEs) depend on non-market coordination and long-term relational contracting. Yet the VoC framework has been criticised for its comparative statics; it explains cross-sectional differences but struggles to account for institutional change or decay within a given system (Streeck and Thelen, 2005).

North (1990) and Greif (2006) offer a more dynamic perspective, treating institutions as equilibria in repeated games and emphasising path dependence. However, their accounts tend to focus on either institutional genesis or sudden collapse, leaving the intermediate phase—slow erosion amid apparent stability—relatively underexplored. Olson (1982) provides a partial corrective, arguing that stable democracies accumulate distributional coalitions that progressively impede growth. Our concept of institutional dissipation builds on Olson's insight but reframes it: the problem is not merely rent-seeking by organised groups but the systematic redirection of private ingenuity from productive innovation to navigating institutional imperfections.

Behavioural economics supplies additional mechanisms. Akerlof and Shiller (2009) demonstrate how animal spirits—confidence, fairness, corruption, money illusion, and narratives—drive macroeconomic fluctuations beyond what rational-expectations models predict. In dissipative systems, collective beliefs about the feasibility of reform become self-fulfilling: widespread scepticism about institutional improvement depresses the expected returns to reform efforts, rationalising continued adaptation to dysfunction.

Mazzucato (2018) contributes a perspective on the role of the state in directing innovation and sustaining public investment. Where public institutions fail to provide mission-oriented leadership, private efficiency may flourish in narrow domains while aggregate productivity stagnates—a pattern consistent with institutional dissipation.

But some recent views of the state drive towards an adaptive organization rather than a hierarchical command center following Rodrik (2020), and Mazzucato (2018), who conceptualize the “entrepreneurial state” as one capable of trial and error, policy experimentation, and iterative adjustment.

Finally, Iversen and Pontusson (2010) show how labour market dualism produces divergent outcomes for insiders and outsiders, with coordination institutions shaping distributive consequences. Their analysis implies that the same institutional configuration can simultaneously enhance efficiency for some agents whilst generating welfare losses for others—a distributional dimension our framework incorporates.

## 2. The Concept of Institutional Dissipation

### 2.1 Functional Definition

An institution transforms uncertainty into order. It reduces transaction costs and provides credible commitments (North, 1990; Greif, 2006). However, because institutions structure predictable routines, they also create predictable gaps—spaces where individuals can act strategically without technically violating rules. These strategic zones become the seedbeds of dissipation. Stronger institutions raise efficiency until a threshhold; beyond it, excessive institutionalisation or entrenched predictability leaves more room for manipulation than for cooperation. Thus, dissipation marks the inflection point where stability undermines renewal.

This functional form captures the essential non-monotonicity: institutions that are too weak fail to support coordination, whilst institutions that are too rigid create exploitable regularities. The threshold betweenstrong and excesszive institutional predictability represents the optimal degree of institutional structure—sufficient to reduce uncertainty but not so rigid as to invite strategic arbitrage.

### 2.2 The Political Feedback Mechanism

Institutions are not neutral containers of rules; they are stabilised through political bargains. Political actors allocate enforcement power, define reform priorities, and internalise the costs of maintaining coherence.

Let's consider the political capacity to reinforce institutions. Dissipation accelerates when the replenishment from political will is weaker than the depletion from private adaptation:

At equilibrium, collective coherence becomes stationary: political effort merely compensates for the erosive effect of strategic adaptation.

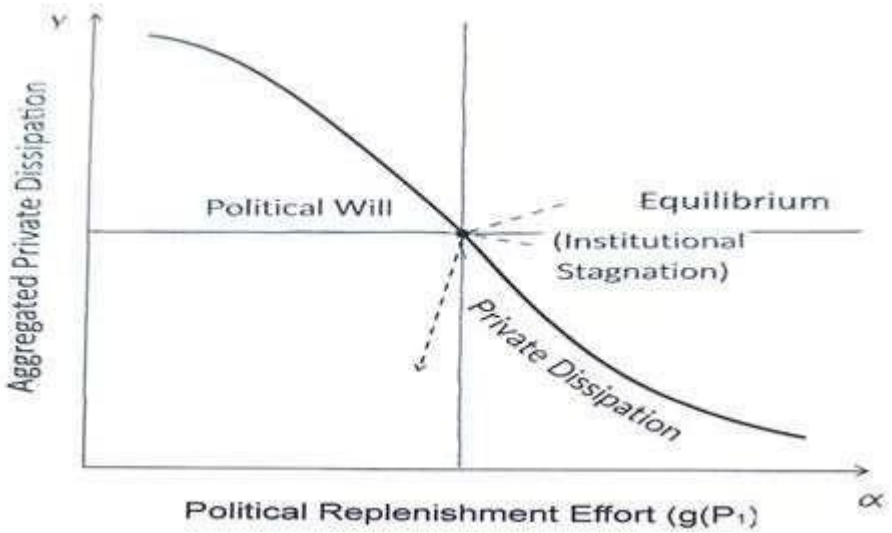


**FIGURE 2 POLITICAL REPLENISHMENT VS PRIVATE DISSIPATION**

*As shown in figure 2, the interaction of political replenishment effort and aggregated private dissipation defines the institutional stagnation equilibrium.*

This dynamic exhibits an important property: higher aggregate private efficiency accelerates institutional decay unless political replenishment increases commensurately. In systems where political

capacity is constrained—by fragmentation, polarisation, or capture—the equilibrium institutional quality may settle at a level well below the social optimum.

## 3. Agents, Firms, and Government: Decisions and Constraints

To ground the theory in microeconomic foundations, we now characterise the decisions and constraints facing the three principal categories of actors: households (agents), firms, and government.

### 3.1 Households

Households maximise utility over consumption (CO), leisure (Le), and a public good (representing institutional quality or social infrastructure) (PG):
*MaxHouseholds=Max (CO, Le, PG)*
subject to a budget constraint (BC):

$$BC=W\text{-}L\text{-}CO\text{-}TR\text{-}T$$

where W denotes the wage, Le : leisure, TR : the tax rate, and T : for transfers.

In a well-functioning institutional environment, households can take their valuation for public goods as exogenous and focus on private optimisation. In a dissipative equilibrium, however, households observe that this valuation responds weakly to their contributions (via taxes or civic engagement), leading them to discount public goods and concentrate on private accumulation or adaptation strategies. This behavioural shift—bounded resignation—reinforces dissipation.

### 3.2 Firms

Firms maximise profits subject to production and institutional constraints. Output depends on capital (Ca), labour (La), and an institutional efficiency parameter (IEP)

$$Output = f(Ca,La, IEP)$$

Profits are:
*$\pi$= Revenue-output-cost of labour-compliance costs or the costs of navigating institutional imperfections.*
where the efficiency parameter (IEP)represents compliance costs.

Firms face a strategic choice: invest in productive efficiency or invest in adaptive efficiency by learning to exploit institutional gaps. In constructive systems with high compliance costs, productive investment dominates. In dissipative systems with low or declining compliance costs, adaptive investment yields higher returns, diverting resources from innovation to rent-protection.

This distinction parallels North's (1990) concept of adaptive efficiency but with a crucial difference: here, adaptation becomes *private* rather than *collective*. Firms optimise for stability of rent within the existing institutional configuration rather than contributing to institutional improvement.

This stability is also associated with a coevolution of institutions and technology (Acemoglu & Robinson, 2019; Aghion et al., 2021).

### 3.3 Government

Government chooses tax rates, public investment, and regulatory enforcement to maximise a social welfare function subject to fiscal and political constraints:

*Max Social Welfare = Lim TR (Tax rate) + lim political weights that may diverge from equal welfare weights + lim the cost of maintening institutional quality.*

Government faces two key trade-offs. First, raising tax rate fund valuation for public goods distorts labour supply and may reduce the tax base. Second, maintaining high costs of maintaining institutional quality requires expenditure on enforcement, monitoring, and reform—resources that could alternatively fund transfers or visible public goods with more immediate political returns.

In dissipative systems, governments confront a political economy problem: the beneficiaries of institutional dysfunction are concentrated and organised, whilst the beneficiaries of reform are diffuse. Olson's (1982) logic of collective action predicts that reform coalitions will be difficult to assemble. Moreover, if households and firms have adapted to low $\phi$, the perceived disruption costs of reform may exceed the perceived benefits, even when reform would raise aggregate welfare.

Rodrik, 2020 suggests that the role of the government cannot be understood independently from the institutional context that enables or constrains its interventions. The idea of an institutional adaptability captures this dynamic ability to modify regulations, norms, and governance practices in response to economic transformation.

## 4. Private Efficiency and the Politics of Adaptation

### 4.1 Adaptive Efficiency versus Institutional Efficiency

North (1990) characterised adaptive efficiency as a positive trait—the capacity to evolve institutions to meet new challenges. In dissipative systems, however, adaptation becomes private rather than collective. Actors optimise for stability of rent, not for improvement of rules.

This implies that policy reforms often encounter paradoxical resistance from precisely those sectors displaying high micro-efficiency: firms, bureaucracies, or local elites that have mastered the imperfections of the system. Their private efficiency depends on the persistence of institutional dysfunction; reform threatens their acquired advantages.

Hall and Soskice (2001) observe that firms in CMEs develop specific assets—skilled workers, relational contracts with suppliers, patient capital—that depend on the surrounding institutional infrastructure. By extension, firms in dissipative systems develop *adaptive assets*: expertise in regulatory arbitrage, relationships with enforcement authorities, or informational advantages about institutional gaps. These assets are valuable only so long as the dysfunction persists.

### 4.2 Dynamics of Political Bargaining

Let political power PP mediate the allocation of institutional resources. In inclusive systems, PP diffuses through representation; in extractive systems, it concentrates. In dissipative systems, power oscillates—fragmented but resilient, producing an equilibrium of distributed capture.

In this equilibrium, each group's short-term optimisation stabilises the broader configuration, even if welfare stagnates. Reform is improbable not because it is technically complex but because every participant has discovered a micro-path of efficiency within macro-inefficiency.

This pattern exhibits features of what Greif (2006) terms a *self-enforcing equilibrium*: no individual actor has an incentive to deviate unilaterally, even though all would benefit from coordinated deviation. The political bargain sustains the dissipative equilibrium because renegotiation would require simultaneous commitment from multiple veto players, each of whom fears being disadvantaged in the transition.

## 5. Formalisation of the Mechanism

We can describe the relationship between private efficiency and aggregate welfare as an outcome of two interacting functions. Let firm-level output efficiency be represented by FLOE

*FLOE = f(intensity of private incentives and institutional parameters conditioning those incentives (labour coordination, capital allocation norms, regulation*). Aggregate welfare is given by:

*Aggregate Welfare=g(Ep,ϕ,θ),W = g(behavioural and distributive parameters such as trust, confidence, and public investment orientation).*

In a frictionless market model with neutral institutions, additional firm level efficiency produces positive returns

Under institutional distortion or weak coordination, we may observe that additional firm-level efficiency produces diminishing or even negative social returns. This non-monotonic relationship constitutes what we call *institutional dissipation of output*.

Hence, macro welfare depends not solely on private efficiency but on the alignment of institutional and behavioural parameters that mediate aggregate conversion. Comparative differences among capitalist varieties can thus be interpreted as variations in the slope offering a testable prediction across regimes.

## 6. Comparative Typology of Political Economies

### 6.1 Constructive, Dissipative, and Collapsing Economies

Table 1 : Comparative typology of Political-Economic Systems

| **Type of systems** | **Empirical Exemple** | **Marginal effect of reforms** | **Nature of efficiency** |
|---|---|---|---|
| Constructive | South Korea (1970s-1980s) | Highly positive | Collective and cumulative |
| Dissipative | Mexico (1990s-2010s) | Weakly positive adaptative | Private & adaptative |
| Collapsing | Venezuela (2000s) | Negative | Survival/ Informal |

*Note : Each system embodies a distinct alignment between institutional coherence and private efficiency*
*Details of table 1 consider 3 types of systems :*
*In a constructive system, cumulative efficiency produces a positive marginal effect of reforms.*
*In a dissipative system, private and adaptative efficiency give a small marginal effect of reforms.*
*In a collapsing system a survival efficiency is correlated negatively with reforms.*
We distinguish three archetypal phases:

1. Constructive economies exhibit positive feedback between private efficiency and institutional quality. Firms invest in productive capacity; governments invest in public goods; households contribute to collective institutions. The VoC literature focuses primarily on this phase, comparing how different institutional architectures generate distinct constructive equilibria.
2. Dissipative economies exhibit decoupling between private efficiency and aggregate welfare. Firms redirect investment toward adaptive strategies; governments struggle to fund institutional maintenance; households withdraw into private adaptation. Institutional quality erodes gradually whilst measured productivity may remain stable or even rise.
3. Collapsing economies exhibit rapid institutional breakdown. The accumulated erosion of dissipation reaches a tipping point; coordination failures cascade; exit (in Hirschman's (1970) sense) dominates voice. This phase is relatively well understood; our contribution lies in illuminating the preceding dissipative phase.

These archetypes are not discrete categories but phases within a common dynamic trajectory. Political economies can migrate from construction to dissipation as institutions become too predictable and power too segmented.

### 6.2 Comparative Lessons

South Korea illustrates how dissipation pressure can be counterbalanced through selective renewal. Strong state direction combined with feedback from private producers permitted periodic restructuring of industrial policy. The state retained sufficient autonomy to impose costs on incumbent firms whilst channelling resources toward emerging sectors. This pattern reflects what Evans (1995) terms *embedded autonomy*: the state maintains close ties with business but preserves the capacity for independent action.

Mexico reveals adaptation without renewal. Following the reforms of the 1980s and 1990s, private actors mastered the imperfections of the liberalised system—regulatory capture, labour market informality, concentrated market structures—without pressure for further institutional improvement. Productivity growth stagnated even as macroeconomic indicators stabilised, a pattern consistent with dissipative equilibrium.

Scandinavian systems exhibit continuous repairability. Transparency and encompassing interest organisations ensure that dissipation triggers reform before decay becomes entrenched. The Swedish and Danish cases demonstrate how active labour market policies, coordinated wage bargaining, and universal social services sustain the positive feedback loop between private efficiency and collective welfare. Iversen and Pontusson (2010) document how these systems have adapted to globalisation whilst preserving egalitarian outcomes—evidence of constructive institutional adaptation.

## 7. The Adaptive Loop and Self-Reinforcement

Figure 3 : The Adaptative Trap

| | |
|---|---|
| Institutional Imperfection→ | Strategic Adaptation ↓ |
| Institutional Entrenchment↑ | Increased Private efficiency← |

*The adaptative trap illustrates how individual efficiency can reinforce collective disfunction*
*As shown in figure 3, the adaptatrive trap illustrates how individual efficiency can reinforce collective disfonction.*

The adaptive reaction to imperfection breeds further rigidity. This cycle can be summarised as:

1. Institutional imperfection emerges (through exogenous shock or endogenous decay).
2. Strategic adaptation: private actors discover profitable responses to imperfection.
3. Rise in private efficiency: adaptive strategies yield measurable gains for those who master them.
4. Entrenchment of imperfection: beneficiaries of adaptation resist reform; political capacity is absorbed by managing dysfunction.

The cycle returns to stage, now with a lower baseline of institutional quality.

Breaking the loop requires an external shock or a reconceptualisation of governance that rewards experimentation rather than mastery of loopholes. Rodrik (2007) emphasises the importance of *policy experimentation*—institutional arrangements that encourage local innovation and permit controlled failure. In dissipative systems, however, the incentive structure discourages experimentation: actors who have invested in adaptive assets prefer the predictable inefficiency of the status quo to the uncertain outcomes of reform.

## 8. Empirical Implications

Although our framework is primarily theoretical, it offers clear empirical predictions testable with cross-national comparative data. The model posits that institutional dissipation arises when the marginal effect of firm-level efficiency on aggregate welfare becomes non-positive once institutional coordination falls below a critical threshold.

To evaluate this, one can estimate a reduced-form specification:

Wi=α+β1(aggregate welfare outcomes in country)+β2(disposable income equality, public investment ratios, or social expenditure share )+β3(private efficiency, labour productivity, total factor productivity, or firm-level return on assets) + β4 institutional coordination (wage bargaining centralisation, vocational training coverage, or regulatory quality indices)

A negative interaction term would support the prediction of institutional dissipation, indicating that high micro-efficiency erodes social welfare when institutional mediation is weak. Data from the OECD, World Bank, and Luxembourg Income Study permit systematic cross-country testing of this Relationship over time.

By connecting the comparative typologies of varieties of capitalism with quantifiable efficiency–welfare gradients, the theory opens a path for empirical validation consistent with mainstream econometric standards.

## 9. Theoretical and Policy Implications

### 9.1 Beyond the Inclusive–Extractive Dichotomy

Dissipation adds a temporal dimension to institutional economics. What appears inclusive at one stage can evolve into a dissipative equilibrium later without ever crossing into outright extraction. The economy appears healthy, but vitality is replaced by competence in navigating decay.

Acemoglu and Robinson (2012), Aghion (2021) rightly emphasise the importance of inclusive institutions for long-run growth, but their framework is better suited to explaining cross-sectional differences and dramatic transitions (colonisation, revolution, state formation) than gradual erosion within nominally inclusive systems. Our contribution is to theorise this intermediate zone: systems that are neither extractive nor vigorously inclusive but rather stagnant amid apparent stability.

### 9.2 Informational and Behavioural Channels

Beliefs about reform feasibility shape incentives. When citizens internalise that "this is how the system works," collective learning ceases, and adaptive routinisation becomes rational. Akerlof and Shiller (2009), Rodrick (2020) document how narratives shape economic behaviour; in dissipative systems, the dominant narrative emphasises the futility of reform and the prudence of private adaptation.

Dissipative systems are therefore held together less by coercion than by *bounded resignation*. Unlike extractive systems, which require active repression, dissipative systems sustain themselves through the rational pessimism of their participants. This mechanism helps explain why dissipative equilibria can prove remarkably stable even in the absence of overt authoritarian control.

### 9.3 Policy Framework

Table: 2 Policy framework to Counter Institutional Dissipation

| **Policy domain** | **Proposed mechanism** | **Expected impact** |
|---|---|---|
| Governance | Reversible transparency mechanisms | Faster institutional self correction |
| Innovation | Conditional subsidies linked to collective reforms | Alignment of public and private returns |
| Civic Education | Revilalization of public ethos | Reduction of adaptative ability |

*Note : effective anti-dissipation strategies reduce the payoff of adaptative efficiency relative to reform effort.*

*Table 2 explains why effective anti-dissipation strategies reduce the payof of adaptative efficiency relative to reform effort.*

Effective anti-dissipation policies reduce the payoff of adaptive efficiency relative to reform effort. Potential interventions include:

- Transparency requirements that expose institutional gaps and reduce the informational rents of insiders.
- Sunset clauses that prevent indefinite entrenchment of regulatory provisions.
- Encompassing institutions that aggregate interests broadly, reducing the fragmentation that sustains distributed capture.
- Mission-oriented public investment (Mazzucato, 2018) that provides focal points for coordination and demonstrates the feasibility of collective action.

Active labour market policies that reduce the dualism between insiders and outsiders, broadening the coalition for institutional improvement.

The capacity to test these relationships empirically reinforces the theoretical significance of institutional dissipation. Cross-country variation in the slope of the efficiency–welfare relationship can reveal how institutional configurations amplify or absorb dissipation effects. This empirical pathway connects our theoretical construction to concrete policy interpretation, enabling future research to identify the institutional thresholds at which private efficiency ceases to aggregate into collective prosperity.

## 10. Conclusion

Institutions fail not by collapse but by slow dissipation. They remain administratively present yet lose their generative power. Private actors, being adaptive by nature, fill this vacuum with ingenuity—redirecting creativity from production to survival, from cooperation to navigation.

The comparative theory advanced here interprets political economies as systems oscillating among three logics: construction, dissipation, and collapse. The key contribution lies in restoring fluidity to institutional economics—reconnecting micro-efficiency with macro-fragility and situating both within a framework that specifies the decisions and constraints facing agents, firms, and governments.

Ultimately, the challenge for governance is to institutionalise flexibility without incentivising complacency. A well-designed political economy must permit individuals to be efficient *for* the system, not merely *within* its inefficiencies.

That is the central paradox of institutional dissipation: the more perfectly we adapt to imperfection, the less we remember how to improve.

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