palgrave macmillan

The Political Economy of Industrial Policy

Ha-Joon Chang

1 Theories of State Intervention: A Review of the Literature

INTRODUCTION

The role of the state in the capitalist economy has been one of the most controversial issues in economics since the birth of the discipline (Deane, 1989). Almost everyone agrees that the state has a role to play, but there is little agreement as to when and how it should act. Perhaps the reason why there is such little agreement is that state intervention is a complex phenomenon involving many contentious issues such as efficiency, morality, power, liberty and legitimacy, to name just a few.

In this chapter we organise our discussion into four parts to make this complex issue more tractable. In the first section we examine analyses of market failure which are mainly concerned with the possible failure of the market mechanism to achieve Pareto efficiency and with the state's role in overcoming such failure. Then we turn to the politico–philosphical debate on whether the state as a political entity should or should not intervene to correct the market outcome, be such correction efficient or not in some sense. Thirdly we consider the political economy – both right-wing and left-wing – literature, which asks whether it is correct to assume that the state serves some 'public' or 'social' purpose rather than individual or group interests. Lastly we examine the government-failure literature, which asks whether the state has the ability to intervene effectively, whatever its intention is.

1.1 EFFICIENCY: THE MARKET-FAILURE LITERATURE

The most developed literature on state intervention is that of market failure or welfare economics. The literature is primarily concerned with the failure of the market mechanism in equating private and social costs and benefits and with the possible correctives to such failures through state intervention.[1] We will examine three groups of arguments in this tradition, that is, public goods, non-competitive markets and externalities.

1.1.1 Public Goods

In the economics literature, goods are usually classified into two categories, that is, private and public. A private good is something that can only be consumed by those who have paid for it, whereas a public good is something that can be consumed by those who did not pay for it as well as those who have paid for it. In other words, supplying a public good to somebody means supplying it to others, not simply because it has to be 'jointly-supplied' or it has 'non-rivalness in consumption', but more importantly because it is not economically feasible to exclude the non-payers. That is, the defining characteristic of a public good is its 'non-excludability' (Olson, 1965, pp. 14–15, 38–40).[2]

Since it is possible for one to consume the good without paying for it once somebody else has paid for it, there is always an incentive to understate one's preference for a public good (Schotter, 1985, pp. 57–63). The possibility of such strategic behaviour means that public goods are likely to be underprovided due to the free-rider problem or the problem of collective action (see Olson, 1965; Hardin, 1982; Elster, 1989). In such a situation, individual rationality leads to collective irrationality, because, through individuals' attempts to maximise their own net benefits (paying as little as possible, given the benefit), everybody ends up suffering from the underprovision. Therefore, in order to provide the optimal amount of a public good, it is argued, the state needs to intervene by taxing people and providing public goods with the revenue (see, for example, Cullis and Jones, 1987, p. 19).[3]

One of the criticisms of the public-good argument is that non-excludability, the fundamental condition for a good to be a public good, cannot be regarded as permanent. According to Peacock (1979a), technological innovation can eliminate the 'publicness' of some goods by solving the problem of non-excludability. He argues that 'even in the most famous "polar case" of a public good, ways and means can be found … by which the problem of non-excludability can be solved' (p. 133). Although this is a valid point, it should not be taken as implying that technical progress will eventually solve all public-good problems (for example substitution of lighthouses with radio signals), because excludability is more a property-rights problem than a technological problem (see Note 2).

Another important criticism of the argument for state intervention based on the public-good consideration is that it does not necessarily justify state intervention.[4] That is, even if there is a public (collective) good, it is not clear whether the 'collectivity' to provide it should be the state. As Olson (1965) argues, in a small group, optimal public-good provision may be achieved without state intervention because in a small group it is likely that there are individual members who gain so much benefit from the public good concerned that they are better off providing the good unilaterally (pp. 43–52). And even in a large group where this condition does not obtain, state intervention is not always necessary. Public goods may be optimally provided even in a large number setting, if some 'selective incentives' (Olson, 1965) in the form of private goods provided by 'political entrepreneurs' (Popkin, 1979) can overcome the free-rider problem by bringing individual cost/benefit structures in line with the social (or group) cost/benefit structure. Of course these arguments do not allow us to conclude that the public-good problem can always be solved by private initiatives. In many cases, the use of coercion by the state (for example taxation) may be the only possible way to resolve the problem.[5]

1.1.2 Non-Competitive Markets

The existence of scale economies and/or collusive behaviour can result in non-competitive market structures, where individual producers' decisions can affect the quantity and price in the market. When monopoly or oligopoly prevails in a market, the quantity of goods supplied is smaller than in the competitive context, as firms face negatively sloped demand curves.[6] Thus, in a non-competitive market, some consumer surplus will be transferred to firms in the form of 'monopoly profit', and such a transfer will impose a 'deadweight loss' to society (the Marshallian triangle). In this case, it is argued, it is justifiable for the state to intervene to guarantee the optimal output, that is, the output which would have been provided in a competitive setting.[7] Anti-trust legislation, which may involve the regulation of pricing and the breaking up of existing monopolies, is the most frequently used interventionist measure in this regard, but public ownership is another commonly practised and probably more powerful measure.[8]

A powerful argument against state intervention to 'correct' non-competitive markets is that based on the theory of 'second best' (Lipsey and Lancaster, 1956), which points out that rectifying monopolistic situations (or any other price distortion) in some, but not all, markets may not necessarily improve the efficiency of the economy. On the basis of this theory, anti-interventionists argue that no gain is guaranteed by anti-trust intervention which does not eliminate 'distortions' from all markets (Peacock and Rowley, 1979a). However this argument does not discredit fully the interventionist argument because the theory of second best does *not* imply that there can be no gain from such intervention, only that it is not guaranteed. Actually the theory of second best may be used as an excuse for wholesale state intervention, because no global optimality is attainable without letting all the other markets depart from their local optimal conditions.

Another anti-interventionist argument related to non-competitive markets is that state intervention is one major source of such outcomes. For example, Friedman (1962) argues that, '[m]onopoly frequently, if not generally, arises from government support of collusive agreements among individuals' (p. 28). The implication, then, is that the state should stop meddling with the market if it is serious about correcting distortions in non-competitive markets. In the words of Mises (1979), '[i]t is absurd to see the government ... point its finger at business, saying: "There are cartels, therefore government interference with business is necessary". It would be much simpler to avoid cartels by ending the government's interference with the market – an interference which makes these cartels possible [such as protectionism]' (p. 52). Although there can be no doubt that state-administered entry barriers are often sources of monopoly, it should be pointed out that many, if not all, initially competitive markets – through business cycles, structural changes or even sheer luck – have been transformed into non-competitive ones without collusion or state intervention.[9] Indeed, if the assumption of self- perpetuating competitive markets is unrealistic, it may be pointless from the public-policy point of view to argue for or against state intervention in monopolistic markets, since there is no criterion according to which they are to be corrected other than the fictitious perfectly competitive market (Demsetz, 1964).

1.1.3 Externalities

One of the assumptions in textbook economics is that each individual has only to consider his/her own means and ends. Technically speaking, individual preference systems (or utility functions) and production functions are independent from those of others. Externalities exist where there are some spill-over effects from an individual's activities to those of others, leading to a discrepancy between the private cost/benefit structure and the social cost/benefit structure. Of course, interdependence among individual activities cannot be a problem *in itself*, but where its effects are not properly compensated for there arises an 'untraded interdependence' (Nath, 1973, p. 43), namely externality.

At least in principle, it may be possible to overcome this problem by defining property rights more precisely and having negotiations between the parties affecting and affected (for example the owner of the smoke-spewing factory compensating housewives living nearby who have to spend extra time and money on laundry). However, in many cases, it is economically impossible to do so, because of the transaction costs involved in information acquisition, negotiation and contract enforcement (Coase, 1960; Stigler, 1975, pp. 106–7; Dahlman, 1979). In the absence of such a 'property-rights' solution, the state is justified in ensuring the provision of goods with externalities in socially optimal amounts through other means. State provision of goods with positive externalities at subsidised prices (for example education, health, social infrastructure), subsidisation of those who create positive externalities (for example, subsidies to R&D), and taxation of those who create negative externalities (for example pollution tax), are examples of state intervention on externality grounds.

Some anti-interventionists try to dismiss the externality argument for state intervention by assuming that the magnitudes involved are negligible. However, as Baumol (1965) and others have pointed out, the list of externalities can be extended almost infinitely. Most goods create some negative externalities in their production processes in the form of pollution, except in those few cases where proper compensation is made. When considering linkage effects (Hirschman, 1958, ch. 6) or pecuniary externalities (Scitovsky, 1954), many goods may additionally be classified as having positive externalities. Some economists even argue that some goods that have conventionally been treated as lacking externalities, say basic foodstuff, can be seen as creating externalities when they are not consumed in the proper amount and therefore induce crime (Schotter, 1985, pp. 68–80). Moreover, there exists interdependence between individual preferences. For example, people have what Elster (1983, ch. 2) calls counteradaptive preferences – 'the grass is always greener on the other side of the fence'. The psychology of luxury-good consumption – part of one's pleasure derives from the fact that one consumes what others do not – is another example of interdependent consumer preference. Indeed once we begin to accept the pervasiveness of externalities, it seems questionable whether we are justified in having market transactions at all. The important issue here is not whether externalities exist or not, but to explore under what conditions market transactions will be (or should be) adopted and under what conditions non-market institutions, including state intervention, will be (or should be) adopted, as new institutional economics has recently tried.

Some other anti-interventionists argue that correcting one set of externalities leads to another. Friedman (1962), for example, has grave reservations about state intervention based on the externalities argument – the 'neighbourhood-effects' argument as he calls it – pointing out that: (a) it will in part introduce an additional set of neighbourhood effects by failing to charge or to compensate individuals properly; and (b) it creates externalities in the form of 'threatening freedom' (p. 32). This is unconvincing since: (a) whether the gains from eliminating existing externalities are smaller than the losses from the newly-created externalities cannot be determined *a priori;* and (b) unsolved externalities also mean the limiting of someone's freedom – the *affecting* in the case of positive externalities, the *affected* in the case of negative externalities – because one party has the desire to trade but cannot (recall that externalities are untraded interdependences).[10]

1.2 MORALITY: PATERNALISM AND CONTRACTARIANISM

In the previous section we discussed the market-failure argument, the most important element in the traditional argument for state intervention. Another important element in the traditional interventionist argument is the moralistic argument that the state, as a representative of the members of society, may intervene in the market, if necessary, at the cost of efficiency. Can this argument be justified?

1.2.1 Paternalism and Contractarianism

The moralistic argument for state intervention usually takes two forms. Firstly, it is argued that the state may intervene in the provision of 'merit goods', which are 'goods the provision of which society (as distinct from the preferences of the individual consumer) wishes to encourage or, in the case of demerit goods, to deter' (Musgrave and Musgrave, 1984, p. 78). Secondly, state intervention may also be justified if society believes that market-type transactions are not morally acceptable in some areas, for example blood donations or police services. In this case, the argument goes, the state, as the social guardian, should remove such activities from the domain of the market and conduct them itself.

The above argument is often branded as paternalism by those who believe in methodological individualism and its politico–philosophic counterpart, contractarianism (for an exposition of contractarianism, see Nozick, 1974). From the methodologically individualistic point of view, the above argument is flawed in that it attaches an independent will to society, which is no more than a collection of individuals. From this politico–philosophic point of view, the belief that the state should decide on what individuals should produce and consume and in what ways is a first step on 'the road to serfdom' (Hayek, 1972).

Those who believe in individualism–contractarianism argue that 'the individual and not the group should be the basic repository of rights and obligations' (Schotter, 1985, p. 18). Thus it is believed that 'individuals should be allowed, within defined limits, to follow their own values and preferences rather than somebody else's. ... It is this recognition of the individual as the ultimate judge of his ends, the belief that as far as possible his own views ought to govern his action, that forms the essence of the individualist position' (Hayek, 1972, p. 59). Of course, this position 'does not assume, as is often asserted, that man is egoistic or selfish or ought to be' (Hayek, 1972, p. 59). However, no other person or authority can impose his/her or its own ethical judgement on the individual, since the individual knows best what his situation is and what his best option in that situation is. Any interference with the making of individual decisions is seen as violating the innate right to freedom of the individual (Hayek, 1972, 1988; Mises, 1929, 1979; Friedman, 1962).

If we do not, or rather should not, introduce any exogenous ethical code other than that of the individual being the judge of his/her own destiny, contractarianism, whether of the Hobbesian or the Rawlsian variety, becomes the only consistent view of the state, or more generally, of politics. As Buchanan says, 'if politics is to be interpreted in any justificatory or legitimatising sense *without the introduction of supra-individual value norms* [emphasis added], it must be modelled as a process within which individuals, with separate and potentially differing interests and values, interact for the purpose of securing individually valued benefits of cooperative effort. If this presupposition about the nature of politics is accepted, the ultimate model of politics is *Contractarian* [emphasis original]' (Buchanan, 1986, p. 240). The ideal state is then the product of voluntary contracts between free individuals who found some potential gains in restricting the unfettered exercise of the individual free will of other individuals and of their own. Contractarianism in its most consistent form should be based on the unanimity rule. Otherwise, however fair the outcome of a politico–economic system may appear from some other point of view, it cannot be justified from the contractarian viewpoint. Imposing a decision on individuals (which is bound to happen except under the unanimity rule) violates the fundamental principle that individuals should be free to make contracts and not be coerced into any transaction, however beneficial it may appear to an outsider.

1.2.2 What should the State do?

On the basis of individualism–contractarianism, it is argued that any state intervention other than some (rather ill-defined) minimal functions is illegitimate because it violates individual freedom as the ultimate value in human society. Indeed, according to Peacock and Rowley (1979b), what they term 'liberalism' is to be 'prepared to trade off economic efficiency for individual freedom where such a policy conflict becomes apparent' (p. 26).[11]

Mises (1979) categorically states that 'the government's only legitimate function is ... to produce security' (p. 40). To him, any interventionist attempt is doomed to invite in more and more intervention, if the state is serious about achieving its original purpose, leading inevitably to socialism. There is no such thing as 'the third way' (Mises, 1929, 1979).

Hayek (1972) argues that state intervention, except in areas that can be justified on contractarian grounds *plus* some 'even-handed' interventions in non-exchange economic activities (for example production activities), is bound to erode individual freedom. Competition (and its prerequisite, freedom of entry) is seen as the best means of coordinating the economy 'not only because it is in most circumstances the most efficient method known but even more because it is the only method by which our activities can be adjusted to each other without coercive or arbitrary intervention of authority' (Hayek, 1972, p. 36). That is, state intervention is objectionable not only because it is inefficient but mainly because it violates the fundamental values of individualism and hence of contractarianism.[12]

Buchanan (1986) gives a typology of the state functions that can be justified on contractarian grounds. According to him there are three levels of collective action. At the first level are activities involving enforcement of the law. The role of the state here is that of an umpire of a game. The second level involves collective action within the limits of existing laws. Here the role of the state is the financing and provision of public goods and services. The third level involves changes in the law itself, namely changes in the rules of the game. Unless there is a unanimous case for changes in the basic rules of the game of society, the role of the state should be either the enforcement of the rules of the game – namely the protection of property (and human?) rights and the enforcement of voluntary contracts – and the provision of special goods and services whose private provision will be suboptimal from the social point of view – namely the provision of public goods.

Friedman, usually known as *the* anti-interventionist economist, states that '[t]he role of government ... is to do something that the market cannot do for itself, namely, to determine, arbitrate, and enforce the rules of the game' (Friedman, 1962, p. 27). This view is similar to that of Buchanan, but in fact Friedman is much more generous, if more vague, about state intervention than the strict contractarians cited above. His list of legitimate functions of the state is as follows: maintenance of law and order, definition of property rights, service as a means whereby people modify property rights and other rules of the economic game, adjudication of disputes about the interpretation of the rules, enforcement of contracts, promotion of competition, provision of a monetary framework, engagement in activities to counter technical monopolies and to overcome neighbourhood effects widely regarded as sufficiently important to justify government intervention, supplementation of private charity and the private family in protecting the irresponsible, whether madman or child (Friedman, 1962, p. 34).

1.2.3 Some Reflections

Denouncing any moral judgment other than those based on narrowly defined individualism, as contractarian economists tend to do, is as meaningless as citing moral reasons for state intervention without discussing the role of morality in our social and economic life (McPherson, 1984). Individualism is not a 'scientific' point of view which can do without morality, as is frequently contended (for example Friedman, 1962), it is no more than a particular form of morality.

Methodological individualists assume that each individual knows best his/her interest and the constraints he/she faces. This view is not without its problems. First of all there are individuals who even contractarians do not regard as wholly responsible (for example, madmen and children), but the borderline between 'normal' and 'abnormal' is ambiguous, as even Friedman admits (Friedman, 1962, pp. 33–4). And, more importantly, who has the right to decide who is responsible and who is not, if there should be no supraindividual value? Secondly, there is 'no intrinsic reason why individuals should always pursue their own good or why they will always do so better than others can do it for them' (Freeden, 1991, p. 89). As Goodin (1986) notes, people make decisions on incomplete information, ignorance of their future preferences, ignorance of the full consequences of their own actions, deceptive decision frameworks, the desire to avoid responsibility for risks. The existence of implicit preferences for preferences (for example reckless drivers and drug addicts are not to be seen as acting in their best interests) is another case in point. In such situations it is not clear whether we should regard individual decisions as the manifestation of their preferences, and therefore argue against all intervention.

In contractarian philosophy it is argued that the state cannot be regarded as being 'above' individuals, since it is a product of free contracts between independent individuals. Contractarians hypothesise a 'state of nature' where all individuals are free to make contracts but are involved in a state of war against everybody else, which leads to the need for the imposition of an extra-individual authority, through voluntary contracts, in the form of the state.

This 'state-of-nature' scenario is of course a fiction. During the history of mankind, the choice has been the one between one form of authority and another, and not the one between anarchy and authority, as the contractarians put it (for example Nozick, 1974). Even a cursory look at the history of the last few centuries reveals that the building of the modern state was largely initiated by rulers, and not by freely-contracting individuals (Poggi, 1990). Moreover it is in contradiction to historical truth to argue that market-type transactions brought about the state – the opposite view is more correct. The market in its present form is a newer form of social institution compared with other forms, including the state. As Polanyi (1957) persuasively puts it, historical experience shows us that:

> [t]he road to the free market was opened and kept open by *an enormous increase in continuous, centrally organised and controlled interventionism* [emphasis added]. To make Adam Smith's 'simple and natural liberty' compatible with the needs of a human society was a most complicated affair. Witness the complexity of the provisions in the innumerable enclosure laws; the amount of bureaucratic control involved in the administration of the New Poor Laws which for the

> first time since Queen Elizabeth's reign were effectively supervised by central authority; or the increase in governmental administration entailed in the meritorious task of municipal reform .... Administrators had to be constantly on the watch to ensure the free working of the system. Thus even those who wished most ardently to free the state from all unnecessary duties, and whose whole philosophy demanded the restriction of state activities, could not but entrust the self-same state with the new powers, organs, and instruments required for the establishment of *laissez-faire* (p. 140).

Of course most contractarians are not so silly as to believe in the 'state of nature' as a historical reality. Buchanan argues that the contractarian argument is an *ex post* conceptualisation or legitimisation of the political process as a complex exchange relationship and not an *ex ante* moral justification of the existing political order (Buchanan, 1986, p. 247). He thus admits that the contractarian argument is not based on actual history but on some arbitrary belief.[13] Nozick (1974) tries to defend the state-of-nature type explanation by saying that '[w]e learn much by seeing how the state could have arisen, even if it did not arise that way. If it did not arise that way, we also would learn much by determining why it did not; by trying to explain why the particular bit of the real world that diverges from the state-of-nature model is as it is' (Nozick, 1974, p. 9). This is peculiar logic. Since it is definitionally impossible that two or more different end-states arise through the same process, it is hardly justifiable to introduce one of them as a 'potential explanation' (as Nozick calls it) of the other. Of course there may be some heuristic value in the exercise, but this advocacy based on heuristic value can only be fully justified when the 'as if' explanation is complemented by the 'as it was' one, unless it can be shown precisely why the 'as if' explanation is superior to the 'as it was' one.

More importantly, contractarianism does not necessarily guarantee a minimal state. For example, if there is a unanimous belief among the members of society that market-type transactions are not morally acceptable in some areas (for example blood donation, defence), taking such activities out of the market may be justified even from the contractarian point of view. That is, what if the individuals in the society gather together to write a new social contract that endorses an interventionist state?[14] It is not satisfactory to argue for a minimal state on the assumption that individuals will opt for a minimal state if they are given a chance, unless we can show that individuals are wealth-maximisers (a common assumption in economics, but nothing more than an assumption) and that the free market will ensure them the maximisation of their wealth (a proposition that has been proven problematic by welfare economics).

1.3 INTENTION: THE POLITICAL ECONOMY LITERATURE

The political-economy viewpoints, both on the left (for example the Marxists) and the right (for example the Chicago school) of the political spectrum, have for long criticised the market-failure approach for too readily assuming that the state will act like Plato's Philosopher King. That is, is it the intention, or the objective, of the state to serve the public? Below, we will examine three arguments questioning such assumptions, namely the autonomous-state approach, the interest-group approach and the self-seeking-bureaucrats approach.

1.3.1 The Autonomous-State Approach

The view that the state should be regarded as 'a dynamic independent force' (Findlay, 1990, p. 195) with its own objective function that is distinct from that of the society as a whole is not new. A stream within the Marxist tradition, originating from Marx's *Eighteenth Brumaire of Louis Bonaparte* (Marx, 1934), has recognised that a certain state may acquire an 'autonomy' from society, if no class is powerful enough to impose its will on the state (for example, Alavi, 1972).[15] One strand in the recently popular 'neoclassical political economy' goes a step further and characterises the state as a 'predator', which, acting as a discriminating monopolist, develops a property-rights structure and a tax system which maximise its 'profit' or net revenue (tax minus expenditure), if necessary at the expense of social productivity.[16] Of course neoclassical political economy recognises that revenue-maximisation by the state is an exercise in constrained maximisation, since the threat of takeover by an alternative ruler from within or without the country imposes a competitive constraint (see North, 1981, ch. 3; Findlay, 1988; Eggertsson, 1990, ch. 10).

The view that the state may act as an entity with its own will (and greed) is a useful antidote to the naive assumption of welfare economics that it will correct market failures as soon as it finds them. Moreover, when the traditional interest-group approach has treated the state as a black box in which interest groups feed their policy inputs, resulting in some disappointingly simplistic policy implications, there seems to be some value in seeing the state as an autonomous entity (Skocpol, 1985; also see 1.3.2 below). However the approach is not without its problems.

First of all, the approach treats the 'autonomous' or 'predatory' state as a unified entity. As recognised even by one of the earlier proponents of the predatory-state approach, the richer institutional context of the modern polity with a bureaucracy and (frequently) a working legislature makes it difficult to apply this simplistic model to an analysis of real-life examples (North, 1990a). In fact the most distinctive characteristic of the modern state is the development of institutional bounds on *arbitrium* (Poggi, 1990, pp. 74–6). In particular, the 'necessity of developing agents (a bureaucracy) to monitor, meter, and collect revenue' (North, 1990a, p. 190) introduces a complication in the form of a conflict of interests between the ruler, who wants to maximise net revenue, and the bureaucrats, who want to maximise the budgets of their own bureaux (see 1.3.3 below for further discussion).

Secondly, talking of state autonomy in the abstract is not very helpful for the understanding of real life problems. Whether we call a state autonomous or not should depend on what issues we are interested in. First, one may wish to investigate the effect of their different degree of autonomy on the actions of different states (for example the Taiwanese state is more autonomous than the Indian state) or the same state at different points of time (for example, the Japanese state in the late nineteenth century was more autonomous than it is now; the Singaporean state may become less autonomous in the future than it has been under Li Kwan Yew). Second, different states may have different degrees of autonomy in different areas. For example the Swedish state may be less autonomous than the Korean state in influencing investment decisions of capitalists, but may be more autonomous in taxing them. Whether or not one should assume autonomy of the state depends on the country one wants to look at, the time period one wants to study and the areas of policy one is interested in.

1.3.2 The Interest-Group Approach

Another group of arguments which question the intention of the state is what we call the interest-group approach. This approach sees the state as 'an arena within which economic interest groups or normative social movements contended or allied with one another to shape the making of public policy decisions' about 'the *allocations* of benefits among demanding groups' (Skocpol, 1985, p. 4).[17] And, the argument goes, since the most powerful groups will be most able to affect the decisions of the state, state economic policies will be inevitably biased towards them.

The most representative of these theories is the 'regulatory-capture' theory of the Chicago school. According to Stigler (1975), the pioneer of this theory, 'regulation is acquired by the industry and is designed and operated primarily for its benefit' (p. 114) through subsidies, entry restrictions, restrictions on substitutes and subsidies to complements, and price-fixing. Political control over this process is limited by the infrequency of voting and the high cost of acquiring information on the side of the voters (Laffont and Tirole, 1988). Introducing the problem of collective action (due to Olson, 1965) in a more explicit manner, Peltzman (1976) argues that the reason why producers – rather than consumers – capture the regulatory agency is that their smaller number makes collective action easier. This version of the interest-group approach then prescribes that the best way to avoid the possibility of regulatory capture is to deprive the state of the power to regulate.

Some Marxists have argued along similar lines, although with different political connotations. They argue that the state, whose existence depends on the reproduction of the dominant mode of production in society, has to serve the interests of the economically dominant class in that society – that is, the capitalist class in the capitalist society (Miliband, 1969; O'Connor, 1973; Gough, 1979). In the simpler version of the theory, the state is seen as defending the capitalist *class* interest, if necessary at the cost of individual capitalists' interests. In this view the solution to the problem of divergence between the 'public interest' and the objectives of the state is to overthrow capitalism and therefore get rid of class divisions and relations of domination, because the public whose interest the state serves will then become the whole of society.

The interest-group approach is useful as a broad framework to understand politics, since it enables us to see how the public is not an homogeneous entity but is made up of diverse groups which struggle with each other to affect the decisions of the state. However, apart from some sophisticated Marxist versions, this approach has the following shortcomings.

First of all, many versions of the approach do not adequately discuss the problem of collective action. As was pointed out by Olson (1965), Hardin (1982) and Hindess (1987), the traditional theories of interest-group politics (both the pluralist and the Marxist varieties) have too readily assumed that all existing interests will be represented. However, even if people have identical preferences they are not necessarily able to act them out due to the difficulty of collective action. As many studies in the tradition of the theory of collective action have shown, which groups can assert their interests depends on how large the group is and whether it is feasible to devise some selective incentive/sanction scheme. In addition, the frequency and duration of the interaction among the members of the group (Axelrod, 1984; Taylor, 1987) and ideology (North, 1981) also matter for the possibility of successful collective action.

Moreover there is the problem of 'agenda formation'. It is not true that all interests can be organised once the configuration of the group is such that the free-rider problem can be overcome. How interests are represented also depends on which issues are more easily put on the public agenda. In a country at any point of time, there exist social norms (or ideologies) according to which some issues simply cannot be put on the agenda for public action, and therefore it is almost impossible to organise an interest group around such issues.[18] 'Certain kinds of argument, powerful though they may be in private deliberations, simply cannot be put in a public forum' (Goodin, 1986, p. 87), or 'although both individual material interests and the interest of particular groups and classes are still the essential forces at play in the politics ... the form in which those interests are publicly expressed and argued over allows for a real "distance" to open up between political and public debate and those interests' (Kitching, 1983, p. 61). The motivation and the capacity of the state also become important variables in determining what kinds of policy alternatives can be discussed, adopted, and implemented, because government leaders and bureaucrats often take initiatives well beyond the demands of social groups (Skocpol, 1985). In other words, the existing forms of politics, the structure of the state apparatus, the prevailing ideologies (or social norms) and so on affect what kinds of interest groups can and would be formed (see Skocpol, 1985, for a detailed discussion).

Thirdly, most versions of the interest-group approach do not adequately deal with the *process* of interest-group politics. Rather, their analysis is 'structuralist' in the sense that the outcome of interest-group politics is seen as predetermined by systemic parameters. Given such a static view of politics, it is more than natural that the proponents of the approach think that the problem of 'biased representation' could never be resolved without destroying the existing social structure (for example a return to the minimal state, the socialist revolution). However, what matters in reality is not only whether a particular social structure allows some or other group to dominate, but also the nature of the *process* of gaining such dominance – in other words, how surplus is appropriated is as, if not more, important as who gets the surplus (Khan, 1989). For example, in some South Asian countries, mobilisation of clientelist groups has become the major channel for surplus appropriation, with some detrimental consequences for capital accumulation (Bardhan, 1984, for India; Khan, 1989, for Bangladesh). Another example is Latin America, where the fractured nature of society produces a volatile pattern of capital accumulation where a growth cycle starts only to be quickly disrupted by hyperinflation and then needs a major social upheaval (for example military dictatorship, austerity programmes) to resume itself (Fishlow, 1990; Amadeo and Banuri, 1991). Interest-group politics may be properly understood only when the particular process of contest for political and economic rights in the society concerned are analysed in detail (for a seminal work in this vein, see Khan, 1989).

1.3.3 The Self-Seeking-Bureaucrats Approach

Another important critique of the 'benevolence' assumption in welfare economics is what we call the theory of self-seeking bureaucrats. The theory is based on the postulate that bureaucrats are in no sense different from other individuals in pursuing their own interests. It is absurd, the argument goes, to believe that one and the same individual will behave altruistically in the office and egoistically after office hours. It is assumed that the bureaucrats are budget-maximisers, following Niskanen's argument that '[a]mong the several variables that may enter the bureaucrats' motives are: salary, perquisites of the office, public reputation, power, patronage, output of the bureau, ease of making changes, and ease of managing the bureau. All except the last two are a positive function of the total *budget* of the bureau during the bureaucrat's tenure' (Niskanen, 1973, p. 22). Since bureaucrats derive utility from higher salaries and greater power of their bureaux, it is rational for them to maximise the budget of their bureaux rather than to optimise the social output.

Although the vote-maximising behaviour of politicians may impose some constraints on the size of the budget (because the politicians, who have to be re-elected, do not want too high taxes), the outcome is likely to be in favour of the bureaucracy. This is due to the fact that the politicians are at an informational disadvantage concerning the cost functions of the bureaux, not only because they lack the expertise to estimate such functions but also because the state bureaux are in monopolistic positions and therefore there is no criterion to gauge their efficiency (Mueller, 1979, p. 157). The politicians, even when they are public-minded, have no more power than to monitor the bureaucracy according to the crude criterion that the total costs of state expenditure should not exceed total benefits (Cullis and Jones, 1987, p. 127). It is thus argued that the bureaucrats, acting as rational and selfish agents, will produce the goods and services under state provision in more than a socially optimal quantity.[19]

The self-seeking-bureaucrats approach can be criticised on the following grounds. First of all, the scope for the realisation of bureaucratic self-interest through overprovision of public goods and services differs according to the institutional setting and the political process around the bureaucracy. For example, if bureaucrats are recruited through written sitting tests (as in Japan or Korea), it is more difficult to expand bureaux (a good way of maximising the budget) than when a higher official can easily recruit anybody he/she wants (as in some developing countries). Also, if the state acts as a 'predator' (see above), it has an incentive to under- rather than over-provide public goods and services (Eggertsson, 1990, pp. 235–6), thus mitigating the tendency of overprovision due to bureaucratic self-seeking. Even in societies where the 'principal' is the diffused public, bureaucrats are not totally free to do whatever they want. Given its claim to be a 'public' agency, the bureaucracy is more vulnerable to 'voice-type' checks – say, media criticism – than private firms are (on the concept of 'voice', see Hirschman, 1970).[20] Indeed, historically there have been institutional developments within modern states that keep bureaucrats from wielding arbitrary powers, such as: competitive exams for appointments; the auditing of expenditure; the development of the principle of equality of citizens before the law; the development of the expectation that office-holders will operate on the basis of the law, their superiors' directives and their own 'science' and 'conscience'; and the subordination of the bureaucracy to ultimate political decisions (Poggi, 1990, pp. 75–6).

More importantly, bureaucrats *can and do* act in a fashion that is not solely self-interested. Often bureaucrats think of themselves, rightly or wrongly, as the guardians of the public (or national) interest, however defined, and act to promote it. One such reason is that 'public-spiritedness', altruism, and so on are often held as a genuine principle, and not as a thin veil to disguise self-interest. As McPherson (1984) puts it, '[i]f whatever moral concerns people have are simply redescribed as peculiar forms of self-interest – she tells the truth because she'll feel guilty if she lies; she voted against the farm bill because it made her feel good to defy the "interests" – then the self-interest hypothesis becomes empty' (p. 77). The second reason is that bureaucrats (like the members of any other organisation) are constantly asked to conform to the organisational objectives of the state, which is always under some degree of pressure to promote the national or public interest.[21] Moreover, as demonstrated by the psychology literature (for example Tversky and Kahneman, 1986), decision frameworks do influence people's decisions. Bureaucrats usually face questions put in terms of public interest, which will invoke a preference-ordering that is different from that used in private decision-making situations (Goodin, 1986). And through the process of endogenous preference formation, they will develop organisational loyalty and other attitudes that differ from what is supposed in the theory of self-seeking bureaucrats (Schott, 1984, pp. 111–17; Simon, 1991).

1.3.4 Summary

As the interest-group approach emphasises, groups in society engage in struggles to ensure property rights over productive assets, to claim more resources from the state budget, and to restrict property rights and the distributive claims of other groups, and in this process, they try, and sometimes succeed, to influence the state to their advantage. Of course it would be problematic to interpret every policy as an outcome of interest-group politics because the state not only responds to interest-group demands but often takes initiatives, for good or bad reasons. In this respect the autonomous- (or predatory-) state approach, which treats the state as an entity with its own objectives, is a useful antidote. However, as was emphasised by the theory of self-seeking-bureaucrats, the state apparatus itself is made up of bureaucrats who act as agents of the ruler (the sovereign in earlier periods and the public in modern democracies). The principal-agent problem here makes it impossible to assume that the state is a unified entity without looking at individual cases in terms of the strength of the hierarchy within the bureaucracy, the independence of high-ranking bureaucrats, the prevalent ideology within the bureaucracy, the recruiting method, and so on.

There can be no presumption that the state will act in the public interest, as is usually assumed in standard welfare economics. However it is equally inadequate to employ another sweeping assumption as to the objective of the state, such as net-revenue-maximisation or budget-maximisation. What kind of objective function the state operates with will depend on: what kinds of interests can be formed and acted out as a pressure on the state; how resistant the state can be to these demands (or how 'hard', in the Myrdalian sense, it can be); what the objectives of the top politicians are; how strongly they control the bureaucracy; how strong hierarchies within the bureaucracy are; how bureaucrats are recruited; what the prevalent ideology within the bureaucracy is and how it is formed; and so on.

1.4 ABILITY: THE GOVERNMENT-FAILURE LITERATURE

In many theories of state intervention it is (implicitly) assumed that the state knows everything and can do everything. Welfare economics is an extreme case of this tendency. In welfare economics it is assumed that the state has all the relevant information for social-welfare-maximising intervention and is able to achieve what it sets out to do. The political-economy literature suffers from the same problem, albeit to a lesser degree. For example, in the predatory-state approach, although the competitive constraint put on the state is recognised, there is a strong presumption that the outcome will be in favour of the state as a 'predator'. The interest-group approach concentrates on whose objectives are imposed on the state but does not properly discuss whether the state can achieve such objectives. The same applies to the theory of self-seeking bureaucrats, where it is assumed that the bureaucrats can assert their own objectives without too many difficulties.

However, recently, the assumption of the 'omnipotent' state has been questioned by arguments which hold that, even if it is 'benevolent' and genuinely tries to improve the efficiency of the economy (although the opposite tends to be assumed among those who hold this view), the state may fail to achieve its objectives. These arguments, which we would call the government-failure literature, have two major strands. One is the informational argument, which points out that the state may be able to collect and process all the information relevant for the correction of market failures only at costs that are greater than the benefits from such correction. The other is the theory of rent-seeking, which argues that state intervention creates additional 'wastes' that may more than offset the benefits it produces. In the following we examine these two arguments, which question the ability of the state.

1.4.1 The Information Problem

When the state contemplates a policy, it needs to spend resources to collect and process information in order to formulate the possible alternatives and make a decision. Even after the policy is decided on it needs to collect and process the information necessary to monitor the compliance of lower-level bureaucrats, on the one hand, and the groups and individuals at whom the policy is targeted, on the other hand.

Part of the information problem is that of insufficient information. According to this argument, the state simply 'does not know better' about the future course of events and such informational deficiency can only be corrected at a prohibitive cost. This is a point which was already made by the Austrian school in the central-planning debate in the 1930s (see Lavoie, 1985, for a discussion of the debate).[22] According to the Austrians, even if it is theoretically possible for the planning authority to 'simulate' textbook welfare-economics prescriptions (as Oskar Lange and others have argued), the amount of information required to do so is so vast that we cannot possibly expect it to collect and process all the relevant information. Indeed the practice of central planning in socialist countries shows that the amount of information that could be processed in time for the writing of the plan is too meagre to allow a plan of even a reasonable sophistication (see Brus, 1972; Dobb, 1974; Brus and Laski, 1989).

A more important dimension of the information problem is the existence of informational asymmetry, or, in the language of modern economics, the principal-agent problem (see Stiglitz, 1987). There exist two types of informational asymmetry in relation to state intervention. Firstly, there exists informational asymmetry between the top decision-makers and the lower-level bureaucrats within the state apparatus.[23] The classic example is the prevalence of shortages in socialist economies due to the attempts of managers of state-owned enterprises to secure sufficient inputs by understating their capabilities (see Dobb, 1970, 1974; Ellman, 1989, chs 2–3). Secondly, there exists informational asymmetry between the state and the policy 'target' entities (for example firms, income groups, individuals). A good example is the existence of firms under infant-industry protection which persistently fail to grow out of their 'infancy' in many developing countries (see Bell *et al.*, 1984). Whatever its source, informational asymmetry means that the state may not be able to implement effectively its policies unless it spends enormous resources to overcome the asymmetry.

Although the information problem is a serious handicap on any attempt for the state to intervene effectively, we think that the problem can be exaggerated.

Problems of information collection and processing exist for state intervention because the rationality of individuals who make up the state apparatus is 'bounded' (Simon, 1983; also see Chapter 2.2.1). Indeed, overcoming the limitations of individual rationality is the very *raison d'être* of human organisations, including the state apparatus (Stinchcombe, 1990). If this is the case, it is unreasonable to criticise the state for having insufficient information while assuming that decision-makers in private organisations (for example firms) know everything they need to know (see Chapter 3.4.1).

Concerning the problem of asymmetric information within the state apparatus, note that the problem exists in any organisation of reasonable size, and not just within the state apparatus. The fact that large organisations, including the state, develop and function reasonably well shows that there are ways and means to mitigate the principal-agent problem, for example by designing an appropriate organisational structure and promoting organisational loyalty (see Chapter 2.1.2). Moreover, asymmetric information may exist between the state and the policy target groups, but it also exists between the parties in private contracts. And, again, the fact that private transactions that involve high informational asymmetry are conducted routinely shows that there are ways to control this problem through organisational innovations.

1.4.2 Rent-Seeking

The theory of rent-seeking argues that state intervention incurs not only traditional deadweight losses but also costs when resources are diverted into unproductive activities by private agents in order to capture rents generated by state intervention (for a survey, see Tollison, 1982; also see essays in Buchanan *et al.* (eds), 1980, and Colander (ed.), 1984).

Rent is defined as 'that part of the payment to an owner of resources over and above that which those resources could command in any alternative use' (Buchanan, 1980a, p. 3), that is, the receipt in excess of the opportunity costs of the resources. An attempt to capture rents, the argument goes, is perfectly rational at the individual level *and* socially productive in a certain context. For example, entrepreneurs innovate to capture the monopoly rent. This entrepreneurial activity is socially productive in a competitive setting where there is free entry, since once rents are created in an industry people will move into the industry and thus drive prices down to competitive levels.[24] However, when the state intervenes to create *artificial* rents, the resources spent to capture them, the theory of rent-seeking insists, may be worth expending from the individual point of view but are wasted from the social point of view, since they are spent in *resource reallocation rather than resource creation.* Buchanan (1980a) states:

> Rent seeking on the part of potential entrants in a setting where entry is either blocked or can at best reflect one-for-one substitution must generate social waste. Resources devoted to efforts to curry [the authority's] favour might be used to produce valued goods and services elsewhere in the economy, whereas nothing of net value is produced by rent seeking. In the competitive market, by comparison, resources of potential entrants are shifted directly into the *production* of the previously monopolised commodity or service, or close substitutes; in this usage, these resources are more productive than they would have been in alternative employments. The unintended results of competitive attempts to capture monopoly rents are 'good' because entry is possible; comparable results of attempts to capture artificially contrived advantageous positions under governmentally enforced monopoly are 'bad' because entry is not possible (p. 8).

Once government restrictions on entry are introduced, rent-seeking activities (and the resulting 'waste' from them) cannot easily be eliminated and some apparently plausible means of eliminating them may merely shift rent-seeking to another level (Krueger, 1974; Posner, 1975). For example the auctioning of monopoly rights (franchise bidding), while eliminating monopoly profit, will transfer the rents to the state, which in turn is likely to lead to higher salaries for bureaucrats. Consequently people will devote 'excessive' time and resources to becoming bureaucrats (say, by investing 'excessively' in acquiring educational qualifications), whose compensation exceeds the real opportunity cost (the compensation for private-sector jobs requiring comparable ability). Even when there is no rent component in bureaucratic compensation, it is likely that people will strive to capture the rent extracted by the state in the forms of tax cuts or subsidies

(Buchanan, 1980a, pp. 12–13). Moreover, according to the proponents of the theory, the existence of rent-seeking activities affects people's perceptions of the legitimacy of the economic system, inviting further state intervention. 'If the market mechanism is suspect, the inevitable temptation is to resort to greater and greater intervention, thereby increasing the amount of economic activity devoted to rent seeking' (Krueger, 1974, p. 302).

On these grounds, the theory of rent-seeking contends that state intervention, be it good-willed or ill-willed, is doomed to generate forms of inefficiency that have not been generally recognised in the standard welfare-economics literature – that is, the 'cost of creating monopoly' (Posner, 1975, p. 823). The policy prescription is that the state should not intervene in a manner which restricts entry. And on a more fundamental level, there is the need for a 'constitutional revolution' (Buchanan, 1980b) to establish a new set of efficient institutions.[25]

The rent-seeking argument provides some interesting insights concerning the interaction between individual behaviours and the institutional setting. It raises the important point that the combined results of individual maximisations can differ sharply according to the institutional settings. However the theory has a lot of problems that may not be obvious at first sight.

First of all, the nature of rent-seeking costs is not clearly defined in the literature, resulting in conceptual confusions (also see Samuels and Mercuro, 1984). In the standard rent-seeking literature, it is customary to regard all resources expended in rent-seeking as wasteful. However rent-seeking may not involve real expenditure of resources but only a transfer of wealth (for example bribery), which does not constitute a social cost.[26] The real costs involved in rent-seeking are costs involved in transferring property rights, that is, transaction costs, and not the transfer elements (Littlechild, 1981; Varian, 1989).[27] Of course, as noted above, the proponents of the theory argue that the transferred rent (for example bribes or the proceeds from franchise bidding) will, at some level, be competed for, for example through excessive investment in education or lobbying for tax cuts. However, such an argument is based on the assumption that within the social system there is *at least one* area into which entry is unrestricted, be it education or the political market of lobbying, which we argue may not be the case (see Chapter 2.2.3 for a more detailed discussion). In addition it should also be noted that, when we relax the assumption of full employment implicit in the theory of rent-seeking, even an apparently unproductive activity can be useful for society (recall the famous Keynesian example of the 'hole-digging' exercise).[28]

Moreover, the wastes from rent-seeking may not even be the major costs from state-created rents. Rent-seeking cost is often of a *once-and-for-all nature,* because once a rent is granted an entry barrier into the rent market is likely to be erected, which will discourage potential entrants from spending resources to dislodge the incumbent. A more serious danger is that state intervention may protect or even encourage inefficient producers or production methods, with a long-lasting efficiency consequence (see also Littlechild, 1981). This problem is not explicitly discussed in the rent-seeking literature, which normally assumes that all rent-seeking agents are identical and use optimal production methods. However, in the real world, there is no guarantee that someone who is competent (or even lucky) at seeking rents is equally competent as a producer, although this may well be the case if rent-seeking takes the form of franchise bidding.

Thirdly, in the rent-seeking literature it is usually assumed that restrictions on entry will only be created by state intervention. This is a strongly biased view. Firms are always anxious to deter potential entrants. Anything from the secrecy of production technologies, to excess capacity, to the brand loyalty of consumers can be used as an entry barrier. The implicit belief behind the theory of rent-seeking – that competitive markets are self-reproducing – is unwarranted (see 1.1.2 above). Krueger's (1974) assertion that the existence of state intervention, and hence rent-seeking, will erode people's faith in the market mechanism, leading to calls for more and more intervention, is also based on this dubious belief in self-perpetuating competitive markets.

Most importantly, rent-seeking may be directly unproductive, but 'indirectly productive'. Rent-seeking is only unambiguously harmful for society when it can be assumed that 'the initial institutional creation of an opportunity for rent seeking [creation of entry barriers] ensures a net destruction of economic value' (Buchanan, 1980b, p. 359). However the costs of rent-seeking may well be more than offset by the dynamic gains of productivity growth which the rent allows, say, by enabling firms to increase R&D expenditure (Littlechild, 1981) – this is precisely the reason why we have, for example, patent systems (given the public-good nature of technological knowledge) and infant-industry protection (given the possibility of learning by doing). Of course, the theory of rent-seeking is correct in arguing that free entry is necessary to guarantee the beneficial effects of rent, but the theory is far too reluctant to acknowledge that the creation of a monopoly by the state may be beneficial for productivity growth if the state can withdraw the rent when necessary (see Chapter 4.4.2).

The reform proposal for a rent-seeking society is also unconvincing. If we can achieve a 'constitutional revolution' and start afresh, then we may talk of non-intervention on a rent-seeking ground.[29] However any realistic person will recognise that the possibility of a successful constitutional revolution is almost nil. In the first place this proposal assumes that, once created, competitive markets will perpetuate themselves. We have repeatedly pointed out that this is not the case. Secondly, the proposal underestimates the power of vested interests, which may not agree to reform. Even Buchanan admits that the majority of individuals are usually losers in rent-seeking games, and therefore the winners will have strong incentives to defend their positions (Buchanan, 1980b). When there is no feasible political platform to achieve such a change, providing such a reform proposal amounts at best to an evasion of responsibility and at worst to an apparently populist rhetoric that amounts to a refusal to reform.

CONCLUSION

Welfare economics elegantly and convincingly spells out why markets may fail and what kinds of interventionist measures the state can employ to correct them.[30] However, as many economists from across the political spectrum argue, the theory is based on a naive set of assumptions about the nature and ability of the state. Even if we do not accept the contractarian argument that the state, being the product of a social contract among free individuals, has no right to intervene in the market, we still have two thorny questions: does the state really serve the public interest?; and can it achieve what it sets out to do?

In relation to the first question we examined three approaches – the autonomous-state approach, the interest-group approach and the self-seeking-bureaucrats approach – and concluded that none of them on its own can provide generalisable assumptions about the objectives of all states, regardless of the time and space where they exist. The question is more of an empirical than a theoretical one. It was suggested that, in order to establish a reasonable set of hypotheses concerning the objectives of a particular state, we should look more carefully at the process of interest group formation and collective action as well as the operation of the bureaucracy in the particular system of political economy in which the state is operating. In doing so, the insights from all the three approaches reviewed can fruitfully be used.

In relation to the second question, we examined two approaches – the informational argument and the rent-seeking argument – which we grouped together as the government-failure literature. It was argued that the importance of the information problem can be exaggerated and that there are ways to mitigate the problem. In relation to the rent-seeking argument, it was pointed out that despite some important contributions, the argument suffers from a few major theoretical deficiencies. Common to these two approaches is their inability (or unwillingness?) to suggest how government failures may be remedied other than by non-intervention. Does this mean that we are condemned to accept failing markets in favour of failing governments as the lesser of the two evils? We will attempt to answer this question in the next chapter.