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An Institutionalist Perspective on the Role of the State - Towards an Institutionalist Political Economy

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1. Introduction

What is the appropriate role of the state? This has been one question that has constantly occupied economists for the last 2-3 centuries since the birth of the subject (for some excellent historical reviews, see Deane, 1989, and Shonfield, 1965). During this period, there have been a number of swings in the dominant opinion on the subject, but the two major swings that have occurred during the last half century after the Second World War are particularly remarkable in their scope and suddenness (see Chang & Rowthorn, 1995a, whose Spanish translation appears in Chang, 1996).

The early postwar years witnessed the world-wide rejection of the *laissez faire* doctrine that failed so spectacularly during the interwar period, and the resulting emergence of a widespread consensus on state activism. By the 1960s, the end of *laissez faire* capitalism was announced in many quarters and there was a widespread consensus that we are now living in the "mixed economy" (alternatively, "modern capitalism" or "organised capitalism"). However, this new consensus was dramatically overturned since the mid-1970s, following the Neo-Liberal counter-offensive, which sought to end the mixed economy and re-introduce market principles to the extent that would have been unimaginable during the early postwar years.

The upsurge of Neo-Liberalism during the last two decades or so has fundamentally changed the terms of debate on the role of the state (for more details, see Chang, 1994a, chs. 1-2). The state is no more assumed to be an impartial, omnipotent social guardian and is now analysed either as a “predator” or as a vehicle for politically powerful groups (including the politicians and the bureaucrats themselves) to advance their sectional interests. No other motives than maximisation of material self interests are accorded to any agent even in the “public” domains of life, denouncing the role of politics as a legitimate way to correct the market outcomes according to the “collective will”. The resulting “minimalist” bias in the terms of debate means that those who want to make a case for state intervention have to fight their adversaries at each and every step of their arguments, whatever the merits of their arguments may be, whereas those who want to discredit state activism can often do so with a very simplistic logic supported by, often unrepresentative, anecdotes.

Although the Neo-Liberal agenda itself has a lot of intellectual limitations and biases, as we will discuss in the rest of the paper, the legacy of Neo-Liberal counter-offensive has not been entirely negative. For one thing, it exposed fundamental problems with the “technocratic” view on the role of the state that prevailed in the heyday of welfare economics (‘50s and ‘60s) and brought politics back into economics (although it ultimately aimed to abolish politics; see section 3.4.). And more importantly, its explicit engagement in “political economy” discussions opened the door for the subsequent rise of "institutionalists” criticisms (e.g., see Evans et al. (eds.) 1985; Hall (ed.), 1989; Toye, 1991; Evans, 1995; Chang & Rowthorn, 1995b).[1] And following the institutionalist criticisms, even some proponents of Neo-Liberal doctrine have recently come to admit (but without necessarily recognising the contributions from their critics) the importance of institutional factors in understanding the role of the state (North, 1994, and World Bank, 1997, are good examples of such change).

Having achieved that important, if unfairly unacknowledged, victory over the Neo-Liberals, however, I think it is fair to say that the institutionalists still lack a full-blown political economy that can replace the Neo-Liberal political economy. In this paper, I will make some suggestions as to what I think should be the building blocks of what may be called an institutionalist political economy. For this purpose, I will dissect the Neo-Liberal research agenda on the role of the state from an explicitly institutionalist perspective and identify what I think are the fundamental flaws in it, and in that process suggest what should be the elements in the institutionalist theory of state intervention that can overcome these flaws.

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[1] A Spanish translation of Chang & Rowthorn (1995b) appears in Chang (1996).

2. Disentangling the Neo-Liberal Agenda

The Messianic convictions with which many proponents of Neo-Liberalism have delivered their messages have created the impression that it is a very coherent doctrine with clear conclusions. However, contrary to this popular belief, the Neo-Liberal doctrine is in fact a very heterogeneous and internally inconsistent intellectual edifice. So before going into the detailed criticisms of this doctrine, it will be useful to delineate the basic fault lines in the Neo-Liberal intellectual agenda and reveal some of its obvious weaknesses.

2.1. The Unholy Alliance: Neoclassicism and the Austrian-Libertarian Tradition

The biggest contradiction in the Neo-Liberal research programme comes from the fact that it was born out of a marriage of convenience between Neoclassical economics as the source of intellectual legitimacy (given its dominance in the academia) and what may be broadly called the Austrian-Libertarian tradition as the source of political rhetoric. The gap between these two intellectual traditions is not a minor one, as those who are familiar with, for example, Hayek's scathing criticism of Neoclassical economics would know (e.g., see essays in Hayek, 1949). However, the marriage of convenience goes on, because the Austrian-Libertarian tradition supplies the popular appeal that Neoclassical economics can never dream of supplying itself (who's going to risk their lives for "Pareto Optimality"? - but many have been willing to for "liberty" and "entrepreneurship"), while the Austrian-Libertarian tradition, given its lack of intellectual legitimacy in "respectable" circles, needs the aura of "science" that Neoclassical economics carries around.[2]

But in return for the increased power of persuasion that they acquired by allying with the Austrian-Libertarian tradition, Neoclassical economics had to pay a heavy price. In order to maintain the alliance with the Austrian-Libertarian tradition, it has had to suppress its interventionist streak, given the strong anti-statism of the latter. So how is this done?

One such method of suppression is to accept the logic of "market failure" behind welfare economics but then not to extend it beyond the set of "politically acceptable" areas. So, for example, the externality argument is often applied to politically less controversial areas such as the environment or education, but is rarely applied to such politically more controversial areas as "selective" industrial policy a la East Asia, which can be justified by the same logic equally well. Given that there is no theoretical way in Neoclassical economics to determine what is the "correct" boundary for state intervention, it becomes necessary to argue that market failures exist as logical possibilities, but rarely occur in reality - naturally without providing much evidence (Friedman, 1962, is a good example).[3]

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[2] This point is best illustrated by the experiences during the early days of "reform" in the former Communist countries. What captured people's imagination in those days was the Austrian-Libertarian languages of freedom and entrepreneurship, and *not* the arid Neoclassical languages of Pareto Optimality and General Equilibrium. However, when the post-Communist governments in these countries chose their foreign economic advisers, it was according, largely, to how high a standing they had in the Western academic "hierarchy", which was determined by how good they were in handling the concepts and the tools of Neoclassical economics.

[3] Friedman's 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

The second method of suppressing the interventionist instinct of Neoclassical economics is to separate, partly deliberately and partly subconsciously, the "serious" academic discourse from the "popular" policy discourse and compartmentalise them. So Neoclassical economists in universities may be doing researches justifying stringent anti-trust policy, but the "lax" anti-trust policy by the government may be justified in terms of some other logic which has no place in Neoclassical economics - say, by citing the need "not to discourage entrepreneurship", etc.. The recent "reform" experiences in the former Communist countries that we just talked about is a most poignant example of such practice.

The last method of suppression is to fully accept the logic of market failure and build models that may have strong interventionist conclusions, but later dismiss them on the ground that "real life" states cannot possibly be entrusted with such policies that are technically difficult (due to informational asymmetry) and politically dangerous (due to the possibility of bureaucratic abuse and/or interest group capture). Various writings by the American trade economist Krugman provide the best example, where frequently a few paragraphs, at the end of an article, of "pop political economy" analysis dismissing the integrity of the state would be used to discredit his own elaborate "strategic trade theory" model endorsing state intervention that went on in the rest of the article.[4] To put it bluntly, the name of the game is that, a Neoclassical economist may build a model that

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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" [his term for externality] 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).

[4] A well-known Neo-Liberal economist, Robert Lucas, reviewing Krugman's book with Helpmann, asked why they had written the book in the first place if they were going to say in the end that the interventionist policies that follow from their models cannot be recommended because of the political dangers that they carry. See Lucas (1990).

recommends state intervention as far as it is "technically competent", but he/she has to prove his/her political credential by rubbishing his/her own model on political grounds.

2.2. The Indeterminacy of the Neoclassical Position on State Intervention

Even when we ignore the above-mentioned tension between the Neoclassical element and the Austrian-Libertarian element in the Neo-Liberal intellectual edifice, there are still disagreements amongst the Neoclassical economists themselves on exactly what the role of the state should be, as we implicitly suggested above.

As I indicated above, Neoclassical economics has a strong interventionist streak that is best manifested in welfare economics. Especially, as Baumol (1965) and others have pointed out, once we begin to follow the logic of externality faithfully, it seems doubtful whether we should have any market transaction at all. Most goods create some negative externalities in their production processes in the form of pollution, except in those few cases where proper compensation is actually 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 which 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 exist interdependences 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 very fact that one consumes what others do not - is another example of interdependent consumer preference.

The list can go on, but the point here is that, even using a purely Neoclassical logic, one can justify an enormous range of state intervention. Indeed, in the 1920s and the 1930s people like Oskar Lange were trying to justify socialist planning on the basis of essentially Neoclassical models (Lavoie, 1985; Pagano, 1985). Thus seen, whether a Neoclassical economist is an interventionist or not depends more on his/her political preference rather than the "hard" economics that he/she practices. Seen in this way, it is important to reject the myth propagated by Neoclassical economists that the boundary between "good" and "bad" intervention can be drawn according to some "scientific" rules.

2.3. Concluding Remarks

Neo-Liberalism is based on an unholy alliance between Neoclassical economics, which provides the intellectual legitimacy, and the Austrian-Libertarian tradition, which provides the political rhetoric. This, in turn, means that the interventionist streak of Neoclassical economics has to be suppressed. Such suppression involves, we pointed out, intellectually and morally indefensible practices like drawing an "arbitrary" boundary around the state without acknowledging its arbitrariness, using different discourses for "serious" academic research and for "popular" policy discussion (again without acknowledging such compartmentalisation), and denouncing interventionist conclusions of formal models with unsubstantiated "pop" political economy. We then argued that, even Neoclassical economics itself does not provide us with any unambiguous "scientific" criterion to draw the boundary between "good" and "bad" interventions. Thus seen, despite its pretence of intellectual coherence and clear-cut messages, Neo-Liberalism is an internally heterogeneous and inconsistent intellectual doctrine with confused and confusing messages.

3. Some Institutionalist Criticisms of the Foundations of the Neo-Liberal Analysis of Market, State, and Politics

Having pointed out the fundamental fractures in the very set-up of the Neo-Liberal doctrine, let us now make some detailed criticisms of it from an institutionalist perspective, questioning the very way they envisage the market, the state, and other institutions, as well as the relations between them.

3.1. What is a Free Market?: Defining and Measuring State Intervention

3.1.1. Defining State Intervention

The Neo-Liberal discourse on the state is basically about whether "free" markets produce socially optimal results, which it thinks is most of the time the case, and whether therefore state intervention may be able to improve the free-market outcomes, which it thinks is rarely the case. Whether or not we agree with the conclusion, the discourse seems straightforward enough, but is it?

This question may look stupid. Don't we know that a "free" market is a market without state intervention? Of course, the argument may go, we may have disagreements on which is a "good" state intervention and which is a "bad" one, but don't we all know what state intervention means? I am not actually sure that we do. The trouble is that the same state action can be, and has been, considered an "intervention" in one society but not in another (which could be the same society in a different point of time). Why is this? Let me answer this question with a few examples.

First, let us take the case of child labour. Few people in the OECD countries at present would consider the ban on child labour as a state intervention "artificially" restricting entry into the labour market, whereas many Third World capitalists (and indeed the capitalists in the now-OECD economies in the late 19th and the early 20th century) regard it as just that. In the advanced countries, the rights of the children not to toil but to be educated are so totally accepted, and have been incorporated into the structure of (property and other) rights and obligations underlying the labour market (as the right to self-ownership has been, since the abolition of slavery), they are *not* a matter of policy debate (i.e., there is no debate on whether the ban on child labour is "efficient" in some sense). In contrast, in the developing countries (of today and yesterday), such rights of children are not so totally accepted, and therefore state action regarding child labour is considered an "intervention", whose impact on "efficiency" is still a *legitimate* subject of policy debate.

For another example, many environmental standards, which were widely criticised as unwarranted intrusion on business and personal freedom (e.g., automobile emission standards) when they were first introduced in the OECD countries not so long ago, are these days rarely regarded as "interventions". Therefore there would be few people in the OECD countries who would say that their country's automobile market is *not* a "free" market because of these regulations. In contrast, some developing country exporters who do not accept such stringent environmental standard as "legitimate" may consider them as "invisible trade barriers" that "distort" the market.

Still for another example, many Neoclassical economists who criticise minimum wages and "excessively" high labour standards in the advanced countries as unwarranted state interventions that "artificially" set up entry barrier into the labour market do not even regard the heavy restrictions on immigration that exist in these countries as a state intervention (not to speak of supporting it), although immigration control sets up an "artificial" entry barrier into the labour market as much as the above-mentioned “interventions” do. This contradictory attitude is possible only because these economists believe in the right of the existing citizens of a country to dictate the terms of the non-citizens' participation in "their" labour market, without explicitly stating their "political" position on this matter.

The examples can go on, but point is that, depending on which rights and obligations are regarded as "legitimate" by the members of the society, the same action could be considered an "intervention" in one society and not in another. And once something is not even considered to be an "intervention" in a particular society at a given time (e.g., ban on child labour or slavery in the OECD countries), debating their "efficiency" becomes politically unacceptable - although there is no God-given reason why this should be the case. The corollary is that, depending on the rights-obligations structure, the same market with the same state "intervention" in the same area - for example, regarding child labour - can be seen as "free" (from state intervention) in one society and not in another.

So, therefore, if we want to decide whether a particular market is “free” or not, we need to understand the underlying institutions which define the rights-obligations structure for the participants in the relevant market (and indeed certain non-participants, when it involves "externalities"). The institutions that need to be understood in this context will include, among other things: (i) the formal and informal rules that govern the way in which interests are organised and exercised (e.g., rules on political associations, rules on incorporation, rules on lobbying); (ii) the formal and informal "ideologies" relating to the notions such as "fairness" and "natural rights" that prevail in the society (e.g., rights for everyone to self-ownership, rights for children to education); (iii) the formal and informal institutions that determine how the rights-obligations structure could be changed (e.g., procedures for legal changes, social customs about when and how some *de facto* rights/obligations can become "legitimate", if not necessarily legalised).

Thus, the apparently simple exercise of defining what is a "free" market (and what constitutes "state intervention") is not so obvious any more - and this is, to repeat, even *before* we can discuss whether some markets are "failing" and therefore state intervention may make them "more efficient”. From the institutionalist perspective, we may even say that defining a free market is at the deepest level a pointless exercise, because no market is in the end “free”, as all markets have some state regulations on who can participate in which markets and in what terms. It is only because some regulations (and the rights and the obligations that they are creating) can be so totally accepted (by those who are making the observation as well as by the participants in the market) that some markets appear to have no “intervention” and therefore be “free”.

3.1.2. How do We Measure State Intervention and Why does It Matter?

For the purpose of international and historical comparison, people have used some quantitative measures of state intervention. At one level, this seems a straightforward exercise. However, how good a measure of state intervention is depends on the theory (of state intervention) that underpins it. Therefore, we need to look beyond the "numbers" that are supposed to measure the extent of state intervention and analyse the theories that lie behind those numbers. Let us explain what we mean by this.

Traditionally, the most popular measures of the degree of state intervention have been the total government budget as a ratio of GDP and the share of the public enterprise (PE) sector in GDP (or total investment). It may be true that these measures give us as good an idea of how "big" the state sector is but it is not true that they are good indicators of the degree of state intervention. This is because a "big" government is not necessarily a more "interventionist" government. The point is very well illustrated by the East Asian countries of Japan, Korea, and Taiwan.

On the basis of these traditional measures, until recently many people believed that we could "objectively" establish that the East Asian countries are "non-interventionist" (e.g., World Bank, 1991, p. 40, Box 2.2.). And except for the (conveniently ignored) fact that Taiwan has one of the largest PE sectors in the non-socialist, non-oil-producing world, this observation does not seem to be too far from the truth - that is, as far as we accept that the "vision" of the role of the state that lies behind these measures correctly reflects the actual role of state intervention in these countries.[5] However, the mode of state intervention in East Asia has been quite different from what is envisaged in the "vision" that lies behind these traditional measures, and thus they "wrongly" measure the extent of state intervention in East Asia.

In the "traditional" vision, the state exercises its control basically through the ownership of the means of production, which is (wrongly) equated with the control over its use, and the reallocation of resources via taxes and subsidies, for example, in the manner prescribed in welfare economics. However, state intervention in East Asia has

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[5] The ratio of government expenditure to GDP for Japan in 1985 was 33%, far lower than those in other industrial nations except the US (37%). Corresponding figures include 47% for Germany, 48% for the UK, 52% for France, and 65% for Sweden (World Bank, 1991, p. 139, Table 7.4). In the case of Korea, the ratio of *central* government expenditure to GNP in 1989 was 16.9%, a figure substantially lower than those for other semi-industrialised countries. Corresponding figures were 21.2% for Mexico, 30.6% for Brazil, 32.5% for Chile, and 33% for South Africa (World Bank, 1991, pp. 224-5, Table 11). Comparable data for Taiwan is not readily available. As of the mid-1970s (1974-77), the share of public enterprise output in GDP in Korea was around 6.4% and that in Taiwan around 13.6%. The average for developing countries was 8.6%. Korea, then, was somewhat less interventionist than the average on this account (but higher than Pakistan (6.0%), the Philippines (1.7%), Argentina (4.8%), which are all regarded to be cases of failed state intervention), and Taiwan substantially above-average interventionist. The corresponding figure for Japan is not available, but on the basis of the share of the public enterprise sector in gross fixed capital formation, Japan (11.6%) as of the mid-1970s was of about average interventionism amongst industrialised countries - the average being 11.1% (see Short, 1984, Table 1). A more recent estimate by the World Bank puts the share of public enterprise sector in GDP for the 1978-91 period at 6.9% for Taiwan and at 10.6% for Korea, when the unweighted average of the corresponding figures for 40 developing countries in the sample was 10.9% (World Bank, 1995, Table A.1.). However, in light of other qualitative evidence, the World Bank figure seems to grossly underestimate the importance of public enterprises in Taiwan. In my view, this may be due to the fact that there are many "public" enterprises that are owned by the ruling Kuomintang Party, which may be officially classified as "private" enterprises. Unfortunately, I have not been able to acquire any systematic data on this.

been conducted less through state ownership and budgetary outlays, but more through measures which need little state ownership or budgetary outlays. They include: (i) regulatory measures (on entry, capacity, price, technology, etc.); (ii) the state's influence on bank lending decisions (especially in Korea and Taiwan, the majority of the banks have been state-owned); and (iii) various "informal" channels of influence on the business sector (a manifestation of what Evans describes as "embeddedness" of these states; see Evans, 1995).

The example does not, in fact, stop in East Asia. For example, some commentators point out that the US federal state, despite its *laissez faire* rhetoric, has strongly influenced the country's industrial evolution through defence procurement programmes and defence-related R&D contracts - especially in industries like computer, telecommunication, and aviation (Johnson, 1982).[6] So, again, the prevailing vision of the role of the state, where "defence" is accepted as one of the "minimum" functions of the state (almost shading into "non-intervention"), makes people underestimate the importance of the US federal government in the country's industrial development.

The point that we are trying to illustrate with the above examples is that how we measure state intervention matters, because the particular measures that we use embody a particular vision of the role of the state which may not be universally applicable, because the institutional assumptions behind that vision may not hold in those contexts other than the one from which that vision emerged. Unless we recognise that different measures of state intervention are based on different theories on the role of the state, which embody different assumptions about the institutions and the political economy of state

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[6] The most recent and striking example of this comes from the aviation industry. The repeated rejections by the US federal government of applications from McDonnell Douglas for a number of critical *defence* projects have damaged the latter's profits so badly that it had to merge with its major rival, Boeing, changing the fate of the country's, and indeed the world's, *civil* aviation industry.

intervention, our empirical investigation of the role of the state will be constrained by the limitations of the theoretical perspective that lies behind the "measures" of intervention that we use.

3.2. What does Market Failure Mean and How Much does It Matter?: "Rival Views of Market Society"

3.2.1. When does the Market Fail?

The term, "market failure", refers to a situation when the market does not work like what is expected of the "ideal" market. But what is the ideal market supposed to do? Given the current domination of Neoclassical economics, the ideal market is usually equated with the "perfectly competitive market" in Neoclassical economics. However, the Neoclassical theory of the market is only *one* of the many legitimate theories of how the market works (and therefore what we can expect from the ideal market and therefore when we can say a market has "failed") - and not a particularly good one at that. In other words, there are, to borrow Hirschman's phrase, many different "rival views of market society" (Hirschman, 1982a). And therefore the same market could be seen as "failing" by some people while others regard it as "normal" or even "succeeding", depending on their respective theories of the market. Let us illustrate this point with some examples.

For example, many people think that on of the biggest "failures" of the market is to generate "unacceptable" level of inequality (whatever the criteria for "acceptability" may be). However, in Neoclassical economics, this is not a market "failure", because the "ideal" Neoclassical market is not assumed to generate equitable income distribution in the first place. This is *not* to deny that many well-intentioned Neoclassical economists may dislike the income distribution prevailing in, say, Brazil, and may support some "non-distortionary" lump-sum income transfers, *but* to point out that even they would argue that an equitable income distribution is simply not something that the market should be expected to generate and therefore the issue is beyond economic '"science".

For another example, a "non-competitive" market is one of the most obvious example of a "failing" market for Neoclassical economics, while the Schumpeterian theory (and before it the Marxian theory) argues that the existence of "non-competitive" (in the Neoclassical sense) markets is an inevitable, if a secondary[7], feature of a dynamic economy driven by technological innovation. Thus, a classic example of market failure in the Neoclassical framework, namely, the non-competitive market, is regarded as an inevitable feature of a "successful" dynamic economy, according to the Schumpeterian perspective.[8] Or to put it differently, a market which is "perfect" in the Neoclassical sense (e.g., no participant in the market has any market power) may look like an absolute "failure" to a Schumpeterian because it lacks technological dynamism.

The point that we have just tried to illustrate with our examples is that, when we talk about "market failures", we need to make it clear what we think the "ideal" market is capable of doing. Otherwise, the concept of market failure can become so elastic that it means hundred different things to hundred different people. Thus, where one person sees a "perfection", another person can see a miserable "failure" of the market, and *vice versa* (the above example about monopoly illustrates this point very well). Only when we make our "theory of the market" clear, we can make what we mean by "market failure" clear.

3.2.2. How Much does the Market Failure Matter?

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[7] Recall Schumpeter's famous metaphor that the relationship between the efficiency gains from competition through innovation and that from (Neoclassical) price competition was "as a bombardment is in comparison with forcing a door" (Schumpeter, 1987, p. 84)

[8] This, needless to say, does not exclude the possibility (which is often realised) that an economy may be full of monopolies but is undynamic.

Now, how much does "market failure" matter, however we may define it? The short answer is that it would matter greatly for the Neoclassical economists while it may not matter so much for other people, especially the institutionalist economists. Neoclassical economics is an economics about the market (or more precisely not even that - it is really about the barter exchange economy, where, to borrow Coase's analogy, "lone individuals exchanging nuts and berries on the edge of the forest"; Coase, 1992, p. 718). In Neoclassical theory, even the firm exists only as a "production function", and not as an "institution of production". Other forms of institutions that make up the modern capitalist economy (e.g., formal producer associations, informal "networks", trade unions) figure, if they ever, only as "rigidities" that prevent the proper functioning of markets (for a criticism of the view of non-market institutions as "rigidities", see Chang, 1995, whose Spanish translation appears in Chang, 1996).

Therefore, for the Neoclassical economists, for whom "the market" is essentially "the economy", if the market fails, the economy fails. And if the economy fails, the state has to step in, as no intermediate institutions or organisation have a legitimate place in their scheme. In contrast, for the institutionalist economists, who regard the market as only one of the many institutional mechanisms that make up the capitalist economic system, market failures may not matter as much, because they know that there are many institutional mechanisms other than markets through which we can organise, and have organised, our economic activities. In other words, when most economic interactions in the modern industrial economy are actually conducted *within* organisations, and not between them through the market (Simon, 1991), the fact that some (or even many) markets are "failing" according to one (that is, Neoclassical) of many possible criteria, may not really make a big difference for the performance of the capitalist system as a whole.

For example, in many modern industries where there are high incidences of monopoly and oligopoly, the market is "failing" all the time according to the Neoclassical criterion, but at the same time these industries were often very "successful" in the Schumpeterian sense that they generated high productivity growth and consequently high standards of living. Such outcome was due to the "success" of modern business organisations which enabled the coordination of a most complex division of labour - so, where Neoclassical economists see a "market failure", other economists may see an "organisational success" (Lazonick, 1991). And if this is indeed the case, state intervention in these markets, especially of the Neoclassical anti-trust variety, may not be very necessary, and indeed under circumstances may actually harm the economy.

The point is not that market failures do not exist or that they do not matter at all - on the contrary, the real world is full of market failures even by Neoclassical standard (see section 2.2.) and they do matter. The real point is that the market is only one of the many institutions that make up what people call "the market economy", or what we think is better to be called "capitalism". The capitalist system is made up of a range of institutions, including the markets as institutions of exchange, the firms as institutions of production, and the state as the creator and regulator of the institutions governing their relationships. Thus, focusing on the market (and market failure), as Neoclassical economics does, really gives us a wrong perspective in the sense that we lose sight of a large chunk of the economic system and concentrate on one part only.[9]

3.3. "In the Beginning, There Were Markets."?: The Market Primacy Assumption

[9] More recently, the Neoclassical economists have started to discuss the workings of non-market institutions, especially the firm (transaction cost economics; e.g., Williamson, 1975) and the state (the "government failure" literature; e.g., Krueger, 1990). However, these analyses have important shortcomings as these institutions are analysed as "quasi-markets" ultimately based on voluntary contracting (see Vira, 1997).

One thing that distinguishes even the most enlightened and open-minded Neoclassical economists from the truly institutionally-conscious economists is their belief in what I call the market primacy assumption. In their view, "in the beginning, there were the markets" (Williamson, 1975, p. 20)[10], and state intervention, organisations, and other institutions are seen as man-made substitutes which emerged only after the defects in the market ("market failure") became unbearable (Arrow, 1974, is the most sophisticated example of this view).

The most obvious example of this market primacy assumption is the Contractarian "explanation" of the origin of the state. In this view, the state has emerged as a solution to the "collective action problem" of providing the "public good" of law and order (especially the security of property), which is seen as necessary (and often sufficient) for markets to function at all (Nozick, 1974; Buchanan, 1986). Thus, in this view, even the very existence of the state is explained according to the logic of "market failure" in the sense that it is seen as having emerged only after the market has failed to provide law and order due to the "public goods" problem - an explanation which is obviously contrary to the historical truth and therefore can only be seen as an "ideological" defence of an "unjust" system (for a criticism, see Chang, 1994a, ch. 1).

At this point, we must emphasise that the fact that someone attributes institutional primacy to the market does *not* necessarily mean that he/she endorses a minimal state view, as the problem here is *not* really about where the right "boundary" between the state and the market should lie. There are may who start (at least implicitly) from the market supremacy assumption but are keenly aware of the failings of the market and willingly endorse a relatively wide range of intervention. Indeed, as we pointed out earlier (section

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[10] Williamson defends this starting assumption on the ground of "expositional convenience", arguing that the logic of his analysis would be the same even if the starting assumption was that "in the beginning, there was central planning" (pp. 20-1). However, as we shall see below, this apparently innocuous assumption has a lot of important theoretical ramifications and policy implications.

2.2.), if these open-minded Neoclassical economists began to take their own logic to the limit, they could end up endorsing all kinds of state intervention.[11] However, they would still see state intervention, or for that matter any other solution based on non-market institutions (e.g., hierarchical organisations like firms), as "man-made" substitute for the "natural" institution called market.

The point is that, in the beginning, there were *not* markets. Economic historians have repeatedly shown us that, except at the very local level (in supplying basic necessities) or at the very international level (in luxury trade), the market mechanism was *not* an important part of human economic life until recently. In fact, although even Joseph Stiglitz, one of the most enlightened Neoclassical economists of our generation, says that "markets develop naturally" (Stiglitz, 1992, p. 75), the emergence of markets was almost always deliberately engineered by the state, especially in the early stage of capitalist development.

Karl Polanyi's classic work shows how even in the UK, where the market economy is supposed to have emerged "spontaneously", state intervention played a critical role in the process. He argues that "[t]he road to the free market was opened and kept open by *an enormous increase in continuous, centrally organised and controlled interventionism* [italics 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;

[11] Lange's defence of socialist planning may be an extreme example, but Schotter's argument for state provision of basic goods (on the ground that an inadequate amount of consumption of such goods can create "externality" in the form of crime), which we cited earlier, is a less extreme example of how the logic can be carried much beyond where most Neoclassical economists are currently willing to take it to.

or the increase in governmental administration entailed in the meritorious task of municipal reform . . . . " (Polanyi, 1957, p. 140).[12]

Also in the case of the US, the early intervention by the state in establishing property rights, providing critical physical infrastructure (especially railways and telegraphy), funding of agricultural research, and so on, were critical for its success in early industrialisation (Kozul-Wright, 1995; even the World Bank now recognises this - see the World Bank, 1997, p. 21, Box 1.2). Most importantly, the US was the home of the idea of infant industry protection (Freeman, 1989), and was indeed the most heavily protected economy among the industrial countries for around a century until the Second World War (see World Bank, 1991, p. 97, Box Table 5.2; Kozul-Wright, 1995, p. 97, Table 4.8).[13]

Moving beyond the UK and the US, we realise that there is virtually no country, except Hong Kong, which achieved the status of an industrialised country without at least some periods of heavy state involvement in the developmental effort. The exact forms of intervention varied - "pre-emptive" welfare state in Bismarckian Germany, postwar French industrial policy, early Swedish state support of research and development, transformation of the Austrian manufacturing sector since World War Two through the

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[12] And he continues: "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* [italics original]" (p. 140)

[13] During this period, few countries had tariff autonomy either because of outright colonial rule or because of "unequal treaties" - for example, Japan got tariff autonomy only in 1899 when all its unequal treaties expired. Of the countries with tariff autonomy, the US had by far the highest tariff rates. Its average tariff rates since the 1820s was never below 25%, and usually around 40%, when those in other countries for which the data are available, such as Austria, Belgium, France, Italy, and Sweden, were rarely over 20%. For detailed figures, see World Bank (1991, p. 97, Box 5.2.).

public enterprise sector, the well-known state-led developments of the East Asian countries - but the fact remains that all successful developmental efforts involved substantial state intervention. So if virtually all now-advanced countries, with the possible exceptions of Britain at certain phases and Hong Kong, developed in some "unnatural" way which involved heavy state intervention, it seems questionable whether there is any point in calling the market a "natural" phenomenon.

What we have just discussed is not simply of historical interest. Whether or not we accord primacy to the market institution makes a critical difference on how we design developmental policies. For example, the severe economic crises that many former Communist countries which have opted for a "big bang" reform have experienced during the last several years is one striking example which shows how the establishment of a well-functioning market economy is impossible without a well-functioning state (see Chang & Nolan, 1995, whose Spanish translation appears as Chang & Nolan, 1996). In fact, if the markets evolve so "naturally" as the Neoclassical economists believe, these countries would not be in such trouble now. Likewise, the developmental crises that many developing countries have gone through during the last two decades or so also show how dangerous it is to assume the primacy of market institutions and believe that it will naturally develop as far as the state does not "interfere" with its evolution. The assumption of market primacy has a lot more serious implications than it first appears to have.

3.4. Can We Rid the Market of Politics?: The Disguised Revival of the Old Liberal Politics

One major assumption behind the Neo-Liberal doctrine is the belief that politics allows "sectional" interests to "distort" the "rationality" of the market system and therefore is something that has to be purged from the market. Criticising the naivete of welfare economics which assumed the state to be the all-knowing, all-powerful social guardian, the "New Political Economy" of Neo-Liberalism tried to demonstrate how politics is an inevitably corrupting force on the economy. The Neo-Liberal political economists have argued that therefore we need to "depoliticise" the economy by restricting the scope of the state and by reducing the room for policy discretion in those few areas where it is allowed to operate, for example, by strengthening the rules on bureaucratic conduct and by setting up "politically independent" agencies bound by rigid rules (e.g., independent central bank, independent regulatory agencies).

There have been many powerful criticisms of Neo-Liberal political economy, and we do not feel that this is a place to go into the details (e.g., see, in chronological order, Toye, 1987; King, 1987; Gamble, 1988; Toye, 1991; Chang, 1994a and 1994b; Evans, 1995; Chang & Rowthorn, 1995a and 1995b, both whose translation appear in Chang, 1996). However, we want to point out some basic issues in order to highlight some fundamental problems in the Neo-Liberal (and indeed Old Liberal) view of politics.

3.4.1. All Prices are "Political".

First of all, the establishment and distribution of property rights and other entitlements that define the "endowments" that Neoclassical economics takes as given is a highly political exercise. The most extreme example will be the various stories of "original accumulation" such as the Great Plunder or the Enclosure in the early days of British capitalism or the "shady" deals that dominate the privatisation process in many ex-communist countries these days, but the continuous political campaigns that established environmental rights and consumer rights as legitimate rights at least in the OECD countries are less dramatic but perhaps equally important examples.

Moreover, there are practically no prices in reality which do not have some "political" element in it. To begin with, two critical "prices" which affect almost every sector, namely, wages and interest rates, are politically determined to a very large degree. Wages are affected not only by minimum wage legislations, but also by various regulations regarding labour standards, welfare entitlements, and most importantly immigration control. Interest rates are also highly political prices, despite the guise of "de-politicisation" that those who support central bank independence want to give to the process of interest rates determination. The recent debate in Europe on the relationship between political sovereignty and autonomy in monetary policy, which was prompted by the approaching European Monetary Union, shows this very clearly. When we add to them those numerous regulations in the product markets regarding safety, pollution, import contents, and so on, there is virtually no price which is "free from politics".[14]

Of course, all these are not to deny that a certain degree of de-politicisation of the resource allocation process may be necessary. For one thing, unless the resource allocation outcome is at least to a degree accepted as "objective", the political legitimacy of the market-based system itself may be threatened. Moreover, an enormous amount of "transaction costs" would be incurred on search and bargaining activities if every allocational decision is regarded as negotiable, as it was in the case of the ex-Communist countries. However, this is not to say that no price under no circumstances should be subject to political negotiations, because in the final analysis, there is no price which is really free from politics.

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[14] We were reminded of this clearly in the British coal crisis in the early 1990s, where the British coal-miners were told to accept the logic of the "world market" and face mine closures with grace. However, the world market prices, which the then British government argued to be beyond political negotiation, turned out to be determined by the "political" decisions of the German government to give subsidies to their coal, of the French government to allow the export of their subsidised nuclear electricity, and of the many developing country governments to allow, at least *de facto*, child labour in their coal mines.

3.4.2. De-Politicisation: The Disguised Revival of Old Liberal Politics

If what appear to be "objective" outcomes of "impersonal" markets are in the end the results of certain (explicit and implicit) "political" decisions about property rights, entitlements, and prices, the Neo-Liberal proposal for "de-politicisation" of the economic policy-making process as a means to restore "economic rationality" also cannot be taken at its face value.

One basic problem with the Neo-Liberal proposal for de-politicisation is that the "rationality" that such exercise wants to "rescue" from the corrupting influences of politics can only be meaningfully defined with reference to the existing institutional structure, which is itself a product of politics (Vira, 1997, for a further exposition of this point). So when the basic institutional parameters of the economy have been, and can only be, set through an "irrational" political process, a call for de-politicisation of the economic process on "rationality" ground rings hollow.

Another problem with the Neo-Liberal proposal for de-politicisation is that its politics is *not* what it pretends to be. The call for de-politicisation is often justified in a populist rhetoric as an attempt to defend the "silent majority" from the greedy politicians and powerful interest groups. However, the diminution of the legitimate domain of politics that de-politicisation will bring only serves to further diminish what little political influence that these underprivileged people have in modifying the market outcomes, which, we repeat, are heavily influenced by politically-determined institutional parameters. Thus seen, the Neo-Liberal call for the de-politicisation of the economy aims to revive the Old Liberal politics in a disguised form (Bobbio, 1990, provides an excellent anatomy of the Old Liberal politics). Like the Neo-Liberals, the Old Liberals believed that allowing political power to those who "do not have a stake" in the existing institutional arrangements will inevitably result in the modifications of either such arrangements or of its outcomes mediated through the market. However, unlike the Old

Liberals, who could openly oppose democracy, the Neo-Liberals cannot do that, so they try to do it by arguing against "politics" in general and making proposals which ostensibly seek to reduce the influence of those "untrustworthy politicians" but ultimately aims to diminish democratic control itself (e.g., proposals for "independent" central bank or regulatory agencies).

The last, but not least, problem with the call for de-politicisation is that it may not be a politically feasible recommendation. For good or bad reasons, all countries have accumulated politically organised groups and have developed certain (at least implicitly accepted) ways to "politically" modify certain market outcomes.[15] Some of these, of course, could be easily eliminated, but others may be so entrenched that they may be eliminated only at very high political and economic costs. Hence the apparent paradox that radical economic liberalisation frequently requires harsh authoritarian politics, in order to achieve the high degree of de-politicisation that is required for such policy, as graphically exemplified by the liberalisation attempt by the Pinochet regime in Chile (also see Gamble, 1988). But the truth is that, however harsh the political regime which pursued it may have been, de-politicisation has never been, and can be, complete in practice, and even backfire.

4. Conclusion: Towards an Institutionalist Political Economy

After pointing out some internal fault lines and indeterminacy in the Neo-Liberal intellectual agenda, we critically examined some of its basic concepts and assumptions from the institutionalist point of view. As we have repeatedly emphasised, the real point

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[15] We should also note that political activities are often ends in themselves and people may derive value from the activities *per se* as well as from the products of such activities (see Hirschman, 1982b, pp. 85-6).

of our criticism is *not* that Neoclassical theory is too little (or for that matter too much) interventionist. As we have pointed out repeatedly, a full-blooded Neoclassical economist can legitimately endorse anything from a minimal state to socialist planning, depending on his/her assumption about technological (and implicitly property rights) conditions. What we are really trying to argue is that the way in which the relations between the state and the market (and other institutions in those rare occasions when they feature) is envisaged in Neoclassical economics prevents an adequate understanding of some fundamental issues surrounding the role of the state. We propose that an approach which may be called "institutionalist political economy" should be the way forward, and suggest some elements of this theory.[16]

Our starting point should be to reject the assumption of market primacy that underlies Neoclassical economics. As we pointed out earlier, Neoclassical economics sees the market as a "natural" institution (if it is ever acknowledged that it is an institution) which spontaneously emerges, but sees other institutional arrangements, be they state institutions or firms (or "hierarchies"), as emerging only when the market "fails". However, saying that the market emerged as a result of the failure of "planning" (not necessarily by the state, but also by other organisations) or "hierarchy" is probably closer to the historical truth, which of course is much more complex. We should see the market as an institution which, both logically and historically, has no primacy over other institutions, and therefore as "natural" (or, for that matter, as "artificial") as other institutions. Only when we do that, will we be able to see the relations between market, state, and other institutions in a balanced and historically more accurate way.

Secondly, we should remember that there are more than one views of what the "ideal" market can do, and that the Neoclassical view is only one of many plausible views

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[16] I have attempted to develop this theory in a number of my previous works. See Chang (1994), Chang (1995), Chang & Rowthorn (1995b), and Chang (1997).

- and not a particularly good one at that. Accordingly, it becomes possible that the same market may be seen as failing by some with one "theory of the market" and as succeeding by others with another theory. Only when an economist makes his/her own theory of the market explicit, we will be able to judge the merit of his/her view that the market is "failing" (or not) and thus to accept or reject the "solution" to the problem, whether it is some kind of state intervention or the establishment of some non-market institutions and/or organisations.

Thirdly, we need to realise that the Neoclassical theory is essentially a theory of the market (and a very schematic and misleading one at that). However, capitalism, as a socio-economic system, is more than a collection of markets, and is made up of many institutions, including, among others, the firms as institutions of production, the markets as institutions of exchange, the state as an institution of politically addressing collective interests, and various producer and consumer groupings (e.g., conglomeration of firms, producer associations, trade unions, purchasing cooperatives, subcontracting networks). Thus seen, market failure becomes, somewhat paradoxically, less of a problem in the institutionalist framework than in the Neoclassical framework, because in the former framework even widespread and severe market failures would not necessarily suggest that the whole "economy" is failing, whereas the latter framework would see it as just that.

Fourthly, we need to understand that the market is a fundamentally political construction. A market cannot be defined except with reference to the specific rights/obligations structure that underpins it. And since these rights and obligations are determined through a political process, and not by any "scientific" or "natural" law as Neoclassical (and other Neo-Liberal) commentators want us to believe, all markets have a fundamentally "political" origin. Therefore, it is impossible to decide whether a market is "free" or not, without specifying the position of the person(s) making that statement regarding the legitimacy of the current rights/obligations structure. Added to this are the more explicit administrations of prices that are found in many markets through price caps, price ceilings, state setting of certain prices, and quantity controls. While some prices may be more politically administered than others in a given context, ultimately no price is free from politics.

This brings us to our fifth element in the institutionalist theory on the role of the state, namely, the need to build a theory of politics which takes a much more broad, balanced, and sophisticated view of politics than what is offered by Neo-Liberalism. Neo-Liberal thinkers see politics as a market-like process, where material benefits are exchanged for political supports, but as a process that ultimately corrupts the "rationality" of the market, because of the discretionary powers that it confers to those who can make and/or influence political decisions. However, this is a fundamentally jaundiced view of politics. The main problem with this view is that the "rationality" that it want to preserve through "de-politicisation of the economy", which is in fact an euphemism for emasculating democracy, makes sense only in relation to the underlying rights/obligations structure, which is a fundamentally political construction. Thus, we need a theory of politics which is not merely an extension of market logic.

Lastly, we need to pay attention to the institutional diversity of capitalism (Albert, 1991; Berger & Dore (eds.), 1996; Chang, 1997).[17] Unfortunately, Neoclassical economics has little to say about the issue of institutional diversity, because it is a theory of an abstract market economy, or rather of an "exchange economy" based on barter, as we have pointed out earlier. Partly for this reason, the Neo-Liberal economists have found it difficult to admit that there are many ways for the state to intervene other than through taxes/subsidies and public ownership, thus misrepresenting, although for

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[17] The issue has been discussed in various areas, including: the organisation of finance (capital-market-based vs. bank-led vs. state-dominated); corporate governance (U-form vs. M-form; H-firm or A-firm vs. J-firm); wage bargaining structure (centralised vs. decentralised); union organisation (centralised vs. industrial vs. company vs. craft); mode of state intervention (Anglo-American, East Asian, Scandinavian, etc.); industrial policy (general vs. selective). For more details, see Chang (1997).

somewhat different reasons, certain countries as being much less interventionist than they actually are (e.g, Japan, Korea, the USA; see section 3.1.2.). In discussing this issue of institutional diversity, understanding the role of the state is critical, not simply because the international differences in the mode of state intervention is a major source of this diversity, but also because the exact institutional forms of, say, corporate governance or labour representation, will have to be legitimatised in the eyes of the (current and prospective) market participants, either through formal legislation by the state or through informal support from the state.

Constructing an institutionalist political economy which satisfied all the above criteria (and I am sure that there are more important criteria that I did not think of) is surely a tall order. However, without a radical restructuring of the ways in which we conceptualise the market, the state, and politics, and the ways in which we analyse the relationships between them, we will not be able to overcome the Neo-Liberal world view, which has dominated the political and the intellectual agenda of our time, in my view with many negative consequences.

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