Globalisation, Economic Development and the Role of the State

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Chapter 1
Theories of State Intervention in Historical Perspective

As Deane (1989) shows in her masterpiece on the history of economic thought, the role of the state has occupied the central stage in the development of economics as an independent discipline. As the early names of the discipline like ‘political arithmetic’ or ‘political economy’ suggest, the very inception of the discipline was prompted by the growing need for policy advice to the rulers of the emerging nation states whose role was growing with the development of capitalism in Western Europe. Although attempts to purge the discipline of those awkward ‘political’ elements culminated in the re-christening of the subject as ‘economics’ around the turn of the 20th century, the state was brought back into economic theory and policy making in a rather dramatic fashion during the interwar period.

One development which brought the state back into economics was the birth of welfare economics, pioneered by Arthur Pigou. By explaining why the free market system purely based on individual maximising behaviour may not achieve socially ‘optimal’ resource allocation as predicted by the then new orthodoxy of neoclassical economics, welfare economics provided justification for the manipulation of price signals by the state. Although during the interwar period itself welfare economics remained a rather esoteric exercise detached from practical policy questions, its use of the orthodox language of marginalist analysis made it possible for later policy makers to break away from the laissez-faire policies without being accused of unscientific behaviour.

Another, more important, development which produced the comeback of the state was the birth of Keynesian economics. By showing that the free market economy may not be able to achieve an
optimal resource allocation at the full employment level of output, the Keynesian 'revolution' justified the new practice of active budgetary policy to fight unemployment and business cycles, which was developing simultaneously in the USA (the New Deal), Germany (Fascist armament programmes), and Sweden (the incipient Corporatist Compromise) (for an excellent account of interwar economic development in the USA and Germany, see essays in Maier 1987; on Sweden, see Wright 1991). As we shall see later, the goals of full employment and smoothing business cycles were unchallenged as objectives of state intervention during the quarter-century after World War II, and consequently Keynesian ideas achieved a pre-eminent status in government policy making.

The consolidation of the socialist central planning system in the USSR was another major interwar development. The rapid industrialisation of the USSR, whose achievement was later proven by its success in halting the Nazi advance on the Eastern Front during World War II, provided credentials to certain non-orthodox interventionist measures such as nationalisation of industry and investment planning, adopted even by many non-socialist countries after the war (for the exposition of these theories, see Ellman 1989) – for example, nationalisation in the UK and France, medium-term (usually five-year) planning in Japan, France, and many developing countries.

These interwar developments culminated in a dramatic swing of economic theory and practice towards interventionism in the immediate postwar years. With the urgent need for postwar reconstruction in the advanced capitalist countries (henceforth ACCs), the establishment of socialism in parts of Asia and Eastern Europe, and the liberation of many developing countries from colonialism, the states in almost all countries in the world were forced to and willing to assume highly interventionist positions in the immediate postwar years. And during the quarter-century after World War II – the period commonly known as the 'Golden Age' of capitalism, interventionist policies were highly successful across the world, firmly establishing the state as an important and often the leading actor in the functioning of the economy (see Margin and Schor 1990 and Armstrong et al. 1991).

If this rise of the state in theory and practice in the Golden Age was dramatic, its fall after the Golden Age was equally, if not more, dramatic. The collapse of the Golden Age has produced a virulent attack on the state both at the theoretical and at the practical levels, starting from the discrediting of welfare statism in the ACCs, being amplified with the spread of liberalisation programmes among developing nations during the 1980s and culminating in the dismantling of socialist central planning since 1989 and the attempt to establish capitalism in Eastern Europe and what used to be the USSR. Although the 'rolling back' of the state has not proved to be straightforward as many anti-interventionists had initially thought, this reversal of trend has had a significant impact on the theory and practice of state intervention.

In this chapter, we survey these developments and provide some critical comments on the major contemporary anti-interventionist theories, which we classify under the general heading of 'neoliberalism'. After presenting an account of the rise of the state in the Golden Age in the first section, we move to an account of the fall of the state after the Golden Age, then we present criticism of some major theoretical underpinnings of neoliberal theories, using both some new theoretical developments and empirical evidence which question the wisdom of this new orthodoxy.

1. THE GOLDEN AGE AND THE RISE OF THE STATE

In this section, we review the political, intellectual, and economic factors responsible for the widespread extension of state activity during the Golden Age following World War II.

1.1 Advanced Capitalist Countries

World War II produced new political coalitions in the advanced capitalist countries with a strong representation of organised labour – often described as 'corporatist' coalitions. The prominent role of the left in the struggle against Fascism during World War II meant that, in the postwar society of class compromise, full employment and social welfare – the overriding objectives of the working class – were to be on the top of the political agenda. Moreover, given the belief that the rise of Fascism had owed a lot to the Great Depression, active state
intervention to smooth the business cycle through the use of new-found Keynesian policy tools was deemed imperative. Although the dominance of Cold War politics put strict limits on more radical forms of labour and other political movements, the new regime incorporated the interests of the working class in national policy making to an unprecedented degree.

As the theoretical possibility of avoiding recession by deliberately injecting purchasing power into the economic system was confirmed by the successes of proto-Keynesian policies during the interwar period (using budget deficits) and of the Marshall Plan in the immediate postwar period (using foreign aid), the state now actively assumed a new role of ‘fine tuning’ the economy through budgetary policy (on the Marshall Plan, see Panic 1990). The old dogma of balancing the budget at all costs was abandoned, and budgetary policy was given the role of coordinating investment and savings so that the economy could stay at full employment level. Social welfare systems, which existed in rudimentary form before the war, were vastly extended following the rise of the ‘corporatist’ political coalitions, and the state was also expected to help stabilise the economy by automatically increasing (reducing) spending in the recessionary (boom) phase of the business cycle.

In many countries, the role of the state expanded much further than the simple maintenance of the level of activity through aggregate demand management. Helped by the success of wartime planning, the old liberal dogma that centralised coordination of economic activities is unworkable was now rejected, and many states started intervening with a view to changing the structure of their economies. Japan and France combined sectoral industrial policy with centralised investment coordination through five-year indicative planning (see Cohen 1977, on France; see Johnson 1982, on Japan). Scandinavian countries operated in a ‘social corporatist’ framework, where centralised wage bargaining and active labour market policy were combined to produce structural change towards high-productivity industries at a speed and orderliness beyond what would have been possible through a pure market mechanism (see Pekkarinen et al., eds.) 1982). Even in the UK and the USA, countries which were least open to the idea of industrial policy, the state involvement in industrial development was substantial (see Thompson (ed.) 1989). The evolution of the European Coal and Steel Community (CSC) and European Economic Community (EEC) during this period even established some grounds for an international coordination of national industrial policies.

### 1.2 Less Developed Countries

During the Golden Age, the state took an even more active role in many less developed countries (henceforth LDCs) than in the advanced capitalist countries. The desire of the newly independent nations to acquire not only political but also economic independence from their former colonial masters put rapid economic development at the top of the political agenda. And, in this period, it was widely accepted that state-led industrialisation was the fastest and surest way to achieve the aim (see Toye 1987).

The traditional reliance of LDCs on primary commodity exports to finance the manufactured imports was thought to be a dead end, given (i) the volatile and apparently falling terms of trade for primary commodity exports; (ii) the fragility of the international economy, as testified by the collapse of international trade following the Great Depression; and (iii) the low income elasticities of primary commodities, which limited the scope for increase in their exports in the future. Also it was thought that primary commodity production lacked the self-reinforcing growth mechanism observed in manufacturing, where faster output growth leads to faster productivity growth (the so-called Verdoorn’s Law, promoted by Kaldor 1966). Therefore, it was thought, the LDCs should move out of their role in the traditional international division of labour as the suppliers of primary products and develop manufacturing industries.

In order for the LDCs to start industrialisation, however, it was thought to be necessary to have an active state intervention. Not only was the traditional infant industry argument evoked to justify the strategy of state-led industrialisation based on heavy import protection and subsidies, but also an array of new theories justifying the centralised coordination of industrial investments were developed within the emerging sub-discipline of ‘development economics’.

The ‘big push’ models of Rosenstein-Rodan (1943), Nurkse (1952), and Scitovsky (1954) emphasised the demand complementarity between different industries, which called for an *ex ante* investment
coordination by the state. Hirschman (1958), while criticising the ‘balanced growth’ models, used the same idea of sectoral interdependence in order to develop an ‘unbalanced growth’ model, where the state-prompted development of the sectors with the most widespread interdependences (what he called linkages) would create imbalances in the economy, which would induce the development of other sectors. Gerschenkron (1966), basing his case on the experiences of earlier European industrialisations, provided a further justification of state intervention based on the interaction of technological (the growing minimum efficient scale of production) and institutional factors (the underdevelopment of financial institutions). Gerschenkron suggested that as a country embarks on a developmental process later and later, it needs to raise proportionally bigger and bigger amounts of savings (as the minimum efficient scale of production grows larger), and therefore needs a more and more powerful institution for industrial financing, the state being the most powerful of such institutions.

These new theories were greeted with enthusiasm by the political leaders and state officials in many post-independence nations of Asia and Africa. In these countries, there existed strong feelings against capitalism, if only for the simple reason that all colonial powers were capitalist. As a result they exhibited preference for more state ownership and central planning, if not outright socialism. On a more practical level, the states in these nations were often compelled to take the role of an entrepreneur, because these nations lacked a well-developed capitalist class which could take over the economic organisations left behind by the colonisers, and whatever little capitalist class there was, it was often politically discredited as the collaborator with the colonial power. Even in the East Asian newly industrialising countries (NICs), where the Cold War consolidated the staunchest anti-communist regimes, vigorous state intervention was regarded as legitimate and necessary, and paradoxically functioned much more efficiently than in other Less Developed Countries (LDCs). Even in Latin American countries, where independence was achieved much earlier and where socialist tendencies were weaker, the political tide was turning for state-led industrialisation. The success of state-led import substitution industrialisation during the interwar period produced new social coalitions that could challenge the landed oligarchy – that is, the alliance between the incipient industrial capitalist class and the urban working class (Peronism being the best example) – and gave them the confidence and power to push further the state-led industrialisation programme.

The result was the emergence of a variety of new industrialisation strategies in LDCs, in which the state played the leading role in manufacturing and infrastructure through its control over state-owned enterprises and/or financial resources. As most LDCs experienced rates of growth more vigorous than the rest of the world during the Golden Age (see Singh 1992a), these strategies – which are usually (and somewhat misleadingly) known as the import substitution industrialisation (ISI) strategies – acquired the status of ‘the’ development strategy.

1.3 Socialist Countries

In addition to the independence of the former colonies, the end of World War II produced another dramatic change in the world political map. The USSR and Mongolia were no longer the only socialist countries in the world. Between the end of World War II and the early-1950s, socialist regimes had been established in Eastern European and some Asian countries (China, North Korea, and North Vietnam), and this meant, largely thanks to China, that now about one-third of the world’s population was under socialist rule. The advance of socialism into other poorer, especially Asian, nations seemed inevitable unless an active policy to ‘roll back’ Communism was adopted.

In the immediate postwar years, the socialist countries, mostly as the victorious parties either in World War II or in their own anti-imperialist struggle, were full of confidence and hope. The rise of the USSR from one of the most backward nations in Europe to a nation which played a crucial role in saving the world from Fascist takeover convinced many people, except some fierce anti-communists, that central planning was as least as viable as the market mechanism in running the economy. The victory of the USSR over the USA in the early space programme suggested to many that, for large projects requiring concerted efforts on the national scale, central planning was probably superior. The fact that even the most backward socialist countries like North Korea and China made very impressive progress
in industrialisation in the 1950s seemed to prove that central planning was an effective way to achieve rapid industrialisation and massive structural transformation.

To be sure, it was obvious that central planning had its own problems, as revealed in the (largely unsuccessful) attempts by Hungary (1956) and Czechoslovakia (1968) to liberalise their economies. However, many advocates of central planning believed that the relentless development of computers, input-output analysis, mathematical programming techniques, and other tools of planning would eventually ensure that the rational order of socialism would triumph over the irrational anarchy of capitalism. Moreover, the supposed ‘classless’ nature of their societies made their policy makers believe that policy making in socialist societies can be treated as a ‘technocratic’ rather than a political exercise. With the beliefs in the perfectibility of tools of forecast and computation, on the one hand, and in the absence of fundamental political conflicts, on the other hand, it was not surprising that many saw the seeds of a truly rational and egalitarian society in the existing societies during this period.

2. THE FALL OF THE GOLDEN AGE AND THE NEOLIBERAL UPSURGE

A series of events which started emerging from the late-1960s began to create growing difficulties for the interventionist models of economic management established during the Golden Age, especially once the political consensus which buttressed the interventionist regimes started breaking down (see later). Policy makers found it increasingly difficult to mediate the growing conflicts while the theorists could no longer assume political neutrality and ignore the considerations of ‘political economy’. To the policy maker, this meant that more and more policies would have to accommodate demands from specific interest groups, and to economics theorists, it meant that it was increasingly difficult for them to remain technocratic. It is no coincidence that the post-Golden Age period witnessed the revival of political economy, both from the right and left.

In this section, we review major contemporary anti-interventionist theories under the broad heading of neoliberalism, without necessarily implying the existence of a unified political philosophy underlying all the theories we examine. In spelling out these theories, we do not attempt to discuss all the details of individual theories, as our purpose here is to provide a broad overview of the changes in the intellectual climate of the post-Golden Age era (interested readers can go back to the originals or reviews contained in Cullis and Jones 1987, and Mueller 1979, for the advanced capitalist countries; Toy 1987, and Shapiro and Taylor 1990, for the NICs; Ellman 1989, and Brus and Laski 1989, for the socialist countries).

2.1 Advanced Capitalist Countries

The long postwar boom in Europe and North America was brought to an end by a variety of factors, including a profit squeeze due to the depletion of surplus labour in the rural area and over-accumulation, growing competition from Japan and the NICs, and the growing globalisation of capital which made national macroeconomic management much less effective (see Glyn et al. 1990). With the growing intensity of distributional conflicts in the face of massive structural change and decelerating economic growth, the existing political consensus on the welfare state based on corporatist bargaining and Keynesian macroeconomic management broke down and, with it, the theoretical consensus on the role of the state.

2.1.1 Monetarism

The best-known attack on the theoretical consensus underlying the Golden Age is the monetarist onslaught on Keynesianism. Basing themselves on the assumption of adaptive or rational expectations, and Walrasian market clearing, the monetarists comprehensively rejected the effectiveness of macroeconomic demand management by the state (for a critique, see Kaldor 1985). This exposed a fundamental weakness in the theoretical structure known as the Keynesian compromise. Under this compromise, the role of the state was confined to the regulation of macroeconomic aggregates, leaving the question of resource allocation to the neoclassical doctrines of free markets (Deane 1989). In political terms, the monetarist rendering of its argument in populist anti-inflationary rhetoric – ‘inflation erodes the incomes of
honest working families and the savings of poor old grannies on pensions - proved especially effective in making the potentially unpopular recessionary policies widely accepted. (On this topic, see the essays in Lindberg and Maier (eds.) 1985.)

2.1.2 Institutional Sclerosis

This is a line of argument which emphasises that institutions designed to guarantee politically-negotiated economic benefits to certain groups (e.g., welfare provisions, trade protection, labour laws) are bound to create rigidities which are harmful to economic development in the long run. Developed particularly in the European context where the corporatist institutions were strong, the argument is often presented under the heading 'Eurosclerosis' (see Giersch 1986), but it has also seen application in the American context by Olson (1982).

The implications of the sclerosis theory for the role of the state were probably more far reaching than those of monetarism. At the political level, it undermined the credibility of state intervention by identifying the very corporatist institutions upon which such intervention is based as the source of sluggish growth and high inflation. At a more fundamental level, the theory challenged belief in collective institution building of any kind by stressing the inevitability of degeneration to which all institutions are subject.

2.1.3 New Contractarianism

Related to the sclerosis argument, with possibly Hayek as the link between the two, is the new contractarianism of libertarian authors like Buchanan and Tullock (1962) and Nozick (1974). The new contractarians argued that any form of state beyond the old liberal minimalist state, which does no more than provide law and order (including, among other things, the protection of property rights), cannot be justified in the eyes of those who believe in the sanctity of individual freedom. A major source of popularity of these writings lay in their emphasis on individual freedom and their articulation of modern discontent with the welfare state and its alleged restrictions on personal choice. The welfare state was no longer to be seen as a benign, if paternalistic, institution, but as a Leviathan which must be restrained to preserve our liberties and the vitality of civil society.

2.1.4 Principal-Agent Models of Bureaucracy

Another important development along the anti-interventionist line was the emergence of various types of principal-agent models of bureaucracy developed by authors like Niskanen (1973), Peacock (1979), and Rowley (1983). These models see the root of many of the problems of the contemporary capitalist countries - for example, the over-extension of the bureaucracy, the waste of resources in government administration, the inefficiency of the public enterprises - in the inability of the principals (the public) to monitor the self-seeking behaviours of their agents in public affairs (the bureaucrats). These models were usually presented as neutral efficiency arguments, but have had much deeper political impacts. By arguing that the same assumption of self-centred behaviours should be applied to both the private sector agents and the public sector agents, they not only questioned the public's trust in the benign paternalism of the welfare state but also undermined the self-confidence of government officials and their commitment to a public service ethic.

2.2 Less Developed Countries

For the LDCs, the end of the Golden Age arrived slightly later than for the advanced capitalist countries, that is, in the 1980s. Although there were growing criticisms of their import substitution strategies, the 1970s was a period of relatively rapid progress for many developing countries, especially for those willing to borrow heavily in the international capital market awash with the so-called petrodollar (see Singh 1992a). However, with the beginning of the monetarist policies in the advanced capitalist countries, industrialisation in most LDCs ran into trouble because of the critical shortage of foreign exchange, promoted by high interest rates, falling world demand, and the debt crisis (Hughes and Singh 1991). The fragile ruling coalitions in most of these countries could not survive the massive external shocks to systems which were already finding it increasingly difficult
to cope with the growing population and the increasing diversification of interests. In the face of severe foreign exchange constraints, most LDCs ended up launching (often unsuccessful) dramatic liberalisation programmes along the lines demanded by the Bretton Woods institutions (i.e., the World Bank and the IMF), whose endorsement suddenly became critical in the continuation of foreign exchange inflow.

### 2.2.1 Attack on Import Substitution Industrialisation

Usually associated with the Bretton Woods institutions, this critique reasserts the wisdom of neoclassical doctrines, especially the Heckscher-Ohlin-Samuelson theory of comparative advantage, which were rejected by the proponents of the import substitution industrialisation (ISI) strategy (see World Bank 1987 and 1991; for criticism see Weiss 1990 and Singh 1992b). The argument is that, by producing goods which could be produced more cheaply (in relative terms) in other countries, countries trying to substitute imports forgo the gains from trade. Moreover, given their small market sizes, the protected industries in the LDCs end up being monopolists or oligopolists producing at suboptimal scales and/or under full capacity and having no compulsion to improve their productivity. Finally, it is argued that the artificially cheap price of ‘capital’ (i.e., artificially low interest rates) created by ‘financial repressions’ associated with ISI leads to lower savings and to the adoption of excessively capital-intensive technologies, which adds to unemployment and income inequality.

### 2.2.2 Rent-Seeking and the New Political Economy

First developed by Krueger (1974) and Posner (1975), the rent-seeking argument asserts that the creation of entry barriers by the state leads not only to the standard deadweight welfare losses but also to additional “waste” from expenditures on “unproductive” political activities intended to influence the state in its capacity as the creator of entry barriers (and the accompanying property rights). In the context of LDCs where the rules of contesting property rights are not as well established as in the advanced capitalist countries, the scope for rent-seeking associated with those state interventions associated with import substitution was seen to be much wider. Associated with this view is the so-called New Political Economy, which shows how a ‘predatory’ state in LDCs can create a property rights structure which maximises its revenues rather than social welfare (North 1981; Findlay 1990). An especially influential recent development has been the extension of these theories to what is similar to the 18th century liberal attack on mercantilism (see e.g., de Soto 1989).

### 2.2.3 Attack on Public Enterprises

The late-1970s and the early-1980s saw the proliferation of reassessments of the performance of the public enterprises across the world, especially in the LDCs. While there were many balanced studies (see Baumol (ed.) 1980; Vernon and Aharoni (eds.) 1981; and Jones (ed.) 1982), there were also some damning indictments of public enterprise as the major source of economic inefficiency and stagnation of the LDCs (see e.g., World Bank 1983). Identifying the source of these inefficiencies as emanating from the lack of profit incentives, competition, and financial discipline imposed by the capital market, the neoliberal arguments for privatisation became a centrepiece of their attack on the interventionist economic management of the Golden Age (for some criticisms of these theories, see Chang and Singh 1993; Rowthorn and Chang 1993). In many LDCs, where the frequent inefficiency of public enterprises was especially damaging, given their weight in the manufacturing and infrastructural sectors of the economy, the support for privatisation spread like wildfire.

### 2.3 Socialist Countries

Following a period of impressive achievement after the war, the socialist countries underwent a prolonged economic stagnation associated with lagging technical progress, institutional sclerosis, and growing political disillusionment (see Bleaney 1988; Brus and Laski 1989). Although the sudden collapse of the socialist system in the late-1980s has made the understanding of their experience less important than previously, it is still the case that some of the theories developed in the context of socialist experience have left us with interesting insights into the role of the state.
2.3.1 The Shortage Economy

Based on an economic situation which is almost the polar opposite of what Keynes faced in the interwar period, that is, a situation where the problem of excess demand is institutionalised through a peculiar incentive system, Kornai invented the concept of the ‘shortage economy’ and developed it into the foundation of his institutionalist critique of socialism (see e.g., Kornai 1979). The fundamental message is that the lack of financial discipline (the so-called ‘soft budget constraints’) associated with the lack of private property leads to a situation where not only a substantial part of national income is wasted in ‘unproductive’ activities such as hoarding of material and human inputs but also there is no incentive to improve the productive efficiency. Moreover, when associated with the absolute political commitments to zero unemployment, the need for the stockpiling of labour inputs produces some perversive effects on labour discipline, originally stressed in a capitalist context by Marxist writers but generalised more recently by efficiency wage theorists (Bowles 1983; Akerlof and Yellen (eds.) 1986).

2.3.2 Property Rights Approach

Although it is difficult to suggest that the property rights approach sprang entirely from the research on socialist economies, some critical initial contributions to the development of the approach originated there (for a survey, see Furuobotn and Pejovich 1972). The argument basically is that the lack of private property institutions in the socialist societies eliminates the individual incentive to remain efficient and improve productivity. This was a particularly damning indictment for the socialist countries, as they traditionally saw their distinct system of property rights as the source of their supposed economic superiority over the capitalist countries. The recognition that this defining characteristic of their system, namely, state ownership of the means of production, might be the root cause of their economic troubles had a profound impact on popular consciousness, as is well proven by the almost irrational obsession with privatisation issues in the post-communist reforms in Eastern Europe.

2.3.3 The Austrian Attack on Central Planning

The oldest, but possibly the most fundamental, attack on socialism is the Austrian attack on central planning. Starting from the interwar debate between Mises and Hayek on one side and Lange and Taylor on the other side, the Austrians have constantly asserted the unviability of central planning (for a good survey of the debate, see Lavoie 1985). They argued that the completely centralised coordination of activities in a complex and constantly changing modern economy would require the collection and processing of information on a scale far beyond the capability of any present or future state. More importantly, they argued that only competitive rivalry amongst genuinely independent, profit-seeking agents can generate and utilise the accurate and detailed information required to run a modern economy. Although quite unacceptable in its extreme form – that all forms of state intervention, and not just central planning, are bound to fail or threaten liberty – the power of this argument is now widely accepted even by many who favour an interventionist state.

3. CRITICAL EVALUATION OF THE NEOLIBERAL THEORIES

As may be seen, different anti-interventionist theories developed in different historical, political, and institutional contexts, on the one hand, and from different theoretical traditions, on the other. Some draw heavily on the neoclassical legacy (e.g., the Breton Woods critique of import substitution), while others draw on more heterodox traditions like Austrian or institutional economics. However, one thing which is common to most of these theories is that they lay more emphasis on the ‘political’ rather than ‘technocratic’ aspects of economic problems, i.e., by questioning the very political foundation of interventionist models of economic management, neoliberal theories have brought issues of morality, justice, and power – although in their own peculiar ways – back into economics. In this section, rather than to criticise theories in the neoliberal tradition individually, we make some general comments on their central theoretical underpinnings.
3.1 Principal-Agent Framework

Common to many neoliberal theories is the principal-agent framework, where the limited scope for monitoring by the principal creates problems of designing incentives for agents who pursue their own self-interests. Major examples will be the problem of designing optimal welfare or social insurance programmes due to the difficulty of identifying the true ‘type’ of the potential subscribers (for a survey of related issues, see Barr 1992), and the problem of designing optimal industrial subsidy schemes or optimal public enterprise management rules due to the difficulty of identifying the source of bad performance (e.g., external shock or bad management).

For certain individual problems, the principal-agent framework is a fruitful approach, since it questions the naïveté of traditional welfare economics and its assumption that state officials always have the incentive to correct market failures once these are identified. However, at a more general level, this framework poses an awkward question – who is the principal and who is the agent, especially in a modern mass democracy? For example, in relation to social welfare programmes, we can argue that ‘the state’ is the principal, but from the points of view of the principal-agent models of bureaucracy or of contractarian political philosophy, the state is an agent of ‘the public’. Thus seen, there are inconsistencies in the ways in which different principal-agent models characterise the process of state intervention.

We are not arguing that there is only one correct way of deciding who is the principal and who is the agent. Indeed, the very existence of different ways of envisaging principal-agent problems in our society reflects the complexity of modern polity. Our point is that, without an adequate understanding of the complex political process in a modern society, the choice of principal-agent models may end up obscuring major issues rather than clarifying them. The political process in a modern society involves collective action and bargaining problems at many different levels (local, industry, or national levels), whose solutions are strongly influenced by social norms (working class solidarity, work ethic, abstinence), political institutions (dictatorial, corporatist, or liberal institutions), and socio-political ‘visions’ (socialism, nationalism, welfare statism, free enterprise). The principal-agent model, given its sole emphasis on wealth-maximising be-

haviour of selfish individuals, cannot take such complexity of political-economic process into account. Thus seen, there are serious dangers in accepting the radical proposals for rolling back the state derived from such models.

3.2 Mistrust of the State

Another common feature of the neoliberal theories is their deep mistrust of the state. The new contractarians see the state as a necessary evil with a natural tendency to expand, which has to be put under constant surveillance by sovereign individuals as partners in a social contract. The principal-agent model of bureaucracy is another well-known manifestation of this belief. If somewhat less obvious, the monetarist argument for a constitutionally binding money growth target is also symptomatic of the belief that the state cannot be trusted to withstand the demands of ‘special interest’ groups. Similar to this is the ‘regulatory capture’ argument propagated by Stigler (1971) that the regulatory agencies may be set up in order to serve public interests but end up serving the interest groups which they are supposed to regulate.

One serious problem with the neoliberal mistrust of the state is that it uncritically (or intentionally?) assumes that the state (or the bureaucrats as its components) always acts in its (their) own interest. Apart from the obvious observation that individuals and institutions do not always act in their own interest, there are too many facts of life which make this simple self-centredness assumption problematic. Even the most casual observation confirms that different states have different degrees of commitment to the public interest, that the boundaries of the public domain are different in different countries and constantly changing even in the same country, that people operating in different environments (e.g., civil servants and businessmen) have different rules of behaviour, and that even the same individual may apply different rules of behaviour in different circumstances (e.g., a civil servant during and outside his office hours). Policy conclusions drawn from models ignoring these facts are at best misleading and at worst pseudo-scientific renderings of the model-builder’s ideological conviction against the state.

More fundamentally, we argue that the more generalised mis-
trust of collective action, on which the neoliberal mistrust of the state is based, is problematic. First of all, it is not correct to argue that institutions (e.g., the state, labour unions) are always (or even predominantly) products of social contracts among free-contracting individuals. Human beings have always existed as members of certain collectivities, and the notion of the free contracting individual is a product of the capitalist order (Polanyi 1957). Individuals are perhaps more a product of institutions than the latter are the products of contracts among individuals. Secondly, the neoliberal preference for individual actions over group actions has some awkward political implications. Neoliberals often attack 'interest groups', but after all, those interest groups are associations of individuals whom the neoliberals regard as absolutely sacred. How can a consistent liberal deprive individuals of the freedom to join a collectivity he/she likes? And, indeed, the neoliberals do endorse certain interest groups such as private firms. If some interest groups are legitimate and others are not, what is the criterion to decide which groups belong to which category? The anti-collectivist rhetoric of the neoliberals merely obscures the existence of a hidden political agenda against certain particular groups.

3.3 Trust in Individual Entrepreneurship

The other side of the coin of the neoliberal mistrust of the state is the trust in individual entrepreneurship. While all pro-market theories believe that ‘wrong’ institutions and state policies lead to allocative inefficiency, many neoliberals would go even further and argue that state intervention impairs the ability of individuals to improve the productive capacity of the economy by generating new knowledge (i.e., innovation) in their attempts to capture profit.

One problem with this position is that it sees entrepreneurship as essentially an individual activity. This view stems from the belief that knowledge is always deposited in individuals, but it ignores the fact that, at least in modern economies, institutions and organisations are also depositories of knowledge. Contrary to what Schumpeter (1987) predicted, institutionalisation of R&D did not decelerate innovation in modern economies, but, if anything, accelerated it. This is because, as the recent literature on technical change shows (see e.g., Dosi et al. (eds.) 1988), innovative activities often are facilitated by collective effort, including, among other things, state support. This means that the old concept of entrepreneurship based entirely on individuals is no longer valid (Chung and Kozul-Wright 1994), i.e., entrepreneurship has increasingly become a collective effort.

Equally problematic is the argument that state intervention creates an incentive to divert entrepreneurship into ‘wasteful’ activities of securing property rights through political means (e.g., Krueger 1974; Bhagwati 1982; de Soto 1989). Although this position is not necessarily wrong, this brings back something the mainstream economists tried so hard to eliminate from the discipline, i.e., value judgments. As the definition of productive and unproductive activities needs some criteria to tell whether a certain activity is ‘necessary’ for the functioning of the economy, it is impossible to come up with a viable concept of unproductive labour without calling in some political and moral value judgements (Driver 1980; Boss 1990). Many of those who condemn political competition (e.g., rent-seeking) as wasteful do not recognise this dilemma, but implicitly assume that a simple deregulation of the present economy will eliminate all ‘unproductive’ activities, which is not necessarily the case (see Chang 1994: Chapter 2).

3.4 Anti-Utilitarianism

Strong anti-utilitarianism, or more broadly anti-consequentialism, runs through most neoliberal theories (for some philosophical debates on consequentialism, see essays in Scheffler (ed.) 1988). Of course, there exists a well-known tension between utilitarianism and political liberalism (on this, see Berlin 1969), and those neoliberal theorists who have been brought up in a strongly utilitarian tradition of neoclassical economics would find it difficult to totally abandon the utilitarian legacy in their thinking. However, many neoliberal positions — such as the new contractarian defence of the rule of law, the Austrian adherence to free competition, and the monetarist insistence on constitutional limits on the formulation of monetary policy — are all based on the idea that there are certain fundamental rules that have to be abided by regardless of their consequences (i.e., individual freedom, freedom of entry, zero inflation). Indeed, many neoliberals claim to be willing to ‘trade off economic efficiency for individual freedom where such a
policy conflict becomes apparent" (Peacock and Rowley 1979: Chapter 26).

However, is this really a tenable position? We think not, because any defence of a certain rule (or procedure) assumes a preference for a certain consequence. Otherwise, we would have to assume that the rule is God-given or totally randomly chosen, which would not be acceptable, even to most neoliberal theorists. For example, we may say that we value the principle of majority rule and therefore are willing to accept certain "suboptimal" outcomes if they are the results of that rule, but why did we decide to value majority rule in the first place? Was it not essentially because we thought that it, on average, would produce the "best" outcome in some sense? If this is the case, the neoliberals are calling for no more than a higher-order utilitarianism, so to speak, based on the recognition of human fallibility (e.g., imperfect foresight, imperfectly transferrable knowledge, weakness of will, whim, etc.), which makes it impossible to custom-design rules for every contingency in order to produce the optimal outcome. Of course, it is possible to get out of this dilemma by arguing that the neoliberal rules are beyond dispute and therefore cannot be interpreted as a product of a higher-order utilitarianism. However, for those who do not dogmatically accept these rules, it is not clear how any man-made rule can be totally devoid of consequentialist thinking.

4. CONCLUSION

The neoliberal revival represents a partial return to the 19th century laissez-faire tradition, supplemented by an Austrian emphasis on the limited transferrability of knowledge and the role of entrepreneurship. The neoliberal approach stresses the efficacy of the free market, and insists on the inefficiency and/or counter-productiveness of state intervention. It blames the past and present state interventions for most recent economic ills, and its prescriptions for most economic problems consist largely of deregulation and reducing the economic role of the state to that of a 'night-watchman'. The failings of state intervention are ascribed either to an inherent shortage of information (the Austrians) or to the self-seeking behaviours of the bureaucrats (Niskanen, Peacock, and Rowley) and/or organised interest groups (rent-seeking, institutional sclerosis).

From the mid-1970s onwards, neoliberal doctrines gained a wide following throughout the world. They inspired liberalisation and privatisation in many developed and developing countries, and even political revolution in many socialist countries. Amongst the advanced capitalist countries, neoliberal programmes were implemented vigorously in the UK and the USA, and somewhat less vigorously in most of the rest. Many developing countries have also implemented neoliberal programmes in the areas of trade, industry, and labour market policy - sometimes by choice and sometimes under pressure from external creditors. As a rule, the promise of these programmes has been that the freeing up of markets and the reduction in direct state intervention would make economies more flexible and creative, helping to solve their immediate economic problems and contribute to their long-run economic dynamism.

It is now frequently, though by no means universally, accepted that the neoliberal programmes have mostly failed to live up to their promise. The problems of the world economy remain formidable; many developing countries which have followed this programme are still in great difficulty; in the advanced capitalist world, the Thatcherite experiment in the UK was conspicuously unsuccessful in making the economy more competitive, and the Clinton administration in the USA overly refuted the ideas associated with Reagonomics. As a result of these experiences, there is growing disenchantment with the neoliberal programme. One partial exception to this new trend is perhaps Eastern Europe and the Soviet Union, but even there the initial optimism in the efficacy of the free market is fading fast.

In this chapter, we have provided some criticism of the neoliberal theories. We have pointed out that most neoliberal theories do not take into account the complexity of human motivation (which differs across agents, societies, and time), the complexity of modern polity (who is the principal and who is the agent?), the importance of the legitimisation process in policy making and implementation, the inevitability of collective managements, in one form or another, of complex modern economy, and so on. Their simplistic notion of politics makes the neoliberal arguments at best misleading and at worst deceitful. To be consistent, neoliberals must either be so naive as to believe that a rewriting of the constitution to ban virtually all collective
action (except the minimal state) is possible, or else have a hidden agenda behind their populist rhetoric, whose aim is simply to roll back the gains made by working class and other "progressive" movements during the 20th century.

Neoliberals, especially those with Austrian influence, are correct in saying that central planning is not the most rational way to run a complex and constantly changing modern economy as its advocates thought it would be. However, it is erroneous to jump from this to the conclusion that all forms of state intervention are doomed to failure. For one thing, even central planning works better than the market for situations where there is one overriding objective, as in wartime or in a space programme. Moreover there are other types of state intervention which are not as informationally demanding as central planning and at least equally effective, for example East Asian-style industrial policy (see Chang 1994: Chapter 3). Contrary to what Hayek says, there is a third way, or rather, there are many third ways.

More broadly, the neoliberal belief that no collective organisation, other than the minimalist state, has any positive economic role to play is not acceptable. For one thing, the firm is after all not a purely individualistic organisation made up only of arms-length contracts, but has a lot of 'hierarchical' and 'relational' elements (Williamson 1975; Pagano 1985). Moreover, there exist extensive 'networks' in the modern economy, which are not pure contractual relationships but are based on trust and solidarity (see Thompson et al. (eds.) 1991). In other words, the world as envisaged by the neoliberals, which is populated by lone individuals whose interactions with each other are only ephemeral, has never existed and probably will never exist (among others, see Polanyi 1957).

Having made the above criticisms, we should point out that even the most ardent critics of neoliberalism would now recognise that it contains some important insights about the economic role of information, the importance of competition, and the like. There is now a widespread agreement that the management of a complex modern economy requires a market which is independent from the state to a considerable degree, although there is still a considerable amount of disagreement regarding to what extent a well-functioning market needs private property (see essays in Pagano and Rowthorn (eds.) 1996). The more important point is that the nature and extent of intervention will vary with circumstances. This means that, although one can talk of certain general principles, there is no hard and fast rule to determine the optimal degree and the desirable areas of state intervention, and that it can only be determined in the concrete historical, institutional, and geographical context.

The neoliberals have served the useful historical function of questioning the viability of the existing forms of state intervention, some of which clearly had serious problems, and of opening lines of inquiry leading to the basis for new forms of intervention. Nevertheless, they have failed to provide an intellectually successful and politically workable programme for comprehensively rolling back the state and achieving their vision of the 'brave new world'. Few now believe that it is either possible or desirable to turn the intellectual clock back to the time before the neoliberal upsurge. Not only has the world economy changed considerably, but both practical experience and the neoliberal critique have revealed some of the flaws in old ways of thinking. The challenge, therefore, is not simply to return to some previous intellectual golden age, but to form a new synthesis in which the valid insights of neoliberalism are stripped of their ideological baggage and integrated into a wider and more objective intellectual framework.