

The State, Market Economy, and Transition

Shaoguang Wang

Department of Political Science

Yale University

What role should the state play in China's transition to a market economy? On this issue, a consensus seems to have emerged among Chinese economists, that is, the government should leave to the market what can be best handled by the market and only concern itself with what the market cannot accomplish, either inherently or for the time being (Gao, 1993). But the extent of agreement should be exaggerated. Behind seemingly accordant statements, a great deal of room remains for argument over specifically what problems can and cannot be resolved by the market.

Accepting the neoclassic assumption of the naturalness, spontaneity, and efficacy of market, and public choice theorists' thesis of the state, some Chinese economists suggest that the role of the state should be restricted to providing defense, defining property rights, enacting and implementing a system of laws, enforcing contracts, and maintaining the value of the currency (Sheng, 1992; Jiang, 1993a; Jiang, 1993b). They believe that if the government leaves economic actors alone, unfettered competitive markets would work better in generating socially desirable outcomes.

In what follows, I argue that the state should play an active role in China's transition to a market economy. The argument is built upon three observations. First, even in mature market economies, state interventions are indispensable for remedying market irrationalities and for organizing efficient markets. Second, market institutions cannot be properly installed without the support of the state. Especially, if China is to establish a "socialist market economy," the state has the obligation to mitigate the hardships and the cruelties caused by the market transition. Third, as a giant developing country, China faces many challenges which cannot be settled through voluntary transactions.

The Roles of the State in Market Economies

In the West, economists often use the theory of market failure found in welfare economics as a rationale for government activity. Market failures here refer to situations in which voluntary transactions do not result in allocative efficiency. Many sources of market failure have been recognized in standard economics textbooks:

Public goods Characterized by their broad use, indivisibility, and nonexcludability, "public goods" cannot be provided for through the market system, i.e., by transactions between individual consumers and producers. A classic example is national defense, which has to be provided by the state.

Infrastructure has some properties of public good. An economy is unlikely to take off unless its infrastructure is sound. Due to the presence of indivisibility, however, private investors may find the provision of infrastructure not profitable, at least in the short-run. That is why infrastructure is financed by governments in most countries (Kruger, 16-7)

Macroeconomics stabilization may also be considered a "public good." Market economies have always been characterized by fluctuations in the business cycle, by periods of boom and bust. Economic stability thus is obviously something desirable, for it benefits all. But precisely for this reason, few have incentives to make contribution to its realization. The government therefore has to bear the responsibility of maintaining macroeconomic stability.

Externalities Externalities occur when there is divergence between private and social costs or benefits. Wherever externalities exist, the actions of an economic agent (individual or firm) impose costs upon, or provide benefits to, third parties who are unlikely to receive compensation, or to be charged, through markets for what they get involuntarily. The result could be either too little or too much production or consumption. Some suggest that it is possible for people to voluntarily get together to solve the problem of externalities. If the number of third parties are large, however, the transaction costs for all those involved to negotiate a solution tend to be prohibitively high. Moreover, externalities always exist and at any given moment there may be many kinds of externalities coexisting at once. Thus, if the state does not come to the fore to internalize them, a great deal of

people's time and resources would be wasted in endless rounds of unproductive negotiation.

Increasing Returns Where economic activities are subject to increasing returns (and/or decreasing marginal costs), a free market will result in monopoly. Facing no competition, a profit maximizing monopolist will sell a lower output and charge a higher price than it would pertain under competition. The outcome thus will be inefficient. A recent development in economics--the theory of "contestable markets"--suggests that where as long as there are potential entrants, the production of a good or provision of a service by a monopolist does not necessarily signify that he will be able to exploit monopoly power (Baumol, Panzar, and Willig, 1982). What is ignored in the theory is sunk costs. In the modern time, there is hardly any industry the entry to which does not involve sunk costs. As a matter of fact, such costs are often very high. Substantial sunk costs are an effective barrier to entry. Thus, monopolists are unlikely to be disciplined by the potential entry of competitors. In other words, government anti-trust policy is still necessary (Stiglitz, 1991a)

Unemployment The competitive equilibrium model predicts full employment. However, due to downward rigidity of interest rates and nominal wages, the signaling mechanism in the capital and labor markets does not work in the ways neoclassic economists predict. As a result, high unemployment of workers and machines have often plagued capitalist economies. Although most economists do not treat unemployment as a market failure in its own right, but rather as a consequence of some other market failures, some economists believe that "high unemployment is the most dramatic and most convincing evidence of market failure" (Stiglitz, 1986)

Incomplete Markets The neoclassic model maintains that competitive markets can ensure economic efficiency, because it assumes that there are a complete set of markets. But, that is not the case in reality. Private risk and future markets, for example, are far from adequate. Markets do not exist for many possible future contingencies and many of the important risks that we face are uninsurable. Incomplete risk markets may lead to inefficient levels of investment. Moreover, prices cannot serve the function of coordinating decisions concerning the composition of capital formation without a complete set of future markets (Arndt, 1988).

In the absence of a complete set of future and risk markets, each economic agent needs a model of the whole economy in order to make future-oriented decisions (like entry and exit). Without formulating expectations about the behavior of other agents, his or her decisions can hardly be considered rational. If s/he does, however, s/he is in effect using as much information as would be required for a central planner. In such a conceptualization of economic behavior, as Arrow remarks, "the superiority of market over centralized planning disappears" (Arrow, ???).

Information Failure Information has two special features: Once information is produced, it cannot be destroyed; and giving it to one more individual does not detract from the amount others have. Efficiency requires that information be made accessible to all who want it. However, private producers of information have interest in keeping it for their own exclusive consumption. For this reason, the private market is unlikely to provide an adequate supply of information. (Stiglitz, 1986). This is true especially when information can be used to further an agent's own welfare or where acquiring and transmitting information is costly. The government could play a part in remedying information failures. Given the asymmetric distribution of information between the consumer and the producer, for instance, the state may use regulations to protect former's interests. In addition, the state may offset externalities in the area of information by collecting, processing, and disseminating crucial information (e.g. information about foreign markets) to those who need it in the national economy.

While the traditional literature assumes that markets are efficient except for some well defined market failures, more recent studies reverse the presumption: it is only under exceptional circumstances that markets are efficient. Greenwald and Stiglitz show that whenever markets are incomplete and /or information is imperfect (which are true in virtually all economies), even competitive market allocation is not constrained Pareto efficient. In other words, there almost always exists schemes of government intervention which can induce Pareto superior outcomes, thus making every one better off (Greenwald and Stiglitz, 1986). Although the pervasiveness of market failures doesn't warrant the state in thrusting its nose into everything, the "optimal" range of government interventions is definitely much larger than the traditional "market failure" school recognizes.

Even if a competitive market might generate a Pareto-efficient allocation of resources, there are still the cases for government action, because an efficient allocation of resources might entail great inequality. According to the Second Theorem of Welfare Economics, for any Pareto-efficient allocation, there exists a set of prices that support that allocation as a market equilibrium, but each with a different distribution of welfare. The problem is to decide which Pareto-efficient allocation conforms to society's notion of distributive justice. Obviously, the market cannot do it. The social welfare function is simply not a market construct; it must evolve from the political process.

Moreover, the Pareto principle can be pushed a step further to allow economic efficiency to encompass not just actual Pareto improvement, but also potential Pareto improvements. These are changes in which some persons gain while others lose, but in which there are overall net gains in the sense that the gainers hypothetically could compensate the losers and still be better off. The problem is that in the "spontaneous order" advocated by neoclassic economists there is no way to ensure that the gainers would compensate the losers (Boadway, 1989). Without institutionalized mechanisms to redistribute income, market forces thus tend to expose individuals to aggregate effects that expand the fortunes of some while reducing the fortunes of others.

Most people think it right to alter the distribution of income in helping the poor or in improving equity. But inequality is not just morally repulsive. Numerous studies have shown that economies in which wealth is very unequally distributed may cause serious incentive problems (Stiglitz, 1989). Inequality has also been found often associated with slower growth (World Bank, 1991; Alesina and Rodrik, 1992; Persson, 1994; Perotti, 1996; UNCTD, 1998).

More important, the survival of a market economy may to a great extent depend upon social equity. If asymmetric rewards and punishments generated by market forces persist, and no adjustments through redistribution take place, then the gap between those who flourish and those who stagnate would continuously widen. As a result, social conflict may become intense and violence may begin to emerge. To contain the level of social disturbance below the suicidal destructiveness of national revolution, the market system must be embedded in a framework of institutions that provides for its own modification in response to social-economic pressures. Thanks to socialists'

efforts and pressures from the working poor in the second half of the nineteenth century and a large part of this century, mechanisms of sharing the benefits of growth more equally have been to various degrees established in all advanced capitalist countries, which have helped to diffuse opposition against the market system. "If this lesson is not learned, if the appropriate instruments of state are not created, the preconditions of socialism will be recreated and the history of the nineteenth and early twentieth centuries will be repeated" (Day, 1993).

The Roles of the State in Market Transition

China is in the process of transition from a command economy to a market economy. Accepting Adam Smith's thesis that the natural human propensity to "truck, barter, and exchange" would automatically lead to market exchange, some people believe that once the stifling state is knocked out of economic realm, "market forces" would emerge full blown to put human society in perfect order. Such a blind belief in the naturalness, spontaneity, and efficacy of the market is probably one of the most dangerous illusions for market reformers. An effective government in fact is a precondition of transition to market economy. There are three reasons.

First, voluntary transactions cannot take place in an institutional vacuum.

A market economy cannot exist without effective legal, administrative, regulatory, and extractive institutions maintained by the state. Institutions are needed to perform, at a minimum, the following functions:

- to define property rights;
- to enact a system of laws;
- to enforce contracts;
- to collect taxes;
- to oversee banks;
- to supervise corporate entities;
- to promote and preserve competition;
- to supply entrepreneurs with information that reduces uncertainty, cuts transaction costs, and secures private sector confidence in making investment decisions;

- to dislodge and then prevent the reemergence of subnational barriers to free factor mobility;
- to facilitate communication and consultation with the private sector, labor organizations, and other important interest groups;
- to conduct strategic planning and macroeconomic analysis;
- to administer social security system;
- to provide the legal context within which disputes between competing economic agents are resolved;
- to ensure that groups capable of sabotaging the expansion of markets are not excluded from the political process.

Those institutions provide stability, certainty, and predictability necessary for facilitating efficient economic transactions. Historically, the creation of national markets coincided with the constitution and expansion of such state institutions in the West. Late developers in the Third World often failed to create functioning market systems and thereby resorted to interventionist regimes not because their governments were too "strong" but rather because their governments were too "weak." A weak state could be very intrusive, but at the same time lack the capacity to construct effective legal and regulatory institutions. (World Bank, 1991) "There is evidence that under conditions of administrative weakness it is harder to create and regulate functioning national markets in goods, labor, and finance than it is for government to manage the bulk of production itself" (Chaudhry, 1993). In this sense, simply "shrinking the state" will not produce efficient market systems. To create competitive markets, new state institutions must be established and strengthened to perform the task of indirect regulation and administration, which is much more delicate and difficult than direct control.

Second, market institutions cannot spring up automatically.

Some people believe that market institutions would spontaneously emerge from voluntary transactions between economic agents if the state stands aside. This has never happened before and we have no reason to believe that it is going to happen now.

Market institutions, in a sense, represent the essential, irreducible minimum of "public goods" that must be provided if markets are going to work at all (Garnaut, 1991). Since they are public goods, people are unlikely to cooperate voluntarily with one another to provide them, just as they would not in regard with the provision of other kinds of public goods. Of course, if

the state does not provide market institutions, private economic agents would have to develop some informal rules to stem uncertainty and introduce some level of predictability into commercial transactions. In the absence of state intervention, however, these agreements are likely to evolve into pacts that neglect the interests of consumers and small producers and reflect only the preferences of those who possess economic power. Thus, as "public goods," market institutions initially have to be brought about by non-economic forces.

Even after the establishment of market institutions, the state still cannot stand aside. Individuals have incentives to break market rules--to corrupt the legal basis of market exchange, to collude in anti-competitive ways, to misrepresent the nature of assets which are the subject of contracts, and so on. Enforcement costs of market-conforming behavior can be extremely high. In countries where there are already cultural and ideological support for self-restraint in maintaining the rules of the marketplace, enforcement costs of market-conforming behavior would be lower. In countries where the market economy is still in the making, however, it is necessary to have more explicit, extensive, and expensive enforcement of the rules by a strong state (Garnaut, 1991).

Third, the market transition is not a consensual but a conflictual process.

As indicated above, the market economy is not just embedded in state institutions, it also has its ideological and moral basis, which is what the economy in the transition is lacking. Neoclassic economists' transhistoric assumption about the human motivation may enable them to generate sophisticated models, but the simple fact is, as Leiberstein points out, people's behavior has often been influenced by "habits, conventions, work ethics, partial calculation, and inertia" (Arndt, 1988). When a great institutional change occurs, they often find it hard to adapt. In the case of market transition, people would not accept market values and behave according to market rules simply because the government has announced that their country has adopted the model of market economy. It took a long time for European countries to develop attitudes favorable to the formation of market systems in the eighteenth and nineteenth centuries, because, violating the "moral economy" that had preexisted the market economy, practices most consistent with market rationality caused a great deal of confusion and disturbance in those societies (Thompson, 1971).

The state socialist system in a sense was also a moral economy characterized by what Chinese call "iron rice bowl" (life-time employment) and "everyone eating from the same pot" (equal income distribution regardless of effort). To create a market economy, the "moral economy" has to be destroyed and a new ethic has to be cultivated or imposed, which is bound to trigger off protests against the logic of the market. Market development thus requires an ongoing process of "legitimation" supported by the armor of coercion.

Moreover, the market transition involves not only the transformation of norms and values but also the redistribution of resources and power. The transition may provide some social groups with opportunities of upward mobility, deprive others of traditional privileges, and threaten the livelihood of still others. The transition is also likely to create inequalities in income and wealth that do not match existing patterns of entitlements, status, and power. In one word, the transition tends to dislocate groups in both the political and the economic realms, which would inevitably give rise to social conflicts and political struggle (Chaudhry, 1993). The creation of market economy in England, for instance, was by no means a continuous and consensual process. Rather, it was a product of power struggle among social groups attempting to shape exchange relations in their interests (Lie, 1993).

In former state socialist countries' transitions to market economy, as many studies have predicted, "whatever their long-term consequences, in the short-run reforms are likely to cause inflation, unemployment, and resource misallocation as well as to generate volatile changes of relative incomes" (Przeworski, 1991). Even in the best scenario, as in China, where everybody benefits, some people will gain much more than others. And very likely, some will benefit at the expense of others. The issue is who will get what, how much, and when, and who will bear the costs. The government of course can use its coercive power to impose the costs on certain social groups. In order to have a relatively smooth transition, however, it is better for the state to adopt measures alleviating transition pains by establishing new "safety nets" and somehow compensating those whose interests are threatened by the reform. This is a very expensive undertaking. The state has to be strong enough to amass sufficient resources for redistribution.

In his classic study of the rise of the market economy in England, Polanyi finds that the origin of market society is not "traceable to the mere

desire of individual to truck, barter, and exchange." Instead, he believes the very idea that human beings have a natural propensity to 'truck, barter, and exchange' was a product of market society; not the other way around. Since the market is not a natural and necessary manifestation of human nature, one should not expect the development of a market economy to be a spontaneous process. In the case of England, Polanyi finds that "the road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism" (Polanyi, 1957). Governments also provided dynamics in transforming other European countries into market societies (Garnaut, 1991). If there was nothing natural or automatic about the rise of market mechanisms in early developers, if "markets," as Chaudhry points out, "are conscious constructs in the same vein that command economies are deliberate arrangements" (247), we have good reason to believe that everywhere a strong state is required to enforce the rules, norms, and institutions that are necessary for establishing a functioning market economy.

The Roles of the State in Economic Development

China needs not only to reform its system but also to develop its economy. In fact, development is the purpose of reform. What role should the government of a poor country play in its economic development? The market failure arguments imply that market economies are all the same and that a theoretically optimal boundary between the market and the state can be found. But this is apparently a wrong assumption. Embedded in different structural situations with respect to the level of development, geographic location, the size of country, culture, and international environment, different economies have to deal with different kinds and different degrees of market failure, which requires them to devise different institutions to overcome such obstacles to their development. In other words, there does not exist a common model of state intervention that can solve market failure problems for all countries and at all times.

More specifically, we have reason to believe that markets may work less well *in* underdeveloped than *in* developed countries and that markets may work less well *for* underdeveloped than *for* developed countries.

Structural rigidities are the main reason why markets may work less well in underdeveloped than in developed countries. For a market economy to function efficiently, the three components of the price mechanism--signaling, response, and mobility--all have to work properly (Arndt, 1988). First, prices must be elastic in signaling changes in demand and supply conditions. Second, economic agents--producers, consumers, workers, and owners of factors of production--must be willing and able to respond to market signals. Third, factors must be able to move readily and easily. But, in practice, those conditions of market equilibrium are often lacking in underdeveloped countries. Prices, for instance, are often distorted by monopoly. Even if we assume that prices are right, responses may be inadequate and factors immobile.

Four problems may cause inadequate responses to market signals. First, influenced by traditional values, habits, conventions, work ethics, and inertia, people in underdeveloped countries may not seek to "maximize" their own material well-being as neoclassic theories posit. Second, information crucial for making rational decisions is often hard to come by in underdeveloped countries. For instance, price changes occurring somewhere else in the province, the country, or in the world may not be known to local farmers. As a result, there is no way for them to construct complete inventories of all the available and prospective alternatives relevant to their objectives. Third, due to low level of education, even if economic actors in underdeveloped countries are willing to respond to market signals promptly and all relevant information is available, they may lack the ability of making rational decisions. For instance, they may not possess the cognitive and computational ability to compare alternatives, or, when facing uncertainty, they may not be able to estimate the relevant probability distributions and rate of discount. Thus, the alternative they select may be far less than optimum. Fourth, the downward rigidity of interest rates and nominal wages is just as strong in underdeveloped as in developed economies, especially in those countries where populism prevails.

For those reasons, in a good many times, the responses to market signals are lagged, inadequate, or even perverse in underdeveloped countries.

Deficient infrastructure, bottlenecks, poor management, and other structural and organizational constraints can further thwart the "spontaneity" of the market mechanism. Due to those characteristic features of

underdevelopment, factors of production are often immobile, unable to move quickly, or able to move but only at high cost (Arndt, 1988). High transport costs, for instance, may make sale of product in the market uneconomic. The lack of mobility of resources, or more precisely, the inability of some of the productive sectors to adjust timely to changes in demand thus make price mechanism less trustworthy.

Leibenstein envisages the economy as a "network of nodes and pathways." According to him, in this network, "the nodes represent industries or households that receive inputs (or consumer goods) along the pathways and send outputs (final goods or inputs for the other commodities) to the other nodes. The perfect competition model would be represented by a net that is complete; one that has pathways that are well marked and well defined, and in which each node deals with every other node on equal terms for the same commodity." If the above analyses are sound, then in the underdeveloped economy net, some of the nodes are hypoplastic, some of the pathways are clogged, and some portions of the economy are isolated from the others. In one word, this is a net which are full of "holes" and "tears" (Leibenstein, 1978), which may justify more government actions in underdeveloped than in developed economies.

Even if markets work as well *in* underdeveloped as *in* developed countries, they may still work less well *for* underdeveloped than *for* developed countries.

According to the neoclassic economic theory, the market is good at achieving Pareto efficiency. But the notion of Pareto efficiency essentially is a static one, which concerns only about the allocative efficiency of given resources. However, static efficiency should not be the only, or even the chief, criterion for judging the performance of economic systems. Especially, from the underdeveloped countries' standpoint, dynamic value creation is far more important than static value allocation. As Suhartono, an Indonesian economist, points out:

The context of the problem facing the developing countries is fundamentally different from that addresses by static analysis: it is not one of merely adjusting the allocation of given resources more efficiently, but rather it is a question of how to accelerate economic and social development... In economic terms, the problem involves an expansion in the production possibility frontier, not

only a movement along it, through increasing productive capacities and through the productive employment of unutilized or underutilized factors of production. Since from the point of view of the developing countries the analysis for static gains addresses itself to the wrong question, it is not of particular relevance (Arndt, 1988).

Not only is allocative efficiency less relevant in developing countries, concern with it may also stand in the way of obtaining dynamic efficiency. Schumpeter contrasts an economy that optimizes subjects to given constraints with an economy that develops its productive capabilities:

Since we are dealing with a process where every element takes considerable time in revealing its true features and ultimate effects, there is no point in appraising the performance of the process ex visa of a given point of time; we must judge its performance over time, as it unfolds through decades or centuries. A system--any system, economic or other--that at every given point of time fully utilizes its possibilities to the best advantage may yet in the long run be inferior to a system that does so at no given point of time, because the latter's failure to do so may be a condition for the level or speed of long-run performance (Lazonick, 67).

Long-run development involves many "big" industrial decisions that cannot automatically flow from decentralized, optimal decision making in the short run (Stiglitz, 1989). Since markets work only incrementally, the elasticities of supply and demand therefore are larger in the long-run than in the short-run. Thus, at best, the market can provide adequate signals only for marginal changes. If large changes have to be brought about in a short time, the price mechanism cannot be relied upon to induce the resources transfer necessary for such changes. Public interventions therefore are required both to invest directly to break critical bottlenecks and to nourish wholesome macroeconomic environment that encourages investment innovation from the private sector (Shapiro and Taylor, 1990).

To prepare economic take-off, underdeveloped countries first have to build up a solid infrastructure and alleviate bottlenecks that are creating disincentives to investment. Without a solid infrastructure in place, the costs of private entrepreneurial activities would be very high, which would clearly hamper industrialization. There is little dispute that, as a public good, the infrastructure has to be provided by the government. As a matter of fact, state and local governments made sizable direct investments in infrastructure projects in the early economic development of the United States (Goodrich, 1968).

Motivated by "a passionate desire to organize and hasten the process of catching up," the state should probably also play a major role in planning and financing key investments of the economy. Typically, capitals in underdeveloped economies are scarce and diffused, especially in the early years of industrialization. Moreover, with the desire to jump into the modern industrial sectors, those countries may want to use production technologies that require capital investments in excess of what individual investors are capable of amassing. Private entrepreneurs thus may not have the capacity to invest and innovate, even if they have the will (Gerschenkron, 1962). When they have the capacity, however, they may lack the will to do so, for two reasons.

First, the returns to some prospective socially desirable or necessary investments (including R&D) may be too long term and uncertain for private firms to undertake by themselves (Lazonick, 1991). Since the markets that are necessary for such investments to be efficiently allocated do not exist, private firms may lack the willingness to assume the risks. Managers of private firms often face intense pressure for short-run returns. Thus they may be very myopia about the future and highly oriented to maximizing short-run profits. Frequently, private firms, ex ante, estimate private rates of return to long-run investments as too low, even though, ex post, private and social returns would be very high. As a result, investments may be socially suboptimal.

Second, large investments are often externality-intensive. An investment project could create opportunities for others elsewhere. For instance, such activities may enable industries downstream to take advantage of scale economies through production expansion, or induce greater specialization among firms. It is common accepted that investments in human

capital and R&D are essential to economic development. But, positive externalities arising from such investments tend to weaken private profit-making firms' incentive to engage themselves in those areas, even though they may pay over time, both privately and socially (Averch, 1990). Individual investors' profit and loss calculus simply could not adequately capture such social benefits.

If investment and innovation are the two wheels of development, the above analyses show that the invisible hand is not adequate in guiding an economy on those two dimensions. State interventions may be needed to help the economy to achieve its full potential. By supporting the development of education, financial systems, communications networks, and other forms of physical and institutional infrastructure, the state can help private enterprises to employ their productive resources at lower unit costs or reap higher prices for their products (Lazonick, 1991). By sponsoring basic researches or demonstration programs, the state can give reluctant private firms incentives to undertake their own R&D projects. The state may also invest in building up nationwide information networks that keep track of emerging information in various industries relevant to other industries and disseminate such information. By providing missing information linkages between industries, the state can fill information gaps that impede innovation in production (Averch, 1990).

Of course, no government has a bottomless pocket. Therefore, resources at the government's disposal need to be used wisely. Historically, no country has entered into modern economic growth without strategic targeting. Strategic targeting is necessary not only because capitals and talents available to the government of a country are always limited, but, more important, because there is evidence that the market alone cannot promote a right structural composition of industries compatible with the strategic goals of the nation. By employing various policy tools to adjust the industrial structure, the state can use its limited resources to stimulate particular lines of economic endeavor and make its economy internationally competitive.

"Virtually all cases of successful economic development have involved state intervention and improvisation of an industrial strategy" (Shapiro and Taylor, 1990). Industrial intervention in the United States during the nineteenth century were huge. The government then targeted railroads and farmers with land give-aways. It also played an important role in protecting

the home market to permit business organizations to develop and utilize their productive resources to the point where they could attain competitive advantage in open international competition. In the United States, the strong protectionism did not recede until after W.W.II (Shapiro and Taylor, 1990).

The Japanese state has gone much further. It has played an important role in preserving the home market for Japanese firms. It has sought to limit the number of enterprise competing in major manufacturing industries, thus creating incentives for existing companies to incur the high fixed costs necessary to attain competitive advantage. It has made efforts to shape the perception of producers and traders, leading them to hitherto unforeseen possibilities. It has promoted cooperative research and development among major Japanese competitors. It has ensured manufacturing corporations access to inexpensive finance. And the Japanese state has also provided industry with a highly educated labor force to fill blue-collar, white-collar, and managerial positions. Without those "disequilibrating" initiatives of the state, Japan's transformation from a backward economy into a heavy-weight player on international markets might have to take a much longer time, if possible at all.

During the late 1970s and the early 1980s, the East Asian Newly Industrializing Economies (NIEs) were often praised as models of laissez-faire by neoclassic economists. Closer analysis, however, reveals the guiding hand of "strong state" in Japanese fashion in those economies (Hong Kong is an exception). In East Asia, rather than relying upon the market to shape the composition of industries, the governments have played a significant role in determining which sectors or industries are more important for the future growth of the economies than others. Moreover, they have tried to divert resources to targeted industries and firms through complex import controls, schemes of concessional loan, and export subsidies (Sabel, 1993). In the end, those governments have had a great influence upon the course and pace of industrialization and upon the evolving structure of the domestic economies.

The cases of the United States, Japan and the East Asian NIEs illustrate that industrialization does not flourish in a fully free-market regime. Their cases also show that a country's comparative advantages are not always naturally endowed. Instead, they can be created if right industries are targeted and right policies applied to strengthen their international competitiveness (Amsden, 1989; Wade, 1991; and White, 1988). Those lessons

are very important for developing countries that are currently constructing market economies, because the "market" that they are "transiting" to is a truly global one, which is dominated by mammoth multinational corporations. To make its economy internationally competitive, a late developer needs a national strategy to give privileged access to public resources to those national business organizations that can best develop and utilize these resources. At the same time, however, it should prevent those organizations from turning into inefficient geriatric "rent-seeking" lobbies. Only a strong state that is relatively autonomous from the influences of domestic and foreign special interests can undertake such a dual task.

Conclusion

China is in the process of the transition from a command economy to a market economy. The transition, by definition, aims at gradually establishing the market as the central mechanism of resource allocation. In the course of transition, however, we should avoid what Galbraith calls "simplistic ideology" (Galbraith, 1990), what Przeworski calls "neoliberal fallacy" (Przeworski, 1992), or what Kornai calls "uncritical, mythical cult of the market" (Kornai, 1992). The market is not a panacea for solving all our socioeconomic problems. Nor is it a neutral, natural, apolitical, and ahistorical institution. Moreover, the market is not an end in itself. Rather, it is just a means to promote social and individual welfare. For this reason, the potential role of non-market means, including state intervention, in improving welfare should be neither dismissed nor underestimated. This essay argues that active state engagement is indispensable for facilitating both market transition and economic development, two items high on China's agenda. Even China one day becomes a mature market economy, state interventions are still needed to correct pervasive market failures.

All governments intervene in economy by default or design. Contrary to neoclassical theory, in real world, less government intervention doesn't always produce higher level of welfare for people. As many comparative studies have shown, it is in those countries where governments have played active roles that economic structural adjustment has been swifter, international competitiveness stronger, growth more sustained, and distribution of income and wealth more equal (Katzenstein, 1978; Johnson,

1982; Zysman, 1983; White, 1988). Of course, it does not mean that we should give a blanket endorsement of indiscriminate state interventions.

Markets fail, but so do governments. In recent years, public choice theorists has rightly emphasized that state intervention, for reasons both intended and unforeseen, often lead to inefficient outcomes. Arguing that government actions are no more than devices to benefit narrow interests and that government failures are far worse than market failures, they conclude that government should be prevented from intervening in the economy. A critique of the public choice school is beyond the scope of this short essay. In what follows, I will only list several obvious flaws of the theory of government failure.

First, the concept "government failure" is not clearly defined. According to the neoclassic economic theory, the market is supposed to result in a Pareto-optimal situation. Therefore, whenever the market results in a less-than-optimal situation, we can call it a "market failure." But we do not have such a yardstick to gauge if a government action is a failure. Unlike the private sector, the government must take care of things other than efficiency. In other words, it constantly faces many trade-offs, including what Arthur Okun calls "our biggest socioeconomic trade-off," that between efficiency and equality (Okun, 1975). Therefore, even if a government action is not Pareto-optimal, it does not necessarily represent a case of government failure.

Second, if we settle with a narrow definition of government failure--a government action that leads to an outcome inferior to that which would be brought about under laissez-faire, then the problem becomes one of counterfactuals: we essentially use something empirically unobservable as the base for comparisons (Shapiro and Taylor, 1990).

Third, due to the lack of a satisfactory definition of government failure, whether market or government failure is worse is an inherently unanswerable question. (Kruger, 1990).

Fourth, while claiming be a positive theory, the literature of government failure has drawn its conclusion largely from preconceived model of behavior, which is so constructed that "it cannot but result in the demonstration of government failure" (Musgrave, 1981).

Fifth, the public choice model has little room for behavioral complexity. According to this model, the state is little more than a machine

to redistribute wealth and income, and every one in politics is seeking to maximizing his or her personal gains. The model has two problems: one, it ignores the fact the human motivation is too many-sided and complex to be captured by the caricature of wealth-maximizing bureaucrats and politicians (Musgrave, 1981); and two, it is devoid of institutions. Even if everyone is a self-interest maximizer, their behavior may be constrained by various institutions. Because the human nature is complex and the institution matters, there could be good and bad officials and governments (just as there are good and bad managers and firms). What needs to be studied is precisely what kind of government is less likely to fail. Trying to find out what make state intervention more successful in some countries than in others is probably "more fruitful, both theoretically and practically, than condemning 'the state' as an inherently anti-development institutions" (Evans, 1989). Although bad government is indeed a key obstacle to economic development, good government is indispensable. The fundamental challenge is to devise institutional arrangements that minimize government failure.

Finally, the literature of government failure is better at explaining failures than success stories, particularly cases of state-led industrialization. The East Asia evidence falsifies the idea that a high degree of state intervention in the economy is incompatible with successful capitalist development.

In general, the assertion that the government can do no better than the markets is simply false. As argued above, efficient market operation cannot be attained without government intervention. The fact that there may exist government policies that would be welfare improvements, of course, does not necessarily create a presumption that government intervention is always desirable. Especially, in the course of the transition from a command economy to a market economy, the role of the state needs to be redefined. The redefinition involves two changes. First, the range of state intervention should be narrowed. The state should concentrate its attention to macroeconomic issues while leaving microeconomic decisions to individual economic agents. Second, policy instruments need to be changed. Rather than relying on administrative commands, the government should try to affect production activity mainly through fiscal and monetary policies and regulatory policies.

The purpose of the essay is not to justify state intervention, but to argue against market utopianism. The central fallacy in the market utopianism is that the market and the state are necessarily separate and ever antagonistic, and that former is benevolent and the latter not. We should refuse to pose the question as a simple choice between the market mechanism and state intervention. Evidence from the cases of successful development suggests that when the state and market mechanism in tandem, when they play complementary roles, the whole is greater than the sum. The wisdom thus lies in pragmatically developing a mutually supportive structure of market and non-market institutions.

References

- Alesina, A. and Rodrik, D. 1992. "Distribution, Political Conflict, and Economic Growth," in Cukierman, A., Hercowitz, Z., and Leiderman, L., eds., Political Economy, Growth, and Business Cycles. (Cambridge: MIT Press), pp. 23-50.
- Amsden, Alice. 1989. Asia's Next Giant: South Korea and Late Industrialization (New York: Oxford University Press).
- Arndt, Heinz W. 1988. "'Market Failure' and Underdevelopment." World Development, vol. 16, no. 2.
- Averch, Harvey. 1990. Private Markets and Public Intervention: A Primer for Policy Designers (Pittsburgh: University of Pittsburgh Press).
- Bardhan, Pranab. 1990. "Symposium on the State and Economic Development." Journal of Economic Perspectives, vol. 4, no. 3.
- Baumol, W.J., Panzar, J. and Willig, R. 1982. Contestable Markets and the Theory of Industry Structure (New York: Harcourt Brace Janovich).
- Boadway, Robin W. 1989. "The Role of Government in a Market economy," in Warren J. Samuels, ed., Fundamentals of the Economic Role of Government (New York: Greenwood Press).
- Chaudhry, Kiren Aziz. 1993. "The Myths of the Market and the Common History of Late Developers," Politics and Society, vol. 21, no. 2.
- Das, Dilip K. 1992. "The Invisible Hand versus the Visible Hand: The Korean Case," Seoul Journal of Economics, vol. 5, no. 2.
- Day, Richard H. 1993. "Bounded Rationality and the Coevolution of Market and State," in Richard H Day, Gunnar Eliasson and Clas Wihlborg, eds., The Markets for Innovation, Ownership and Control (Amsterdam: North-Holland).
- Evans, Peter B. 1989. "Predatory, Developmental, and Other Apparatuses: A Comparative Political Economy Perspective on the Third World State," Sociological Forum, vol. 4, no. 4.
- Galbraith, John K. 1990. "Revolt in Our Time: The Triumph of Simplistic Ideology," ???
- Gao, Shangquan. 1993. "Taking a Market-oriented Direction and Pushing forward in a gradual Way: A Basic Experience of China's Economic Reform," a paper presented to International Symposium on the Theoretical and

- Practical Issues of the Transition toward the Market Economy in China.
Hainan, China.
- Garnaut, Ross. 1991. "The Market and the State in Economic Development: Applications to the International Trading System," The Singapore Economic Review, vol. 26, no. 2.
- Gerschenkron, Alexander. 1962. Economic Backwardness in Historical Perspective (Cambridge, MA: Harvard University Press).
- Goodrich, Carter. 1968. "State In, State Out: A Pattern of Development Policy," Journal of Economic Issues, no. 2, pp. 365-383.
- Greenwald, Bruce and Joseph E. Stiglitz. 1986 "Externalities in Economies with Imperfect Information and Incomplete Markets," Quarterly Journal of Economics, no. 90.
- Hirschman, Albert O. 1958. The Strategy of Economic Development (New Haven: Yale University Press).
- Jiang, Xiaojuan. 1993a. "Shichang Yunzhuang Yu Zhengfu Zhineng Zhuanhuan" [The Operational Efficiency of the Market and the Changes of Government Functions], Gaige [Reform], no. 1, pp. 62-67.
- 1993b. "Zhongguo Tuixing Chanye Zhengce Zhongde Gonggong Xianze Wenti" [Public Choice Issues in China's Industrial Policies], Jingji Yanjiu [Researches in Economics], no. 6, pp. 3-18.
- Johnson, Chalmers. 1982. MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975 (Stanford: Stanford University Press).
- Katzenstein, Peter, ed. 1978. Between Power and Plenty (Madison: The University of Wisconsin Press).
- Kornai, Janos. 1992. "The Postsocialist Transition and the State: Reflection in the Light of Hungarian Fiscal Problems," American Economic Review, vol. 82, no. 2.
- Krueger, Anne O. 1990. "Government Failure in Development," Journal of Economic Perspectives, vol. 4, no. 3.
- Lazonick, William. 1991. Business Organization and the Myth of the Market Economy (New York: Cambridge University Press).
- Leibenstein, H. 1978. General X-Efficiency Theory and Economic Development (New York: Oxford University Press).
- Lie, John. 1993. "Visualizing the Invisible Hand: The Social Origins of 'Market Society' in England, 1550-1750," Politics and Society, vol. 21, no. 3.

- Musgrave, Richard A. 1981. "Leviathan Cometh-Or Does He?" in H Ladd and T Tideman, eds., Tax and Expenditure Limitation (Washington, D.C.: The Urban Institute Press).
- Okimoto, Daniel I. 1989. Between MITI and the Market: Japanese Industrial Policy for High Technology (Stanford: Stanford University Press).
- Okun, Arthur. 1975. Equality and Efficiency: The Big Tradeoff, (Washington, D.C.: Brookings Institution).
- Perotti, Roberto. 1996. "Growth, Income Distribution, and Democracy: What the Data Say," Journal of Economic Growth, Vol. 1, pp. 149-187.
- Persson, T. Tabellini, G. 1994. "Is Inequality Harmful for Growth?" American Economic Review, Vol. 84, pp. 600-621.
- Polanyi, Karl. 1957. The Great Transformation (Boston: Beacon Press).
- Przeworski, Adam. 1991. Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America, (Cambridge University Press).
- 1992. "The Neoliberal Fallacy," Journal of Democracy.
- Sabel, Charles F. 1993. "Learning by Monitoring: The Institutions of Economic Development," unpublished paper, M.I.T.
- Shapiro, Helen and Lance Taylor. 1990. "The State and Industrial Strategy," World Development, vol. 18, no. 6.
- Shang, Hong. 1992. "Tuidong Woguo Zhengzai Jingli Zhedi TiZhi Bianqian" [Pushing the On-going Institutional Changes Forward], Jingji Yanjiu [Researches in Economics], no. 5.
- Stiglitz, Joseph E. 1986. Economics of the Public Sector (New York: Norton).
- 1989. The Economic Role of the State (Oxford: Basil Blackwell).
- 1991a. "The Invisible Hand and Modern Welfare Economics," NBER Working Paper # 3641.
- 1991b. "Government, Financial Markets, and Economic Development," NBER Working Paper # 3669.
- Thompson, E. P. 1971. "The Moral Economy of the English Crowd in the Eighteenth Century," Past and Present, no. 50.
- UNCTD (United Nations Conference on Trade and Development). 1998. "Income Distribution, Capital Accumulation, and Growth," Challenge, Vol. 41, No. 2, pp. 61-80.

- Wade, Robert. 1991. Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization (Princeton: Princeton University Press).
- White, Gordon, ed. 1988. Developmental States in East Asia (London: Macmillan).
- World Bank. 1991. World Development Report (Washington, D.C.: World Bank).
- Zysman, John. 1983. Government, Markets, and the Growth (Ithaca: Cornell University Press).