A STUDY OF THE ALTERNATIVE POLITICAL ECONOMY PERSPECTIVES ON STATE INTERVENTION IN THE IRANIAN ECONOMY

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Dedicated to

My

Beloved Parents

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INTRODUCTION

Is there any need to present a neat study of the theoretical treatment of the State in the context of the alternative conceptual frameworks? Is the State logically a concern of theoretical economics? Is it required, in reviewing the functioning of a certain economy, to have any incentive to study the role played on the part of the State in the process of economic development? To respond to the stated questions and even to some more in the same line, whether in the positive or whether in the negative, one should clarify one's standpoint. Effectively, the nub of the matter lies not only in the answer to the posed questions, but also, more importantly, in the perspective which one holds. Before embarking on an elucidation of this point, let us examine sketchily, in the scanty space of the Introduction, the place of the State in the history of economic science.

A review of the history of economic science reveals that economists have generally regarded the existing State as a given one. It is so because the State is conceived of as a part of the discourse in the realm of political science. This leads to the conclusion that economists need not get too involved in considering the State. This justification originally emanated from the classical tradition which focused on the market as a "self-acting order". But, it later derived sustenance also from a rigid application of the principle of specialization in the social sciences.

The idea that the economy could be a distinct area as well as an object of independent study arose, in fact, in the eighteenth century. By then, the intellectual instructions of the social scientists were wide-ranging since society, polity and economy were regarded as different parts of one united entity. By the end of the subsequent (nineteenth) century, however, economics had gained a distinct niche for itself among the other disciplines and hence there was an attempt to narrow its scope. Political science took care of the study of the government and state; sociology got concerned with the working of the society; and economics, now as a separate discipline, sought to provide theories of market behavior and the price system in the context of the neoclassical paradigm. In the perspective of this tradition, while the individuals were regarded as wise, rational and able enough to follow their interests through the free play of the market forces, no need was felt to postulate any more roles for the State. "The entrenchment of a broadly pro market-limited State perspective within the gut of the domain of the dominant paradigm and the professionalisation of economics have conspired to lead to a situation in which economist have never felt much of a need to develop a fully-fledged theory of the State" (Dearlove, 1987, p. 5). North, too, mentions that the economists have been mainly unconcerned with the issue of the State. "The existence of a State is essential for economic growth; the State, however, is the source of man-made economic decline. This paradox should make the study of the State central to economic history: models of the State should be an explicit part of any analysis of secular changes. But while the Long Path of historical research is strewn with the bones of theories of the State developed by historians and political scientists, economists traditionally have given little attention to the issue" (North, 1981, p. 20).

Adam Smith, the "Father of Political Economy", minimized the importance of the State, emphasizing instead to the role played by "individualism", and intending to reduce the State's function to an irreducible minimum. "Every man, as long as he does not violate the laws of Justice, is left perfectly free to pursue his own interests his own way, and to bring both his industry and capital into competition with those of any other man, or order of men. The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society. According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings; first, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or smaller number of individuals, to erect and maintain; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society" (Smith, 1937, book IV, Chapter IX, p. 651).

Smith, however, did not neglect the social arrangements and institutions. His review of guilds and so on as well as functions of the State are clear examples. In contrast, Ricardo, who gave a modern abstract form to economics, while concerned with the practical problems such as currency and taxation, dropped from his analyses not only the fundamental question of the State, but also, that of the other institutions. His tradition, followed by neo-classicists, has resulted in the fact that the modern economics has broken not only with the study of the State but also, even for a while, with that of the social institutions.

While some division of labor in different fields of social sciences is acceptable, drawing a rigid line of demarcation between, say, economics and political science does not seem reasonable. By the alternative theories. The critical discussion is organized in four chapters. In the beginning, to reveal the historical fact hidden nowadays that the State has always played a considerably important role in the pursuit of economic development, I will make an attempt to trace the role of the State in the history of British economy, just as an illustrative case-study of early industrializers. Needless to say, in the process of theoretical assessments of the next few chapters, as the prime parts of this thesis, the main analytic implication of the historical discussion will be implicitly revealed. More specifically, our critical review will indicate which theory has artificially attempted to neglect the historic fact of State engagement in the economy, which has been extensively examined in the first chapter of the present thesis.

In an endeavor to present the main purpose of this study – i.e., the critical study of the alternative theories concerning the role of the State in the economy, I will organize the remaining chapters as follows. The second chapter is devoted to a critical analysis of the role of the State in neo-classical Theory. In accomplishing this task, I will try to critically review some of the contributions concerning the role of the State in the Iranian economy in the light of the reviewed theory. Herein, the deficiencies of the application of the reviewed theory to the Iranian case will be discussed. The third chapter is allocated to addressing the role of the State in the Keynesian Theory. Some criticisms of its limitations would, then, be followed. In the same line, some scholarly independent studies, nowadays recognized as "classics", would be judged. Those writings concerned development policy favoring state involvement. The critical assessment of some contributions regarding the role of the State in Iran in the light of the reviewed theory will be done in the remaining part of the chapter. In taking one step further to analyse the role of the State, the last chapter of the present thesis is dedicated to the radical view. Following the examination of some theoretical points regarding the primacy of this perspective over the previously examined theory, a preliminary attempt will be made to review some important roles of a radical State engaged in a transitional economy (Society). Some contributions concerning the critical situation of the post-revolutionary Iran will be examined as well.

CHAPTER 1:

THE ROLE OF THE STATE IN THE ECONOMIC DEVELOPMENT OF EARLY INDUSTRIALIZERS: AN ILLUSTRATIVE CASE-STUDY OF BRITAIN

INTRODUCTION

Having in mind and reviewing the research questions as well as the hypothesis of this thesis, it seems relevant that before proceeding on critically analyzing the various paradigms pertaining to state intervention in the economy and, then, reviewing the Iranian economic analysis in the light of the various theories from the standpoint of the analysts of the macro-economic issues of Iran, we seek to embark on a historical review of the role of the state in the economic development process of the so-called industrially developed countries. Putting it in other words, this historical examination could be justified based on some other reasons as well. If, according to our hypothesis, the idea of the development on the basis of the free play of the market forces is rejected in the now-developing countries in general, and Iran among them particularly, then, reviewing the historical process of the developed countries, at least, to get a rough idea on what lessons could be drawn from the history, regarding the development story of the industrialized world, would seem reasonable.

One important question could be raised in a searching mind as follows. Given, supposedly, the important role of the state in the historical developmental process of the today's developed nation, if there is any scientific reason to be concluded that still the state interventionism is the necessary condition to free the developing countries from the underdevelopment trap. This very important question, seems that, could be addressed through the objective outcome of the application of each theory in the real world rather than by intellectual analysis of the paradigms. In other words, if the state intervention, as compared to the period under the sovereignty of market forces, brings about suitable economic results, the comparison of the application of the two theories could be concluded as one to the benefit of the first. This conclusion, however, is not the only one, which could be drawn from the historical review of the development of the industrial economies. According to the mainstream narrative of the development, the failure of the today's developing countries stem not only from rejecting the historical fact of the free market, but also from the prevalence of the "wrong" theories in the twentieth century following the end of the Second World War. Going into detail of the officially narrated history of capitalism, the following reveals:

According to this version[1], global capitalism has emerged twice in the history: firstly, at the end of the nineteenth century, peaking around 1910 and subsequently disintegrating between the World War I and World War II; secondly, after 1950, and especially mid-1980s, while aiming at establishing the global market economy existing one hundred years earlier.

The first episode of capitalism happened through economic reform and the development of international institutions as much as through the powerful conquest and colonial rule. Beginning around 1840, Western European powers exercised the superior industrial as well as military power to challenge the traditional countries. Gradually, after several decades, global market was getting established through industrialization, building (often) foreign-financed railways, using steamships, choosing market-based, export-led growth leading to low level trade barriers among east-central European, Asian, African and Latin American economies, lasting for several decades, from 1860s to 1914.

The continuation of the open international system, and in other words, the emergence of the opportunity for effective participation of the much of the developing world, even outside of Europe and North America, through promoting the rapid economic growth, gradually, led to the establishment of the era of the economic convergence.

The emergence of the First World War, however, left its severe impacts on the newly appeared global capitalist system for more than half a century. Among them, the following could be mentioned: the failure in the reestablishment of the financial strength of the late

[1] This part is a summory of a long article written by Sachs and Warner (1995).

nineteenth century liberal order, the end of the British superiority in the international financial system by the Great War and the failure of any other power in replacing it, the overwhelming decade of the 1920s by financial instability and failure of the gold standard as contributing in the Great Depression in the 1930s, the weakening of the export-led growth of the primary products by low and unstable prices of commodities in the 1920s, and its devastation by the Great Depression, leading to the absolute failure of the terms of trade and profound protectionism in the western developed economies. As a result, what could be witnessed after the First World War across the globe was, in fact, the intense competition of the state planning, authoritarianism, and militarism vis-à-vis limited government and market-based economies.

At the end of the World War II, the international economic system seemed messy. In fact, the international trade was destroyed by currency inconvertibility as well as acceptance of protectionist measures due to the incidence of the Great Depression and World War II.

Although later, the market-based economic relations were restored among the leading economies during the 1950s, however, the governments of almost all developing societies adopted either socialist policies or a kind of "third way" between capitalism and socialism, state-led industrialization.

This version of the global capitalism, then, attempts to explain the various forces at play in providing the ground to implement socialist and state-led industrialization policies. In doing so, interestingly enough, this way of understanding depicts the forces mainly as (enormously mistaken) "policy experiments" rather than decisive decisions taken by the conscious leaders or as inevitable consequences of the economic structures of the countries in question. The forces could be summarized as follows:

INTERNATINAL ECONOMIC FORCES. Probably, the failure of the world trading system could be reflected to as the main factor behind the acceptance of the state-led industrialization politics following the World War II. Since almost all of the developed economies followed inconvertible currencies and high level of tariff barriers, therefore the governments of the developing world viewed the prospects of the international trade with a lot of skepticism. This export pessimism was justified by some economic analysts as well.

MACROECONOMIC POLICIES. The currency inconvertibility at the end of the World War II was not only because of trade policies but also macroeconomic policies as well. Exchange controls were introduced during the Great Depression, however, the pressures of the wartime inflationary finance seems to be more important factor in the spread of inconvertibility. In almost all countries, government wartime purchases were financed through inflationary finance, coupled with domestic price control, foreign exchange controls, and rationing of goods.

INTELLECTUAL BELIEFS. The spread of state-led industrialization and socialist policies were the outcome of the coalition of several streams of intellectuals' beliefs in supporting their adoption. Following two world wars and the Great Depression, capitalism had proved to have the negative characteristics predicted or even subscribed by theorists, both critics and negaters of the system. The radical notion of exploitation, denoting it as the result of the aggression of the richer nations to underdeveloped economies, was attractive among the elites of the latter countries. To overcome this problem and pave the road for rapid industrialization, large-scale public investment became the growing belief among a range of theorists. Even the widespread advice for development planning in mainstream development economics should be regarded as the consequence of these ideas. Marx, Hobson, Lenin, Keynes, Rosnsteinrodan and Gershchenkron were among these theorists inspiring intellectual beliefs.

STATE BUILDING. Mercantilist trade and industrial policies played a crucial role in consolidating the political power in nation states. In consequence, state-managed development was viewed in political and economic terms, augmenting national unity as well as being considered as an economic strategy. Further, since independence constituted a part of the slogans put forward to mobilize the people during the struggle against imperial powers, hence, initiating protectionist trade policies and erecting barriers against foreign direct investment were regarded essential in achieving self-sufficiency. Being used industrial-military establishments, trade and industrial policies undertook even more direct role in state building. These policies were exploited after Second World War by many newly independent nations.

POLITICAL ECONOMY. Trade policy, in the very recent models, is based on the outcome of the relative political power of the different parts of the society. Although those powers and interests have, in fact, played a crucial role in state-led industrialization strategy of now-developing world, however, it seems that they have left their impacts in continuation of those policies rather than their initiation and their start. More clearly, ideology, state building, and geopolitics rather than domestic interest groups were the essential forces initiating state-led industrialization strategies. Having led these strategies, to the establishment of a protected sector, their interest groups were created to defend themselves.

As seen, this version of history of capitalist development confines the interventionism to the recent decades of the twentieth century. Consequently, it seems necessary to explore, through a scrutiny, this point that whether the today's industrialized countries have passed the development process while refusing state intervention vis-à-vis applying *laissez faire* policies. Considering the limitations of this thesis, we concentrate our effort to review only the history of economic development of Britain. It could be shown, with more work, that the history of the overwhelming majority of the other developed economies resembles that of Britain.

1.1 THE MIDDLE AGES:

1.1.1 EDWARD I:

Beginning from the thirteenth century, the study of the history of how the government has been involved in the economic orientation of Britain reveals that the growth of national policy of state intervention in economic matters has been followed as an important goal. Specifically, beginning from the reign of Edward the first, for several centuries, a steady increase in the scope and complexity of the regulation was followed.

Until the reign of Edward I, because of the prevailing local character of government in the details of the affairs, rather than the dislike of the government to regulate the economy, the central government undertook limited responsibility concerning the control of economic activities.

Recognizing the potential influence of the actions of the central power on the economic life of the nation, the goal of the legislation of Edward the first was protecting order and administration and providing the necessary basis to secure the exchange. Edward I began to implement the policy of importing skilled labor force from the Continent to establish the industries lacking in Britain. Besides, the beginnings of the west of England cloth manufacture are attributed to him (Meredith, 1910, p.92).

In some detail, in the Middle Ages, by the end of the thirteenth century, in Britain, two different and alternative types of national staple were working: the home staple and the foreign staple. Sometimes the first one was allowed by the King and sometimes the second. As the home staples were adopted to be used as a context to export of wool, ten or more major English towns and cities were chosen as the places to which all foreign merchants *must* refer for purchasing wool, and also all wool planned to export *must* be firstly supplied to the native customers. Any adopted economic policy, however, at those periods, was chiefly viewed as a revenue-stimulating source. So, restricting free trade on wool was not an exception and mainly formulated to facilitate the collection of export duty. However, preference of merchants of a few large markets, to whom applying specific policies would be much easier, over a huge number of small markets, had its definite effects (Tawney, 1966, p. 139-40).

Even more restrictions were designed for the foreign staple. A single large continental city was selected and all exports were *required* to carry the wool there. The aim, here, passed over financial and included diplomatic and political ones. More specifically, this policy was, not only exercised to collect tax, but also doing favor to the continental allies, and transferring subsidies to them. It appears to have been that *restraining* the export trade to a few small groups of native or alien merchants and favoring the native customers meant nothing but preferring the national interests through laying the ground to provide the necessities of expanding a national and integrated market in which the chief aim -or at least the definite outcome- was ultimately developing a powerful and sovereign economy. To prevail her "still far inferior to Germany in all the industrial arts, in the technique of commerce and in the power of accumulated capital was enabled by the genius of her statesmen, wielding the irresistible force of a united people and perusing a policy as resolute and remorseless as it was subtle and far-sighted, to break down the timid and vacillating defenses of the Hanseatic League, and to lay the foundations of its economic supremacy on the ruins of German commerce and industry" (Ibid p.136) even until sixteenth century. However, the battle between staple (monopoly) system in general and a demand for free trade[2] in wool comprised the characteristic feature of the fiscal history of the coming (fourteenth) century.

The early instance of the need to regulate town life appeared on the reign of Edward the second through "the Act of 1318 excluding victuallers from the more important civic offices. [It] seems to have aimed at a better enforcement of the assize of bread and ale. It is interesting as an early instance of the need for national regulation of town life, which became constantly greater" (Meredith, 1910, p. 92).

1.1.2 <u>EDWARD II:</u>

This, nevertheless, by no means, meant that economic life was a forgotten issue. In other words, it was Edward II who firstly initiated to develop a local wool manufacture. More specifically, in 1326, the king prohibited the export of all materials for making cloth which might disturb the staple and common profit of England. Further, " [i]n the first half of the fourteenth century Edward II tried to prohibit the import of foreign cloth, except such as was destined for the use of the nobility" (Pirenne, 1937, p.221).

1.1.3 <u>EDWARD III:</u>

During the reign of Edward the third (1327-77), a great increase in the legislative activities concerning the economic life could be found. It would be enough interesting to proceed on, here, a general review of some certain laws. The following include the special headings of the most important ones (Meredith, 1910, pp. 92-4).

(I) Class Organization.

(a) The limiting laws of 1336 and 1363 regulating the maximum amount spent by different classes on dress and diet.

(b) During this period a bunch of measures regulated wages and prices. Among them, the proclamation of 1349, the confirmatory statute of 1351, preventing any increase whether

[2] It is interesting to note that , here, open trade is referred to in the fourteenth century context which included a considerable export duty (tawney, 1966, p.140).

in the wages or the price of food due to the incidence of Black Death.

(II) Bullion Regulation.

The prohibition of export without license in 1335 and the order of 1340 on the compulsority of a certain amount of import against every sack of exported wool.

(III)Direction of National Industry.

The general Act of 1337 to promote weaving was passed to: (a) restrain the export of wool and import of cloth, and (b) limit the wearing of clothes made of other materials. Protecting the immigrant weavers was the other aspect of the Act. Besides, in 1328 and 1353 there were measures, which dealt with the official grading of cloth exposed for sale.

(IV)Restraint of Immoral Gain.

According to the Act of 1351, the merchants were prohibited to make profit by exchanging coins, and also engrossing in the staple towns was prohibited.

(V)A Corn Law.

The first Corn Law of 1361, while revealing the increasing importance of commercial agriculture sought to secure the cheap price of corn through forbidding the corn export, but to Calais and Gascony.

It is believed by economic historians that Edward the third initiated the consistent British policy aiming ultimately at the development of national power. According to one of the serious attempts reviewing comprehensively his commercial policy,

"The main object of Edward's wars was to establish national industry and commerce.... It would justify the reputation Edward III enjoyed as the Father of English commerce.... He endeavored (a) to foster foreign commerce, (b) to foster industry.... He desired to increase the volume of trade.... He endeavored to develop a manufacture for which the country was specially suited, and to do so he showed himself somewhat cosmopolitan in inviting artisans from the Continent." (Cunningham, 1898. pp. 266-269, 298-299, 310-311, 470-471, summarized from Tawney, 1966, pp.119-120).[3]

Although the policy adopted in those ages was partly exercised through taxation (even arbitrarily and unconstitutionally), however, it left its impact effectively. "In most medieval countries during most of the middle ages economic policies were first and foremost commercial policies since these best served a ruler's fiscal interest and the consumption needs of society, but also because industrial interests capable of making their voices effectively heard normally emerged only at a relatively late date" (Ibid., p.360). Hence, the higher taxation of wool cloth over raw material led to the promotion of the suited industry in the country. Inviting in the weavers from other countries was in fact, a practical way to support the cloth manufacturing in the realm as well. "Edward III of England encouraged Flemish textile workers to settle in his Kingdom" (Cipolla, 1976, p.361). Besides, he "promised them the royal protection. Within a few years hundreds of them had taken advantage of the opportunity and were established in England" (Southgate, 1934, p.51). However, this, by no means, meant

[3] It is worth to note that in his later writings (dated 1910) Cunningham evaluates the plans of Edward III not far-seeing since he did not succeed to converge the conflicting interests. Hence, Cunningham comes to the conclusion that the industrial policy of Edward III was inconsistent and its various parts did not constitute a homogenous whole. Having his later comments in mind, two points could be mentioned: firstly, expecting further than the then existing reality from the stand of experiments on economic policy making, might not be much justifyable. Secondly, it must be mentioned that new ideas do not discredit our analysis at all. Failure in formulating a consistent policy, which reveals its deficiencies in reality, is something and the attempts for developing an economy is another, where the latter, as the one revealing the interventionist endeavors of the policy-makers to develop the country, is to our interest.

However, as noted earlier, it should be fixed in mind that any adopted economic policy at those periods was viewed as a revenue-stimulating source as well. This point has been asserted by W. Unwin, as one who criticizes Edward III openly, where he writes: "when acting on his own responsibility, Edward persistently returned to a policy of restriction and monopoly for the simple reason that this policy enacted him to borrow." (Cited from Tawney, 1966, p.122).

According to Unwin, Edward "returned" to restrictive policies since the Parliaments during the reign of Edward favored "free trade" policies, formulated and enacted several statutes in different years to counteract Edward's restrictive decisions. It would, however, be an entire mistake to count on those attempts more than the reality. Putting it alternatively, the free trade legislations of the Parliament were no more than ineffectual protests vis-à-vis the administrative and fiscal actions of the King, becoming a dead letter even within a year. (Ibid., p. 131).

that the other restrictive policies, such as controlling the import, export, or the way the income is spent, following economic as well as non-economic goals, were not employed.

Although Edward III is believed to have been the first King who attempted, deliberately, developing a local wool manufacture, (Chang, 2002, p.19), however, exercising some identical policies, as previously noted, goes back to earlier than his reign. (Bland, Brown, Towney, 1914, p. 186).

In 1337, Edward III passed the statute of the prohibition of export of materials used for making cloth, which could be regarded as a complementary act for the statute passed during Edward II, and a sufficient one towards developing manufacturing in the realm. He passed a statute "which prohibited the import of woolen cloth." (Davis, 1966, p. 307). This statute had such a significant role in transforming the production structure of England that an economic historian believes that no matter how important it was in the fourteenth-century, the seventeenth-century trade would not have been very different from the fourteenth-century without it (Ibid. p. 307). Interestingly enough, the law was still in force even in the eighteenth century.

In the case of wool, even when its export was not banned, the King exercised his power to control its supply while the diplomatic motive, besides the fiscal ones, was followed. The diplomatic one included the keeping the alliance of the large clothmakers of Flanders against France. "Edward III ... as part of assemblage of political and economic measures designed to apply diplomatic pressure to Flanders in preparation for war with France (Cipolla, 1976, p.361). The fiscal incentive, in its turn, embraced the finance of war purposes. Moreover, when the wool export was used as an organ of international finance, through transferring subsidies to the continental allies of the King, later, to secure the country against exports with no money return, and along the line of providing the realm money, gold and silver, according to the enactment of the Parliament in the 1340, "the staplers were required to deposit a large part of the value of the wool in money at the Tower before leaving the country" (Tawney, 1966, p.144). More specifically, " two marks of silver should be deposited at the Tower for every sack of wool exported, and an equivalent requirement formed the central feature of the staple at Calais." (Ibid., 1966, p.129).

In summary, during the period of twelfth to the late thirteenth century, the decisions made and actions taken by the Kings and even sometimes by the Parliaments reveals obviously the nature of the policies formulated deliberately to aim at directing the economy to achieve certain results both in the economic realm, such as industrialization, and non-economic arena, like following political goals.

1.1.1.4 <u>RICHARD II:</u>

The reign of Richard the second witnessed the continuation of the legislation, though with an increase in its mass and scope. Some of the most important laws are as follows (Meredith, 1910, pp. 94-95).

(I) LABOR LAWS.

The most important ones are the Act of 1388, which fixed the maximum wages for agricultural labor, and forbade the poor peasants to divert their children to non-agricultural jobs, and the Act of 1390, fixing wages within statutory maxima.

(II) BULLION REGULATION.

To maintain the national supply of bullion, an Act was passed in 1381.

(III) NAVIGATION.

Due to the unsatisfactory results of the first navigation Act of 1381, its scope became restricted when according to the Act of 1382 the English ships enjoyed only preference, instead of monopoly, of export trade.

(IV)ALIEN TRADERS.

In 1393, according to a compromise, foreign traders were excluded from wholesale trade with one another and from retail trade in any English town. In fifteenth century, the foreign merchants resided in English towns were encouraged to nationalize themselves.

(V)CORN LAW.

The Act of 1394 permitted the export of corn except to the King's enemy, revealing an increase in the consideration of the producer's interest.

During this reign, based on the Act of 1406, and following the labor laws, peasants earning yearly less than one pound were prohibited to send their children to towns as apprentices. In 1403, alien importers were forbidden to transfer out their money. The cloth industry as well as rural employment deserved special importance concerning national regulation. Therefore, beyond woolen industry, the extension of protectionist policy embraced the prohibition of importation of silk manufacture in 1455 (Pirenne, 1937, p.221). In 1445, the Norwich western industry was regulated according to the first of a series of statutes.

During the era of Richard II, some main elements of mercantilist policy could be found in the acts of Parliaments, while followed inconsistently and uncontinuously. Among them, as cited, the first Act for the protection of the native shipping interest in 1381, and the anti-alien legislation of 1393 could be named. (Tawney, 1966, p. 131). We could be in a better position to appreciate the significance of these acts when we come to know that at the end of the thirteenth century aliens, whether from Germany, Italy, or Fleming, carried out two-thirds of the English wool exported (Ibid., p.142). This superiority in transportation industry could not be gained but because of the larger capital, better ships and better methods of insurance enjoyed by them. However, the enactment of the new statutes also reflects nothing but the changing circumstances in the interests of England, thanks to the implementation of some restrictive policies[4] adopted by the state during the last decades. Among them, just mentioning an example, the famous statute of 1353 could be named that by which the continental staple was removed and the home staples were substituted to be re-established at realm.

1.1.5 EDWARD IV:

The reign of Edward the fourth witnessed stronger activities. In 1463 protection was assigned to: (a) agriculture to prohibit the importation of corn under specific conditions, (b) series of manufactured goods. To guarantee a steady supply of bullion and keeping necessary amount of wool for cloth industry, the trade of staple was regulated as well. More clearly, "foreigners were forbidden to export wool" (Pirenne, 1937, p.221). In 1464, the prohibition of continental cloth reflected the protectionist policy of Henry VII (1485-1509), the first modern King of England. The statute of 1465 is considered as one which regulates nationally the chief industry of the nation including the trade which was carried on alike in towns and villages. In 1478, the exportation of bullion was regarded as a crime and in 1483 comes the prohibition of the usage of machine in the cap-making industry (Meredith, 1910, p. 96).

1.1.6 EDWARD VI:

In the sixteenth century, among all European states, it was England which could follow the most consistent economic policy. Her insular character and the unity of the customs let England, compared to any other continental European country, exercise a stronger control over foreign trade. In other words, during the later Middle Ages, English overseas trade was chiefly controlled by foreigners, now it was mainly transferred into the hands of English merchants (Southgate, 1934, p.74).

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[4] Restrictive policies could be regarded as mercantilist policies since it attempts to save the domestic merchants, manufacturers or shipowners against foreign competitors. (Tawney, 1966, p.128).

Enjoying all the means at the hands of the government as the supportive instruments for its expansion, now the cloth manufacture aimed at conquering foreign markets as the first English policy, using the Merchant Adventurers' company as the main instrument.[5]

In April 1550, a complain came that fixing the price of cloth by the Merchant Adventurers' Company at a low level had led to a loss one pound for manufacturers on each piece. Investigation revealed that the chief cause of the problem was the large number of the clothiers (cloth merchants) many of whom lacked a proper apprenticeship in the business. Hence the government took a fast reaction in restricting their numbers and regulating the making of cloth more carefully. This passed into law and, later on, was accompanied by another one restricting the new employment in the cloth industry on condition of having seven years' apprenticeship at weaving (Tawney, 1966, p. 148).

Even when necessary, the government did not hesitate to put some sort of monopoly power in hands of a company, just to solve the economic problems and direct the issues to the right way. Only as an example, the country, in the reign of Edward VI, was suffering from a financial crisis as well as demoralization and dislocation of internal and external trade following the great accumulation of debt to foreign bankers and a desperate debasement of the coinage to half its previous value as a result of the wars of Henry VIII. The remedy to that, in 1552, was repayment of the installments using the foreign resources of Merchant Adventurers' Company in return for granting the monopoly of foreign trade to it and withdrawing the privilege of German merchants (Ibid. pp. 149-150, 206). Moreover, based on its attempts "to restore the financial credit of the realm and turn the rate of exchange in favor of England" (Ibid., p.134), the government

[5] The Merchant Adventurers' Company could be regarded as the continuation of the government's will in applying definite policies. The Merchant Adventurers' Company which established a staple of cloth, substituted a wool exporting company, in the middle of the sixteenth century, while the importance of wool export had been steadily falling for a century and that of export of cloth proportionately increasing.

conferred more monopolistic rights to the company. "By the charter of 1564, monopoly of the Company was further safeguarded against the competition of other English merchants." (Ibid. p. 150).

This is not merely limited to the sixteenth century. Two centuries earlier, in the fourteenth, "the Government conferred upon [the Company of Wool Staplers] a monopoly of the export trade, in consideration of their services in the collection of customs, the furnishing of loans and the payment of large subsidies to continental powers." (Ibid. p.145). And this happened to appear while the wool-growers and wool dealers viewed the Company as one "standing between them and the foreign merchants." (Ibid. p.145). Putting alternatively and to speak in the economic phraseology of the modern times, the Company was violating the laissez-faire economic policy and preventing the free contact of the domestic producers with foreign merchants.

1.2 THE MODERN AGES:

1.2.1 QUEEN MARY

From the late fifteenth century onwards, in other words, specifically during the Tudor period, a glance at the increasing number of the statutes marks the enhancement of government intervention in the economy to control manufacturing industries.

The new national government of the sixteenth century England not only enjoyed power and efficiency, but also could exercise its control extensively. In a comparison, previously (in the Middle Ages) the Kings were vaguely able to secure their position and authority. By the modern times, however, the Kings in the new national states were powerful enough to build up strong governments able to levy taxes, wage wars, make laws, and secure justice over the territory. This process, continuing to the present time, by which the national states have taken over the earlier authorities, is often called statism.

Under the strong rule of the Tudors (1485-1603) issuing mercantilist laws was increased and its enforcement improved. Henry VII (1485-1509) and his son Henry VIII (1509-1547) attempted to strengthen English economy through re-enactment of older laws and passing new ones all designed to protect home industry, encourage the importation of raw materials, prevent the export of bullion, build up the merchant marine, and strengthen the royal navy. "By the reign of Mary (1553-1558) and her half-sister Elizabeth (1558-1603) the tradition of government action in the economic sphere was very strong and a series of important laws endeavored to regulate, to mold, to stimulate almost every phase of English economic life" (Clough and Cole, 1968, p. 224).

Among those, one of the most important laws was the Weavers' Act of 1553 to protect the cloth industry. Another law, however a more complicated one, attempting to regulate industry was the Statute of Artificers of 1563. It sought to control the transfer of industry to rural areas as well as tried to provide proper training to workers to get higher qualities for English wares.

Some of the regulations of industry were extended during this period. To introduce or strengthen some industries, monopoly grants were applied to make window glass, starch soap, saltpeter, alum, and the like. Besides, in line of carrying out other types of governmental encouragements, old laws prohibiting imports of articles like cutlery, hardware, and wool cards were enforced.

From the Middle Ages, until sixteenth century, the wool exports duty constituted the chief part of the resources for the government. To increase the proportion of the exports duty on cloth in government's sources of revenue, it was significantly revised in 1557 leading to the exclusive position of the Company to export cloth.

Moreover, Queen Mary restored the privileges of the German merchants on two conditions of admittance of English traders in the Prussian ports as well as the acceptance of Merchant Adventurers' monopoly of trade in unfinished cloth with the Netherlands and shipping cloth purchased by Germans only to their own ports in Germany. (Ibid. p.206).

The Hanseatic (German) merchants enjoyed rights in foreign trade in the London steelyard, dated from thirteenth century (Southgate, 1934, p.55), which were mainly "a safeguard against sudden gust of native hostility" (Ibid. p.204). English merchants sought to demand regularly, in the reign of Richard II, Henry IV, Henry VI, Edward IV, and Henry VII, the withdrawal of the rights unless otherwise they enjoyed the same privilege enjoyed by German traders. At last, the government, by taking two measures, changed the situation totally in the interests of the British economy. More specifically, firstly, by withdrawal of the rights of German merchants, the British economy was revitalized through restoration of financial credit of the realm as well as the turn of the rate of exchange in favor of England; and secondly, when the privileges were restored to German traders, the equal rights got granted in Prussian towns.

1.2.2 <u>QUEEN ELIZABETH</u>

The England of Elizabeth was much weaker than Germany in industry, commerce and capital accumulation. Pursuing a definite and far-seeing policy, however, England laid the foundation of her economic supremacy on the ruins of German economy. This was not possible until and unless two mutual, however conflicting, reasons happened to exist. In the first place, "there was no powerful state in Germany to protect the commonwealth, and to maintain the time-honored privileges of German merchants in foreign countries" (Ibid. p.135). In the second place, a connection and close interaction appeared to evolve between the financial administration of Elizabeth's government, the organization and expansion of commerce, and the development and regulation of national industry, a threefold connection being realized in the Merchant Adventurers' Company which established the commercial and industrial supremacy of the country for the next several centuries. Interestingly enough, these interactions were directed from above by the government through deliberate and consistent policy leading to national progress. Unwin believes that "England of Elizabeth was enabled by the genius of her statesmen,..., and pursuing a policy as resolute and remorseless as it was subtle and far-sighted, to breakdown the Hanseatic league" (Ibid. p. 136).

In 1557, as noted, the government decided to revise the export duties on cloth. This was to be done, however, in such a way that chronic privileges of the Hanseatic traders disappear and, at least the English traders enjoy the privileges similar to the ones exploited by the Hanseatic merchants.[6] Frustrated from the previous restrictions, the Hanseatic League ended all direct trade with England, lasting until the accession of Elizabeth in 1560, while its restoration happened yet with less privileges.

Elizabeth, in 1559, repealed the laws enforced by Henry VII and Henry VIII restricting the shipping of English goods by English vessels. However, the imported goods by foreign ships had to pay higher duties; hence the English ships still enjoyed privileged over foreign ones. While being free only for eight years (1555-1563) to be exported without a special license in 1593, following earlier laws, the export of grain was prohibited below a certain price, aiming at securing an adequate amount of food grain for the people.

The second decade of the reign of Elizabeth was a period of a series of restrictions on foreign trade and international credit which culminated in 1576 (Ibid. p.212). According to Unwin, modern England has its beginning in the last fifteen years of Elizabeth's reign. During these years, the policy of commercial as well as industrial monopoly reached its final culmination. Besides, during the last ten years of her era, there could rarely found any single article in common

[6] Previously, the export tax on undressed cloth had amounted to 1s. 2d. for English, and 1s. for the Hanseatic ones. It was revised, later, and increased equally to 6s. 8d. for both English as well as the Hanseatic traders. (Tawney, 1966, p. 206-207).

use –coal, soap, salt, starch, iron, leather, books, wine, fruit-unaffected by patents of monopoly. (Ibid. p.217).

In the Elizabeth's era, the state was at the service of the merchants who were used, in their turn, as agents of the crown. "Thus were laid the foundations of British commercial prosperity and of British world power."[7]

During the reign of Elizabeth, the maintenance of the military and naval power, as well as providing a secure subsistence for all Englishmen was considered as general aims for the government. Protected the two main sources of national power (the military and naval power), conceived as mutually interdependent, the method was to lay down in permanent laws the framework for safety and stability on the one hand, and to treat all dangers and deviation from the equilibrium either by executive intervention or by temporary enactment on the other. The former head include the reform of the coinage, the statute of artificers, the poor-law code, the planting of new industries, the gradual extension of wages, the regulation of the price and sale of the corn in times of dearth.

The Statute of Artificers was enacted in 1563 with the intention to lay down the conditions to employ the agricultural and industrial wage-earners. Although there was no need for any special training for the agricultural laborers, all artificers were required to have served as apprenticeship for seven years. The goal was not only to secure good workmanship, but to lessen the unemployment by preventing the employment of the untrained men. It thus closed the industry to three-quarters of the rural population (Hill, 1967, p.72). Moreover, its aims included to secure a sufficient number of agricultural laborers, to regulate rates of wages, and to arrange an industrial code to meet the needs of the time (Southgate, 1934, p. 95). Even in some trades, the masters had to employ one journeyman for every three apprentices.

[7] Narrative of Hagedorn cited by Unwin in Tawney, 1966, p. 215.

To strengthen the production power of the nation, the government was concerned to develop the industries having pertinence to national security through planning and executive measures. To forbid the importations of competing foreign agricultural and manufactured goods, several laws were enacted and orders were made, say, in 1559 and 1563, while the doctrine of the balance of trade was firmly held. Besides, tillage were promoted both to increase the employment level of the country and to make the nation independent of the food import. Monopoly power in certain industries was granted to individuals or companies firstly to promote new industries and methods, secondly to introduce stable organization into existing industries, and thirdly as a means to raise revenue. Other grants aimed at promoting the manufacture of window-glass, salt, starch and many other items (Meredith, 1910, pp.96-101).

1.2.3 SEVENTEENTH CENTURY

Under the first two Stuarts, James I (1603-1625) and Charles I (1625-1649) the role of the government in economic matters was strengthened, imposed and extended.

The regulation initiated by James I in 1605 followed a twofold purpose. On the one hand, all English woolens were put under the authority of the royal inspector to control the quality and dimensions of the textiles, and on the other hand, to be sure that the export duties were collected. The decisions initiated in 1606 and 1632 attempted to increase the quality of the woven silk through forbidding the use of gum in dyeing silk and incorporating the silkmen into a guild. In 1624, although the Parliament forbade the grant of monopoly by the King to individuals, however, still the provision of such a concession to corporations continued. The government felt responsible for the welfare of the people. Hence, during the cloth trade depression of 1620-1625, it informed the clothiers that they not only must not dismiss their workers, but also do their best to keep up employment. Moreover, the government ordered merchants to buy cloth as much as possible and the wool dealers to sell wool cheap (Clough and Cole, 1968, pp.229-230). Some other and similar initiatives were made during the hard times of cloth trade in 1629-1631 and succeeding years. Under the system of the local poor relief, the abuses in the raising, selling, and hoarding of grain as well as the use of grain for brewing were forbidden, while it was checked that the poor get grain at fair prices.

Meanwhile problems of commerce, specially those concerning the colonies deserved special importance. The proclamations issued in 1615 and 1622 reinforced the old navigation laws. The law passed in 1621 ordered that colonial tobacco, before landing in the foreign countries, must be landed in England. Nevertheless, a law more rigorously was initiated in 1624 ordering that colonial tobacco should be carried only in English ships. In 1630, a law prohibited the shipment of export goods from England in foreign ships.

It seems clear that by the mid seventeenth century, "English was slowly developing a well-rounded mercantilism which affected not only foreign trade but industry and internal administration as well" (Clough and Cole, 1968, p. 232).

When the strong administration debilitated by the civil war in the mid seventeenth century, with that went the possibility of the control of internal economic life which had been effective at least from sixteenth century. Hence, English mercantilism focused on foreign trade and colonies. Power shifted to the hands of the Parliament, which, represented the landed and business classes, both approving the mercantilist legislation although the main beneficiaries were the latter ones. The government agricultural policy shifted attempting to keep good prices for the landlords. Then exports of grain were permitted, even sometimes by paying bounty. After a century, in the latter half of the eighteenth century, a new law banned the export of grain under specific price situation. Exercising high import duties, forbidding the importation of French goods, and development of colonial markets all were in the interests of the manufacturers. The navigation laws and the colonial system benefited the shipping and commercial interests. The act of 1651, consolidating the foundations of the English colonial and shipping system, sought to limit the maritime trade to the benefit of the English business. After a decade, the act of 1660 was passed to strengthen and correct the defects of the previous one. More clearly, " it was designed to assure England a supply of valuable goods produced by its colonies, to give to English merchants the business of distributing these goods to the rest of Europe, and to give the government the tariff duties on such goods imported for re-export" (Ibid., p. 346). Later, the Staple Act of 1663 gave England a monopoly power of the colonial markets by prohibiting the importation of any European goods to colonies not boarded in England. The other act passed in 1673 exercised duties on the enumerated articles shipped among colonies aiming at strengthening the position of England more than ever as the center of the colonial trade. The four above-mentioned laws (passed in 1651, 1660, 1663, and 1673) constituted the main acts upon which the government could enforce its economic wishes in the framework of the old colonial system.

1.2.4 EIGHTEENTH CENTURY

Moreover, according to the woolen Act of 1699, transportation of any wool, yarn, and woolen textile from one colony to another was forbidden. This happened when the English woolens were the main product as well as export item while simultaneously; some colonies were developing the manufacture and export of coarse woolens. Similarly, when the felt-makers in London recognized that hat is made cheaper in America, by petitioning, they secured that Hat Act of 1732 by which the export of hat among colonies and also having more than two apprentices in colonial hatmakers were forbidden. On the other hand, England promoted the production of various goods in America, which could not be produced at home. "In 1704 large bounties were provided for colonial tar, pitch, hemp, masts, yards, and flax. Bounties were also arranged for indigo (1749), potash and pearl ash (1751), and silk (1770)" (Clough and Cole, 1968, p. 350).

In the early seventeenth century, the quality of the cotton industry was poor and the quantity produced was insufficient. Therefore, among the products imported to Britain during the seventeenth century, and demanded increasingly, were cotton materials mainly from India. The "excessively high price of raw silk, especially since the King Sardinia had prohibited its export" (Mantoux, 1961, p.198) had impeded the progress of the silk industry in Britain as well. As the usage of Indian cotton and Chinese silk extensively spread, complaints were made. What would happen to British woolen industry if the competition continues? Considering the serious threat of the imported materials, the parliament, by an act passed in 1700 forbade "absolutely the import of the printed fabrics from India, Persia and China" (Mantoux, 1961, p.200). Having not been realized the expected results of the law, in the early eighteenth century, the manufacturers of the woolen goods directed the petitions to the parliament and the unemployed weavers even attacked people dressed in cotton material. The heavy tension came to an end only by passing a new law forbidding, more explicitly and far-reaching than the previous one, such importations.

As already mentioned, prior to the early eighteenth century, the chief policies of the British government were confined to expand trade (through colonization[8] and Navigation Acts) as well as generating

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[8] Colonial policies of the British government has played an active as well as a very considerable role in the economic development of England. Prof. Irfan Habib, while computing some statistical evidence, believes that at the turn of the eighteenth century, the colonial wealth (income) transferred to England "was equal to 70 per cent of the entire British domestic investment" (Habib, 1975, p. 8). Hence, " the pace of British Industrial Revolution was certainly determined ... by the pace and intensity of her colonial expansion and exploitation" (Ibid., p.14). facing with the increasing gap between importas and exports (unbalanced trade accounts), Britain attempted to cover the gulf by re-exporting the products of her colonies. To have a more clear idea, beginning from the seventeenth century, 80-90 per cent of the exports from london was consisted of woolen cloth in 1640. sixty years later, however, it decreased to only 47 per cent of the English exports. The main reason for this dramatic change should be attributed to the alteration in the share of the re-export trade growth of the American as well as Eastern products, changing from 3-4 per cent of total exports to some 30 pe cent during the same period. Among them,

revenue to cover its costs. Even deliberate promotion of the woolen manufacturing, regarded as the most important exception to that policy, could mainly be considered through revenue generating point of view. In contrast, beginning from the early eighteenth century, the nature of policies sought to change directly towards deliberate promotion of manufacturing industries. This does not mean, by any means, that designing trade policy was set aside or the trade, while declining, continued in the context of a free one. "The expansion of British overseas trade during the eighteenth century did not take place within a free trade world, but within an imperial system designed to direct trade to the benefit of the mother country" (Thomas and McCloskey, 1981, p.87). In Evans' words, in the eighteenth century, "Britain's protective attitude towards commercial markets provided a fair foundation for commercial growth" (Evans, 1983, p.107). Arithmetically speaking, the money value of imports, and that of exports as well, were around 7 times more in 1800 than in 1700. Considering 50 per cent increase in the population and even taking into account the prices increase, still it will be valid to say that there was an enormous rise in trade during this 100 years (Hill, 1957, p.50). The policy shift has been big enough to be concluded by Davis (1966, p.306) that "the system of protective duties ... was not ... something ancient, encrusted with tradition, ... [but] its beginnings date only

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two-thirds of the imports of the Virginia tobacco were re-exported to Europe. While, at the beginning of the seventeeth century, the Brazilian sugar had conqured the English market; at the end of that, the product of the English West Indian islands swept away it not only from England but also from North European market. Numerically, West Indies sugar imports to London rose from 148 thousand cwt. In 1663/69 to 371 thousand cwt. In 1699/1701, and one-third of the latter figure was re-exported. Calicoas, enjoyed the cheep Indian labour at a half penny a day in the last quarter of the seventeenth century, opened up new markets for textile. Its imports increased from 240 thousand to 861 thousand during the above-mentioned period; two-thirds of the latter re-exported (Davis, 1962, pp. 257-260).
The three commodities comprised the value of the two-thirds of the English imports from outside Europe and almost the same value of English re-exports to Europe (i.e., 1230 thousand Pounds out of 1986 thousand pounds). Indian silks and mixed fabrics, Indian pepper and some other commodities experienced the same histories. Thus, not only the new type of the English trade expansion but also the appropriate ground to support the capital accumulation fostering the Industrial Revolution in the next century became possible through English governments' colonial policies concerning the exploitation of the cheapness in the colonies and creating new expansive markets. "Thud\s in the seventeenth century the English brass, copper, and iron-ware, silk and linen, hat-making and tailoring, glass and earthen-ware, paper cordage and leather industries, and others, were being fostered by their protected markets across the Atlantic, gaining strength with which they would later emerge into competition with Europe and further modify the structure of English trade" (ibid., p.261).

from the very last years of the seventeenth century". More specifically, in the course of fifteen years (1690-1704), the general level of the import duties was sharply raised by four fold. This rapid increase, in a comparison with the coming developments, was important enough to be believed that, not only the total changes in the tariff policy during the eighteenth century were less important, but also the coming changes emanated from the new tariff situation appeared in the mentioned short period of time[9] (Ibid., pp.306-307). Besides, the reform of the mercantile law introduced in 1721, during the reign of George I (1714 – 1727), dramatically changed the British industrial and trade policies.

In the context of the old tariff structure, as valid until the accession of William III, five per cent tax was levied on the value of most imported and exported goods (Thomas and McCloskey, 1981, p.93). Hence, by his reign "there was little direct protection for English industry" (Davis, 1966, p.308). Observing the increasing threat of the cheap Chinese and Indian textiles against English woolen industry, as the great British industry, firstly, in 1690, the enactment of a 20 per cent taxes on their import, and later, in 1701, the prohibition of their import under the act entitled "An Act for the more effective imploying the poor by incoraging the Manufactures of this Kingdom" were initiated. This initiation was not only "the first important modern example of a deliberate industrial protection, [but also] it certainly aided the development of native cotton and silk industries" (Ibid. p.309). As a result, the export of cotton goods rose very fast and passed that of woolens just after 1800 (Hill, 1957, p.50).

Even when heavy imports of industrial products threatened the domestic market "the marked turn towards a greater industrial self-sufficiency... owed a good deal to protection of industry's market at

[9] Reviewing the new tariff structure as one coming out of the need of government to implement specific policies rather than need for money to wage wars, Davis, however, believes that "in the fifteen years after the accession of William III to the English throne [in 1668], the English tariff structure was translated from a general low-level system which, though still fiscal in its purpose, had become in practice protective" (Davis, 1966, p.307).

and seventeenth ones. In other words, while previously pressed by duties and bounties in the British as well as the colonial markets, both linen and silk were augmented to great industries of the eighteenth century Britain, revealing "clear examples of infant industries reared to maturity under protection" (Davis, 1966, p.316). Raising the general level of the import duties from 5 per cent up to even 25 per cent in the turning point of the seventeenth century to eighteen has led to the conclusion that "these measures created a real protection for British industry; they provided the foundation, and most superstructure as well, of the tariff wall that nineteenth-century Free Trade demolished" (Ibid., p.310).

The Navigation Acts, enacted in 1660 and revised several times, provided the ground for a monopolized carrying trade for England and shared extensively in the expansion of the protection as well. Four types of regulations were exercised based on the Acts. Firstly, the nationality of crews and the ownership of the vessels used to carry the foreign traded goods. This was done to exclude the more efficient Dutch from colonial carrying trade. Secondly, the destination of the colonial goods. According to the laws, England was the first market where to be supplied the colonial goods, and an origin to re-export them. Thirdly, a system of rebates, drawbacks, import and export bounties, and export taxes. Some certain English manufactures were protected by grants against foreign manufactures in the colonial markets. Fourthly, restriction of manufacturing in colonies. The colonies were prohibited to produce some specified goods (Thomas and McCloskey, 1981, pp. 94-95).

Following the changes at the level of the import duties, criticisms of the export duties, and among them, especially those on woolen began to spread. This led to firstly leaving the general export duties unchanged at 5 per cent and later, in 1700, repeal of all export duties upon woolen cloth, although the general abolition of all export duties happened during the Wallop's great customs reform in 1722.

The decline of the taxation embraced the raw materials of British industry as well. Following the increase at the general level of duties, all raw materials bore even up to 25 per cent duty leading to pressures exercised to adjust them. This effort provided its fruit leading to downward adjustment of duties. The abolition of duties began from textile industries raw materials; however, it was, again, the measures taken in 1722, which repealed the duties of many items of raw materials. As some instances and to have more clear idea, the duty on cochineal and some minor dyestuffs abolished in 1714, it was lowered on Turkish silk and mohair yarn in 1718, the duties on flax were repealed in 1752, on Irish woolen in 1740, on linen yarn were reduced in 1752, and abolished in 1756, and the raw silk duty abolished in 1765 (Davis, 1966, pp. 311-314). Davis states that "nearly half the total value of raw materials imported in the 1770's came under categories for which duties had been specially reduced or abolished by individual protectionist measures during the preceding half-century –notably silk, flax, and textile yarns- and it is possible that the industries concerned ... would not have grown as fast if those special exemptions had not been given" (Ibid., p. 315).

The next step in strengthening the industrial protection was the matter of drawback, that is, the repayment of the customs duties of the imported goods at the time of the re-export. As a result, in 1720 a commodity was repaid seven-eights of the 20 per cent duty when re-exported. "Drawbacks in association with the new level of import duties, specifically brought up the matter of industrial protection" (Ibid. p.312).

Yet, there were some other steps to be taken to bolster the industrial protection. Export bounties chiefly began in 1722 for silk wares, with the excuse of exercising duty on imported raw and thrown silk. In 1732, it embraced sailcloth, however, this time along with the abolition of the raw materials import duty. And, in 1742, after covering linen sent to certain foreign as well as colonial destinations, it finally expanded in 1756 (Ibid., p.314).

Interestingly enough, the introduction of the policies through the new legislation of the early decades of the 1700s, and also the support of the authorities for these policies, continued even on the eve of the Industrial Revolution, i.e. the latter part of the eighteenth century. Accordingly, a concentration of new protective legislation was initiated between 1763 and 1776. Among them, there were new prohibitions on import of foreign silk, leather gloves, stockings, velvets and other silk goods as well as increases in duties on linens and paper. Besides, simultaneously, two opposite policies were followed concerning, on the one hand, importation of a new range of raw materials and, on the other, the exportation of machinery. While the first category enjoyed reductions of duties, the second one witnessed prohibition of the export of textile machinery and tools in 1774 (Ibid. p.314).

Anyhow it is believed that not only England, but also the whole Western Europe have been characterized by a high degree of self-sufficiency before the Industrial Revolution. As moving towards industrialization as well as urbanization, however, the British exports embraced industrial products in exchange for raw materials and food.

1.2.5 <u>NINETEENTH CENTURY</u>

1.2.5.1 <u>First Half:</u>

Leaving behind a more than two decades lasting war (1793-1815), Britain encountered a depression continuing, in varying degrees, till the middle of the nineteenth century. In this interval, the internal market faced with exhausted demand. Further, the European markets were not available for British products too (due to their restrictive policies as well as debilitated economic state). More clearly, following Napoleon's defeat at Waterloo in 1815, and exhausted by a quarter of century of warfare, Europe pursued the British example in following the protectionist policies to recover its economy. Thus, high tariff barriers in Europe, impeding the flow of free trade, left their impacts against England able to produce more than the needs of its domestic market. In consequence, there, the door remained open to trade mainly with her colonies (Southgate, 1934, p.338). Having in mind the superior economic situation of Britain, her efforts to export more and her technological superiority after several decades of the start of the Industrial Revolution, doubtless, it seems interesting to note that average customs rate of Great Britain during 1821-25 was 53.1 per cent. This is comparable to, just to give an example, 20.3 per cent, of France (in the same period) which is regarded by conventional wisdom as a country having high tariff rates (Nye, 1991, pp. 23 and 26).

Due to adoption of deflationary monetary policy and reduction in government wartime spending, private enterprises were discouraged to embark on new investments which led to economic depression in Britain. These factors contributed to the decreasing economic activities and trade depression which lasted up to 1822. By the 1940s imports surpassed exports in value. Since the erected obstacles to the free trade had resulted in inevitable reduction in British exports relative to her decreased imports, this led to "the campaign against current protectionist policies which persuaded statesmen after 1842 to pass free trade legislation" (Walker, 1968, p.106). Interestingly enough, Walker states that it was the enforced will of the "statesmen" (or a state control matter) rather than a natural and spontaneous approach, or alternatively, a full-fledged one embracing all sectors including navigation, which provided the ground to repeal restrictive regulations to shift to a *laisser-faire* environment.

It is interesting that even some scholars believe that there was not such a *laissez-faire* story in Britain at all. Brebner (1948, pp. 252-53) states that "British laissez faire was a political and economic myth..., that is, a slogan or war cry employed by new forms of enterprise in their politico-economical war against the landed oligarchy.... Although laissez faire never prevailed in Great Britain or in any other modern state, many men today have been led to believe that it did. One might go further and declare that today even some scholars believe that it did. Part of that misbeliefe in scholars may be attributed to taste or to temperamental preferences, and part to their reliance upon the work of other scholars...[those works have been] so passionately motivated as to be a science, despairing, and warped reassertion of the myth in terms of legal and constitutional history".

Going back to our main story with some detail and reviewing the grounds leading to some developments in the nineteenth century, "under the influence of the Wealth of Nations of Adam Smith" (walker, 1968, p.120), and to raise money to finance the war[11] of American Independence, in 1779, restrictions on Irish trade were removed being allowed to trade with the colonies. In 1787, England and France agreed to decrease duties on most of imports. This new trend of experiencing some elements of free trade, however, came to an end at the time of the outbreak of war in 1793. Keeping in mind the influential teachings of Smith, still during the indicated period, the overwhelming thought was not in favor of free trade, but being for protectionist ideas, in the manufacturing sector, to say the least. This could easily be shown by its opposition to free trade with Ireland in 1785, regarding its fear from competition with cheap Irish labor. Besides, regarding conflicting interests even among the same industry, free trade faced with some problems. For instance, while smelters did not prefer free entrée of pig iron, the hardware manufacturers did. Or, as spinners did favor the ban of foreign yarns, weavers did not (Ibid., pp. 120 and 122).

[11] Ironically, the initial reason for the state intervention in the economic arena as well as its renouncement from being actively involved in initially protectionist ideas, returns back to the same one. More clearly, as history reminds us, at least one of the main reasons of the states' economic involvement has been raising money to finance wars. The reasons, however, remain there untouched even when the free trade ideas were, increasingly, becoming influential(Walker, 1968, p.120).

It has been estimated that more than 2000 regulations were valid in 1815 to control trade, while mostly framed to meet wartime needs. However, their necessity and desirability could be questioned at the time when the British manufacturing was potentially greater than that of other countries, needing cheaper raw material to fully realize its capacity vis-à-vis prohibition of importation of some manufactured goods. Among them, silks, cottons, woolens, tobacco, and gold and silver wares could be mentioned. Some others were subject to taxation even up to 50 per cent of their value. Of those highly taxed commodities, tea, coffee, sugar, bacon, butter, cheese, and even potatoes could be named. Under the circumstances that British shipping enjoyed supremacy over that of other maritime nations, naturally, even the usefulness of the navigation laws seemed doubtful.[12] The complexity of fiscal legislation and the difficulty of its interpretation left the merchants with some problems. Moreover, the duties mainly imposed for revenue purposes rather than protective ones, were not effectively working. Moving to foodstuff items, from 1770 to 1842 the import of livestock products were banned and corn importation witnessed severe restrictions. Concerning the latter item, although its export was hampered beginning from the eleventh century, however, the history of Corn Law begins from 1436, giving its growers almost a monopoly power. After the Restoration, the law passed in 1689, at the time the Parliament was controlled by the landed interest, legitimized the payment of bounty on corn exports, prohibited the export duties, and reserved those for imports. Following bad harvests for some years, Parliament, through enacting Burke's Act of the year 1773 sought to facilitate imports and restrict exports. By 1790, England had ceased corn exports and begun to be a corn-importing country (Hill, 1957, p. 50). The passage of two acts, respectively, in 1804 and 1815 permitted the wheat imports only if the home prices increase to certain levels. Putting alternatively, above the levels of those determined prices, the free importation of wheat was

[12] Ironically, Adam Smith defended the perpetuation of the Navigation Acts.

permitted. Interestingly enough, the second act, while passed in the peacetime, raised the minimum price of the wartime from 66s to 80s. Two reasons were provided for that. Firstly, regarding increase on the import duties of all merchandise classes, the farmers were entitled to be protected as much as the manufactures were. Secondly, keeping in mind the limited capacity of the overseas suppliers as well as the then available transport facilities, the domestic producers must obtain enough profit through beneficial prices to produce sufficient amount of food to feed increasing population of England in the first half of the nineteenth century (Walker, 1968, pp. 122-24). Although the review of the law revealed more protection in the agricultural sector, however, the way for liberalization was being paved.

In fact it was to the advantage of the British economy to promote as much free trade relationships as possible. The reasons for taking steps to implement that policy were simply that she passed the early nineteenth century war as a dominant ship owning country, the first country to use power-driven machinery in vast scale, enjoying nearly a monopoly portion in textile and hardware production, and ultimately being able to undersell the native producers of the other countries. Considering the mentioned reasons, the British capitalists, being in need for cheap labor and imported raw materials, and their employees, in their turn, needing cheap food, were convinced that removing hindrances to the free exchange of their manufactured commodities for imported primary products, unlike the previous regulated phase, would benefit them much more. They, both, thought that the protective Corn Law was passed for the benefit of the landowning class leading to a rise in the cost of living (Walker, 1968, pp.125-126). In consequence, "in the postwar years a formidable series of reforms took place" (Supple, 1973, p.320)

To remove the restrictions on free flow of trade, in 1823, the Navigation Laws were modified and British colonies were permitted to trade directly with Europe. Comprising three-fifth of the government revenue, customs duties could not be abolished but to be moderated embracing a vast range of imported commodities. Besides, exports and imports must be treated simultaneously, while, hitherto, each had been treated separately.

According to an official report in 1840, it was revealed that 95 per cent of the customs revenue was derived from 17 out of 1150 dutiable commodities. Those goods included foodstuffs and beverages, some raw materials and manufactured articles. Based on financial measures taken between 1842 and 1845, duties on raw materials were not to exceed 5 per cent, those on partly manufactured goods 12 per cent and those on wholly manufactured goods 20 per cent. The system of agricultural protection was violated as well. Ultimately, 750 dutiable goods were affected (Walker, 1968, pp. 127-128).

As a result of revenue surplus, in 1845, the policy of duties abolitions extended to 430 dutiable commodities and export duties disappeared. In 1846, Britain was not a free trade country, however, she had experienced a dramatic change in fiscal policy. In all, customs duties were abolished for 605 and reduced for another 1035 dutiable goods (Ibid., pp. 128-129).

Considering the reduction in duties gained in the industrial sectors, it brought about a situation in which the defense in favor of the protection, already provided for agricultural sector, appeared to be problematic. A bill introduced in 1846, although confined only to modify scale of the duties on corn, however, paved the way for the abolition of the Corn Laws. It is believed that "it was not until Irish famine forced repeal of the Corn Laws in 1846 that the retreat from protection became an irreversible movement" (Deane, 1967, p. 210). In 1849, the Navigation Acts, while enjoying some relaxations for the last several decades, were repealed. However, "repeal was stoutly resisted in the House of Lords by members who doubted the ability of British ships to compete on equal terms with the fast American "clippers."

Tory speakers reminded the House that even Adam Smith had approved the Navigation Laws." (Walker, 1968, p. 133).

As indicated earlier, the repeal of the protective laws was closely monitored from the point of view of disturbing British supremacy. This is true even for conservatives who captured power following several years after the repeal of the Navigation Act. As a matter of fact, being satisfied with the results of the continuation of the British ability to compete, later, they did not attempt to violate the free trade legislation. Even more, they confined the import duties for revenue purpose only and directed Britain to be a free trade country.

1.2.5.2 The Third Quarter:

By the mid nineteenth century, a long period of depressive environment had come to an end in England, and an era of economic prosperity had begun. The third quarter of the century witnessed the golden age of English agriculture, industry and commerce. This period of economic prosperity was ascribed to the principles of *laissez-faire* (Southgate, 1934, pp. 341-42). Again, interestingly enough, even during the period ending to the 1860s, which is treated as thoroughly free period in England and protectionist one in France, the average customs rate is 15 per cent in England in 1856-60 comparable to 10 per cent in France. Both the figures at the end of the third quarter of the century decreased to, respectively, 6.7 per cent and 5.3 per cent (Nye, 1991, pp. 25-26). This period is explained as one following *laissez-faire* principle bringing in economic prosperity in England. "By 1850,...the triumph of *laissez-faire* philosophy of government was virtually complete in Britain" (Deane, 1967, p. 208).

In the budget of 1853, duties were repealed for 123 articles and reduced on another 133. Putting it differently, before 1860, there were 419 dutiable goods, which was reduced to 48, of which only 15 made very significant contribution to the revenue. In the 'sixties "free trade would usher in an era of prosperity and universal peace, was on the verge of realization" (Walker, 1968, p.134) was regarded as a prophecy.

This, however, was not more than an illusion since "this did not prove to be the case, as after 1870 European States embarked on policies of high protectionism and militarism" (Ibid., 134). England, specifically, following a series of budgets introduced in 1860 and onwards to abolish or reduce the duties, was a free trade country. [13] The suitability of free trade policies, however, "a generation later, when British industrial supremacy was no longer unchallenged, could not be taken for granted" (Ibid., p. 135).

1.2.5.3 The Fourth Quarter:

The prosperity of Britain in the third quarter, however, was followed by a depression in the last quarter of the nineteenth century. Between 1874 and 1896, the average retail prices index fell from 117 to 83 (Ibid., p. 274). During the same period, along the line of increase in money wages, the real wages rose much further, from 133 to 176 (Ibid., p. 275). On the contrary, business profit fell because of the increase in the supply of capital owing to the development of joint stock company enterprise and banking. The fall in prices could be addressed by an increase in the demand for gold followed by its concomitant falling production, on the one hand, and an enormous expansion in the commodity production, on the other. The increase in the demand for gold was because of its increasing use as the standard of value. The expansion of the output of commodities was due to improvements in methods of production, transport and availability of new areas for exploitation. European immigrants to these areas exported increasing amount of cheap food and raw materials to Britain which left devastating impact on British agricultural producers.

In spite of increase in national income as well as income per head in the course of the fourth quarter, the number of the unemployed members of trade unions increased. This could be

[13] It is interesting that, comparing the numbers of government empolees in 1870 and 1780, Evans (1983, p.285) believes that still "[g]overnment was now, through the agency of its inspectors and commissioners, a regulator, coordinator and, within limits, director of business including... factories and coalmines."

explained by the acute trade depression of 'seventies and 'eighties, from 10.2 per cent in 1866 to 11.4 per cent in 1879. Between 1874 and 1900, the British imports (mainly foodstuffs and raw materials) grew much faster than her exports and re-exports; the gap bridged by shipping earnings and taxes levied in the colonies. Numerically, and in absolute values, between 1872 and 1900, her import value increased from 355 million Pounds to 523 million Pounds. Simultaneously, however, trade deficit embarked on a rising trend, changed from 40 million Pounds to 169 million Pounds. Further, exports encountered an abrupt competition of overseas production in her previously monopolized market. Nevertheless, the industrial power of Britain expanded as well. Although, the estimation of the amount of the proper impact of free trade on the British commercial and industrial expansion is impossible, however, "the fact remains that Great Britain under a free trade regime expanded her industrial and commercial power" (Ibid., p. 276).

The closing quarter of the nineteenth century, as compared with the preceding quarter, witnessed a slower rate of export trade. The annual average growth rate of British export was 5.3 per cent between 1840 and 1860, 4.4 between 1860 and 1870, 2.1 between 1870 and 1890, and only 0.7 between 1890 and 1900. Even more, after 1872 her exports decreased in value (Ibid., p.277). More specifically, the British share of world export trade in manufactured goods declined from 38.1 per cent during 1881-85 to 30.7 per cent in 1896-97. This was due to a much more rapid expansion of world trade, compared to Britain's. The decline and its aftermath coincided with the period that the U.S.A as well as European countries were involved in developing their industries, protected by tariff walls. This led to a much lower degree of export expansion of the textile industries during 1870-1900 as compared to the period of 1850-70. Furthermore, the industry's employed labor force decreased from 15.4 per cent in 1851 to 9.3 per cent in 1881 and 7.2 per cent in 1901 (Ibid., p.278).

The same story was true for the British metallurgical industries, which in 1870 was leading the world, while in the closing decades of the century was far behind the U.S.A and Germany. The rapid expansion of the American and German industry owed to an increase in the size of business units, formation of trusts in the U.S.A and cartels in Germany, the one that lagged in Britain. This feature of the free trade Britain, i.e., the small size of business units, led to the production of the specialized commodities for numerous markets, as opposed to cut production cuts and controlled prices in the expanding protected home markets of the U.S.A. On the other hand, Germany, lacking the advantage of Britain in access to colonial markets, welcomed protection for "infant industries" (Ibid., p.279). Furthermore, there are some complaints against some industries of America and Germany dumping on the free trade British market. In words of Walker "[a]bove all, it was contended that American and German industrial expansion was due to protectionist policies, which, giving to home producers a monopoly of the domestic market, encouraged the organization of production by powerful trusts and cartels. The formation of strong business units of a similar pattern was impossible in Britain as long as she adhered to a policy of free trade" (Ibid. p.280).

The prosperity of Britain in the third quarter, however, as noted, was followed by a depression in the last quarter of century. The depression in shipping industry, some technical changes, and the emergence of some new competitors with more efficient application of capital led different groups to discuss the causes and remedies of the depression. Further, as explained, in continental Europe this peaceful period was accompanied with industrial expansion (especially in Germany) in which *laissez faire* philosophy had no place; government support secured an active role (Southgate, 1934, pp. 342-343). Considering the economic prosperity in the continental Europe vis-à-vis the economic depression in Britain led the observers to expect a gloomy economic situation for the latter.

In consequence, "politicians, business men, the economists, alike could not fail to observe that Great Britain was holding the principles of *laissez-faire* which did not commend themselves to the competitors. In other countries economic activity was being assisted by the State in many ways; what was good for Germany and the United States could not, it was argued, be bad for Great Britain. There was a growing feeling that the Government ought to do for British industry and trade what the Imperial German Government was doing for German industry and trade. British statesmen did not accept this view at once; nevertheless, the end of *laissez-faire* was in sight" (Southgate, 1934, p.344).

In the last decades of the nineteenth century, the competitive situation for the British industries was so tight. The adverse impact of the revival of economic nationalism overseas, on the one hand, and the lag of British industries, those based on scientific research, on the other, led to an environment in which, only one exporting industry, coalmining, was regarded as a flourishing one, which was considered harmful for the long-term interests of the nation.

1.2.6 TWENTIETH CENTURY:

"It was not until after 1918, when Britain found herself in the same position as Germany had been after 1870, that she began to "rationalize" he industries, seeking to eliminate domestic cut-throat competition, cut out waste and promote greater efficiency be enlarging the size of her industrial units and reducing their numbers" (walker, 1968, p. 280).

Although trade recovery in the late 'eighties, alongside some other political issues, temporarily had led to the stoppage of protectionist agitations, it revived, ironically, in the later years of the century, by the former free trade spokesman, Joseph Chamberlain. To consolidate the empire unity, Chamberlain argued that the free trade system has to be discarded and, instead, a system of preferential tariffs constructed for empire products. He made a triplet-aiming suggestion including reduction in unemployment through protecting the British industries. Subsequently (in1903), the Tariff Reform League was established, and, several eminent economists criticized "one-sided free trade". In Chamberlain's own words, expressed in a series of speeches, "British manufactures ... had been loosing ground since 1872.... Agriculture has been practically destroyed, sugar has gone, silk has gone, iron is threatened, cotton will go. How long are you going to stand it? " (Walker, 1968, p. 299). Then he outlined a program concerning exercising new duties as follows: "no taxes on raw materials; low taxes on food other than colonies; and to offset the slight increase in the cost of living, a reduction in the duties on tea, sugar, and other commodities of popular consumption. Home industries are to be protected by an ideal, scientific tariff constructed by a body of experts commissioned by the Tariff Reform League." (Ibid. p.299).

"The rather defensive assumption behind it was that, as British industry could no longer dominate the whole world, it might as well concentrate on the quarter of it which was in a British Empire fenced off against the aggressive foreigners. The case against Free Trade was indeed powerful, especially, when British industry was no longer either the largest or the most efficient in the world, and when the country was notably lagging in the technologically new industries of the twentieth century. The classic Manchester argument that an industry which could not produce more cheaply than any other on the world market ought to go out of business might bear the sacrifice of a new small occupation, or even the British agriculture, hardly of a large chunk of Britain's basic industries and prospects" (Hobsbawm, 1969, p.243).

Despite controversies organized by the rival parties to contradict the ideas of the Tariff Reform League, the subsequent elections, held in 1906 and 1911, inserted the adherents of tariff reforms as the political winners.

The retreat from *laissez-faire*, beginning from early twentieth century was neither due to the application of collectivist theory nor because of the conversion of the British statesmen to a different ideology. It, simply, stemmed from the need for a social reform.

The outbreak of the First World War began to leave its impact on British economy with the diversion of the economic resources to meet the needs of war machine. The first step taken to leave free trade policies was the introduction of McKenna duties of 1915, a 33 ⅓ per cent tariff, to limit the importation of luxury goods and to support shipping as well as improving the foreign exchange (Southgate, 1934, p.354; Walker, 1968, p. 316).

"By 1918 the government had taken over the running of several industries, controlled others by requisitioning their output or licensing, organized its own bulk purchased abroad, restricted capital expenditure and foreign trade, fixed prices and controlled the distribution of consumer goods .... The protection of "key" industries was no longer a theoretical issue. The contemporary rationalization and amalgamation of industries by government, or even their nationalization, was now a matter of practical policy" (Hobsbawm, 1969, pp. 240-241).

Being heavily dependent upon safe international commerce, British security as well as economic prosperity was now interrupted by outburst of the war. Leaving the export markets into the hands of the competitors, British import values heavily increased from 696 million pounds in 1914 to 1316 million pounds in 1918, while her exports and re-exports values remained almost unchanged around 532 million pounds.

The slump had not come to an end as it continued till the outbreak of the Second World War. Unemployment expanded in a way that unemployed people ranged from one-fifth to one-tenth of the insured population. Export and re-exports value did not show any increase for the next three decades after a boom in 1920, falling even to half in 1921. The percentage of unemployed members of the trade unions increased from 2.5 per cent in 1919 to 15.6 per cent in 1921. The closing month of 1920 experienced the beginning of the price fall as well. The exogenously-induced increase in the British exports values in the early 1920s (due to the strikes in the U.S.A. and Germany) temporarily lessened the worsened effects of economic variables hitherto experienced. Again, however, her share in world trade began to decrease as the 1920s approached its last years. Even worse was to follow: by early 1931 the economic recession was greatly intensified. In short, the level of industrial activity fell from 109.1 in 1925 to 81.1 in 1932, increasing the insured unemployed people to 22.1 per cent in 1932 (Walker, 1968, pp. 319 and 320). The hazardous future led the economic officials to confess their hopelessness on absence of any improvements for the next ten years.

The British economy could recover permanently if there was a flourishing export trade; the one, which faced with obstacles including competition of overseas industries supported by high tariff barriers. This opinion, although covered a part of the fact, but not the total. As mentioned, the British main problem was this that industries by which she had exercised her supremacy over the world economy and experienced the first industrial revolution were now aging and becoming obsolescent. The world trade pattern was changing as well. Consequently, as previously explained, her leading economy faced lessened severe changes, beginning before 1900. Further, the technological advances leading to change in taste of her customers formed the big difficulty of the British industries. The early twentieth century trade boom did not provide any improvement in the trends but postponed the realization of their full impact on British economy. Therefore, "the post-1920 British recession was not basically due to war time dislocation of industrial and trade patterns" (Ibid., p.321).

The very industries which had hitherto provided the ground for Great Britain to enjoy supremacy over other nations began to suffer in the early decades of the twentieth century. Shipbuilding industry was among them. Having obtained high productive capacity, it had to face competition from countries such as Germany and Japan, which previously were its customers. Moreover, the shipbuilding firms suffered from the shortage of capital to renovate the industry to meet the new demand. The cotton industry lost ground, partly to India, which had obtained in the last decades of the earlier century. Now, India, China and Japan were enabled to use advanced cotton manufacturing techniques. Numerically, the export value of British cotton industry declined from 125 million pounds in 1913 to 47 million pounds in 1933 as the number of its workers decreased from 646 thousands to 350 thousands during the period of 1911-1938. The woolen industry, in its turn, did not remain unaffected from the recession as well. The export value of British woolen industry fell down from 32 million pounds in 1913 to 14.5 million pounds in 1933 and the size of labor force from 261 thousands in 1911 to 230 thousands in 1938. A part of this decline stemmed from competition with the woolens produced in tariff-protected countries.

As a matter of fact, under the prevailing conditions of life in the twentieth century, despite the existence of any theory of government believing in harmful effects of the state intervention in the economic matters, the extension of government functions seemed to be essential even before the outbreak of the war. Had this done and expanded even more during the wartime, however, the extended functions were regarded as transitional one, dictated by the pressures of the period of the wartime, and needed to be adjusted to those prevailed before war. However, it was, in actual fact, a false imagination which not only did not come to truth, but also proved totally wrong when in the beginning of the 'thirties taking severe steps along the line of government intervention became necessary. Before 1929, even the conservative governments had no other way but to undertake some responsibilities in managing economic affairs. "Between the wars, and especially during the 1930s, Britain, as we saw, turned from one of the least into one of the most trustified or controlled economies, and largely through direct government action" (Hobsbawm, 1969, p. 242). The Dyestuffs Industrial Act (1920), the Safeguarding of industrial Act (1921), and substantial amount of subsidies devoted to sugar-beet growers from 1924 onwards, are the beginning steps taken to breach the rules of free trade regime. The last measure was initiated to make more profit from farming sector, to control the rural-urban migration, and to guarantee the maximum potential amount of sugar during the wartime. The subsidy policy left its impact as establishing a sugar-beet industry to provide one-fourth of the British sugar consumption in 1934.

Before the war, a part of public utilities, including water, gas, electricity, tramway, docks and warehouses were owned by municipalities. After the war this policy of the public ownership of resources providing public services extended. The British Broadcasting Corporation (1926), London Passenger Transport Corporation (1932) and British Overseas Airways Corporations (1939) were established and the generation of electricity was transferred to the Central Electricity Board. State investment in the Anglo-Persian Oil Company, valued, later, up to hundreds of million pounds and ownership of 48.89 per cent of British Petroleum Company stock could be mentioned among them. The government, in 1938, nationalized mineral royalties and thereby compensated "the error made in time past in allowing the ownership of coal to fall into the private hands" (walker, 1968, p. 330). Furthermore, as mentioned, whatever the economic theories believed in state intervention, after the war the labor unrest was so intensive that left the government no alternative but to interfere in the industrial affairs, to offset the impacts of the widespread strikes. "By the middle 1930s laissez-faire was therefore dead even as an ideal, except for the usual financial journalists, spokesmen for small business, and the economists" (Hobsbawm, 1969, p. 244).

Although the National Government, formed in late 1931, had no intention of following a planned economy, however, the critical situation led it to be, ultimately, responsible for two major breaches in the function of British economy, namely, the abandonment of gold standard and free trade. Following the withdrawal of 21 million pound worth of gold, mainly to France, and a large budget deficit, leading to 25 million pound credit granted from outside, which was drained in the course of one month, the National Government postponed the private right to exchange domestic money for gold for export purposes. This ended with devaluation of pound sterling, which felt to about 70 per cent of its former value.

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To provide the ground for the pound to be used as international money and to avoid extreme fluctuations of exchange rates, in 1932, the Government established the Exchange Equalization Fund, containing gold reserves and foreign currencies.

Besides leaving the gold standard and initiation of foreign exchange control, as major changes regarding the British economic policies, the National Government "decided to make Great Britain a protectionist country" (Walker, 1968, p.341). In consequence, it pursued the way followed by other countries in erecting protective walls vis-à-vis the free flow of commodities, as closing the free trade market.

Further the reasons put forward by the pre-1914 tariff reformers, i.e. saving the domestic industries against the cheap and free flow of foreign goods, new arguments were used by those contesting in 'thirties. Viewing the unbalanced trade as a threat, not only the protectionists argued for the necessity of its compensation but also the free traders were convinced that the devaluation of pound, following the abandonment of gold standard, will not per se suffice to overcome the balance of trade deficiency. The working classes, also, were among those believing Britain could no longer enjoy the dumping for cheap commodities of the rivals. Some other reasons could be

Potato imports were controlled by licenses issued by the Board of trade, and a potato Marketing Board was authorized to limit output and control distribution. All hops were sold through a Hop Marketing Board, and Milk Marketing Board was set up following price decline in 1930-31. Cattle farmers were protected by import restrictions. In 1934, a system of temporary subsidy was introduced for beef, which was made permanent in 1937. Mutton and lamb producers were protected through import agreement with some countries as well as introduction of price insurance schemes in 1939. To control the importation of eggs, some agreements were made with some foreign countries and tariffs were introduced. To support pig producers, the government imposed import restrictions and, also in 1934, allotted import quotas to foreign countries. A Bacon Development Board was established, obtaining more power by the Bacon Industry Act (1938) (Ibid. p. 346). "Equally unthinkable in terms of Victorian capitalism, the government set about regulating prices, and output by legal compulsion, notably in agriculture, about one third of whose output was brought into state-sponsored marketing schemes in the early thirties" (Hobsbawm, 1969, p.242).

Government intervention in the industrial sector took the form of supporting the trend towards combination and concentration. This trend, as taking place in the U.S. and Germany in late nineteenth century, was not considerably happening in Britain. The trend of establishing large-scale firms was jacked-up during the post-1931 depression and imposition of protective tariffs. Government supported the rationalization of industries, which meant measures of industrial reorganization including "amalgamation and reorganization of business units, the closing down of unremunerative and insufficient plant, and the concentration of production of industrial units equipped with automatic and semi-automatic machinery" (Walker, 1968, p.348).

The implementation of this program inevitably led to what at that time was known as "technological unemployment". Hence, Britain was to cope with widespread socio-economic problems coming out of rationalization of industry. In 1931, however, the expended unemployment was not "technological" but stemming from contraction in demand for British staple exports. The advice of the Balfour Committee on Trade and Industry (1929) was closure of inefficient plant. The government provided its help since relying upon competitive mechanism to remove excess capacity could take a long time.

Other initiatives were employed to get rid of excess capacity as well. Taxation concession and pressure by Import Duties Advisory Committee were among them. The imposition of high tariffs was conditioned to the implementation of rationalization schemes. In 1934, government supported the promotion of the British Iron and Steel federation which closed down some plants. The Lancashire cotton Corporation was established to purchase and leave aside the surplus spindles. As another example of government intervention vis-à-vis the free market mechanism could be mentioned its interference to the benefit of the railways taken the form of restrictions imposed upon road transport by Road Tariff Act (1930) and Road and Rail Tariff Act (1933).

In the five years preceding the outburst of the Second World War, the Commissioners appointed under the Special Areas Act of 1934 spent 16 million pounds to develop new industries, on public works schemes, and on local social services. The measures proceeded by the commissioners were followed by the attempts of the Ministry of Labor which, firstly, created labor camps and training center and, secondly, provided financial aid to promote migration to more prosperous areas. Even by the end of 'thirties, Britain did not know how to adjust the agricultural and industrial structures to challenge the new world. "Once the Nazi tyranny had been overcome, public opinion was prepared to accept far-reaching measures of government intervention" (Ibid. p.3561).

CONCLUSION

In this chapter we conducted a historical research concerning the economic role of the State in Britain. It was substantiated that, contrary to what is generally believed regarding the prevalence of a free-trade regime and, consequently, the absence of significant State intervention in the course of her industrial development, the State has been actively engaged in developing the economy. Beginning from the thirteenth-century, severe attempts were made to overcome relatively backward economic situation of the economy. In doing so, a vast variety of policies were employed. Local manufacturing was encouraged through the prohibition of export of raw materials and import of final goods. Skilled labour force was imported and a set of legislations was passed so as to establish national industry and commerce. To conquer foreign markets, the policy of commercial and industrial monopoly was followed as well. More specifically, in this era, import substitution industrialization strategy was actively pursued. From eighteenth-century onwards clear examples of infant industry strategy was also promoted. Furthermore, it was shown that even the free-trade legislation in the nineteenth-century was based on the will of statesmen to overcome the economic depression. Curiously, the average customs rates in Britain during the free-trade period were higher than those in some protectionist countries. As the economic depression prevailed in the last quarter of the nineteenth-century, again the protective measures were erected. Such initiatives were continued even till the outbreak of the Second World War turning Britain to a protectionist economy.

CHAPTER 2

THE ROLE OF THE STATE IN THE NEO-CLASSICAL THEORY

markets forward to function efficiently to reach Pareto optimality through different policy devices (Ghosh, 1997, p. 148).

There is, however, an additional role for the State implicitly in this theory. Fundamentally, the rights of individuals to initial endowments as well as to the gain from trading them are considered, in this paradigm, as a prerequisite to obtain Pareto-efficient allocation in the markets. That is why guaranteeing property rights as a minimalist role of State seems self-evident. This point reveals another fact. Efficiency, in the neo-classical paradigm, as the main criterion to omit State from economic arena, is based upon State protection of private property rights.[1] Therefore, a stream, including Nozick (1974), believes that any State involvement in any reallocative activities of the initial resource endowments of the private agents for any redistributive purposes is nothing but a violation of promise in guaranteeing the private property rights. This, if it happens, leads to the inefficient functioning of the economy causing negative welfare effects (Ibid, pp. 148-49).

Believing in absolute rights to property and hence the indispensability of protecting this basic law against any violation, some theorists, including Nozick, endorse the minimal State, or what has sometimes been called the 'nightwatchman State'. This State is legitimate as long as it takes care of people against force, fraud, theft, and enforces contacts. Undertaking any more responsibility beyond safeguarding rights against violation will, inevitably, involve the violation of rights (Nozick, 1974, pp. 26-27). According to the libertarian point of view, involvement of State in providing public services (building roads and libraries) with the intension of improving the quality of life, taking care of disabled (poor, unemployed) citizens, and supervising individual lives (through any sort of censorship or prohibition) is considered as unjustified State interference. This

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[1] It seems interesting that while the realization of the goal of neo-classical economics is predicated upon the existence and authority of state, however, this very critical concept is, at best, considered as an implicit and minor factor in this paradigm.

minimal State, therefore, raises taxes from the society only to cover the expenditures concerning the defence of citizens against aggression (Wolff, 1991, pp. 9-11).

However, any government lacking explicit authority will obviously fail to defend the just rights of its citizens. In other words, even to fulfill the above-mentioned minimalist economic function in the society, a State should enjoy enough authority to take care of a system of law and order to provide the ground for people to acquire or transfer the property. In the words of Olson (1965, p. 13) "any government is economically beneficial to its citizens, in that the law and order it provides is a prerequisite of all civilized economic activity." But, Nozick (1974, p. ix) adds two implications: that the minimal State "may not use its coercive apparatus for the purpose of getting some citizens to aid others, or in order to prohibit activities to people for their *own* good or protection". Therefore, a State has no right to force people to contribute to projects which improves their well-being. Besides, compulsory redistribution is illegitimate since it is done by State and not through voluntary action of individuals.

Now, however, the question could be posed: what is the theoretical argument on the basis of which the neo-classical paradigm agrees with State interference with economy? The answer, here, will be concentrated on the analysis of the possible failure of the market mechanism in reaching Pareto efficiency and the function of State in compensating that failure. To do this, two sets of arguments will be examined in the following. The first is the analysis of market failure. Here, we will be concerned with two questions: how it is possible that market mechanism can fail in fulfilling Pareto efficiency conditions? And how can the state overcome such failure? Then, in continuation, we turn to reviewing the government failure literature. In doing so, the critical question will be scrutinized whether the State is basically able to intervene effectively in the economy.

2.1.1. THE MARKET-FAILURE LITERATURE:

This literature examines the circumstances in which the market mechanism fails to equate private costs and benefits with their social equivalents and, further, how the State can intervenes to correct it. Three groups of arguments, here, namely, public goods, non-competitive markets and externalities, will be reviewed.

2.1.1.1. Public Goods

A public good, obviously, must have an opposite meaning as compared to a private one. A private good is defined such that it can be consumed only when it is paid for. Thus, the benefits derived from the good are internalized, consumption is rival and exclusion is feasible. Buchanan (1968, p. 50) defines it as "[a] unit that is produced corresponds to a unit consumed by only one person, and neither its production nor its consumption generates, positively or negatively, relevant external or spillover effects on persons other than the direct consumer".

A public good, in contrast, is one whose consumption could not be withheld from those who have not paid for it. Alternatively, a common, collective or public good is defined as one in whose case those who do not pay for it can not be excluded from sharing in the consumption of that good. According to Samuelson (1954, p. 387), a collective consumption good is one "which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good." Technically speaking, efficient utilization of resources requires the equality of price and marginal cost. In the case of public good, marginal cost of admitting an additional user is zero, so, according to this rule, should be its price. However, even if the marginal cost is zero, the production cost of the facility is not so. This cost, in one way or another, must be covered (Musgrave and Musgrave, 1989, pp. 42-45).

Olson (1965, p. 14) states that the common or collective benefits or as they are usually called "public good" by economists, are provided *"by governments"* [emphasis added]. But, why should governments provide the public goods? It is the non-excludability characteristic of a public good that creates the possibility that one may consume a good for which one has not paid, while the good is simultaneously consumed by somebody else who has paid for his consumption. Therefore, as one's consumption is not conditioned on making a payment, this could lead to the underprovision of public goods. It is a case of the well-known free-rider problem or the problem of public action; a situation under which everybody suffers while all attempt to maximize their benefits. In the words of Buchanan (1968, p. 88) "the individual will not contribute voluntarily to the costs of public goods, at least not in an amount sufficiently large to generate optimal levels of provision". To overcome this unwelcome situation, it is argued that the State has to step into the economic arena to provide enough amounts of public goods through taxing people. This is entails going beyond purely competitive mechanisms.

One criticism concerning the public-good argument leading to State intervention is that the non-excludability characteristic of a good-which is believed by some scholars as one fundamentally differentiating a public good from a private good – can not be considered to be a permanent one. For instance, technological improvement is the element which must be regarded as one eliminating the publicness of a good (Musgrave and Musgrave, 1989, p. 14). Regarding this valid point, it should be born in mind that the problem of excludability is mainly a property rights problem rather than a technological one. The historical example of English Parks, which changed from being a private good to a public one just because of the rising political power of the commoners leading to the elimination of their exclusion from using the Parks, illuminates the point.

The other criticism concerns the justification of the indispensability of State intervention in providing a public good. Olson

(1965, pp. 43-52) argues that under certain circumstances (gaining a lot of benefit from unilateral provision of the public good in a small group, and realization of certain conditions – such as provision of some incentives in overcoming free-rider problem in a large group) the sub-optimality of public good provision might be removed. Having said that, however, we should not conclude that public goods can always be provided under market mechanisms. In many cases, the coercion apparatus (such as taxation) must be used to achieve the optimal provision of public good (Chang, 1996, pp. 8-9).

2.1.1.2 Non-Competitive Markets

The prevalence of scale economies and/or collusive behavior, where quantity and price in the market can be controlled by individual producers, can lead to non-competitive market structures. If these circumstances, i.e. monopoly or oligopoly markets, came to exist, the less than competitively produced quantity of goods will lead to monopoly profit for firms and deadweight loss for society. In the face of this, it is argued, the State should interfere in the economy to increase output to the amount which would have been produced under competitive environment. Regulation of the Private Sector – taking the forms of anti-trust legislation and price control[2] is a frequently used interventionist measure. Public ownership too has been commonly used.

An important criticism against State intervention in correcting non-competitive markets in predicated upon the second-best theory, which argues that adjusting only some monopolistic markets may not necessarily lead to the improvement of the economic efficiency.[3] Since

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[2] This might be applied to the public enterprises if following private sector behavior is possible by them.

[3] The main proposition of the theory of the second-best can be stated briefly. In the words of Lipsey and Lancaster (1956, p. 11) "[i]t is well known that the attainment of a Paretian optimum requires the simultaneous fulfillment of all the optimum conditions. The general theorem for the second-best optimum states that if there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, although still attainable, are, in general, no longer desirable. In other words, given that on of the Paretian optimum conditions can not be fulfilled. then an optimum situation can be achieved only by departing from all the other Paretian conditions. The optimum situation finally attained may be termed a second-best optimum

anti-trust intervention fails to remove distortions from all markets, therefore, it is argued that its limited application in a few limit cases lacks merit. However, the interventionist argument does not actually get invalidated, since, if the theory of second best shows that there is no necessary gain from such action, at the same time it does *not* necessarily imply the lack of any gain either (Ibid., pp. 9-10).

Regarding non-competitive markets, there is one other argument against intervention. This states that interference is itself a major factor in giving rise to non-competitive markets. It is Freidman (1962, p. 28) who believes that "[i]n practice, monopoly frequently, if not generally, arises from government support or from collusive agreements among individuals". This is also a challenging argument. It could be pointed out that while the State intervention, such as entry barriers, can lead to monopolistic situation, however, many competitive markets, without any State interference and only through structural changes, business cycles, etc., have been transformed into non-competitive ones.

Before proceeding to concentrate on the negative and positive arguments concerning the public enterprises, as a measure applied to counteract the impacts of non-competitive markets, let us begin with mentioning the point that prevalence of the widespread waves of privatisation in various countries, since the mid 1980s, reflects the point that not only have the governments lost confidence in public enterprises, but also the views of many experts have changed regarding power of the public enterprises to meet some defined objectives such as allocative efficiency, full employment, sectoral, regional and general development etc. The shifts in the real world situation and theoretical attitudes have come about due to: the ideological and political changes of the period witnessing the triumph of Thatcherism and Reaganism, the economic crisis and the associated fiscal crisis of recent years, and certain unresolved

because it is achieved subject to a constraint which, by definition, prevents the attainment of a Paretian optimum".

that such problems could also be found in private firms while covered under monopoly prices. This suggests that those private monopoly firms are not only able to cover the costs of their inefficient managers but are even sometimes allowed a net profit.[6]

It is worth mentioning here that sometimes the whole argument is based upon an inadequate conceptualization. The confusion of productivity with efficiency is one example. Sometimes efficiency is identified with productivity (i.e., Labor Productivity) by some international study groups and productivity missions. However, while low labor productivity could stem from pure inefficiency (e.g., bad managerial supervision, bad organisation of work task, etc.), it could also arise from *efficient* combination of labor with low levels of capital. So, it may be stated that the confusion of labor productivity with efficiency leads to the conclusions that high capital-labor ratios would associate with efficiency (White, 1978, p. 30).

The other criticism regarding inefficiency in state-owned enterprises is attributed to the lack of incentives for public managers in the presence of a soft budget constraint (-that is, survival of the firm despite continuing losses) and a multiple agency relationship and without the discipline exerted by the financial market on management. Although such problems leave their impacts on the public firms, but as compared to those afflicting the private firms, it seems that the difference is one of degree rather than kind. To overcome that, some suggestions pertaining to incentive schemes including relating the payment of public managers directly to the firm's profit or inversely to the prices, have been made.

Another criticism of anti-interventionists concerns this point that even when scale economy dictates a non-competitive market structure, regulating private firms (anti-trust legislation, price

[6] The misbehavior of policymakers, here, is not justified. They must assume their responsibilities in efficient operation of both public enterprises, through supervision, and private firms, through regulation. Failure in doing so leads to non-market failure having roots in historical, social and political conditions.

opposing to the idea of judging economic performance by "efficiency", and while mentioning the concrete economic definition given to the concept of efficiency, he emphasizes the point that a transfer from a situation inside the production possibility frontier to a new one on that frontier would be by no means considered a better or a socially preferable one. Putting it alternatively, moving away from a situation of "inefficient" production to a situation of efficient production can not be necessarily regarded as a good thing. This is so because such a comparison between two alternative situations requires a value judgment on income distribution.

Therefore, the comparison, and the preference based upon that, are valid if and only if they have not worsened income distribution, even though in the new situation more of all goods are produced. Professor Patnaik, however, does not just stand on this position and argues further. He concentrates himself on the concept of efficiency itself and not a movement from an inefficient to an efficient situation.

Although Professor Patnaik agrees with the proposition that a vector-wise increase in output from a given endowment of inputs is regarded as an improvement in productive efficiency, he disagrees with another proposition with which this is supposed to be synonymous. Knowing that associated with any activity set is a set of implicit prices, if at these prices some other activity set yields a profit, the consequent move to this set represents an improvement of efficiency. While the first proposition relates to production outcome, the second one relates to activity choice, and is usually advanced in the context of the view of trade as a possible way to increase efficiency.

The latter proposition, however, bases itself on the belief that the production possibility frontier in the new situation with trade lies outside the old one for the situation without any trade. This is so because the country enjoys a new situation where the vector-wise availability of goods is larger as compared to the old pre-trade one.

Having in mind that efficiency is defined as an increase in the vector-vise availability of goods, then trade is considered as an efficient activity (Production). This proposition, however, implicitly assumes that trade does not lead to a situation of unemployment or idle capacity. But, if trade paves the way for the presence of such a situation, even if the economy is on a higher production possibility frontier, the new actual situation may be interior to the previous one.

In fact, what is implicit in the conclusion of the second proposition concerning the efficiency-augmenting effect of trade is the assumption of full employment. If this assumption gets realized, then the whole question boils down to the comparison of two alternative bundles of goods. But, this assumption, which is a base for neo-classical economics, does not always get fulfilled as a rule. Consequently, if the assumption is dropped as an unreal one, then while the first proposition still remains valid, the second one loses its validity.

In this way, Professor Patnaik argues that the only valid definition of efficiency available in economics refers to the absence of two very different types of waste. While one, arising from an improper activity-set, is recognized by neo-classical economics, the other, with significant practical implications, arising from the forced idleness of resources, is not recognized by neo-classical economics.

The usual objection against the establishment of public enterprises arises from the view that some other effective control instruments can be found. Thus, it is suggested that the substitution of public firms by the use of regulation would prevent the rise of incentive problems. This substitution would not only impede the public firms from extracting monopoly power, but hold also let them operate enjoying a normal profit. Two arguments have been advanced against this.

(1) The incentive problems can arise with regulation if the members of the regulatory authority follow their own ends.

Externalities lead to market failure since they cause prices to give improper signals concerning the real scarcity of resources (Hyman, 1973, pp. 43-4). In other words, the presence of externalities leads to discrepancy between private costs and social costs or, equivalently, between *marginal private product* and the *marginal social product*. If the external economies exist, marginal private cost is greater than the marginal social cost. By contrast, in the presence of external diseconomies, marginal social cost exceeds marginal private cost. Therefore, by equalizing private marginal cost and price to determine the optimum production level, the creator of external diseconomies (a polluting factor) will produce a higher level of output as compared with a situation when the social costs of pollution (the diseconomies) was included in his calculations (socially optimum level of production). In the presence of external economies, the opposite is true.

The externality, as defined, lets us conclude that the failure to pay for the benefit (positive externality or external economy) or harm (negative externality or external diseconomy) caused to others implies the absence of a market. This could be because of: (1) the lack of individual property rights over certain goods (common property); (2) jointness in production or consumption. Here, it is argued that, government intervention can eliminate the discrepancy between social and private cost (or product) by internalizing the cost or benefit to society created by the activity of an economic agent. In doing so, a variety of ways, including levying taxes (known as Pigovian taxes) on producer of external diseconomies (for instance, pollution tax), and regulation, to prevent the creation of diseconomies can be employed (Acocella, 1998, pp. 96-99). Other examples of state intervention on externality grounds include providing goods with positive externalities at subsidized prices (such as education, health, social infrastructure) and subsidizing creators of positive externalities (for example, subsidies for R&D).

Having said that, however, some argue that, at least in principle, if the property rights weredefined properly and negotiations held between the two affecting and affected parties, some ways of overcoming the externalities problem could be found. In other words, **efficient resource allocation is possible by independent maximizing behavior of the parties without any need for State interference.**

More clearly, Coase (1960) argues that the most important issue facing a society is designing institutions in such a way as to maximize possible efficiency. He makes two propositions, of which the first (called Coase theorem by Stigler) is the most discussed one in his argument.

(1) If a number of conditions are satisfied (including prior assignment of property rights and absence of transaction costs), agents affected by externalities can reach mutually beneficial agreements without government intervention; moreover, if there is only one position that maximizes social wealth, the agents involved will reach that position regardless of the way property rights were assigned.

(2) If there are transaction costs, the possibility of reaching the most efficient position through the market can depend on how property rights are assigned; therefore property rights should be assigned in such a way as to ensure that the most efficient position (which is not necessarily unique) will be reached.

Of course, the other two necessary conditions for the first proposition are: (1) an external authority to ensure the performance of contracts, and (2) money. In consequence, the only remaining role for the government would be assigning property rights and ensuring contracts.

He illustrates a hypothetical case in which a rancher and a farmer are involved. Taking the rancher as a perpetrator and the farmer as a victim in an external diseconomy relationship, he reviews alternatives of assigning property rights to any of the participants and their dealings with externality.

Coase, then, concludes that the optimal allocation of resources is independent of the assignment of property rights and the most efficient allocation of resources could be reached while there is no transaction costs and no matter if any action (fencing the field) is or is not taken to prevent the external diseconomy. This, of course, does not mean that the income distribution has been left unchanged in the two cases. In this way, the first proposition of Coase is supported.

To explain his second proposition, Coase continues his example to show how transaction costs leave their impact on efficient allocation of resources. He argues that, depending on the size of the transaction costs, they will have different impacts. If transaction costs are low, their impacts will be negligible. But, if those costs are greater than the potential net benefit, they will discourage those who lack property rights to negotiate to adopt the most efficient solution. In this way, he argues that when there are transaction costs, achieving the most efficient allocation of resources is not invariant to how the property rights are assigned. Putting it differently, in the case of the real world, in which transaction costs are present, the way in which property rights are assigned, leaves it impact on efficiency.

It seems Coase Theorem is significant in that it reveals that in some cases the external effects might be internalized without government intervention. In doing so, identifying the two parties is absolutely necessary. In addition, the costs of organizing the externally affected parties (transaction costs) to take any action must be very low. This happens if the number of the externally affected parties is small. To take an opposite example, the case of air pollution could be considered. This embraces a large number of affected people as well as affecting firms. So, not only the costs of organizing the affected are high, but also, once organized, they face the problem of deciding which affecting firm has to be sued and which one bribed. As the number of the two participating parties shrinks to a very small number through which the affecting party is clearly identifiable and the organizing costs for the affected one are low, the results of the Coase Theorem will be applicable. Should this be the case, according to Coase, there will be no need for government interference to internalize the externality by levying a tax or direct regulation (Hyman, 1973, pp. 54-6). Therefore, the theorem might be applicable to those cases which Buchanan (1967, p. 176) calls "small-number externalities", including goods or services which are partially divisible with interactions limited to groups of critically small size.

Coase's work, especially his first proposition, has faced some criticisms (Acocella, 1998, pp. 100-104).

The first criticism is this that the theorem is tautological. The theorem assumes the following: the agents behave rationally, there are no transaction costs or legal barrier for exchange, the property rights have been assigned, and therefore inefficient resource allocation will be totally removed through an agreement reached by economic agents. It is said to be tautological because the inefficient resource allocation can be improved for one without worsening the other's condition. This situation is always reachable if there are no transaction costs.

The other criticism concerns the point that without the presence of a government to force the agents to negotiate, they might take hostile positions instead of adopting cooperative behavior. Gaining economic profit, however, may not in itself bring about cooperative behavior among the members of the society if non-economic goals are considered as privileged. Besides, the overall distribution of income affects such cooperation.

The other problem which concerns the Coase proposition is the effects of the way the property rights are assigned. This point matters from a distributive point of view in a case in which the transaction costs are absent, and from both distributive and efficiency points of view when transaction costs are present.

2.1.2 THE GOVERNMENT-FAILURE LITERATURE

Reviewing various theoretical positions on the role of the State makes clear the point that what is implicitly assumed is the ability of the State to know and do everything. It is reminiscent of the legacy of the early development economists who assumed that the State enjoyed unlimited capacity to intervene in the economic system (Shapiro and Taylor, 1990, p. 863). Furthermore, in this kind of welfare economics which constitutes an extreme example, the implicit assumption is that not only does the State enjoys all the essential information needed to maximize the social welfare, but also that it is able to achieve all its goals. The political economy approach also makes much the same assumption albeit to a lesser extent.

Recently, however, this very important assumption has been challenged. Leaving aside the arguments on the government's intention in intervening in the economy, and holding the State as a benevolent institution attempting to raise the level of economic efficiency, the question has nonetheless been raised whether the State may fail in meeting its goals? Since this is a significant question which has to be dealt with, we will make an attempt in the following discussion to critically scrutinize it. The discussion on these issues, which might be called the government-failure literature, embraces two major strands. The first one is the informational argument which analyses the point that the State, being able to collect and process the necessary information, will rectify the effects of market failure but at a cost which nullifies the positive impact of such intervention. The second one is the theory of rent-seeking, which asserts that government intervention will cause some wastes which, comparatively, may exceed the benefits of such correction. These two sets of arguments which probe the ability of the State will be examined here.

2.1.2.1 Incomplete information

Asymmetric information points to a situation in which the two parties involved in a transaction face unequal amounts of available information. One of them, called the principal, lacks full information and the other, called the agent, enjoys full information. The coinages refer to the idea that principal depends upon agent in transactions with unclear characteristics. Such a transaction, in general, and State intervention, in particular, encounters two various types of asymmetric information: (a) adverse selection; and (b) moral hazard.

The first problem of informational asymmetry arises when the principal is not able to observe the situation, or important exogenous features, of the agent or the good involved in transaction. When in the health-care market the competent physician can not be distinguished from the incompetent one, and in a used car market a cream puff can not be differentiated from a lemon, then the good physician and good car may be driven out of the market because of adverse selection problem.

The adverse selection problem was first illustrated by Akerlof (1970, pp. 489-90) while referring to a used car market as an example of a situation in which a considerable amount of asymmetry of information exists. He explains that in contrast to owners, who, after owning a specific car, have a good idea of the quality of the car, buyers have little knowledge concerning the reliability of a used car. Now, an asymmetry of information has developed between buyers and sellers (as against Gresham's Law). Applying the market price of a used car to one in average condition, motivates only those owners who have cars with equal or worse condition leading to lowering the average condition of cars. The bad cars, which are known in America as lemons, tend to drive out the good cars. At last, what remain are only lemons and the market disappears. This is a Pareto inefficient situation. Therefore, here the market fails to play its fundamental role in providing the ground for a beneficial, and thus an efficient, transaction for both parties.

Stiglitz and Weiss (1981) clarify the problem of adverse selection in detail with reference to bank money lending when the riskiness of some borrowers could not be determined a priori.[7] Then, the bank charges an interest rate which may itself affect the riskiness of the loans by either: (1) sorting potential borrowers; or (2) affecting the actions of borrowers. Here, the bank, facing imperfect information about its borrowers, and to neutralize the perverse effect of a high interest rate, will formulate a "bank-optimal" interest rate, at which demand for loans exceeds supply of funds. Such interest rate, while rationing the credit, maximizes the expected return to the bank and is the equilibrium one.

The second, and more important, part of the informational asymmetry relates to the existence of moral hazard (incentive), or as it is called in the language of modern economics, the principal-agent problem. This situation arises when the principal fails to monitor the functions of the agent or the features of the good controlled by the agent where the agent has no incentive to be concerned about the principal's interest. According to Stiglitiz (1987, p. 966) this situation arises when there is imperfect information, either concerning what action the agent has undertaken or should undertake. An example of that is the effort or care taken by a seller in performing a service. In the absence of monitoring, the seller has no incentive to provide high-quality goods, even though the consumers are ready to compensate it (Inman, 1987, pp. 659-661).

Regarding State intervention, it should be mentioned that initiation and implementation of a policy compels the government to collect and process some vital information in order to achieve its set out objectives. At the first level, it is the information related to the possible alternatives of a policy to provide the required circumstances for a wise decision-making. After adopting and while implementing a policy, there would be some need to collect and process information on how the lower-level bureaucrats have been functioning, on the one

[7] Stiglitz and Weiss show that the results of their analysis are applicable to a wide range of principal-agent problems including those related to employer-employee relationship.

hand, and how the targeted groups in the society have been affected, on the other.

However, collection and processing of information encounters two types of problems. The first type is the problem of adverse selection. This argument maintains that the State is not sufficiently aware of the prevailing situation. And any attempt to overcome this informational inefficiency will only be possible at an exorbitant cost. This point, in fact, has already been made by the Austrian School, concerning the central planning debate, which holds that the required information for a plan is so vast as not to be possible for the planning authority to collect and process it. The example of central planning in socialist countries reveals the fact that, compared to what was needed for a reasonably sophisticated plan, the amount of collected and processed information was insufficient. As one of the critics of the central planning in the command system indicates:

"It is self-evident that, in order to make efficient choices, precise and flexible information as to the costs and effects of each variant is indispensable.... [T]he basic method of planning under a command system is the method of material balances, which amounts to separately collating and making compatible the rows and columns of an input/output table. However, as the number of items to be considered reaches many hundreds of thousands, it proves hardly possible to compile a comprehensively consistent plan based on individual material balances. As a result plans worked out which, although very detailed, are inconsistent and therefore *a priori* incapable of being fulfilled in their totality. Construction of plans which cannot be fulfilled as a whole may be called the 'planning paradox' of the centrally planned economies. Theoretically the solution to this problem could be found in the input/output technique by inverting leontief's matrix, which would lead to a consistent set of intermediate products. However, the statistically obtainable input/ output tables contain data that are too highly aggregated; and information regarding detailed technical coefficients and available primary production factors either does not reach the planning centre at all, or reaches it late and in a distorted form. An additional technical problem – unrealistically assuming the availability of sufficiently detailed information – would be the inversion of such a highly disaggregated matrix". (Brus and Laski, 1989, pp. 41-43).

Concerning State intervention in the economy, the moral hazard happens to exist at two levels. First, it exists between the top policy-makers and lower-level bureaucrats in the State apparatus. As a classic example, the case of socialist economies could be pointed, in which the managers of the public enterprises used to understate their capabilities just to obtain enough inputs. Brus and Laski (1989, p. 44) assert that "[t]he informational weaknesses of command system interact with weakness of incentives.... To compensate for this a variety of specially designed incentive schemes has been tried throughout the entire period of operation of the command system – both for workers... and for managers. However, the very logic of the command system demands that incentives should be geared to plan fulfillment; this, intertwined with the information barriers, has become the main source of deformation. The managers' interest in plan fulfillment is to be fostered both by immediate financial rewards and by their general career prospects. The interest of rank-and-file employees is linked to plan fulfillment less directly".

The second level of moral hazard exists between the State and the policy target entities, such as firms. One example is the firms treated under infant-industry protection policy while the infancy period does not come to an end. Several causes for this asymmetric information leading to moral hazard could be presented. The promotion of wrong infant industries by government and failure of many firms to exert needed technological efforts (Bell, et. al., 1984, pp. 118-128), the choice of suboptimal technology by government (White, 1978, pp. 47-50), ill-advised government policies, and the interference human beings who *satisfice* because they have not the wits to *maximize* [emphasis original]" (Ibid; p. XXVIII).[8]

Human rationality faces practical limits - namely: skills, values and knowledge. However, the limits to rationality are not static, and are predicated upon the atmosphere of the organisation within which the decision is made. Therefore, they are variable ones and potentially changeable as a result of the consciousness of the limits (Ibid, pp. 38-41 and 240-244). "The individual can be rational in terms of the organisation's goals only to extent that he is *able* to pursue a particular course of action, he has a correct conception of the *goal* of the action, and he is correctly *informed* about the conditions surrounding his action. Within the boundaries laid down by these factors his choices are rational – goal-oriented. Rationality, then, does not determine behavior. Within the area of rationality behavior is perfectly flexible and adaptable to abilities, goals, and knowledge [emphasis original]" (Ibid, p. 241).

Having accepted the idea of bounded rationality, it would be meaningless to condemn the State, as a human organisation, for interfering in the economy with insufficient information, while assuming that private bodies enjoy all necessary information for policy making.

Regarding insufficient information causing uncertainty about the economic life, it should be mentioned that overcoming this deficiency in itself urges business management to plan for the future. Choosing certain parameters among alternatives affecting the production level, and the conclusion of contracts concerning the purchase of inputs or sale of outputs, are all examples of how a firm undergoes long-term commitments to offset the unforeseen developments. Having said that, it does not seem reasonable to oppose State planning to interfere in the economy with the excuse of

[8] "The theory of administration is concerned with how an organization should be constructed and operated in order to accomplish its work efficiently". (Simon, 1976, p. 38).

informational asymmetry whereas the private firms do the same under similar conditions.

Needless to say, any intelligent planning is subject to the availability of sufficient information. Firms plan for future using the available information and some informed guesses. This information is largely produced by external sources including consultants, research institutes and a central office of statistics; hence, it is accessible to everybody. For State involvement in the economy, the information needs are not always too much to prevent an effective intervention. Therefore, the argument based on the insufficiency of information in the hands of government, which at the same time does not cognize this insufficiency in the case of firms, cannot be taken seriously.

The example of the Japanese government in overcoming the information problem provides a counterpart to the "insufficient information" argument. "Japanese officials view that the "pure" market is flawed by ... imperfect information.... [Therefore] MITI officials rely on industrial policy to compensate for the above mentioned shortcoming in the market-place.... [In doing so, and] to exert a direct influence on market outcomes [,] MITI can affect developments in the market by quietly leaning on large companies, industrial associations, banks, securities houses, and other private-sector institutions" (Okimoto, 1989, pp. 12 and 17-18). This is what could be easily organized in many economies. In Japan "the network of individual decision-centers... generates an extensive circulation of information on the basis of which rational decisions can be made... Because Japanese society is organized in ways that diffuse power and decentralize decision making, the information costs of adopting an industrial policy are minimized... Leaders in the public and private sectors make a point of exchanging large amounts of information" (Ibid, pp. 33-34). The extensive informational network in the hands of the State leads to the conclusion that "MITI's influence today [not only] rests on... its capacity to gather and process information... [but also to] elicit cooperation from private enterprise, MITI draws on a... superior information" (Ibid, pp. 144 and 145).

Regarding the moral hazard problem (exchange of late and costly information) within the State, it should be noted that this situation does not arise independently form the State structure. If the design of the organization is such, which allows the top decision-maker to be able to control the activities of the subordinates and receive enough information, to reduce the information costs, the latter should be allowed to enjoy more leeway.

The other factor in decreasing the moral hazard problem, and hence the time and cost associated with such a situation, besides the improvement of organisation design, is the development of organizational loyalties among the bureaucrats. Considering the decisions in the light of the organizational aims, will substantially reduce the costs of the agency and increase the efficiency of the State apparatus (Simon, 1976, pp. 12-14).

We have earlier demonstrated that a proper institutional design is an effective measure for reducing the informational asymmetry. If the structures of institutions are so as to ease the transfer of information between the State and firms, the discrepancy of information can be narrowed. Japan, as Okimoto (1989, pp. 155 and 156) declares, can be taken as an example. "Japanese policy networks are extensive and serve as channels for the transmission of valuable information. Business executives are often willing to take MITI officials into their confidence, sharing sensitive information even to the extent of divulging what may be proprietary in nature.... [P]olicy networks also include informal relationships between government officials and industrial leaders... Informal networks give ministries like MITI the attitude to discuss problems, work out differences, and build consensus with the private sector. If its officials did not devote so much time and energy to cultivating personal relationships with key leaders in the private sector, MITI would not be nearly as effective as it is".

In addition to the MITI officials' initiatives in expanding close relationships with the industrial firms, transfer of information has been eased as a result of State promoted associations to exchange information. Such initiatives leave the Japanese market with a structure which "provides multiple points of entry for government information". (Ibid, p. 17).

2.1.2.2 Rent-Seeking

Economic rent occupies a considerable place in the history of economic analysis. Buchanan (1980, p. 3) defines the rent as "that part of the payment to an owner of resources over and above that which those resources could command in any alternative use". In other words, rent, simply, means a return in excess of the opportunity cost to the owner of a resource. Regarding this definition, rent-seeking is taken as an equivalent to profit-seeking by some economists. Besides, the expectation to acquire excess return is interpreted as a stimulator of value-increasing activities. This excess return is considered as a short-lived phenomenon, being eliminated by competition.

The attempt to capture the competitively removed rents, however, is different from what is meant by rent-seeking. Rents are created by two different sources. Firstly, rents can be raised *naturally* in the price system by shifts in demand and supply curves. In this context, rent-seeking can be regarded as an equivalent to profit-seeking. Secondly, rents could be contrived *artificially* through government intervention. This kind of rents is not exempted from competition and this is where rent-seeking comes upon the stage (Tollison, 1982, p. 575).

The theory of rent-seeking, which has earlier been contributed by influential work of Krueger (1974), argues that government restrictions give rise to various forms of rents which stimulate people to compete to secure them. Competition for rent-seeking activities, sometimes, takes legal forms whereas in some other instances – such as bribery, corruption, smuggling and black market – it does not. Competitive rent-seeking activities emanating from government-induced quantitative restrictions, lead to: (1) operation of the economy inside the transformation curve; (2) the welfare loss which is greater than that from the tariff equivalent of the quantitative restrictions; and (3) a divergence between the private and social costs of certain activities (Krueger, 1974; p. 291).

The effective quantitative restrictions cause the import license to be a valuable commodity although it is associated with some costs. This characteristic of licensing leads to competitive allocation of resources to capture those licenses. Putting it in other words, import quotes, controlled by the State, generate economic rents to the license holders. The benefits, derived from the rents, are so large as to promote the private resources to divert from productive activities towards competition to access to licenses – that is, unproductive channels. All this process leads to social welfare loss.

The literature on rent-seeking activities is predicated upon micro-theoretic consideration, mostly using examples from trade and commercial policy of the state. To have a clearer idea of rents, here, we point to one of the examples provided by Krueger as follows (Ibid, pp. 292-93).

Expecting high remuneration from government jobs and considering the total official-plus-unofficial incomes as a main decision variable in accepting a career, promotes, reasonably, competition for those jobs. On the other side, government selects its employees among above-average educated applicants. According to human capital literature, the amounts invested in human capital are determined by their rates of return. Obviously, one expects that a specified level of education would be equally compensated among various lines of endeavor. If, however, the case is such that higher than average incomes accrues to government employees while requiring higher education, more people will attempt to invest in attainment of above-average (higher) education. Here, the competition takes place for entry into government service through acquiring higher education, on the one hand, and accepting unemployment on the other, which is partly a competition to acquire rents.

At the individual level, rent is regarded rational and people do not perceive themselves, in most case, as being rent-seekers. Even, socially, it could be considered as a stimulating factor in a specified circumstances. In the context of a competitive setting with free-entry, monopoly rents created by innovators will stimulate others to step into the industry which will, ultimately, lead to decreased and competitive prices. But, if the achievement of monopoly rents is subject to, say, lobbying, the resources expended for that are *wasted* from social viewpoint. The reason is that these expenditures have no addition to social product (Tollison, 1982, p. 576).

The same story is true, according to the adherent of the theory, as soon as the State interferes with the economy, providing socially wasteful rents even though such rents may be conceived to be beneficial from the individual point of view. Rent-seeking situation is a self-perpetuating one and, as long as the State is upon the economic stage, any attempt to remove its effects will, at most, shift it from one level to another. The durability of a rent-seeking situation, on the one hand, and the expectations of the people to enjoy rents, leaving an impact on their perception of the government's legitimacy, on the other, leaves no scope for the State other than the continuation of interference. This is such that Kruger (1974, p. 302) concludes "[i]f the market mechanism is suspect, the inevitable temptation is to resort to greater and greater intervention, thereby increasing the amount of economic activity devoted to rent seeking. As such, a political "vicious circle" may develop. People perceive that the market mechanism does not function in a way compatible with socially approved goals because of competitive rent-seeking. A political consensus therefore emerges to intervene further in the market, rent seeking increases, and further intervention results".

The theory of rent-seeking, although casting some clearer light on the relationship between the outcomes of the individual maximizations and institutional settings, suffers from serious problems which are worth exploring.

Firstly, the definition regarding the nature of the rent-seeking costs is not clear enough, leading to conceptual confusion. A look at the standard rent-seeking literature shows that all resources spent on rent-seeking are regarding as wasteful. However, it is not the case that all rent-seeking activities bear real expenditures. In the instance of bribery, what we face is only a transfer of wealth from briber to bribed without any social cost. In other words, the real costs implied by rent-seeking are those involved in transferring property rights – i.e., transaction costs.

The other problem relates to the narrow definition of wastes in the rent-seeking theory. Actually, the theory deals with wastes emanating from the existence of entry barrier erected by government intervention. The more important problem, however, remains unexplored since the theory assumes identical rent-seeking agents. But, this could not always be the case in reality. Thereby, the theory never explicitly deals with the problem of wastes stemming from inefficient rent-seeking agents (with long-lasting inefficiency consequences) supported by State. More clearly, while wastes arise only *once* from the erected entry barrier, *perpetual* wastes originate from operation of State supported sub-optimal agents.

Not only Krueger mentions corruption as a means of seeking rents, but also the concept of rent-seeking and corruption has been used interchangeably by the later writers. Hence, it seems necessary that the relationship between the two concepts to be clarified a bit more. If corruption is defined as the use of public office for private gain, that would be illegal. But, as mentioned, many forms of rent-seeking are legal, and this does not let one regard rent-seeking as only a form of corruption.

Moreover, some cases could be easily found that in which corruption eliminates rent-seeking rather than being conceived as a formal rent-seeking. As an example, if import licenses are allocated by government officials to their extended family, no resources have been expended to compete for the quota rent despite the fact that the case is a definite example of corruption. Furthermore, contrary to Krueger's belief that corruption creates rents by raising the incomes of government official above the level they could otherwise earn in the private sector, it is the case here that firstly corruption gives rise to rent-seeking and they are not identical, and secondly, corruption and rent-seeking are two distinct activities carried out by different people (Meier and Rauch, 2000, pp. 440-41).

The next point relates to the orientation of the rent-seeking theory. Actually, it would be justifiable if the rent-seeking theory attempts to bring to the notice of the concerned scholars, among the other points, the significance of the diversion of resources from productive investment to unproductive channels. But the problem arises when one notes that the related literature insists upon the biased assumption that entry, barrier is merely erected by State intervention. In other words, by putting that "[t]he competitive dissipation of rents, however, is not what is meant by 'rent seeking' " (Tollison, 1982, p. 575), and interpreting it as an equivalent to profit seeking, the literature focuses absolutely on rents contrived artificially through government action (Ibid, p. 575). This is where the problem arises. To secure its profits, a privately-owned firm always tries to discourage a new entry. Therefore, concealing any needful information vis-a-vis a potential entrant and bribing to ensure the issue of contracts, all could be counted as entry barriers. In fact, what brings about the main bias in the rent-seeking theory is this impression that a monopoly situation can never come out of a competitive situation – that is believing in self-perpetuating competitive markets. The previously stated quotation of Krueger that the State intervention will lead to more and more intervention and marginalization of market mechanism, openly manifests such a belief.

In the context of the concentration of the rent-seeking literature on government, as alleged to be the chief source of the diversion of resources, focusing on State regulations should be regarded as a further limit for the theory. In many countries, the government is actively involved in most of the economic (be it developmental or recurrent) activities. This is true, specially, in countries in which the economies are dependent upon extraction of some raw materials, say, oil, copper, etc., leaving considerable amounts of income in government's hand. Thus, if the State is to be conceived of as the main generator of rents, it is the other grounds, not regulations, which have to be recognized as the main source of rents. As some examples, government contracts in purchasing services and goods (both durable and non-durable as well as for immediate consumption or for developmental projects) and, in the recent years, the sale of public properties under privatization schemes, could be mentioned. All this is involved in transforming a huge amount of rents to the benefit of the favored ones.

Therefore, a simplistic interpretation of rent as something emanating essentially from government regulations prevents a correct comprehension of the problem. One is the point that no reference is made to the political and economic configuration of the society, such as the class-structure and the existence of monopoly, as underlying the prevalence of rents. The other is the belief that the removal of the State from the economic arena and leaving all economic activities to the care of the market mechanism will lead to the elimination of rent-seeking and associated wastes, bringing about efficiency. The naive argument that focuses on the government and that too on government regulation is of little help in understanding issue.

Some points, too, could be made regarding the concept of productive economic behavior. It is believed that rent-seeking is an unproductive behavior. Certainly, no economy can be sustained unless it is, at least partly, productive. But, two points emerge, here, in relation to productiveness. Clearly, issuing a patent to support the intellectual property rights of an innovator and the enforcement of infant-industry policy are two examples where the creation of rents and hence by implication of rent-seeking possibility is not unproductive necessarily. Here, the economy, as a whole, gains, whereas rent-seeking has taken place and, adding up together, no *net* economic value has been wasted. Thus, rent-seeking appears to be beneficial to whole economy indirectly, although the problem would arise if the state do not stop its support when necessary.

The second point regarding the unproductive impact of rent-seeking is whether it could be concluded that all the resources involved in this activity constitute outflows from the economic system. If not, then what form do they take? If consumed, could it be said that they lead to decrease the investment rate in the economy? Or they just increase the production costs? To answer this type of questions, using Keynesian argument, it could be mentioned that as long as expenditures (whether productive or unproductive) cause an increase in effective demand, that would lead to increased investment, employment as well as production.

In this regard, Keynes (1936, p. 325) writes "There are *two* ways to expand output.... [The first is] to promote investment .... [and the second is] to promote consumption.... If it is impractible materially to increase investment, obviously there is no means of securing a higher level of employment except by increasing consumption". He also mentions (Ibid, p. 220) ""[t]o dig holes in the ground", paid for out of savings, will increase, not only employment, but the real national dividend of useful goods and services. It is not reasonable, however, that a sensible community should be content to remain dependent on such fortuitous and often wasteful mitigations when once we understand the influences upon which effective demand depends".

Thus, in economies with unutilized capacity, rent-seeking may raise the equilibrium level of production and as a consequence increase the growth rates of investment and production. In a fully-employed economy, the rent-seeking behavior might cause inefficient utilization of resources although the associated reasons are well beyond government regulations and are related to the pattern of income distribution (Ghosh, 1997, pp. 153-157 and Chang, 1996, pp. 27-31).

2.2 REVIEWING THE CONTRIBUTIONS OF THE CASE OF IRAN

2.2.1 BANANI AND MODERNIZATION OF IRAN

The early work examining Iran in the context of the Westernization project, including modernization of the society and development of the economy, just to overcome the backward social and economic structure of the country, looks at the State in an interventionist framework, and criticizes it from a neo-classical point of view.

In analyzing the root causes of the Reza Shah's ill-fated attempts to develop the economy in 1921-41, Banani (1961) reviews the financial reforms, agricultural reforms, foreign trade policy, the development of modern transportation and communication, industrialization and development of natural resources, public construction and urban development, all to draw some conclusions regarding the process of economic development and modernization of Iran in the early decades of the twentieth-century.

In reviewing foreign trade policy, Banani mentions that from the beginning of the sixteenth-century onwards, foreign trade acted as the main road of the penetration of Europe into Iran. Industrial revolution and economic imperialism accelerated the importation of foreign goods to Iran. There was another important reason for that as well. In those days, the tariff duties, the most important source of the country's revenue, were subject to treaties imposed by outside powers. It was after the defeat of Iran in 1827 that Russia, through the treaty of Turkmanchai (1828) enforced a free trade policy regarding Russian imports to Iran. Effectively, not more than 5 to 8 per cent duty could be levied on Russian imports. Very quickly, Britain and other European powers demanded and actually enjoyed similar advantages. In this way, Iran lost its tariff autonomy until 1928 when it was regained. The Anglo-Russian economic policy towards Iran before the First World War led to the widespread use of foreign manufactured goods in Iran. Easy access to foreign goods prevented Iran from changing old methods of production and introducing modern ways of production to meet new internal demand. In this period, Iran faced an increasing volume of imports, consisted almost entirely of which consumer good such as cotton textiles, sugar and tea.

According to Banani, the foreign policy of Iran in the interwar period could be divided into two distinct phases. The first covered the period between 1919 and 1929, and the second one lasted from 1930 to 1940. While the first phase was marked by continuing relatively free trade, the second way characterized by the introduction of government controls and increasingly active state structures. The new restrictive policies were initiated mainly because of external causes, namely, an increasing unfavorable balance of trade, the depreciation of the exchange rate of Iranian Rial, and the coming into being of a Russian foreign trade monopoly policy to Iran in 1930. Under these circumstances, Iran embarked upon establishing her State foreign trade monopoly in 1931 though earlier, in 1930, State controls had included foreign exchange controls as well. The new initiatives were launched with the hope that the State control of exchange and foreign trade would bring in economic autarky. In other words, it was expected that a favourble balance of trade, a sound position for the Rial, expansion of exports, industrialization, efficiency and self-sufficiency would emerge following the enforcement of new policies. In short, the Act of 1930 meant the adoption of the statist neo-mercantilist policies. It is worth noting that what was meant by foreign trade monopoly was, by no means, actual government conduct of trade. Rather, foreign trade monopoly simply meant government regulation by means of quantitative controls and the requirement of import and export licenses.

In examining the industrialization attempts of that era, Banani believes that it should be done in the light of this philosophy that in introducing mechanical industry, Reza Shah sought to substitute the cohesive force of the central state for the old corporate basis of society. Regarding encouraging private initiatives, he shows that some laws were ratified to exempt the privately established factories from tax for 5 years: their machines were exempted from import quotas and there were even preferential tariff rates. However, the existence of a powerful landowning class, a tendency to hoard savings in silver and gold, and a lack of confidence on political stability as well as on government support were among the chief reasons which debilitated private activity in Iran.

Having mentioned all that, Banani adds that due to the instinctive belief of Reza Shah in the virtues of an omnipotent State, it was obvious from the beginning that industrialization efforts would be undertaken by direct State action. In practice, the regulations governing industries led to a prominent role of the State in industrial affairs.

In concluding his ideas on the way the economy was run, Banani explains the undesirable results of Iran's economic controls. Among them, the following may be mentioned: an increasing degree of State control over the financial affairs, not always beneficial government measures as a result of erratic exercise of control, the vigorous growth of the sheer volume of the government's financial activity, growing bureaucratic paraphernalia, official overvaluation of the Rial leading to the loss of agricultural exports, the inevitable move towards bilateral trading with soft currency countries because of the unrealistic exchange policy, and dislocations in the country's economy due to the severe government interference with trade activities. Banani, then, states his final question – the one which openly contains its answer from his standpoint as well: in the light of the above facts it must be asked whether the motives for the controls were sound, and whether the controls were the best way of fulfilling the government's goals?

2.2.2 NILI AND STRUCTURAL ADJUSTMENT POLICY

After the revolution, the contributions, opposing the post-revolutionary interventionist State, in the context of the mainstream neo-classical tradition, began to spread when the Iran-Iraq war was ended, i.e., the late 1980s. This, effectively, was a reaction to the then prevailing economic situation, particularly, during the last years of the war. This position has now appeared to fully dominate all discussions regarding economic policies during the recent history of Iran. According to Nili (1997) the formulation of stabilization policies through administrative mechanism for a rather long period (1981-89) coupled with continuously accelerated inflation (300 per cent) at the same period distorted the relative prices of key products. On the other hand, black markets emerged for all commodities under the government regulation. The increased gap between the administered and free market prices created unproductive employments and rent. In 1988, just as an example, despite a considerable fall in the value added of the fundamental services sub-sectors, such as education, health and transportation, the services contributed over 50 per cent of the G.N.P., of which, 45 per cent belonged to business. All this led to the conclusion that the bureaucratic mechanism causes a biased allocation of resources, abnormal growth of intermediary services, unjust distribution of income, rent-seeking, decreased government income and expansion of corruption. The remedy, therefore, was setting equilibrium prices in *all* markets. The new equilibrium prices would, naturally, reflect the scarcity of the goods and services and, consequently, lead to an unbiased resource allocation – that is, to the satisfaction of true demands. Furthermore, the elimination of dual prices in the market would remove the stimulus for corruption.

Nili continues that the other concerned variable, leaving a severe impact on the economy, was the budget deficit. In 1988, over 50 per cent of the government budget was realized through borrowing from the Central Bank of Iran. This led to nothing but chaos in the fiscal sector, and, as a consequence, in the monetary sector. Since the government was the main supplier of a vast variety of goods and services, and the exchange rate was set below (sometimes $^1/_{50}$ and even $^1/_{100}$ of) the black market price, any change in the price of these goods, services as well as foreign exchange would create a new source of income for the government leading to decreased budget deficit and, finally, less inflation rate. Almost over a decade, in fact, the real expenditures of the government continued to fall substantially. The comparison of the periods immediately before and after the revolution reveals that the real recurrent budget in 1989, failed to touch even 50 per cent of the figure realized in 1977. The circumstances were even more dramatic for real developmental budget. During the same period, it experienced an over 80 per cent fall. It was, actually, a unique period in the fiscal history of the country in terms of a continuous decrease in the government spending. In that interval, infrastructural sectors suffered heavily. On the one hand, according to the stabilization policies, the administered prices prevented the power, oil and gas sectors from earning enough income to cover their current expenditures. On the other, the distorted relative prices left those sectors with a huge increase in demand. As a result, not only did the consumers feel frustrated in meeting their demands, but the government too was misled in estimating the future social needs.

Nili argues that over the years of 1981-89, a considerable portion of the government budget (in the absence of any privately owned bank) was financed through borrowing from the central bank. This way of financing of budget deficit caused a vigorous increase in the money base. To prevent an abnormal liquidity growth, the government sought to regulate the credit allocated to private and public sectors by professional as well as business banks. Besides, the banks were subjected to charge the preferential interest rates. As time passed, the accumulation of the financial resources in the banks and the low level of the interest rate charged from investors, led to a situation in which the banks failed to cover their costs. This led them to make losses. On the other hand, the banks were forced to reject the demand for loans which increased due to the negative real interest rate.

Having said all that, Nili concludes that, by no means, the prevailing disequilibria in a production, capital (exchange), money and labour markets could be justified. And this led, ultimately, to prolonged stagflation, leaving behind a poor and unequal society. In such a case, the unavoidable role of the government in the economy boils down to an attempt at bringing about a just distribution of poverty.

2.2.3 NILI ET Al. AND INDUSTRIAL STRATEGY

In another contribution (Nili et al., 2002), while attempting to formulate an industrial strategy for Iran, Nili and his colleagues argue that in the light of the economic globalization as well as capital and trade liberalization, the issue of State intervention has changed. This is a new role of the State in the industrial development. In these circumstances, an industrial strategy would get involved in restructuring industrial activities rather than setting industrial priorities or undertaking directly protective intervention. The role of the State, therefore, is determinant in setting up the market mechanism and developing a competitive atmosphere, and also to remove market deficiencies. The effective implementation of industrial policies, the argument goes, requires the satisfaction of some significant prerequisites, including political stability, individual property right, macroeconomic stability, institutional infrastructures, development of entrepreneurship, and technological research and development. To satisfy all these conditions, the State is required to be increasingly harmonious with the private sector. Moreover, the decision and policy making system must be governed by the most competent managers. The policy making system, hence, should be such that the policy makers feel free from any pressure originating from pressure groups and the formulated policy should not be a reflection of any vested interests. The realization of all that is predicated upon capacity building in the government which enables it to initiate, implement and control the appropriate policies.

To mention the main component parts of the State intervention in realization of an industrial development strategy, Nili and his co-authors declare that the review of the Iranian macroeconomic indices, over the last several years, reveals an unstable environment for private sector activities. The unjustified structure of the government expenditures (as a result of the gigantic size of the government) on the one hand, and its unstable income structure (dependence upon oil revenue) on the other, have led to "high-cost economy", frequently suffering an unbalanced budget which ends in deficit financing through borrowing from the Central Bank (printing money). The superiority of fiscal policy over monetary one has caused high rates of inflation and undermined the instruments of monetary policy in controlling inflation. The bureaucratic attempt to ease the high inflationary pressures, through a fixed foreign exchange rate, caused an overvalued Iranian Rial. Note that any disturbance in macroeconomic stability would leave its negative impact on growth rate through reducing the efficiency of market mechanism.

They add that the changing role of the State, on the one hand, and the globalization, on the other, make the development of the private sector a crucial element in realizing industrial development. Therefore, the development of the private sector remains a major task for the government. In doing so, the role of the public institutions should be confined to a facilitative one rather than direct protection, and providing resources to stimulate the business. In line with the institutional development, they advise the revision of the principles of the constitution concerning State ownership.

Although the infant-industry protection was among the chief policies of the early industrializers as well as of the newly industrializing East Asian countries, under the new environment and the emerging developments regarding world trade, there would no longer be any room for such policies for establishing modern industries. The implementation of regulated trade policies, in the globalization era, would be limited. Since trade, in itself, transfers technological knowledge, failing to be a part of the competitive world would impose a country's technological capacity building. Large capacities in many industries, too, imply that the world market should be taken into account seriously. Therefore, in the context of the new approach and to be a member of WTO, the State should gradually reduce and, ultimately, remove all continuous and unconscious protections which are regarded as disordering elements for the stimulative structure of the economy. Parallel to that, the State should formulate the foreign policy in line with the international economic cooperation to absorb foreign direct investment. This will pave the way for the transfer of modern technologies through transnational corporations, without which, according to the experimental evidences, any attempt to improve the internal technological potential would remain unsuccessful.

2.3 CRITICISM OF THE REVIEWED CONTRIBUTIONS

In regard to Banani's contribution, it could be stated that he is not concerned with the requirements of the historical conditions in which Iran was located in the early twentieth century. That period was witnessing the transition of Iran from a static society based on Landlord-Peasant relations to a dynamic capitalist economy. In a backward economy, becoming an instrument for the primitive capital accumulation was regarded as an indispensable task by the Reza Shah's State. Other factors, such as evictions and encroachments, like in other societies, played their roles in achieving primitive accumulation, but role of the State was crucial. The cohesive role of the State has been also emphasized by Marx when he analysed the primary accumulation of capital in England in the first volume of capital. This is fully contrary to what Banani states. He diminishes all this process to the "belief" of Reza Shah in undertaking the industrialization efforts by direct State control. That is why he, then, attributes all undesirable economic results to the government controls and questions the motives behind them and the policy itself. Following this way of reasoning, he overlooks the internal requirements of an emerging modern economic (capitalist) system and interprets all the policy alterations in the context of reaction to the external causes. This could not be regarded as the root causes if, as noted, we review the prevailing conditions in Iran in the early decades of the twentieth-century (Issawi, 1971; Jamalzadeh, 1917; Karshenas, 1990).

Suffering from the absence of an independent tariff system over a period of a century, the prevalence of an overwhelmingly agricultural economy, the existence of little manufacture, and the lack of required infrastructure for a capitalist development such as roads, railways, ports etc., on the one hand, and the dependence of the country upon importation of goods, which included, to an overwhelming extent, consumer goods, on the other, left no alternative for the government but to adopt some regulations such as monopolized foreign trade policy, as well as a controlled foreign exchange regime in order to overcome the backward conditions and move towards a capitalist society. The capitalist development in Iran did not emerge through a process of natural socio-economic development, but it was forcibly imported (Hashemi-Rad, 1999).

Considering primary accumulation of capital, the mid 1920s up to 1960 constitute an important period in the recent economic history of Iran. During this period, dramatic changes came about in the economic structure of Iran leading to the substitution of landlord-peasant relations by modern capitalism. By the end of 1930, political unrests were gradually repressed and a centralized political power emerged. But, the old mode of production continued to exert a retrograde influence thwarted any progress. Now, the ground was ready for the State to embark on a new strategy. The State was ready to play a decisive role in the economy through building roads and railways and investing in industry in order to give rise to an integrated internal market. According to Bharier (1971, pp. 50 and 107) the annual growth rate of gross domestic fixed capital formation increased even up to 40 per cent during 1930s and more than doubled between 1926 and 1938. And, the share of imported capital goods in total imports increased from 3 per cent in 1927 to 33 per cent in 1938.

All this reflects the need of the critical economic situation of Iran at that time and also demonstrates that there was no other option but severe State intervention if the economy was to be developed, no matter in which direction. This very important point could not be realized if an analysis is based upon a subjective interpretation in the context of the ahistorical neo-classical paradigm.

As already seen, in the contributions concerning post-revolutionary developments, the government is referred to as the root cause of all economic problems experienced during the last decades. In fact, the writings of this stream, even in dealing with the pre-revolutionary era, point to the government's import-substitution industrialization policy, as compared to the export-promotion policy initiated in some Asian economies, as the chief element causing price distortions, wrong market signals, an immature private sector, and, ultimately, economic inefficiency. Reviewing this sort of writing, as done above, reveals that from the standpoint of the authors, the State, in itself, is wasteful and any government intervention displays the same characteristic. Hence, this way of analyzing State economic behavior seems to lack any theory of State. The reason is that the State is seen as an inefficient actor from the beginning of the argument; hence the argument adds nothing to our knowledge about why government intervention necessarily leads to inefficiency. In fact, it seems that from the beginning, an ideal-type of market, which is equated with the perfectly competitive market of neo-classical economics, is postulated and the rest of the analysis proceeds on the basis of this premise, which is untenable in the real world.

Among the reviewed contributions, Nili is alike straightforward on this. He points to the bureaucratic mechanism as the lying at the core of all Iranian economic distortions and recommends restoring *all* markets to a state of free functioning, leading to the establishment of equilibrium (market) prices. That is why he still optimistically believes and insists that the rate of inflation, according to the first five-year development plan, would have fallen to 9 per cent in 1993 if the whole package of the structural adjustment policy had been allowed to work; no matter that through the pursuit of a reverse trajectory, it jumped to 48 per cent in 1995 due primarily to following the main guidelines of the neo-liberal policy (though there were some other unforeseen factors such as unification of foreign exchange rates).

The other example is the monetary growth rate targeted at 9.4 per cent per annum during the first plan (1989-93). This has not only been out of line with economic realities, but has also not even been consistent with the plan's targeted average rate of 15.7 per cent per annum inflation. But, according to Nili, all this was feasible since the plan's approach, based on equilibrium prices in *all* markets and removal of State regulations, had envisaged a reasonable relationship between structural adjustment policies and the main stimulants of aggregate demand – that is, liquidity and government spending.

In his argument, as in the others', not only has no distinction been made among the likely improving effects of the various State-initiated policies, but they have all been condemned as distortion-creating. This way of analyzing leaves no room for sorting out and classifying the government policies for analytical purposes and for drawing some lessons about the policies, such as the circumstances of their formulation, their particular impact and what might have been otherwise. This line of literature gives the impression of being unaware of the theoretical points made in the beginning of this chapter.

However, if we are to express the intellectual roots of these contributions, they seem to have been inspired by neo-liberalism (as a synthesis of neo-classical economics and Austrian-Libertarian tradition). This argument contents that the State can not be seen as an impartial and omnipotent social guardian. On the contrary, the State is run by self-seeking politicians and bureaucrats, who not only have limited ability to collect information and implement policies, but are also under pressure form interest groups. This imperfect nature of the State results in government failure in the forms of rent-seeking, corruption, etc. This belief is obvious in Nili et. al., though in a conservative form, and their prescription to overcome the State's weaknesses is based upon this presumption.

Regarding the *new role* which they attribute to State, it should be added that what they think is new, in fact, is not. Following the economic and political changes that the Golden Age of Capitalism has brought about, it was more than three decades ago that a change cause over the debates concerning the role of the State. The main contributors were renowned neo-liberal economists such as Friedman, Stigler, Buchanan, Hayek, Krueger, Little, and etc. So, what effectively seems new, is the conditions following the recent socio-economic retrogression which brings the dominant liberal ideology to their notice as the last resort. This leads them to believe in the market-primacy assumption (Chang, 2002, p. 546).This belief, consequently, confines the role of the State to be in harmony with private sector and to adjust for the market failure. But the fact is that the markets did not exist in such a pronounced form in the beginning. This is what the economic historians have demonstrated except for basic necessities at the local level and luxury goods at the international level. It was the State which deliberately brought about the markets, especially in the early stage of capitalist development, as the example of England which was reviewed in the first chapter of the present thesis, shows.

Regarding macroeconomic stability, though the quantitative changes have been analysed in the mentioned contributions in some detail, no attempt has been made to explore why a set of policies leading to instability in macro variables has been formulated. Putting it differently, this argument lacks any analysis concerning the nature of the State itself and some other related realities which all led the government to undertake such an economic role.

Actually, the problem with the policies of the State was that the State was unable to continue to fulfill the two distinct and mutually incompatible roles. On the one hand it had to increase its spendings which effectively was the main growth stimulator. On the other hand, it had to serve for the accumulation of capital, given the class configuration, by commercial bourgeoisie. Note that the value added of the intermediary class increased to almost one-fourth of the G.D.P. Therefore, the State budget was used to strengthen private wealth. This meant excessive inflationary pressures for the masses through price increases, indirect tax hikes and deficit financing. Besides, the failure of the government to carry out its distinct roles caused economic stagnation (on the contradictory role of the State, see Patnaik, 2000, p. 147). Therefore, whereas the performance of the formulated policies is scrutinized and criticized, the circumstances giving rise to such policies remain intact.

CONCLUSION

In the critical review presented in the current chapter, an attempt was made to study the arguments concerning market-failure, and, subsequently, the available remedies which could be initiated by the State so as to rectify the deficiencies. In so doing, we sought to show that the arguments provided in the context of conventional economics, suffer such naïve premises which permeate the whole arguments. Then, in proceeding to examine the approaches regarding the incapability of State to fulfill its functions and achieve its goals, again, the arguments of the adherents of those approaches were critically discussed. The assessment of the application of the theory to the case of the Iranian economy, too, substantiated the weaknesses of the whole paradigm. These theoretical deficiencies can not be remedied without changing our entire perspective and making an attempt to construct an alternative theory to review the economic role of the State. This task will be attempted in the coming chapters.

CHAPTER 3

THE KEYNESIAN REVOLUTION AND THE COGNITION OF THE ROLE OF THE STATE IN DEVELOPMENT ECONOMICS

INTRODUCTION

In the proceeding chapter, the neo-classical perception of the State as well as its application to Iran was critically analysed. It was concluded that both the theoretical approach to the role of State, and, consequently, the perception of the role of the State in the case of Iran based on this approach appeared invalid. In the present chapter, we will seek to critically examine the Keynesian theory of State intervention. Subsequently, the contributions of some other scholars contributing to development economics, who have the same way of thinking as the Keynesians, would be presented. Then, the applicability of this theory to the Iranian economy will be critically reviewed.

3.1. THREE DIFFERENCES BETWEEN KEYNESIAN AND CLASSICAL SYSTEMS

Trained as a neo-classical economist, Keynes did not reject the natural law basis of conventional economics. Indeed, his idea was not based upon a break with conventional theory. Rather, his reformist perspective suggested that on account of differences which might exist between a real economy and the natural law archetype, the policy conclusions flowing from conventional analysis must be amended. Alternatively, while holding a perspective revealing the limits of the applicability of the conventional theory, he continued to emphasize the richness of the theory despite the critical differences existing between reality and the abstract paradigm.

When we look at the Keynesian system and compare it with the classical system, three differences stand out. It is because of these differences that the Keynesian system prescribes State involvement in the economic arena.[1]

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[1] Since the main theme of the present chapter concerns Keynes's ideas and his way of thinking on state intervention in the economy, it is better to quote extensively his own arguments rather than explaining them indirectly. However, while I shall attempt to explain Keynes's view through his statements made in *The General Theory*, it is interesting to quote the following. "Indeed it is strange, seeing how commonly the view is attributed to Keynes that fiscal policy is crucial to real output determination, that *the general Theory* is concerned with an economy in which neither a government nor for that matter a foreign sector exists at all" (Godley, 1983, p.135).

problem, Keynes poses the question whether "reduction in money-wages have a direct tendency, *cet. par.*, to increase employment, "*cet. par.*" being taken to mean that the propensity to consume, the schedule of the marginal efficiency of capital and the rate of interest are the same as before for the community as a whole?" To answer the question in the negative, Keynes argues that "the volume of employment is uniquely correlated with the volume of effective demand measured in wage-units, and that the effective demand, being the sum of the expected consumption and the expected investment, cannot change, if the propensity to consume, the schedule of marginal efficiency of capital and the rate of interest are all unchanged."

"Thus the reduction in money-wages will have no lasting tendency to increase employment except by virtue of its repercussions..." on any of the three previously noted factors.

Keynes reviews the most important repercussions on these factors and among them points at the following ones.

(1) "If the reduction of money-wages is expected to be a *reduction relatively to money-wages in the future,* the change will be favourable to investment, because as we have seen above, it will increase the marginal efficiency of capital; whilst for the same reason it may be favourable to consumption. If, on the other hand, the reduction leads to the expectation, or even to the serious possibility, of a further wage-reduction in prospect, it will have precisely the opposite effect. For it will diminish the marginal efficiency of capital and will lead to the postponement both of investment and of consumption."

(2) "The reduction in the wages-bill, accompanied by some reduction in prices and in money-incomes generally, will diminish the need for cash for income and business purposes; and it will therefore reduce *pro tanto* the schedule of liquidity-preference for the community as a whole. *Cet. par.* this will reduce the rate of interest and thus prove favourable to investment. In this case, however, the effect

of expectation concerning the future will be of an opposite tendency to those just considered under [1].”

Consequently, Keynes comes to the point that in a closed system “we must base any hopes of favourable results to employment from a reduction in money-wages mainly on an improvement in investment due either to an increased marginal efficiency of capital under [1] or a decreased rate of interest under [2].”

In considering how the wage cut fails to stimulate employment automatically, Keynes seeks to argue in further detail the above-mentioned two possibilities as well as the attempt of government in facilitating those situations. “The contingency, which is favourable to an increase in the marginal efficiency of capital, is that in which money-wages are believed to have touched bottom, so that further changes are expected to be in the upward direction. The most unfavourable contingency is that in which money-wages are slowly sagging downwards and each reduction in wages serves to diminish confidence in the prospective maintenance of wages. When we enter on a period of weakening effective demand, a sudden large reduction of money-wages to a level so low that no one believes in its indefinite continuance would be the event most favourable to a strengthening of effective demand. But this could only be accomplished by administrative decree and is scarcely practical politics under a system of free wage-bargaining. On the other hand, it would be much better that wages should be rigidly fixed and deemed incapable of material changes....”

“It follows that with the actual practices and institutions of the contemporary world it is more expedient to aim at a rigid money-wage policy than at a flexible policy responding by easy stages to changes in the amount of unemployment;-so far, that is to say, as the marginal efficiency of capital is concerned. But is this conclusion upset when we turn to the rate of interest?”

“It is, therefore, on the effect of a falling wage- and price-level on

Further, from another angle, Keynes in chapter 17 of *The General Theory*, while dealing with the properties of interest, changes his definition of what he calls the *natural rate* of interest, as compared with what he believed in *Treatise on Money* –namely, the rate of interest which equalizes the rate of saving and the rate of investment. Acknowledging that this rate of interest could not be "unique", Keynes adds that "I had, however, overlooked the fact that in any given society there is, on this definition, a *different* natural rate of interest for each hypothetical level of employment. And, similarly, for every rate of interest there is a level of employment for which that rate is the "natural" rate, in the sense that the system will be in equilibrium with that rate of interest and that level of employment. Thus it was a mistake to speak of *the* natural rate of interest or to suggest that the above definition would yield a unique value for the rate of interest irrespective of the level of employment. I had not then understood that, in certain conditions, the system could be in equilibrium with less than full employment."

Secondly, Keynes introduces the speculative-motive for liquidity into the system. In this way, Keynes treats money as a device for speculative purposes through which a transactor can fulfill his profit-taking nature. In an attempt to give the definition of the speculative-motive for liquidity, and its importance (i.e., why it should be regarded as a critical factor) in an economy, in chapter 13 of *The General Theory*, in which he reviews the general theory of interest rate, Keynes divides the liquidity-preference into three parts, and, indeed, further to transactions-motive and precautionary-motive, introduces "the speculative-motive, *i.e.* the object of securing profit from knowing better than the market what the future will bring forth." In this regard, Keynes puts that "[t]here is, moreover, a further ground for liquidity-preference which results from the existence of uncertainty as to the future of the rate of interest, provided that there is an organised market for dealing in debts. For different people will estimate the prospects differently and anyone who differs from the predominant opinion as expressed in market quotations may have a good reason for keeping liquid resources in order to profit, if he is right."

Then, on the problem of the desirability of having a highly organized market, he writes "in the absence of an organised market, liquidity-preference due to the precautionary-motive would be greatly increased; whereas the existence of an organised market gives an opportunity for wide fluctuations in liquidity-preference due to the speculative-motive."

"It may illustrate the argument to point out that, if the liquidity-references due to the transactions-motive and the precautionary-motive are assumed to absorb a quantity of cash which is not very sensitive to changes in the rate of interest as such and apart from its reactions on the level of income, so that the total quantity of money, less this quantity, is available for satisfying liquidity-preferences due to the speculative-motive, the rate of interest and the price of bonds have to be fixed at the level at which the desire on the part of certain individuals to hold cash (because at that level they feel "bearish" of the future of bonds) is exactly equal to the amount of cash available for the speculative-motive. Thus each increase in the quantity of money must raise the price of bonds sufficiently to exceed the expectations of some "bull" and so influence him to sell his bond for cash and join the "bear" brigade."

"Nevertheless, circumstances can develop in which even a large increase in the quantity of money may exert a comparatively small influence on the rate of interest. For a large increase in the quantity of money may cause so much uncertainty about the future that liquidity-preferences due to the security-motive may be strengthened; whilst opinion about the future of the rate of interest may be so un-animous that a small change in present rates may cause a mass movement into cash. It is interesting that the stability of the system and its sensitiveness to changes in the quantity of money should be so dependent on the existence of a *variety* of opinion about what is uncertain. Best of all that we should know the future. But if not, then, if we are to control the activity of the economic system by changing the quantity of money, it is important that opinions should differ."

Thirdly, Keynes regards income as the primary determinant of saving. This recognition is in a sharp distinction from the classical belief according to which nothing but interest rate through free market forces would bring the saving supplied by households into equality with investment demanded by business. Previously reviewed flexible wages and prices now combined with free equilibrating movement of rate of interest, all lead the classical economists to assume that an equilibrium is to be reached with a full employment. In chapter 14 of *The General Theory,* while reviewing the classical theory of the rate of interest, Keynes writes "this tradition has regarded the rate of interest as the factor which brings the demand for investment and the willingness to save into equilibrium with one another. Investment represents the demand for investible resources and saving represents the supply, whilst the rate of interest is the "price" of investible resources at which the two are equated." Then Keynes points out that "the ordinary man...brought up on the traditional theory, and the trained economist also, has carried away with him the idea that whenever an individual performs an act of saving he has done something which automatically brings down the rate of interest, that this automatically stimulates the output of capital, and that the fall in the rate of interest is just so much as is necessary to stimulate the output of capital to an extent which is equal to the increment of saving; and, further, that this is a self-regulatory process of adjustment which takes place without the necessity for any special intervention or grandmotherly care on the part of the monetary authority. Similarly...each additional act of investment will necessarily raise the rate of interest, if it is not offset by a change in the readiness to save."

Keynes, however, believes that this way of reasoning is erroneous and expresses his different opinion from the classical (and neo-classical) theory emanating from the emphasis which classics have placed on the influence of the interest rate upon the propensity to save. "The classical theory of the rate of interest seems to suppose that, if the demand curve for capital shifts or if the curve relating the rate of interest to the amounts saved out of a given income shifts or if both these curves shift, the new rate of interest will be given by the point of intersection of the new positions of the two curves. But this is a nonsense theory. For the assumption that income is constant is inconsistent with the assumption that these two curves can shift independently of one another. If either of them shifts, then, in general, income will change; with the result that the whole schematism based on the assumption of a given income breaks down. The position could only be saved by some complicated assumption providing for an automatic change in the wage-unit of an amount just sufficient in its effect on liquidity-preference to establish a rate of interest which would just offset the supposed shift, so as to leave output at the same level as before. In truth, the classical theory has not been alive to the relevance of changes in the level of income or to the possibility of the level of income being actually a function of the rate of the investment."

Then Keynes argues that "the functions used by the classical theory, namely, the response of investment and the response of the amount saved out of a given income to change in the rate of interest, do not furnish material for a theory of the rate of interest; but they could be used to tell us what the level of income will be, given (from some other source) the rate of interest; and, alternatively, what the rate of interest will have to be, if the level of income is to be maintained at a given figure."

Keynes goes on to say that there are two points which might have warned the classical school that something was wrong. "In the first place ...it is not certain that the sum saved out of a given income necessarily increases when the rate of "interest is increased; whereas no one doubts that the investment demand-schedule falls with a rising rate of interest. But if the Y-curves [which any of them relates the amounts saved out of an income to various levels of the rate of interest] and the X-curves [which any of them is the position of the investment demand-schedule] both fall as the rate of interest rises, there is no guarantee that a given Y-curve will intersect a given X-curve anywhere at all. This suggests that it cannot be the *Y*-curve and the X-curve alone which determine the rate of interest."

"In the second place, it has been usual to suppose that an increase in the quantity of money has a tendency to reduce the rate of interest, at any rate in the first instance and in the short period. *Yet* no reason has been given why a change in the quantity of money should affect either the investment demand-schedule or the readiness to save out of a given income."

"[T]he traditional analysis is faulty because it has failed to isolate correctly the independent variables of the system. Saving and Investment are the determinates of the system, not the determinants. They are the twin results of the system's determinants, namely, the propensity to consume, the schedule of the marginal efficiency of capital and the rate of interest. These determinants are, indeed, themselves complex and each is capable of being affected by prospective changes in the others. But they remain independent in the sense that their values cannot be inferred from one another. The traditional analysis has been aware that saving depends on income but it has overlooked the fact that income depends on investment, in such fashion that, when investment changes, income must necessarily change in just that degree which is necessary to make the change in saving equal to the change in investment."

"Nor are those theories more successful which attempt to make the rate of interest depend on "the marginal efficiency of capital". It is true that in equilibrium the rate of interest will be equal to the marginal efficiency of capital, since it will be profitable to increase (or decrease) the current scale of investment until the point of equality has been reached. But to make this into a theory of the rate of interest or to derive the rate of interest from it involves a circular argument, as Marshall discovered after he had got half-way into giving an account of the rate of interest along these lines. For the "marginal efficiency of capital" partly depends on the scale of current investment, and we must already know the rate of interest before we can calculate what this scale will be. The significant conclusion is that the output of new investment will be pushed to the point at which the marginal efficiency of capital becomes equal to the rate of interest; and what the schedule of the marginal efficiency of capital tells us, is, not what the rate of interest is, but the point to which the output of new investment will be pushed, given the rate of interest."

Then, Keynes comes to the main conclusion and clarifies the difference between his and classical ideas.

"The reader will readily appreciate that the problem here under discussion is a matter of the most fundamental theoretical significance and of overwhelming practical importance. For the economic principle, on which the practical advice of economists has been almost invariably based, has assumed, in effect, that, *cet. par.,* a decrease in spending will tend to lower the rate of interest and an increase in investment to raise it. But if what these two quantities determine is, not the rate of interest, but the aggregate volume of employment, then our outlook on the mechanism of the economic system will be profoundly changed. A decreased readiness to spend will be looked on in quite a different light if, instead of being regarded as a factor which will, *cet. par.,* increase investment, it is seen as a factor which will, *cet. par.,* diminish employment."

3.2 SOME FURTHER JUSTIFICATIONS FOR STATE INTERVENTION

Generally speaking, Keynes's multifaceted ideas seem distinguished at least at three dimensions.

First, new conceptualization in macroeconomic analysis based upon the balance between aggregate demand and supply.

Second, provision of a logical basis for an active government management of the economic arena. Keynes avoided being trapped in the classical idea concerning the separation of the polity and the economy and the related view that the market economy would be fundamentally stable and properly functioning if it is left free from State interference. In fact, his justification for effective State intervention was based upon this argument that though suffering inherently from instability, the functioning of the private markets can be realized if they are exposed to active government management.

"The core of the Keynesian heritage has surely been the concept of macro economic management itself. The governments could direct the movement of economic aggregates within the national economy, through the manipulation of fiscal and monetary instruments, but without systematic interference in particular markets or in property right" (Radice, 1988, p. 153).

Finally, there is the argument for a specific set of policy prescriptions termed "countercyclical demand management." More clearly, facing a period of recession, Keynes recommended an active fiscal policy, including expansion of public expenditure, tax reductions, or public works to be financed by fiscal deficit. Policy reversal – i.e., deflationary policy, was advised during an excess demand period.

During the postwar period, Keynes's thought on the deficiencies of the private economy and the indispensability of State intervention to overcome such instabilities provided the ground for a social consensus to accept a managerial State and mixed economy. Needles to say, some other factors played an important part in boosting the role of the State in the economy. To name just a few, the following could be listed: the legacy of the war economy, the demands of reconstruction, the expansion of universal social benefits, the emergence of newly established nation-states, and the heritage of backward economies. All these, however, operated in the context of the Keynes's vision which provided theoretical justification for the new role of the state vis-a-vis the old *Laissez faire* system.

Through his theorization, Keynes demonstrated that, while benefiting from a managerial state, a middle way would be available between the complete socialization of the means of production and unrestrained capitalism. This led to a new political discourse. Furthermore, Keynes's ideas contributed to the evolution of a class compromise.

Keynes argued that, within a capitalist economy, through utilization of macroeconomic management and without violation of private rights, full employment and sustained economic growth would be accessible. Consequently, his viewpoints were welcomed by many politicians with the hope to make national frameworks of regulation to sustain them. The Keynes's ideas were applied to justify a variety of practices associated with the "mixed economy" (Hall, 1989a).

As a powerful means to overcome the deficiencies of *Laissez-faire*, the State, as noted, was regarded as a significant institution by Keynes. He criticized the nineteenth century dominant theory of State as a perverted theory which failed in several manners.

Keynes (1936, Chapter 23) states that, under the conditions of *Laissez-faire*, the growth of wealth of a country may be interrupted by insufficient inducements to new investment. Those inducements could be found either in home investment or in foreign investment. Under conditions in which aggregate investment is determined by the profit motive, the investment opportunities will be governed in the long run by domestic rate of interest. Foreign investment, on the other side, will be determined by the size of the favourable balance of trade. Thus, in a society facing the absence of any direct investment under the auspices of public authority, it would be reasonable for the government to the preoccupied with the domestic rate of interest and the balance of foreign trade.

Now, if the wage-unit, liquidity preference, and banking conventions are almost stable, the rate of interest will tend to be governed by the quantity of the precious metals, which, in its turn, will largely depend upon the favourable balance of trade. In fact, when the State has no direct control over the domestic rate of interest, the only *direct* means at its disposal is to increase foreign investment, by increasing the favorable balance of trade. Furthermore, the effect of a favorable balance of trade on the influx of the precious metals constitutes the only *indirect* means available to the government to reduce the domestic rate of interest in order to increase the inducement to domestic investment.

In regard to this policy, it is worthwhile to mention that two limitations may be realized. Firstly, if the domestic interest rate falls to a low level, which, through a stimulation of investment and the subsequent increase in employment, causes a rise in wage-unit, then the efforts to raise foreign trade will be defeated. Secondly, if the domestic interest rate falls so low, which, as compared to elsewhere, leads to a stimulation of foreign lending disproportionately to the favorable balance of trade, then an increase in the efflux of precious metals will nullify the previous advantages. Notwithstanding, the weight of Keynes's criticism is directed against the inadequacy of the *theoretical* foundations of the *Laissez-faire* doctrine – i.e., against the notion that interest rate and the volume of investment are self-adjusting at the optimum level, therefore the preoccupation with the balance of trade would be a waste of time.

Furthermore, Keynes in his 1933 article, 'National Self-Sufficiency' (Collected Writings, 1982, vol. XXI, pp. 233-46), says that the nineteenth-century free-traders believed, firstly, that just they were clear-sighted and sensible, whereas any intervention in free trade was because of ignorance and self-interest; secondly, that free trade solved poverty through the allocation of resources to the best use; and thirdly, that it secured peace, justice and diffusion of progress.

Keynes then maintains that there are two wrong points with this argument. First, international peace does not now seem to be assured by maximization of international economic relations, since this involves the protection by each country of its foreign interests, competition for new markets, and the progress of economic imperialism. Second, free trade was advantageous in the nineteenth-century since, on the one hand, migrations required complementary flows of goods and capital, and on the other, there were considerable differences in levels of industrialization. Today, however, the system of international capital flows serves purely financial interests. In this way, Keynes finds the orthodox belief in free trade unjustified.

Consequently, Keynes changes the orientation of his mind from the orthodox theory and attempts to provide an alternative perception of the role of the State. In fact, Keynes believed that, since the world of *Laissez-faire* was dead, so for the State in the new era, the pursuit of domestic expansion must have priority over the determination of interest rate in international financial markets. Therefore, the State should be explicitly concerned with a higher level of domestic employment, rather than material prosperity. "The Keynesian revolution, which cast doubt on the market's ability to achieve optimal results, was used to legitimize economic planning. Keynes's emphasis on domestic economic prosperity as opposed to international concerns was extended to support national industrialization strategies in the Third World (Shapiro and Taylor, 1990, p. 862).

3.3 THE MAIN CONCERN OF THE KEYNESIAN THEORY OF STATE

Let us begin the argument with noting the point that an economy can come close to full employment through State intervention. According to Keynes, businesses increase (decrease) investment not because of low (high) interest rate. Rather, they do so in the light of *reviewing* the marginal efficiency of capital and the rate of interest (until the equality between them is achieved). In Keynes's system, investment is considered as an "exogenous" variable which is strictly influenced by profitability in the business sector. This exogenously determined investment variable is what determines the level of national income. Put differently, an economy is expected to produce the amount of output (income) which is directly regulated by the investment carried out by business sector, in the absence of State intervention.

On the other hand, households, who allocate a part of their income to saving, are not motivated by interest rate, since "[i]t is increased output which produces the increased saving" (Keynes, 1936, p. 328). Therefore, the higher (lower) the level of income, the more (less) the amount of saving supplied by households. In other words, saving is regarded as an "endogenous" variable in Keynesian system which is determined by the level of income.

The statements made in the foregoing provide the basis for the problem which Keynesian system is concerned with. The principal concern of this system is to remedy national income shortfalls or economic gluts. These problems emanate from deficiency in the exogenously determined investment, i.e. the fact that it is less than the amount sufficient to maintain full employment. This discrepancy is caused by the emergence of risky situations for business and by a gloomy environment of profitability of the firms.

The nature of the problem which is to be solved leads us to consider the circumstances under which the State steps in to interfere with the economy. Indeed, in the context of the Keynesian system, the appearance of a flourishing and prosperous economy is brought about by a buoyant level of exogenously determined investment. However, if the readiness of the private sector to invest is low, due to the previously made theoretical points, then some other remedy should be initiated. Referring to Keynes, that entity, not being envisaged under *laissez-faire* formulation, is the government which counters the impact of the investment shortfall. This could take the form of selling government bonds to finance public investment (deficit financing) and new government spending, or to directly stimulate private consumption.

Now, it seems clear that the economic philosophy of Keynes, in which the government is seen as the guarantor of full employment through adjusting its own spending to offset shortfalls in firms' investment, "is a stark contrast to the non-interventionist posture of *Laissez-faire*" (Sawyer, 1987, p. 27).

In this respect, the government will discharge a dual responsibility. While, on the one hand, it attempts to reduce the rate of interest to such a level as to secure the full employment rate of investment, on the other hand, it seeks to regulate the rate of investment and the size of the capital stock. Thereby, Keynes sees "the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organizing investment" (Keynes, 1936, p. 164).

This induces Keynes to think of socialization of investment leading to a change in the realm of the State to that of being the chief entrepreneur. Keynes, however, was far from backing State socialism. "I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment; though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative. But beyond this no obvious case is made out for a system of State Socialism which would embrace most of the economic life of the community. It is not the ownership of the instruments of production which it is important for the State to assume. If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary. Moreover, the necessary measures of socialization can be introduced gradually and without a break in the general traditions of society" (Ibid, p. 378).

Keynes believed that the state should be treated as a guardian supervisor, and promoter of civilised society. And, its duties depended upon the performance of the private sector. This created an interest in a wide variety of issues such as economic efficiency, social justice, population, health, peace, legal structure, etc., on the one hand, and a wide range of activities such as the provision of satisfactory employment and inflation levels through fiscal, monetary and trade policies and the elimination of extreme distributional inequalities, the establishment of national data bases, the preservation of the natural environment and so on, on the other. Thus, Keynes's ideal State was not a neutral administration working according to a set of pre-set rules. Rather, it was an active supervisor with a program of evolutionary change, including modification of the rules of the game. He limits the domain of the State to those activities which are not done at all by private individuals. "There is a traditional distinction between macroeconomic management in the Keynesian manner, designed to exercise general control over the economic environment, and more detailed forms of intervention designed to modify economic ownership and control, influence the allocation of economic activities and redistributive benefits, which often extend well beyond anything envisaged by Keynes" (Winch, 1989, p. 110).

Although concerned about the private enterprises, however, if their functions remain not performed by them, Keynes prescribes the State supervision and regulation of the microeconomic sphere. Therefore, Keynes puts his ideas between the two extremes, namely, *Laissez-faire* and unregulated capitalism, on the one side, and the displacement of the existing private sector activity by nationalization and state ownership, on the other. However, there are "Left-Keynesian... believing that the logic of Keynesianism leads to greater intervention, such that what may have begun as macroeconomic management requires extension into microeconomic intervention to ensure success" (Ibid, p. 124).

3.4 THE SCOPE OF STATE ACTIVITY IN KEYNESIAN THEORY

Whereas no systematic explanation of the nature and scope of the State activity have been provided by Keynes, however, his ideas could be inferred from his scattered remarks and put together in the following principles.

Firstly, the state is the *guardian of the common good*, i.e., it is responsible for protecting the interests of society as a whole. The State has the right to control vested interests which conflict with the common good.

Secondly, the State is an *agent of social rationality*. It is a means by which society could consciously control its nature and direction as opposed to being left to the blind forces of *Laissez-faire*. The State is expected to collect information, to consult expert opinion, and thereby formulate long term and short term policies to serve the common good. Influencing the propensity to consume, assuming greater responsibility for the direct organization of investment, and undertaking public investment are some of the ways by which the state can discharge its social responsibility.

Thirdly, the State is the *protector of individualism and personal freedom*. State action, if correctly directed, would be for the benefit of the individuals. In fact, State activity is seen as a *precondition* of successful individualism, which improves the efficiency of resource utilization and eliminates a part of the hazards of pure *Laissez-faire*. By attacking sources of uncertainty, by providing data banks and by reforming institutions, the State would be able to improve the environment in which individual rationality is exercised. The State also can preserve and increase the realm of freedom. Keynes was, of course, concerned with that interpretation of freedom which was consistent with the common good rather than unlimited freedom. Considering the individual level, the removal of involuntary unemployment by State activity will certainly lead to an increase in personal freedom. Hence, planning and economic management could be regarded as defence of freedom of economic life as well as measures in line with the moral principles of liberty.

Fourthly, the most rational models of interaction between the State and private sector are *forms of combination and partnership* which derive the advantages of both central control and individualism. Different forms of partnership could be envisaged based on experiences of different countries and circumstances. One major form is semi-public corporation. With variant constitutions, their general principles are that they are owned and financed by the State, run by a board of directors composed wholly or partly of State appointees, and are responsible to parliament. Beyond this, the State plays no role in running the corporations and each board autonomously follows its decisions. The Bank of England as well as universities could be cited as examples. The other form may be State activities to improve the environment and performance of private enterprise. Providing data, removing uncertainty and promoting stability are among the main activities.

Fifthly, the assessment of State-funded activity has to be done on n*on-commercial criteria*. So, there would be no problem when some projects earn substantially less than what the private sector earns, whereas other projects would be considered publicly beneficial at even negative returns. To Keynes, it was the nineteenth-century that was preoccupied with the criterion of financial results for testing the desirability of any action, private or collective. Therefore, public works are not worthless in a situation of depression even when they appear non-profitable from a commercial viewpoint. It would be obviously better if the public projects are directly useful such as social infrastructure which enriches society by eliminating involuntary unemployment and adds to the stock of national wealth.

Finally, *moderation* governs the pace of state-induced changes. Reform should be purposeful, peaceful and gradual rather than violent or revolutionary. The State should be run by an enlightened and rational bureaucracy which represents the general interest and overrides class and vested interests (O'Donnell, 1989, pp. 299-308).

3.5 REVIEW OF SOME CONTRIBUTIONS OF DEVELOPMENT THEORISTS IN LINE WITH KEYNESIAN THEORY OF STATE

Beginning from the middle of the twentieth-century, economists concerned with development policy have often favored State involvement. The legitimizing principle in justifying active State involvement in economic issues and providing the ground for economic planning is rooted in the Keynesian revolution. Keynes's concentration on domestic economic prosperity as opposed to international concerns, which was revealed in his *The General Theory*, had its counterpart in the adoption of national industrialization strategies in the newly developing world.

In the theoretical arena, the necessity of a new and separate field to study the development situation was felt. Development economics emerged following the Keynesian concepts. Moreover, the arguments that the general equilibrium theory is incapable of describing the whole process of development, and also, the structural change would not be automatically generated by decentralized decision-making at the micro level led to a new approach on the role of the State in promoting economic development. As mentioned in the foregoing, a stream of contributions of development theorists arose which now has appeared to be recognized as classic writings in the cited area. It seems worthwhile to review some of those arguments just to get familiar with the line of thinking which may be regarded as a precursor for the rise of a new era in which State intervention was emphasized.

The huge amount of required investments compared to the available financial resources, as well as the failure of the price mechanism either in initiating vital economic decisions, as distinct from marginal changes, or in bringing about the resource transfer needed for industrialization, necessitated the search for some other mechanism. Public intervention was conceived something which would support investors, which would attempt to redesign the international trade environment, and which would directly invest to overcome the critical impediments.

An economy with a low level of savings, an insufficient or destroyed infrastructure, relative backwardness and the need for industrialization, and an unfavourable position in world trade and international division of labor, was seen by leading theoreticians as constituting an appropriate site for planned development directed by the State. The literature which placed emphasis upon state intervention, unanimously neglected, however, the complexities and difficulties associated with State interference. These were later regarded as their deficiencies.

3.5.1 ROSENSTEIN-RODAN AND ECONOMIC RENOVATION

Rosenstein-Rodan (1943) in his report prepared for the reconstruction of Eastern and South-Eastern Europe immediately after the Second World War notes the severe problems facing the development of the region. In discussing the sources available for investment, he notes not only that there would be no automatic provision of resources for the task of industrialization, but also that the existing institutions of international investment would not be appropriate. Therefore, there is a need for a scheme of planned industrialization including a simultaneous planning of several complementary industries. Besides, since the increase in overhead costs and fixed capital has increased the risk of loss of capital, and since the political risks of international investment are also high, State supervision and guarantees can substantially lower risks.

Rosenstein-Rodden lists several reasons why industry needs to be created as one huge firm or trust: (a) the need for skilling of labour which is never accomplished spontaneously under *laissez-faire* due to unprofitability; (b) the advantages of large-scale planned industrialization because of complementarity of different industries which reduces the risk of not being able to sell and, also covers costs through external economies; (c) the rise of two other types of external economies because of creation of a system of different industries, namely, the Marshalian economies external to a firm within a growing industry, and secondly, economies external to one industry due to the growth of other industries; (d) The lack of incentive within the prevailing institutions for investments which are profitable in terms of social marginal net product but are not so in terms of private marginal net product; (e) the lack of multiplier effect in diffusion of industrialization in the structural disequilibrium situation after the war which could only be compensated through planned industrialization. Hence, he states that "[a]ctive participation of the

State in economic life is a new factor which must be taken into account as a new datum" (Ibid, p. 204).

3.5.2 SINGER AND GAINS OF FOREIN RESOURCES

Singer (1950) mentions the following three reasons why he thinks that international trade is not of importance to underdeveloped countries: firstly, the logical confusion between the absolute amount of foreign trade and the ratio of foreign trade to national income; secondly, the difference in productivity of labor between export industries and domestic production industries; and thirdly, the existence of large self-contained groups remaining outside of the monetary economy and therefore not affected by any changes in foreign trade. Then, he moves to pose the question whether the foreign sector is beneficial to underdeveloped countries in raising their productivity standards, transforming their economies into monetary ones, and spreading modern technology to them.

Despite the first reaction that the higher productivity of foreign trade sector would bring benefits to the economy, as argued in textbooks, this view is untenable. The question of ownership as well as opportunity costs is relevant here. The export facilities, largely a result of foreign investment, are never integrated into the internal structure of the underdeveloped economies, except in a geographical sense.

Its multiplier effects largely leak out abroad. The cumulative addition to income and employment is meager. In fact, foreign investment in underdeveloped countries should be regarded more as an internal investment in the industrialized societies. The very differential in productivity between the export and domestic sector is also another indication of this fact. Furthermore, foreign investment brought in for the purpose of transforming the underdeveloped countries to those providing food and raw materials to the industrialized countries, has not just been of little benefits to the former. By the application of the principle of opportunity cost, it may even be regarded as being positively harmful. The export sector would have been less profitable than the domestic sector if specialization in food and raw material sector had not taken place. The economy could then have diversified its production structure and developed its own manufacturing base. The principle of specialization along the line of static comparative advantages has never been accepted either in underdeveloped countries or in the industrialized ones. And this is the reason why industrialization should have occurred in the underdeveloped country with its effects on the general level of education, skill, way of life, investiveness, habits, store of technology, and creation of new demand.

Besides the removal of the secondary effects of the foreign investment from the underdeveloped countries and the diversion of those countries into activities with less scope for technical progress, the benefits of foreign trade-cum-investment has exposed them to the adverse terms of trade. Given the lower productivity in the production of food and raw materials, and dismissing the possibility of increases in the real cost of the manufactured exports in the industrialized countries over those of primary products of underdeveloped countries, the deteriorating terms of trade for primary commodities have led to faster rises in the standards of living in the industrialized countries ever since from the last quarter of the nineteenth-century. This has happened because if the fruits of technical progress in manufacturing industries of the industrialized countries were distributed to producers in the form of rise in real income the same benefits in the case of food and raw material production in the underdeveloped countries have been transferred to consumers in the industrialized countries in the form of fall in prices.

Falling long-term trend of prices of primary commodities relative to manufactures arises from the contribution of some other factors as well. Technical progress does not have the same impact on the demand for manufactures, as it has on primary commodities. While the rise in real income increases the demand for manufactures more than proportionately, the demand for food is not very sensitive to the rise in real income. In the case of raw materials, technical progress in manufacturing mainly leads to a reduction in the use of raw materials for per unit of output. The little increase in demand, coupled with the law price elasticity of demand for primary commodities causes large price falls. Thus, the industrialized countries have enjoyed the fruits of technical progress both in the manufacture of primary commodities as their consumers and in the production of manufactured goods as their producers. On the contrary, the underdeveloped societies were adversely affected both as the consumers of manufactures and as the producers of raw materials. This is the reason why foreign investment of the traditional type is believed to be a part of a system of economic imperialism and of exploitation.

Singer, then, concludes that foreign investment, coupled with the type of foreign trade which came with it, failed to spread widely and evenly the seeds of industrialization throughout the world. Besides, he adds that the fruits of the investment-cum-trade system and the favourable terms of trade enabled Europe to provide the needs of her large number of emigrants to North America. Thus, the benefits of European foreign investment constituted the main foundation of the considerable capital formation in that region. The economic measures and policies coming out of this analysis would be to redefine the purposes of foreign investment and foreign trade in order to produce changes in the structure of comparative advantages and of the comparative endowment of the different countries rather than developing a world trade predicated upon existing comparative advantages and distribution of endowments. The reinvestment of profits and the absorption of rising productivity in primary production in rising real wages may ensure the retention of the results of technical progress in the underdeveloped countries.

3.5.3 NURKSE AND PROBLEM OF LOW SAVINGS

Nurkse (1953) reviews the problems of developing countries from another angle. He discusses the low savings in developing countries and then questions why capital formation in those areas is deficient. He believes that it is the limited size of the market which inhibits the adoption of capitalist methods in the productive process in the early stages of a country's economic development. In other words, in the exchange economy of the real world, small size of the domestic market in a low-income country can constitute an obstacle to the application of capital by firms, and thus a hindrance to development. While poverty is associated with low labour productivity, productivity is a function of the capital-intensity of production. Any individual entrepreneur, however, is inhibited to apply capital by the small size of the market. Thus, a vicious circle of poverty can keep a backward economy in a stationary condition, in a state of "underdevelopment equilibrium" analogous to the "underemployment equilibrium" in advanced industrial countries that Keynes had talked about. Economic progress not only is not a spontaneous affair, but on the contrary, the spontaneous working of the system keeps it trapped at a certain low level equilibrium.

The escape from this deadlock, according to Nurkse, is only possible through an enlargement of the market. Initiating complementary projects creates market (customer) for each other's products. Whereas a single enterprise may not succeed, a wide range of industrial projects may succeed in that the people working in those industries would provide a large market for the products of the other industries. This contributes a case for balanced growth. To bring it about, ordinary price incentives would be of little help since the discontinuities in the technical forms of capital formation are regarded as serious deterrents. Besides, slow growth can not meet the demands of the increasing population. In the development of western capitalism, according to Schumpeter's theory, rapid growth was achieved through the initiatives of individual producers. The creative entrepreneurs and their imitators carry out innovations and produce new commodities, which deepens the stream of real income.

Despite the fact that the addition to physical output by applying modern machinery may be enormous, this increase is only the engineering side of the mater. The economic side is concerned with value productivity, and not simply with the physical one. The value productivity, in turn, is confined by the poverty of the consumers. The marginal productivity of capital in the economically backward countries may be tremendous if the primitive methods of production are to be replaced by modern machinized plants. But while the physical output increases enormously in this manner, the value productivity may still remain at a low level due to the limited purchasing power of the people.

In fact, it is only balanced growth that can realize the technical physical productivity in economic terms through the enlargement of the aggregate size of the market, induced by increased investment in a wide range of complementary activities. Here, the notion of external economies could be applied since each project contributes to the enlargement of market size, which creates economies external to the individual firm. Despite a considerable marginal productivity of capital in a wide range of complementary industries, the private investment in a single project may not be justified due to the market difficulty. That is why a wave of investments in a vast variety of activities can economically succeed and overcome the stationary equilibrium of underdevelopment.

In underdeveloped economies the forces that are to overcome the economic stagnation may have to be deliberately organized to some extent. To take an example, Japan's case could be considered in which the state acted as the great innovator and industrial pioneer in the early industrial development. This stage has been "planned" and carried out in large measure by the state. It was only after the removal of obstacles, including the difficulty posed by the limited size of the market, that the State delivered its projects to private sector. Basically, until the early twentieth-century, Japan's development orientation was towards an expansion of the domestic market, and it was only later that export markets emerged as an important target.

3.5.4 GERSCHENKRON AND HISTORICAL DIFFERENCES

Gerschenkron (1966) was also among the first who explained the role of the State in the process of economic development using the context of the historical development of the nineteenth-century backward European economies. While mentioning that no historical research can save the living generation the task of the finding their own solutions for the prevailing problems, he conducts a historical research on industrial process of some European backward countries of the nineteenth-century. In comparing Russia and Germany with the more advanced one – i.e., England, he observed some differences not only with regard to the speed of development (the rate of industrial growth) but also with regard to the productive and organizational structures of industry as well. He, moreover, realized that those differences mainly arose from institutional instruments which were absent in an established industrial country. He argued that the nature of the state's intervention in the development process is directly predicated upon a country's economic situation relative to more advanced economies.

The rapid pace of technical changes, and the widening gulf between the levels of development across the nations forced the backward countries to search for paths other than those already followed by the earlier industrialized country. While the need for a high speed of development in the countries entering the stage of industrialization was satisfied by the application of the most modern and efficient techniques available, England's industrialization, since it was the first, witnessed the use of relatively unsophisticated techniques which improved only gradually. The utilization of the capital intensive technology, as revealed in the economic history of Europe in the nineteenth-century, required increases in the average size of the plant, and have a particular pattern of development.

The industrialization of England took place with no substantial bank credits for long-term investment purposes. In fact, the more gradual character of the industrialization process removed any need to initiate any new institutional instrument to provide long-term capital to industry. However, in a relatively backward country the situation is different: capital is scarce and diffused, the industrial activities are risky, there is a pressure for bigness, and the entrepreneurial talent is scarce. These circumstances caused the emergence of an alternative banking system involved in industrial investment. Thus, the German banks, for instance, developed to fulfill roles quite different from those of the British banks. Unlike the British banks which concentrated on commercial banking, German banks went into industrial banking. Moreover, in Germany, it was heavy industry which attracted the attention of the banks.

Besides the difference in natural conditions, Gerschenkron observed in his review that the difference in institutional instruments of industrialization is one reason which prevents the generalization of the industrial development in the European continent as a whole. He refers to Russia as a country in which the particular role of the State distinguished the Russian model of industrialization from that of some other countries such as Germany and Austria. In Russia, the State, based upon its military interest, played the role of the main agent in directing the economic progress in the country. In doing so, not only did the administrative reforms create a suitable framework for industrial development, but railroad building also appeared to be the main lever for rapid industrialization. Using various devices such as preferential orders to domestic producers of railroad materials, high prices, subsidies, credits, and profit guaranties to new industrial enterprises, the government paved the way for maintaining high as well as increasing growth up to the end of the nineteenth-century. Furthermore, the reorganisation of the Russian tax system, the financing of industrialization, the stabilization of the Rouble and the introduction of the gold standard facilitated foreign participation in the Russian industrial development.

In Russia, the severe scarcity of finance, which left the banks short of sufficient funds to finance large-scale industrialization, the low standards of honesty in business, the high distrust of the public, which prevented the banks from collecting the available small-sized capital funds, nullified all attempts of the banks for initiating long-term industrialization policies. Therefore, the satisfaction of the needs of industrialization required the intervention of the government in supplying funds, the government through its taxation policy, succeeded in directing the resources from consumption to investment.

Effectively, the policies followed by the Russian state resembled those applied by the Central European banks. The incompetence and corruption of the Russian bureaucracy, which gave rise to a formidable amount of waste, should not blind us to the undeniable success of the pursued policies. As a result of the government's developmental attempts, the industrial growth not only did not stagnate but also continued its pace. And this process could continued even when the government's efforts slackened somewhat, Russian industry reached a stage where even in the absence of government support it could move forward independently.

Briefly, the use of different instruments for industrialization, in conformation with the needs of this particular stage of backwardness, became possible only when the State-sponsored industrialization processes had made some headway. Generally speaking, we can conclude that the role of the government in the development effort in the case of the old industrializers was confined to providing the proper environment for the private sector. However, in the followers, the state, just to overcome the relative backwardness, widely intervened and became more directly active in extracting and allocating resources as well as in establishing firms.

Some scholars, while acknowledging the role of State intervention, placed emphasis upon the nature of intervention – i.e., on the quality rather than the quantity of the interference. Let us turn to those now. In the following we shall first discuss Rodrik's contribution which distinguishes the autonomous state from the subordinate one. Then, in the same context, Kornai's argument will be discussed.

3.5.5 RODRIK AND SUBORDINATE STATE

Rodrik (1992) argues that in the debate about State intervention, what matters is the quality of intervention, not its quantity. Borrowing a concept from the political science literature – i.e., State autonomy, he attempts to formalize it, and show how it can be used in solving some problems concerning State intervention. More particularly, Rodrik seeks to demonstrate that intervention could be differentiated by distinguishing between "autonomous" State and "subordinate" one. The contrast between the two styles of States is considerable. In an autonomous State, government decisions are made autonomously, and the private sector can not avoid them as they are to be implemented. In fact, the outcomes of the government decisions are based upon the nature of the interaction between private sector and government. Myrdal calls these two "hard" and "soft" states. For them, the current terminology in the political science literature is "strong" and "weak" states.

An autonomous State is committed to its policies and also takes into account the response of the private sector to its policies. A subordinate one would follow the private sector, rather than heading it. Setting its policies *after* the private sector has made decisions impinging on the level of economic activity, the subordinate State does not have any incentive to remove market failure. In other words, the subordinate State lacks any mechanism that would commit it to reward or punish the private sector for its behavior. To take an example, the delay of a government in paying export subsidies to exporters in order to reduce the anti-export bias of the trade regime will be regarded as an unpredictable payment. This will be revealed as a failure of government's policy since it no longer serves its initial purpose of inducing export incentives. This is the behavior of a subordinate State which has no incentive to undertake its responsibilities as the promise of the private sector has been realized. The autonomous State takes a lesser amount of politically motivated decisions since it is economically harmful.

Then, it could be said that a subordinate State, as compared to an autonomous one, systematically under-provides economically desirable interventions and systematically over-provides politically-motivated (and economically harmful) interventions.

As a result, to come to the conclusion whether the State should intervene in the economy depends upon the response to the following important questions: are state institutions sufficiently insulated to intervene appropriately whereas confining politically-motivated interference?; or are they subordinate to pressures from below leading to get things more wrong. In other words, an implication of this line of reasoning is that the policies can no longer be judged by asking what they are. Taxes, subsidies, and the like leave different impacts under different (autonomous or subordinate) states. An export subsidy, in a subordinate State, mainly transfers resources to preferred clients, and in an autonomous one, offsets an existing anti-export bias.

Now, it could be asked: where does autonomy come from? How can states acquire it? Is it possible to set up autonomous institutions while being responsive to the needs of the population? Rodrik believes that an improvement of the quality of policy making depends on designing appropriate institutions. Alternatively, autonomy should be engineered. Political institutions are not born autonomous or subordinate, they become so.

3.5.6 <u>KORNAI AND PROBLEM OF SHORTAGE</u>

In focusing on the problem of *shortage* which plays the same role in a socialist economy as the problem of unemployment does in a capitalist economy, Kornai (1979) poses the question: what *constraints* limit efforts at increasing production? He, then, argues that three large groups of constraints could be discerned. (1) *Resource constraints:* the use of inputs in production cannot exceed the volume of available resources. (2) *Demand constraints:* sale of the product can not exceed the buyer's demand at given prices. (3) *Budget constraints:* financial expenses of the firm can not exceed the amount of its initial money stock plus its revenue from sales. Any of the three constraints which limits choice is called "effective constraint" and defines the characteristic of the social system.

From the effectiveness of constraints point of view, two types of systems are discerned. The first is the *demand constrained system* in which the effective constraint on production is the demand of buyers. In other words, while the quantity of resources is enough to increase the level of production, the demand as a constraint counteracts any attempt to do so. To take an example, the *"classical" capitalism* which faces the contradiction between the tendency of unlimited expansion of production and the limited purchasing power of the market can be regarded as *demand constrained system.* The other is the *resource constrained system* in which the available physical resources act as effective constraints to increase the production. *A classical socialist economy* which preceded the economic management reform of the 1960's and 1970's is considered *a resource-constrained economy.*

In regard to budget constraint, it could be said that it is either *hard* or *soft.* A budget constraint is hard if a firm has to cover its expenses from its sales, and taking credit from a bank is contingent on following its strict rules. The budget constraint is soft if the above-mentioned measures are missing for a firm. Two phenomena reveal whether a budget constraint is hard or soft.

First: *Survival.* One indication of the hardness or softness of a budget constraint is to observe what happens to a firm as a result of financial difficulties. If losses, regardless of their origin drive a firm to bankruptcy, then the budget constraint would be seen as a hard one. The case is the reverse if the State helps the firm to overcome the trouble. Various ways are available for a government to do so: subsidies, exemption from the payment of taxes, allowances, softly-conditioned grants of credit, etc. Here, effectively, the State is regarded as an insurance company which will certainly compensate each and every loss. In other words, the presence of a paternalistic State is a guarantee for the survival of the damaged firms.

Second: *growth* of a firm is the other indirect criterion to conclude the hardness or softness of a budget constraint. The budget constraint is hard if the growth of a firm is dependent upon its own financial position –i.e., savings and accumulation as well as strictly conditioned banks loans. Put alternatively, a hard budget will lead a firm to bankruptcy if its investment faces a financial failure. The survival and growth of a firm and the absence of any bankruptcy threat in case of financial failure are indications of the presence of a soft budget constraint.

3.6 SOME THEORETICAL ASSESSMENTS AND CRITICISMS

3.6.1 ON KEYNES'S IDEA

In his review of the State intervention through fiscal policy, Professor Patnaik (1997b, Chapter 5) criticizes the Keynes's formulated State intervention as follows. He firstly states that Keynesians believe in the self-contained nature of capitalism which enjoys internal institutions capable enough to provide the ground for a smooth functioning of the system. Keynesians, however, as opposed to the critics of Keynesianism, are dubious about the capability of the market for playing such a role. Hence, Keynesians accept the

the agreement of the involved parties, through reducing their original claims. Therefore, Professor Patnaik's ultimate conclusion is as follows. "The Keynesian belief in the efficacy of State intervention, and indeed the Keynesian theory of the State as an enlightened, benevolent entity standing above classes and arbitrating between them for the good of all, is based on a down grading of the role of conflict in a capitalist society. And it is an appreciation of this conflict that fundamentally informs the Marxist theory not only of the State, but also of crises" [Ibid, p. 92].

Mattick (1980), in reviewing the crisis of the mixed economy, seeks to explain its main causes through criticizing the shortcomings of Keynes's theory of State economic intervention. Interpreting the great crisis of 1929 as the abandonment of the equilibrium theory of a self-regulating economy, he remarks that the crisis was defined to be brought about by a lack of effective demand due to a decline in consumer needs, leading to a lower level of new investments and hence more unemployment. The remedy, arrived at through this interpretation of bourgeois theory, was to be the stimulation of the production. However, given the problem of achieving this goal through profit-determined market relations, State intervention was sought to be utilized to stimulate production. This was to help capital extract itself from the crisis by means other than its own resources. In this way, production would expand independent of profit and without the promotion of capital accumulation directly. The invention of the multiplier effect theory was to substantiate this reasoning.

To make the point clearer lets us expand the analysis to cover the depression period. While public works during the Great Depression only reduced unemployment, the World War II brought about full employment and ended the depression. This came about without capitalist accumulation, and thereby, without a new economic upswing. Periodic crises have been conceived of as a part of capitalism. But the postwar boom happened when the confidence in the ability of capital to survive had been shaken. So, how could the appearance of the boom be explained? The Marxist theory of crisis explains it by saying that capital restored once more the link between profit and accumulation. The worldwide destruction of capital values and the changes in the structure of capital, together with the expansion of surplus values caused by technical improvements in the means of production allowed capital to achieve a rate of profit sufficient for capital expansion. Therefore, the boom was the outcome of a crisis situation in which a disproportionality could be seen between the creation of profit and the required accumulation. Here, state-induced production which compensated deficient demand was originally perceived as a limited measure and a temporary relief to overcome the depression until the next business upswing. In fact, public works and state economic management were adopted in the hope that capital would be able to create the circumstances necessary for a new economic upswing from its own resources.

However, the contradiction, inherent in the production of surplus value, would again appear here. That is, because of increased amount of capital invested in means of production, there is a reduction in the ratio of surplus value relative to total capital. Whereas the absolute amount of surplus value increases by accumulation, the same process of accumulation brings about a reduction in the rate of profit. This process comes to a point at which actual rate of profit would be too low to sustain the rate of accumulation needed for realizing even the surplus value produced. In this way, it could be argued that a boom, sooner or later, would change into a depression whilst later, through satisfying some specified conditions, the opposite will be the case.

But, bourgeois economic theory interprets all these ups and downs in a different way. It is so because price relations in the market, rather than production and production relations, are essential factors to be considered. Therefore, even if the state is to interfere with economy, it attempts to influence only market processes. In a Marxist approach, State intervention would fail to restore sustainable growth to economy. Indeed, under conditions of capitalist production, prosperity and depression constitute the contradictory characteristic feature of the development of the social forces of production.

In criticizing Keynes's theory, Fine and Murfin (1984 chapter 2) argue that according to his theory, the economic problem is to be interpreted in terms of deficient demand. This line of the perception of the problem determines the solution as one which regulates the level of demand so as to secure full employment. This task could be accomplished by changes in expenditure caused by the application of fiscal and monetary policy. Here, however, the political role of the State as well as the nature and direction of its intervention are important. Therefore, the details of the direction of the expenditure would be regarded as an insignificant issue from macroeconomic point of view and, consequently, would be considered merely as microeconomic policy.

Industrial policy, in other words, is regarded as merely subordinate microeconomics. It was Keynes's preoccupation with aggregate demand that led him to use the example of digging hole and filling them up. His only concern, in other words, is with the indirect effect on industry through the provision of effective demand. This is so while the other aspects of classical economics have remained unchallenged by Keynes. Specifically, the question of economies of scale and externalities which constitute major technical factors underlying State economic intervention could be mentioned.

3.6.2 ON IDEAS APPEARED IN INDEPENDENT STUDIES OF DEVELOPMENT THEORISTS AND SCHOLARS

Rosenstein-Rodan reminds us of the various obstacles in the path of development and explicitly acknowledges the need for an active participation of the State for a planned industrialization scheme.

Hans Singer is among the first prominent theorists who draws the attention to the baneful effects of the international division of labor and trade for the underdeveloped economies. He traces the roots of underdevelopment to international factors arising from the nature of modern technology (Szentes, 1984, p. 71). The assessment of this controversial issue, whether modern technology can be regarded as the root cause of underdevelopment or whether social causes should be emphasized, remains beyond the scope of this thesis. However, the remedy to overcome the problems highlighted by Singer, that is, unemployment of labor, shortage of capital, etc., in an era in which the market operations are dominated by the activities of transnational corporations with centralized systems of decision-making, must incorporate the active involvement of the State in managing the task of industrialization.

Nurkse rejects the spontaneousness of economic progress and denies the potentiality of automatic forces in accessing economic backwardness. He cites the initiatives taken by the Japanese State to substantiate how the deliberately organized intervention of the State, can overcome the difficulties of development.

Gerschenkron attempts to demonstrate that the new institutional instruments (mainly the State) distinguish the new models of industrialization from the old one.

Rodrik, in responding to whether the State should intervene in the economy, emphasizes the "insulation" of a State as a condition for an appropriate intervention. More clearly, he sees the need for a State which has been appropriately engineered in such a manner that it does not feel compelled to give way to any internal pressure. This Statist approach in analyzing political economy is not new. Effectively, this resurgence of interest in treating the State shows the frustration with the other extant approaches which have been adopted by the other scholars. One source of dissatisfaction emanates from the pluralist paradigm with a counterpart in the *laissez-faire* school of economics, which assumes perfect competition and believes in the invisible hand. According to Statists neither of these two conceptions is relevant since the government plays an active as well as an independent role in shaping a country's economy.

The other source of the Statists' dissatisfaction relates to the theories which view the officials as the prisoners of class interests (Marxist analysis) and the countries as captives of a rigid international hierarchy (dependency analysis). They argue that the State can take a position and play a role which may be beyond the mere interest of various domestic dominant societal forces or foreign dominant powers. However, even a Marxist stream, stemming from Marx's *Eighteenth Brumaire of Louis Bonaparte* (Marx, 1934) recognizes a State which enjoys "autonomy" from social forces. This may happen when a class powerful enough to enforce its will on the State is absent in the society.

In this approach there are some concerns which need to be dealt with. The argument presumes that the collectivities of State officials formulate economic goals and implement policies which are distinct from the demand of society. In the worlds of Skocpol (1985, P.5) "States... may formulate and purpose goals that are not simply reflective of the demands or interests of social groups, classes, or society. That is what is usually meant by "state autonomy". Unless such independent goal formulation occurs, there is little need to talk about states as important actors". Then, she suggests to investigate the capacities of States to implement their policies. "Pursuing matters further, one may then explore the "capacities" of states to implement official goals".

It seems that if the mentioned two elements – a State's autonomy (that is, having distinct goals and interest) and strength (that is, capacity to act) – are left aside, the Statist argument can not contribute to the clarification of matters (Chan, 1988, pp. 40-41). In other words, these *a priori* conditions to adopt a Statist perspective must be demonstrated rather than assumed. However, this demonstration is hampered if talking of State autonomy is not confined to its abstract form, but is taken as an issue to understand the real life problems. Putting the matter differently, "the" State will be typified in different alternative ways depending upon what issue one is interested in. Firstly, different degrees of autonomy leave different effects on the actions of different States. Taking any two different States of the developing world would clarify the point. Besides, even the autonomy of the same State would be different at different points of time. Comparing the situation of any country, say, some decades or a century ago with its prevailing autonomous situation, or the present situation of a specific country with its future will clarify issues. Secondly, a State may have different degrees of autonomy in different areas. One State may be less autonomous from another one in promoting private investment, but more autonomous in taxation. Therefore, the autonomy of a State is highly contingent on the country, the time period and the areas of policy one is interested in. Indeed, the shifting references turn the concept of the State to an elusive one, which faces the danger of being used vacuously as a universal explanation of a variety of institutional phenomena.

The other concern is questioning what the Statist approach precisely means by the autonomy of State. More clearly, whether a strong and autonomous State constitutes a sufficient, necessary or only facilitative condition for the task of capital accumulation, income distribution and the like. One can ask for example whether the differences in the developmental performances of two different countries may be attributed to the differences in the autonomy and strength of their respective States. If not, the answer should be sought in some other areas. And the conclusion would be that even if yet the State may be taken as an important entity, its role in, say, capital accumulation and distribution processes is only a facilitative one, crucial, but not decisive.

The last concern is that the assertions about autonomous and strong State should be regarded as the beginning and not the conclusion of Statist analysis. So, it seems necessary to search about motives and the consequences of the State's action.

Kornai's discussion on how a firm behaves facing budget constraint reveals whether a State could be classified as an autonomous one in the sense defined in the foregoing or not. More specifically, he discusses the case of a subordinate interventionist State (with a reference to a socialist economy essentially as a resource-constrained one) for a firm with soft budget constraint. Such an inefficient State, therefore, is unable to play any particular role in stimulating the economy at the macro level through following some specific targets. In other words, the objective of the State, through intervention, is reduced to the maintenance of the prevailing environment mainly by satisfying the financial requirements of the firms. It is typical of the limitations of a State which has recently come under fire as one even incapable of setting some priorities regarding aggregate output and employment conditioned by some bottlenecks as a consequence of the presence of a resource-constrained economic system. The State, then, is conceived as the chief reproducer of the constraints by the misallocation of resources.

3.7 REVIEWING THE CONTRIBUTIONS ON THE CASE OF IRAN

3.7.1 KARSHENAS AND ECONOMIC REFORM

In a contribution, Karshenas (1998), while reviewing the structural adjustment policies, treats the role of the Iranian government, though within a limited framework. In analysing the performance of the ill-fated economic reform and structural adjustment, embarked upon immediately after the end of the war, he states that the fundamental factors obstructing economic reform and growth in Iran arise from the internal conditions which developed during the last two decades of economic stagnation. Besides, a number of external shocks have aggravated the economic situation in Iran since the time of the 1979 revolution. The developments of the Iranian economy, however, have been shaped by the government's policy response to the weakening circumstances. In other words, though in a unique position to introduce the needed economic restructuring, the post-revolutionary government, through policy interventions during the 1980s, only added to the inefficiency and rigidity of the industrial construct left from the era of the old regime.

Instantaneously following the victory of the revolution, the government, introduced a nationalization program of a considerable part of the large-scale modern industry, and of the entire banking and insurance system. During the war period, the plethora of government controls in other economic spheres also increased, including the initiation of a system of rationing and direct subsidies for a large number of (up to 300) goods, foreign exchange controls and rationing, quantitative foreign trade restrictions, and controls in product market. Therefore, it could be said that the expanded role of the government was not stemming from a shift from private to public ownership, but as a result of direct interventions in the operation of markets, e.g. foreign exchange controls, maintenance of a system of multiple exchange rates, control over interest rates and bank credits and direct price control in a large number of product markets. Price distortions gradually emerged with a serious impact upon all economic activities. The disequilibrium and inefficiencies associated with the various economic controls forced the government to formulate a liberalization and restructuring program as soon as the war came to an end.

Karshenas, then, concludes that Iran's current economic crisis is rooted in the instability of industry, exchange rates, public sector management, and so on. Efforts to overcome these deficiencies have been unsuccessful since they have failed to go far enough. To tackle the challenges of reform, Iranian institutions and system of governance must change. In so doing, he makes some suggestions as follows.

In addition to restructuring the inefficient industrial enterprises, as a major prerequisite for economic reform, the government should spend additional funds on education, health, economic infrastructure, and other core economic activities. To finance the required spending of the adjustment program, the government has to increase domestic resource mobilization through reforming the taxation system. The separation of commercial and charitable functions of the semi-public charitable foundations, just to manage their productive assets according to commercial norms, is indispensable. In addition to that, an assessment of the commercial viability of the public enterprises has to be undertaken. Under a new comprehensive industrial plan, the renovation of key industries in line with the static and dynamic comparative advantages of the country should be helped. For the remaining enterprises, the net foreign exchange drains should be closed. Those which do not involve foreign exchange drain should be maintained in the medium term. The privatization of public enterprises may proceed as well.

Concerning labor relations, salaries need to be adjusted to the requirements of the market rather than being imposed by the government, as strict pay scales indexed to the rate of inflation. The latter is a problem while a rapid structural adjustment program is in action. Given the prevailing highly restrictive labor law in terms of hiring and firing of labor, a new and more flexible labor law should be introduced.

3.7.2 HASHEM PESARAN AND MONETARY GROWTH

Hashem Pesaran (2000) in reviewing the Iranian macroeconomic trends maintains that during the last two decades the economy has been subjected to both internal and external upheavals, disruptions and shocks. All these contributing factors have prevented the exploitation of its economic potential, nulltifying the attempts to take full advantage of domestic resources as well as the new opportunities emerging in the world economy as a result of rapid technological advances and the increasing globalization of the world economy. The adverse economic conditions (acute stagflation) stemming mainly from the revolutionary upheavals and their aftermath, were further aggravated by the regime's foreign policy adventurism with its adverse consequences for Iran's access to international capital markets, extensive nationalization of the entrepreneurial and the banking system, continued uncertainties over property rights and the role of the private sector in the economy, centralized and inward-looking government policies aimed at maintaining a highly over-valued official exchange rate through import compression, foreign exchange restrictions and generally interventionist economic policies with far reaching implications for resource allocations, particularly in the financial and industrial sectors. The result had been an economy in a state of acute disequilibrium with highly distorted prices signals.

To consider an example, Hashem Pesaran examines the monetary growth and inflation during the past two decades. While estimating an econometric model concerning money supply, he finds that, given the rather under-developed nature of the capital and bond markets in Iran, almost all financing needs of the public and private sectors are met through the banking system. Hence, credit expansion plays a decisive role in money supply growth, and therefore inflation. Although there are feedbacks from increases in money supply to credit expansion in principle, he believes that in the post-revolutionary Iran with a strictly regulated credit expansion and in the absence of a more active and timely interest policy, it is not the availability of funds (through increases in money and quasi-money) that determines credit, but it is rather the political resolve of the government and Bank Markazi (Central Bank) which determine the growth of credits and hence money supply growth. This implies that Bank Markazi must be able to control the economy's rate of credit expansion in order to control inflation. The task, however, seems to be complicated by political factors and the Bank's apparent inability to raise deposit or expected profit rates above the inflation rate.

In this way Hashem Pesaran concludes that in the final analysis the chief contributing factors in the excessive monetary expansion and inflation has to be found in the government's unwillingness to oppose credit demands of politically powerful groups (both inside and outside the government). In Iran these political considerations are more critical for the conduct of monetary and credit policies both because of the size and political importance of the semi-public enterprises, and the relatively non-responsive nature of interest rates to changes in the economy's inflationary environment. The inevitable consequence of lending money with low interest rates has led to excess demand for bank credit and credit rationing, leaving undesirable rent-seeking implications. In the realm of the controlled foreign exchange and trade policy, the existence of the enormous (over 2000 per cent) premiums on the black market rate led to gross distortions in relative prices. This, too, encouraged rent-seeking at the expense of productive activities, and masked large government subsidies to those consumers and producers who had easy access to the country's foreign-exchange earnings at the official rate.

3.7.3 RENANI AND DYNAMICS OF STATE

Renani (1998) in reviewing the dynamics of the State believes that the Iranian State, for some reasons, has increasingly played a decisive role in the economy. In fact, it has gradually turned out to be the vanguard in bringing in economic development. This characteristic feature of the state is revealed by the share of the budget in the gross national product which has been dramatically rising from next to two percent in the early years of the twentieth-century to over 60 percent just in the recent decades. The item which allowed this to happen was the rising oil revenues. This new income source allowed the State to remain unconcerned with the other sources such as customs duties and taxes which previously contributed as major parts of the budget.

Thus, the institutional development in Iran (i.e., increasing role of the State in the economy emanating from its socially-independent source of income) has left its impact in the form of the monopolistic power of the State, capable of imposing its economic will upon the society. This is shown by the fact that there has been a reduction in the share of the State's complementary[2] developmental activities in the total (complementary and substitutive)[3] developmental activities from the mid-twentieth-century. Arithmetically speaking, it witnessed a downward trend, from 0.286 in the late 1940s to 0.150 in the late 1990s. The State thus has been perpetually moving away from an indifferent State (keeping a low profile on economic activities) to an interventionist State (with a huge role in the economy).

The Iranian State, it is argued, may be analysed in the context of public choice theory. Here, the politicians and bureaucrats enjoy enough power to pursue their own interests. Consequently, they have attempted to allocate the budgetary resources for the substitutive activities just to maximize their power domain. Moreover, they have done so since rent-seeking and free-riding is more plausible in the substitutive activities than in the complementary ones (to see the difference, just compare the rent-seeking in the establishment of firms and mines as opposed to the extension of the judiciary).

Then, Renani concludes that given the decreasing trend in oil revenues and the inefficient structure of the administration, on the one hand, as well as the deep impact of globalization and technological advancement, on the other, the State has no other way but to restructure itself and initiate new directions for its development plans. In doing so, the State should leave the substitute activities to

[2] Complementary activities constitute those which are classified as the public affairs in the Iranian budgetary context. They are activities whose output is utilized both by firms and the State as complementary inputs in the production process. They play such a substantial role that their lack would lead to the stoppage of the functioning of firms and the State. Judiciary, preserving law and order, providing technical services, transportation and mass communications, etc., are classified as complementary activities.

[3] Complementary and substitutive activities comprise all activities which are grouped as economic, social and public (excluding defence) affairs in the Iranian budgetary context.

the hands of the firms as much as possible and then conduct the activities which are complementary rather than substitutive. In this way, firms will have more room to move and the State will get involved in more supportive activities.

3.8 CRITICISM OF THE REVIEWD CONTRIBUTIONS ON THE CASE OF IRAN

Work on the Iranian economic issues is generally characterized by a corpus of descriptive studies empirical research with extensive application of econometric techniques, fieldwork, etc. There is no doubt about the merits of such works. However, whilst they benefit the reader by providing a better comprehension of facts, these studies fail to add much to his/her knowledge of explanations. Or, they rarely render a complete picture of the totality of the underlying economic, political and ideological factors, and the struggle of social classes and fractions underlying the evolution of modern Iran. "The literature on Iran is also marked by diverse and conflicting theoretical perspectives, concepts and categories, many of which are wholly inappropriate or of questionable validity" (Moghaddam, 1984, p. 227).

Some of the accounts under criticism here suffer from those limitations, and are also marked by internal inconsistency. Nili et. al., reviewed in the preceding chapter, are one example. Despite their belief in a neo-liberal State, when they describe the prevailing economic situation or depict the ideal-type State, they slip into other competing theories, giving rise to an eclecticism of approach. Karshenas's contribution is another example. As he urges the government to carry out "a comprehensive industrial plan", he simultaneously promotes privatization and liberalization schemes and makes suggestions for a reduction in the sphere of State activity. Such activity, he suggests, should be limited to core (infrastructural) economic activities which is the role undertaken by a neo-classical State. The implementation of such a comprehensive industrial plan must be premised upon a State with fully-fledged power and potentialities. Obviously the vision of such a State is in stark contradiction with the notion of the State in an economic adjustment program. Such a program leaves the State, from a theoretical perspective, with no justification, and, from a practical point of view, with no vehicle for interference. Therefore, a clear comprehension of the argument is not possible. Let us, however, leave aside all this and attempt to comprehend his implicitly-stated perception of the role of the State in the economy.

Karshenas views the lack of sufficient growth as the main challenge of Iranian economy. Observing the government's policy response, both in the preexisting structures of the economy and under the new institutions, he puts forward his ideas on the economic reform of the State in the context of the structural adjustment policy. This policy has been formulated from late 1980s and implemented to a certain extent. Besides the lack of any new idea in his contribution concerning the reform of the economy, he limits himself to criticizing the way the government intervenes in the economy and, then, puts forward some suggestions to move the reform policy far enough. He, however, never clarifies why the reform has not been sufficiently far-reaching and the goals have not been achieved, even though all his main ideas have been pursued, and have been obvious to policy-makers in Iran. More specifically, he suggests that the Iranian institutions and systems of governance must change. Since the change in those institutions and systems was itself among the goals of the reform plan, this question could be asked why that goal failed. He, in fact, seems to neglect the nature and the capacity of the State in pushing forward the reform program. He expects the State to change its policies just to move forward the already ill-fated economic adjustment policy.

In Karshenas's contribution, the unsuccessful efforts to overcome economic deficiencies have been regarded as being rooted in the failure to go far enough. However, if this is the "reason" for failure, then, no attempt has been made to discover what the "causation" was. In fact, he neglects to include the underlying factors which impeded the adjustment program. But, if placing emphasis upon the implementation of the unfortunately policies is not worthless, it by no means points the way towards overcoming the difficulties. Therefore, the question why the policy could not go far-enough remains relevant but unanswered. For instance, he has no answer to the lack of success of the taxation reform. He hesitates to raise any question about the State per se. Actually his expectation of the government to change its policies just to overcome the shortcomings implies that he regards the will of the State as the only underlying factor involved in transforming deficiency into a success. In this way, effectively, he views the State as an "autonomous" entity.

The analysis of Hashem Pesaran clearly reveals that he sees the State completely as an interventionist subordinate entity under the heavy pressures of various interest groups. He sees the Iranian economic problems as emanating from political decisions, whether the revolutionary upheaval itself or its consequences such as extensive nationalization and centralized government policies concerning economic variables. Those political factors, according to him, lead to an acute disequilibrium in the economy. Such political decisions are taken under pressure from the politically powerful groups, with the State unable to oppose their demands. In fact, the weak State, incapable of overcoming any single group, remains subordinate to them and inevitably distributes subsidies, say, in the form of low interest rate loans, to the vested interests. This has rent-seeking implications.

Although his analysis uncovers how a weak government serves the vested interest groups through transfers and subsidies, the argument takes mainly a descriptive form which attempts to explain how a government fails to formulate policies independently from interest-groups concerning economic development. Putting it an unincorporated part (i.e., the State) which lacks any conjunction with the other characteristics of the society, would always be misleading. Instead of scrutinizing the underlying grounds of the development of a phenomenon, we concentrate here on some other minor or secondary. In the account being criticized, the egoism and self-seekingness of bureaucrats, built up by the increasing oil revenues, rather than the requirements of a capitalist development have been conceived as the main causes of the State interference.

Setting aside the said requirements, the emphasis merely upon the will of bureaucrats is due to the failure to incorporate the despotic nature of the regime into the analysis. In other words, the neglect of the political causes of the developments would marginalize some determinant elements which underlie the misbehaviour of the politicians and bureaucrats. If the function of a system remains closed to the public, and the civil society gets deprived of vehicles to monitor it, each and every single State, sooner or later, would develop the totalitarian tendencies which undermine public supervision. Therefore, establishing a political economy approach, without politics would bring out a deficient and misleading analysis.

Interestingly enough, Renani (2001) considers the point that the higher officials expect the theoreticians, not to criticize or revise but only, to justify their dreams and policies. If it is true, then the same higher officials would desire nothing but the obedience of bureaucrats as well. So, here, analysing the political process becomes of considerable importance. However, there are ways and means to control the realization of bureaucratic self-interest through overprovision of public goods or services. Institutional developments such as establishing certain criteria to recruit bureaucrats, the auditing of expenditure, the superiors' directives and the bureaucrats' science and conscience are some examples of ways of imposing constraints on the bureaucracy.

The other point is that the self-seeking is not the sole characteristic which may be attributed to bureaucrats. They regard themselves as the guardian of the national interests, however defined, and attempt to realize it. Hence, this genuine tendency of those who are not mere materially-oriented bureaucrats is ignored if we focus only on self-interest.

It can be concluded that reviewed contributions attempting to explain the role of the State in the Iranian economy do not reveal much about how the state intervenes in the economy. The fact that these analyses hold some truth does not mean that they are sufficient to reveal the entire gamut of interaction of State decision with the economy.

CONCLUSION

The foregoing critical review of the arguments favoring State intervention reveals how the State is often envisaged as omnipotent, and capable of taking care of development obstacles. Hence, no need was felt to discuss the nature of the State or the socio-political conditions under which the state-directed initiatives would take place. It seems that the comprehension regarding the need for a vehicle, other than self-regulated market mechanism, to vanquish the problems mentioned above was a step forward. However, sooner or later, social realities, mainly in the post-colonial societies, showed that treating a State in such a blanket form, whilst neglecting to include the analysis of its components, would be insufficient. A more detailed analysis of the structure of State is needed, as is a State which is altogether more radical.

CHAPTER 4

TOWARDS AN ALTERNATIVE PERSPECTIVE ON THE ROLE OF THE STATE IN ECONOMIC DEVELOPMENT

INTRODUCTION

The preceding chapter, sought to review critically the role of the State in Keynesian theory. Then, some case studies about the role of the State in the economic development of Iran were discussed. Having concluded that there were some deficiencies in the theoretical approach as well as in the case studies, we will move on in the present chapter to study the radical approach towards the role of the State in the economy. Following the review of the relationship between State and society, a preliminary attempt will be made to justify theoretically some tasks of a radical State in a transitional society. Subsequently, some contributions concerning the Iranian State from a radical point of view will be critically examined.

4.1 THE CLASS-MEDIATION VERSUS THE CLASS-DOMINATION THEORIES OF STATE

In the preceding chapter we concluded that the modern liberal theorists tend to visualize the State as an institution which is above society and disarticulated from its structure, serving the interests of the totality of society and mediating the social antagonisms. Such theories suffer from some shortcomings whose recognition leads one to consider theories with, broadly speaking, a radical orientation. It is, in fact, a critique of the class-mediation conception of the State as well as the acceptance of the interpretation that the State is not an independent structure above society, but is deeply embedded in the total social processes, which produce the marked contrast between the liberal and radical theories of the economic role of the State.

The class-mediation theory is premised upon the immutability of the system of property relations, exactly like the order of nature. In answering how the various classes arrange the things among themselves, it comes to the necessity of an institution which is powerful enough to mediate the conflicting interests. The State, in the real word, is the counterpart to that theoretical construction.

The weakness of such a theory lies in its main assumption – that is, self-maintaining class structure of society. A glance at history reveals the superficiality of this assumption. The lesson could be easily drawn from history that as different forms of property relations associated with their concomitant class structures have followed one another, there is no reason to assume that such developments would be stopped in the future. It will be so clear if we remember that the class structure of society, as a part of past social developments, has no root in the natural order of things. Sweezy (1942, Chapter XIII) puts that prior to the question posed by the liberal theory on how various classes, in a given class structure, will manage their conflicts, some other question should be asked which is as follows. "How did a particular class structure come into being and by what means is its continued existence guaranteed?" (p. 241). An attempt to answer this question will lead one to a function of the State which appears to be prior to what the liberal theory assumed.

Given a certain class structure of a society, an institution capable enough to enforce violence so as to maintain such a set of property relations between owners, on the one hand, and the owned and non-owners, on the other, happens to be essential. It is, effectively, the State which enjoys such an exclusive power to the fullest degree; the one which gives the State the characteristic to be regarded as the guarantor of a given set of property relations. This way of looking at State will lead one to answer the question concerning the origin of the State in a peculiar way. In so doing, it is argued that the State is nothing but the product of a long struggle in which the class that possesses the key means of production will form a State in order to enforce the set of property relations which serves its interest. Alternatively, the State is the child of the dominant economic class. As soon as the historically untenable assumption of the natural or self-enforcing characteristic of the class structure of society is dropped, no other justification for where the State comes from would be acceptable. It seems clear that if the State power was possessed by the disadvantaged classes, it would be undoubtedly used to establish an alternative social order so as to take care of their own interests. Sharing of State power among various classes will ultimately bring out a State which holds the conflict in itself.

The argument just cited, connotes the underlying idea of the so-called class-domination theory of the State which is regarded as an alternative to the class-mediation theory (Ibid, p. 243). While, the latter takes a certain class structure for granted and considers the State as the institution for reconciling the conflicting interest of the various classes, the former identifies the social classes as the product of historical development and views the State mainly as the instrument belonging to the ruling classes to guarantee the stability of the class structure. It follows that as far as capitalist society, in which producers are deprived of owning their means of production - as opposed to a simple commodity-producing society where producers possess their means of production - is concerned, the protection of private property is identical with preservation of class domination.[1]

4.2 THE STATE AS AN (ECONOMIC) INSTRUMENT OF CLASS RULE: TWO VIEWS

The approach that the State is an instrument of class rule can be assimilated to economic reductionism if one assumes that the economic base determines, on the one hand, the balance of political forces in the struggle for State power, and on the other, the institutional form of the State as an instrument over whose control political struggle is waged. But, the approach can be developed in another direction so as to regard the independent role of political

[1] Just to avoid probable misunderstanding, we would like to add the following note. The idea of interpreting the State as an organization to preserve private property was by no means the initiation of radicals including Marx and Engels. In contrast, this idea was the main concern of political thought from the disintegration of feudalism and the beginning of the modern State. In fact, they were Bodin, Hobbes, Locke, Rousseau, Smith, Kant, and Hegel, among many others, who identified this task of the State. They believed in the institution of private property as the necessary condition to realize the personal freedom. On the contrary, Marx and Engels commented that to expand the domain of that freedom to include everybody and, also, to prevent the use of private property as a means of exploitation, *Private Property, on the basis of the completion of certain definite historical conditions, has to be abolished* just to achieve a classless society (Sweezy, 1942, p. 244).

action in the transformation of economic base and the conduct of class struggle. Thus, it seems essential to examine the instrumentalist thesis from the viewpoints of Marx and Engels as two leading figures in the context of the radical discourse.

In its least developed form, the instrumentalist approach simply means that the State is an instrument of coercion and administration rather than being an independent and sovereign political subject. In other words, this way of looking at State and the interpretation of politics that the form of the State is a reflection of the economic base of society and the way the State intervenes in the economy is a reflection of the needs of the economy and/or of the balance of economic class forces has been developed by Marx and Engels in *The German Ideology*. In the chapter on Feuerbach, they write about the relation of State and Law to Property as follows: "the modern State, which, purchased gradually by the owners of property by means of Taxation, has fallen entirely into their hands through the national debt, and its existence has become wholly dependent on the commercial credit which the owners of property, the bourgeois, extend to it, as reflected in the rise and fall of state funds on the stock exchange. By the mere fact that it is a *class* and no longer an *estate*, the bourgeoisie is forced to organize itself no longer locally, but nationally, and to give a general form to its mean average interest. Through the emancipation of private property from the community, the State has become a separate entity, beside and outside civil society; but it is nothing more than the form of organization which the bourgeois necessarily adopt both for internal and external purposes, for the mutual guarantee of their property and interests. The independence of the State is only found nowadays in those countries where the estates have yet not completely developed into classes, where the estates, done away with in more advanced countries, still have a part to play, and where there exists a mixture; countries, that is to say, in which no one section of the population can achieve dominance over the others. This is the case particularly in Germany.

The most perfect example of the modern State is North America. The modern French, English and American writers all express the opinion that the State exists only for the sake of private property, so that this fact has penetrated into the consciousness of the normal man."

"Since the State is the form in which the individuals of a ruling class assert their common interests, and in which the whole civil society of an epoch is epitomized, it follows that all common institutions are set up with the help of the State and are given a political form. Hence the illusion that law is based on the will, and indeed on the will divorced from its real basis - on *free* will. Similarly, justice is in its turn reduced to statute law" (pp. 77-78).

The same view about the relation between state and ruling class could be found in their other works as well. Marx and Engels in *The Manifesto of the Communist Party* (1848, p. 486), while discussing the development of bourgeoisie, note the following. "Each step in the development of the bourgeoisie was accompanied by a corresponding political advance of the class.... [T]he bourgeoisie has at last, since the establishment of modern industry and of the world market, conjured for itself, in the modern representative State, exclusive political sway. The executive of the modern State is but a committee for managing the common affairs of the whole bourgeoisie"[2].

Marx and Engels emphasize that the independence of the State from the dominant class is illusory. In fact, the ownership of property determines political power and the State's claim in representing the general interest is negated due to the presence of social classes. In other words, the interests of the dominant class (bourgeoisie) is

[2] Having said all that, it is interesting to note that not only "Marx never worked out a systematic and formally complete theory of the State" (Sweezy, 1942, p. 239), but also while in the early 1840s Marx was involved in political journalism and his critique of Hegelian framework to show the need for the abolition of private property and the abstract State, in contrast Engels proceeded to pave a different theoretical path. Based upon his understanding of political economy, it was, in fact, Engels who anticipated the Marxian class theory of State. Therefore, he wrote his *outlines of a critique of political economy* as well as some articles on the social question in England (Jessop, 1982, Chapter 1). Moreover, it is believed that "Marx left a thoroughly ambiguous heritage, never fully reconciling his understanding of the State as an instrument of class domination with his acknowledgement that the State might also have significant political independence" (Held and Krieger, 1984, p. 1).

maintained and served in the name of the general interest. The State treats the civil society as if considerable differences of interest were absent. In doing so, it masks the exclusion of some classes from the political power, on the one hand, and, articulates an ideological distortion, on the other. Held and Krieger (1984, chapter 1) mention that the idea of defining the State as a site of autonomous political action was progressively overshadowed and class power became the major concern. However, it, by no means, negates the position that the State may be independent of sections of the dominant class. This independence is confined to the conflicts between fractions of capital, and between domestic capitalism and international capitalist markets.

At its most extreme, the previously noted theme implies that the State is a pure reflection of the economic base without any reciprocal influences. Such a formulation, however, has not been expressly declared by Marx and Engels. They attempted to argue that different modes of production determine different forms of state as well as state intervention. Despite their argument that the correspondence between base and superstructure was a general rather than a narrowly-concerned rule, simple economism and complex forms of economic reductionism have been widely adopted. Needless to say, the ideas associated with an exclusive and one-sided emphasis upon economic determinism which, in fact, believes in ultimately self-sufficiency of the economic base and the determinant role of its spontaneous development in social evolution suffer from some theoretical problems. The failure of political action in altering economic base and or the nature of class relations until it is permitted by economic factors is just one example.

In developing the instrumentalist approach, further than implying that political class struggle is a reflection of economic conflict between capital and wage-labour, Marx and Engels frequently point out many complexities stemming from the presence of other social classes. This would be evident as the general theory of class struggle offered in *Communist Manifesto* is compared with the concrete historical analysis provided in their work on France, Germany and England. "In the former we find a general account of the progressive polarization of class forces consequent upon the consolidation of the capitalist mode of production and a paradigm of the gradual but inevitable transformation of narrow, localized economic class struggle into a broad-ranging, unified political class struggle to wrest control of the State as instrument from the ruling bourgeoisie. In the latter we find a wealth of descriptive concepts specific to the political class struggle and its various modalities and a whole series of attempts to grapple with the conjunctural specificity of the struggle for State power. Thus Marx and Engels discuss the relations obtaining among different class fractions, the role of class alliances, the role of supporting classes such as the smallholding conservative peasantry and the Lumpenproletariat, the relations between classes in charge of the State and economically dominant classes, and so forth.... They [i.e. Marx and Engels] also examine the role of political parties in the representation of class interests in the struggle for control of the State apparatus and compare it with the effects of Bonapartism and other forms of executive rule. In short, at the same time, as their analyses of political class struggle reveal the complexities of state power, they also affirm the importance of that struggle in securing control of the State apparatus and shaping its operation. This lends further credence to the instrumentalist approach" (Jessop, 1982, p.13). Subsequent discussions among Marxist writers engaged in theoretical combat reveal that instrumentalism is not the most adequate approach to a Marxist analysis of state (Ibid. p.15).

Close examination of the work of Marx and Engels indicates that the problems associated with instrumentalist approach are as follows. Firstly, the uncertainty arising from the metaphors rather than more extended concrete analyses in the formulation of instrumentality of state. Secondly, the difficulty associated with explaining different forms of the State. While they explain the different forms of the State in terms of change in economic base and/or in the balance of class forces, however, such solution, however, can not match the view that State is a neutral instrument. Thirdly, taking the State as a simple instrument of class rule, it is necessary to explain how the dominant mode of production is reproduced when the economically dominant class does not occupy the key positions in the State system. The special case of this situation is when there is a temporary equilibrium in the class struggle and the State apparatus is independent from dominant class. The Second French Empire under Louis Bonaparte facing a temporary equilibrium between a declining bourgeoisie and an ascendant proletariat is one example provided by Marx himself (Ibid, p. 16).

Clearly, Marx's idea in *The Eighteenth Brumaire* indicates a departure from his earlier works. The State, here, has a capacity to impress the power of the bourgeoisie. In his own words "[w]hile the *Parliamentary Party of Order...* declared the political rule of the bourgeoisie to be incompatible with the safety and existence of the bourgeoisie, by destroying with its own hands in the struggle against the other classes of society all the conditions for its own regime, the parliamentary regime, the *extra-parliamentary mass of the bourgeoisie,* ...invited Bonaparte to suppress and annihilate its speaking and writing section, its politicians and its *literati*, its platform and its press, in order that it might then be able to pursue its private affairs with full confidence in the protection of a strong and unrestricted government. It declared unequivocally that it longed to get rid of its own political rule in order to get rid of the troubles and dangers of ruling" (Marx, 1852, pp. 172-3).

It could be concluded that at least two strands in Marx's account concerning the relation between state and social classes may be distinguished. The first position emphasizes the distinct sphere of the State in the society which need not be linked to or controlled by certain interests. Therefore, the State gets a centrality in the society.

The second strand is the dominant position which sees the State as the class instrument emerging to coordinate a class-divided society in the interests of the ruling class (Held and Krieger, 1984, p. 4).

4.3 TOWARDS A RADICAL THEORY OF STATE INTERVENTION

The protection of the private property is not the only concern of the State. It fulfills several other functions, which, however, remained implicitly recognized by Marxist writers. Therefore, this point has received little attention in the discussion of the theory of State leading to the neglect of the State as directly economic instrument. As Sweezy (1942, pp. 244-545) puts it, "[t]he fact that the first concern of the state is to protect the continued existence and stability of a given form of society does not mean that it performs no other functions of economic importance. On the contrary, the state has always been a very significant factor in the functioning of the economy within the framework of property relations which it guarantees. This principle is generally implicitly recognized by Marxist writers whenever they analyse the operation of an actual economic system, but it has received little attention in discussions of the theory of the state. The reason for this is not difficult to discover. The theory of state has usually been investigated with the problem of transition from one form of society to another in the foreground; in other words, what we have called the primary function of the state has been the subject of analysis.... Consequently, the theory of the state as an economic instrument has been neglected".

For the very reason that Sweezy provides, in this part of the present chapter, we would like to discuss some of the economic roles of the State which are of considerable importance in smooth functioning of the economy. Therefore, what follows may be regarded as the least or some of the basic elements of the State intervention in the economy so as to transform the society a step further in the direction of any ideal society in which the State is justified and legitimate to fulfill more tasks in the line with responsibilities of a radical state. More specifically, what would come in the following, is just a preliminary attempt to provide a theoretical context in which a radical State can vindicate its tasks in a transitory society, or as may be called an emerging economy. However, before proceeding on that, we need more clarification.

4.4 COSTS AND THEIR BROAD DOMAINS

In the second chapter of the present thesis, the point was extensively discussed that the central concern of the neo-classical theory of economics is the realization of allocative efficiency. It is in this framework that market failure is studied since as soon as it happens, a part of the welfare on which the theory was premised, is lost. The remedy for market failure is allegedly State interference. This remedy is theoretically accepted since welfare economics assumes that there is no real cost for society arising from State intervention. But, is that so? In reviewing the government-failure literature, we demonstrated that such is not the case, but rather State intervention is a costly activity.

The genesis of the hypothesis costless State intervention in the realm of welfare economics emerges from the very definition of economics itself which may be found in any textbook. In the following we will refer to a couple of them. "In Stigler's words [1942], "Economics is the study of the principles governing the allocation of scarce means among competing ends when the objective of allocation is to maximize the attainment of the ends"" (quoted from Dewett, 1958, p. 5). Also, according to Robbins [1931], "Economics is the science which studies human behaviour as a relationship between ends and scare means which have alternative uses" (quoted from Ibid, p. 3). What is missing in such definitions, is cost. A glance at the chapter on Costs and Production in Stigler's Theory of Price (1942) reveals the point that what is discussed as the costs of production is nothing but costs directly involved in the process of material production. In other words, the fact is neglected that "a significant portion of economic costs are made up of the costs of actually allocating resources between production units and managing the production process within the production units.... From this point of view, the costs of actually producing goods... are not the only costs of our economic life" (Chang, 1996, p. 47).

Interestingly enough, and contrary to the usual definitions provided for economics, when the same definition is discussed from the state's point of view, not only underlying cost, but also even "waste" is considered. "From the point of view of the state, Economics may be defined as the "study of those principles on which the resources of a community should be so regulated and administered as to secure the communal ends without waste". (Wicksteed)" (quoted from Dewett, 1958, p.5). And, since state intervention in the real life is costly, seemingly, according to the noted definition, such costs should be regarded as "waste".

Recently, however, the costless economic activities argument – excluding costs associated with activities other than material production – has been challenged. Put differently, it is argued that not only production but also resource allocation involves some costs. In this connection, the costs associated with the resource allocation in the market economy (i.e., market transaction is not costless) as well as the costs associated with the process of resource allocation by State intervention (i.e., State allocation of resources is not costless) are the two costs which may be mentioned. These costs nowadays are known as transaction costs.

4.5 TRANSACTION COSTS

Generally speaking, transaction costs emanate from properly rights. In other words, they are the accompanying parts of decentralized ownership rights, private property and exchange. In a collectivist economy, in which the decisions are made centrally, administrative costs will substitute transaction costs. In modern economies an increasing portion of resources is allotted to transaction costs. Nonetheless, up to the Second World War the economic theory was silent about them. Therefore, all the literature which could be found for transaction costs, with whatever analytic complexities, has been developed only over the recent decades.

Transaction costs embrace a set of heterogeneous inputs. To conclude a contract, the parties have to find each other so as to communicate and exchange the necessary information. The description, inspection, weight and measurement of the goods, consultation with lawyers, transfer of title, keeping the records and the possibility of taking legal action, all are costly issues included in transaction costs. All these costs are incurred for the purpose of reducing uncertainty. "For many purposes it may nevertheless be an efficient research strategy to proceed *as if* transaction costs occurred even under full certainty. Transaction costs then become, as Stigler (1967) put it, 'the costs of transportation from ignorance to omniscience' " (Niehans, 1987, p. 676).

Having had the definition of the transaction costs, it could be argued that the costs associated with the State interference with the economy may be classified as some sort of transaction costs. In the second chapter of the present thesis, while reviewing the government-failure literature, we pointed out the problems involved in such intervention and the associated costs which were imposed upon the economy. In fact, it was argued that the literature believes in two sets of problems which create their associated costs, namely, the informational costs and rent-seeking costs. It was further argued that there are ways and means to reduce the costs. The problem of the government-failure literature, as noted earlier, is that it theoretically believes in costlessly running of the economy, an assumption that does not hold in the real world. In a race in which a costless ideal market is compared with a costly real State, the former will no doubt, supersede the latter. The failure of such a wrong comparison would be obvious as soon as the intervention and market transaction are viewed in the real world. If this is the case, the right comparison, as opposed to what the government-failure school does, should be between the costs of resource allocation through market transactions, on the one hand, and, the costs of resource allocation through State intervention, on the other. This way of treating the problem poses the real question which is in fact the nub of the matter and the locale of conflict. That question is the following. Under which mechanisms – i.e., State allocation or market allocation – the same level of allocative efficiency may be achieved at a lower cost? If this question is answered convincingly in favour of State, the way would then be paved for the consideration of a role for the state which would be challenging the exclusively market-favoured arguments associated with conventional economic theory. Let us regard what responsibilities a radical State can undertake in this line.

4.6 SOME RESPONSIBILITIES OF A RADICAL STATE

4.6.1 REDEFINING THE PROPERTY-RIGHTS

A well-defined as well as effectively enforced property-rights system is seen as saving transaction costs and has been regarded as an important role of the state in various strands of economics. In this regard, North (1981, p. 21) maintains *"a state is an organization with a comparative advantage in violence*, extending over a geographic area whose boundaries are determined by its power to tax constituents. The essence of property rights is the right to exclude, and *an organization which has a comparative advantage in violence is in the position to specify and enforce property rights"* [emphasis added]. While, theoretically there is no need to regard the state as the exclusive provider of a well-defined and effectively enforced property-rights structure, however, the legitimately monopolized access of the state to use of violence denotes the possibility of considering the state as a cost-effective agent to do so. "Since there are economies of scale in providing these services [i.e., protection and justice], total income in the society is higher as a result of an organization [i.e., a State] specializing in these services than it would be if each individual in society protected his own property" (Ibid., p. 23).

At the first glance, such an argument offered in the foregoing, may seem to share enough commonalities with neo-classical view leading to be considered under a single perspective. But even if there appears to be such similarities, we would like to emphasize that we take issue with the matter in the context of a radical perspective. In other words, we refuse to accept the simplified notion of property-rights which confines all that to what exists in the neo-classical analysis of market. However, to justify such an extension in the property-rights system, we need an alternative theory. Let us be clearer.

To begin with, we remind that the mainstream discourse on the role of the State is about whether the State intervention can improve upon the working of the free market. The reason is that the neoclassical analysis is mainly premised on the market primacy assumption.

We would argue that, owing to the limited scope of this argument no meaningful conclusions can be drawn about state intervention, even though some interventionist models within the neo-classical context may be built to justify certain types of State interference, as indeed has been the case. Put differently, without changing the definitions and therefore the context, even the attempts of those critics who seek to find the resolution of the problems of the economy in State intervention would be futile. We will argue that the assumption concerning the privilege of market over any other non-market institution is totally false, and in the neo-classical context the definitions of the free market, and therefore that of State intervention, are problematical. Thus, an alternative theory is needed for justifying State involvement. It is only in that case, i.e., providing new argument as well as environment for State involvement, that some radical, including redistributive, tasks for the State will be conceded. Let us emphasize here again that the reason for the failure to find a meaningful approach to the problem in the neo-classical framework is that the discourse per se, owing to the highly complicated definitions of market, and therefore State intervention, is problematical (Chang, 2002, p. 542).

The neo-classical discourse begins with this view that the problem of distortion in the market has been created by State interference. Moreover, it regards the bureaucrats and politicians as self-seekers who are endowed with limited capabilities for in running the State. Hence, its proposal to solve the said difficulty (i.e., the distortion) is the following: depoliticize the economy and, under the existing pattern of wealth distribution and without any redistributive attempts, leave every thing to be determined through a politically-independent entity – i.e., the market. In fact, the neo-classical theory regards the State as a political entity, which in fact is, and, consequently, views State involvement as an unreasonable politicization of the economy. Now, if the initiated remedy is "depoliticization" of the economy, the question may be posed here whether the market itself is not a political construct? Once, in an intellectual attempt, a positive answer to this question has been established, it will be revealed that neo-classical proposal (for depoliticizing the economy) could not be regarded as an accurate one. Having established that, the ground would be paved to design an alternative perspective in which State engagement, including redefinition of the property-rights structure, would be vindicated. To respond to the question, we may begin our analysis with the main issue under our consideration – that is, the property rights (Ibid., p. 549). Effectively, as noted, if we can theoretically prove in the following that the functioning of market, similar to that of State, is a politically-motivated act (as we have historically demonstrated in the first chapter of this thesis), then we may argue that the existing distribution of property rights (even though established under market mechanism) is also a political issue and can be regarded no more valid under an alternative political environment. This argument will provide enough legitimacy for a radical State to interfere in the economy through redefining the property rights and with a redistributive agenda.

In the neo-classical tradition, the establishment and the distribution of property rights for the participants of the market, is easily regarded as given. But, we claim that it is a highly politically involved issue, and furthermore, even the rights-obligations structure itself has been always subjected to severe changes. In the second chapter of this thesis, the nature of the property rights has been briefly reviewed and here we would just add that in the most extreme case property rights have been redistributed through the means of politics, including corruption, theft and violence. The case of privatization, which is routinely going on in many developing countries, is the other example of the involvement of politics (and, to be sure, a corrupted one) which ultimately constitutes and defines the endowments. The review of the history of the advanced countries indicates that the same rights which are now regarded as basic and unquestionable, have been severely denied during long centuries. The right to self-ownership, the right to minimum working hours, the right to organize, etc., constitute just a part of the previously refused rights. In the first chapter of the present thesis we have explained how the maximum wages were fixed for agricultural labours and even how the right of choosing the desired job- i.e. transferring from agriculture to industry, was defined for the Poor in Britain in the fourteenth-century through Labour Laws.

The recent developments, such as campaign against environmental pollution, while being regarded as a legitimate issue, are also politically-motivated ones with certain economic outcomes. These are considered as new rights reflecting the fact that the political struggle to change the rights-obligations structure is still valid. "Thus

Furthermore, the effects of various regulations such as safety, pollution and import contents on product markets reveal the impact of politics upon interest rates which indeed may be regarded as expressing in a stark form a fact about the price system in general.

4.6.2 CONDUCTING (CONSTRUCTING) A NATIONAL ECONOMY

If what was noted in the foregoing – that is, all prices directly or indirectly are politically determined ones – is true, which indeed is, then the whole argument of "get the prices right" remains meaningless. Besides, there will be no more logical reason for conducting a fashionable structural adjustment policy just so as to overcome "price distortions". This idea, implicitly drawn from the previous one, in fact, provides another responsibility for a radical state. Such a state, while placing itself in a national framework and as rejecting fallacious positions on free trade (Patnaik, 2003a; Shafaeddin, 2003), will attempt to reconstruct a modern socio-economic structure. That national framework is the one which plays a historically progressive role and informs freedom struggles – i.e., is anti imperialist, democratic, inclusive, with an agenda of emancipation of the people through an improvement *inter alia* in their material living conditions (Patnaik, 2003b).

4.6.3 REDUCING THE INSTABILITY AT THE MACRO-ECONOMIC LEVEL

The other role which has to be played by a radical state so as to fulfill its minimum commitment is to reduce the instability at the macro-economic level through aggregate demand management. Instability in the economy will, in fact, divert resources to channels in which micro level rational calculations may not necessarily be in line with the macro level rational calculations. This will increase not only the production costs, but also the transaction ones.

The most obvious example is the exorbitant amount of resources spent under uncertain circumstances just to safeguard the contracts concluded among parties. Richardson (1972) maintains that the firms are not islands of planned co-ordination in a sea of market relations, but rather they are linked together in patterns of co-operation and affiliation. The essence of co-operative arrangements is the fact that the parties accept some degree of obligation and therefore give some degree of assurance regarding their future act. However, there are variations in the scope of assurances and degree of formalities. A trading relationship between two partners which is stable enough to facilitate production and give a clear picture of future demand, is the simplest form of co-operation. The stability may be attained from goodwill or from formal arrangements such as long-term contracts and shareholding. Although proceedings such as appropriate investment and organizational decisions give no formal assurance, the behaviour itself provides enough reason for the partners to believe that they can rely on future relations. In this case there would scarcely be any need for formal specification and the function of goodwill, behaviour and reputation makes any other costly arrangements unnecessary. Here, the State may play a considerably important role in bringing in a favourable atmosphere concerning the future stability of the business.

The unstable conditions in which the firms expect some changes in prices is another example which may divert the resources to unproductive ways. Under such circumstances they decide whether or not to hold cash balances (or even inventory) as an alternative way of holding wealth (investment) (Patnaik, 2005). This sort of decision making not only has a considerable impact upon production costs, but it also implies that the time consuming procedure to find the right and convincing environment gives rise to transaction costs. Once the State succeeds in establishing stable macro-economic conditions, the said costs will reasonably decrease which results in to a boost to economic growth.

a State with its motivated agents intervene in the economy, but also it must fulfill its other related task – i.e., improving the motivations leading to improved behavioral standards.

Basu (1983) maintains that the order associated with multitude of economic exchanges and the absence of anarchy and fraud shows that human beings are not guided only by selfishness. "The 'invisible hand' would not be able to co-ordinate a multitude of selfish acts to bring order... if it was not aided by the adherence of individuals to certain commonly accepted values.... Thus we have to make room for our sense of values" (Ibid., p. 2011). He believes that there are two ways of solving social problems: one is imposing fines for violating the laws; the other is to inculcate in human beings suitable values. "It is true that the latter would take much longer to implement, but it is ethically clearly more attractive and ought to be the ultimate objective" (Ibid., p. 2012).

Regarding the point that many individuals often join the State while bearing certain non-selfish values, it is the task of a radical State to teach and propagate the true public-oriented norms and let them be internalized. Opposed to the view which regards the motivations as given and, inevitably, reduces the change in motivations only to shaping behaviour through rewarding or punishing, the State must establish institutions which embody certain norms and values. Such institutions will provide the ground for the individuals to internalize the social values. No doubt, the thorough fruit of such activities would be realized only when they are matched with concomitant radical developments concerning socio-economic and political structures.

Having said all this about the variety and complexity of human motivations, and having accepted the establishment of the right institutions, now the question may be raised: how do these elements leave their impact upon the role of the state in economy? No doubt, governments will act more honestly in societies where high standards of behavior in public life have long been established. This point will be clearer if we compare these societies with the others which lack such norms even though the latter ones possess the same institutions for rewarding or punishing. While the existence of such institutions for treating the behaviours directly could be found useful, a change in motivations would be more effective in improving behavioural standards. To do so, direct ideological advice through emphasis on public service ethic and indirect encouragement (through changing the institutions which define incentives) may be employed.

If the foregoing could be classified in the context of the educational task of the State, then in line with the extension of the educational responsibilities of a radical State, we may argue that a State can attempt to influence the education system as well as mass media in order to promote national ideology or a new value system.[3] This further step will decrease the costs of bargaining and the exchange of information since common language and approach provides the ground for easier communication.

4.6.5 ESTABLISHING A PLANNING CENTRE

The other task of the State in line with its attempts to decrease the transaction costs may be establishing a planning centre. The centre may function as a focal point for co-ordinating behavior as well. We have already explained how the firms may co-operate. Now it could be added that the focal point may be utilized so as to facilitate the co-operation in, say, investment in complementary projects. If a prime characteristic of the focal point as Schelling (1969, p. 57) puts, is prominence or conspicuousness which leads to co-ordinated decisions and behaviors, the planning centre in our model takes more initiatives.

[3] This may be opposed on the ground that it recalls the act of some authoritarian regimes in propagating their ideologies. But, what we are thinking about is totally different. We treat a democratically elected government with a certain agenda which has been approved by the people. This provides enough legitimacy for the State to teach and train the people based on the accepted platform.

In an indicative planning, representatives of economic groups participate mainly to prepare an input-output table for the principal sectors of the economy. Therefore, enough information will be available for decision-making. This plan will compensate the price system deficiency which fails to provide adequate information for management concerning future economic conditions. In our model, the indicative planning will accommodate the private sector and decentralized decision-making to the goals of the new power structure within State bureaucracy. The economy will benefit from indicative planning because of the following reasons: reduction in the production bottlenecks, increase in the over-all rate of expansion, reduction in investment fluctuations, and better decision-making for government and business. (Cohen, 1969, Chapter 1).

In a society which passes the first phases of the transition from a capitalist economy, besides providing information to the firms about the needs of the society, the State, through making radical institutional changes, and in the context of the indicative planning, will provide enough ground so as to realize its goals in the line with achieving the standards of a new society.

The most important part of the indicative plan is the estimated pattern of final demand. However, since in our model the State plays its crucial role in developing the economy, therefore, herein the composition of the final demand is neither given nor determined outside the planning process. Consequently, as opposed to a purely indicative model, which assumes away the questions of conflict, in our concept of the planning process, decision making is not divorced from planning. In other words, planning, through encouraging a shift in resources, directs development and orients growth in a new direction along the line of fulfilling the basic needs of a developing society. This is because the orientation of development is taken as a normative matter of values, choices and conflicts.

4.7 REVIEWING THE CONTRIBUTIONS ON THE CASE OF IRAN

4.7.1 SAHABI AND THE NATIONAL BOURGEOISIE

Sahabi (1993a and b) in his historical review of the economic development in the Western industrialized countries maintains that: contrary to what is said about the role of the invisible hand, the reality reveals the fact that the State has played a crucial role in the process of the development of the advanced economies. In fact, not the free trade theory, but rather ideas such as List's have theoretically led those economies. An examination of the history of the U.S, France, Belgium, Germany, Japan etc., provides enough evidence to believe in the historically leading role played by the State.

Now, the question before us is: how can State intervention in the process of economic development in countries such as Iran be justified? Actually, all theories regarding the exclusion of the State from economic arena have based themselves on the presumption of a self-maintained market economy. The reality, however, is not so. Effectively, in underdeveloped nations, resources have not been mobilized, the economic capacity has remained idle, and social institutions are passive. In such a society, the absence of a State, pioneer in inducing economic development, will lead to a deepening of underdevelopment.

There are several reasons which justify State intervention in the economies like Iranian one. The first is the presence of a weak private sector which is active mainly in the trade sector and passive in the manufacturing industries. Under these circumstances, privatization will mean nothing but the halt of the industrial investment. The second is the absence of the so-called "invisible hand". In reality, it has changed to the "visible hand" of the dominant economies in the dominated ones including Iran. Leaving the economy in the hands of the market is tantamount in practice to expanding the domain of the powerful industrial economies in the internal affairs of the underdeveloped countries. The other is the conflict between economic growth and a just income distribution. The past experience of the Iranian economy reflects the point that as economic growth speeds up, the income distribution becomes more skewed. The lack of enough time just to catch up with the industrially developed economies is the other concern. If they have spent some centuries to be considered as developed economies, the time span for the underdeveloped world, including Iran, to level the unpaved way of the underdevelopment, has reduced to some decades. Thus, an actively involved State is needed to boost up the whole procedure of the development. In an oil-based economy, such as Iran, the State intervention becomes more inevitable just because of the oil revenues.

While emphasizing on the need to privilege social interests and motivations over individualistic ones, Sahabi maintains that the historical experience indicates that capitalism, owing to its internal conflicts, will be eroded, and, finally, substituted by an alternative economic system. However, the argument goes, the historically civilized nations, such as India, Egypt and Iran, are heavily threatened by capitalism. Therefore, the main concern, for those nations, must be to ensure that they are not prostrated by the onslaught of capitalism before the latter is destroyed. As the essence of socialism may not be renounced, recent experience appears to suggest that efforts to realize it are doomed to defeat. Hence, there is no other way but to look for a new path in which while the government negates the unjust mode of capitalist production, it provides the ground for a system which is intrinsically progressive. Such a State must follow the policies demanded by the people rather than introduced by the international power circles, including the division of labour imposed by imperialism. To do so, a State must be based on an elected government, enjoy the support of the people and have organic relations with the layers of the society.

In justifying why, at the present and in the absence of the noted conditioning Iran needs a nationalist state to support the national bourgeoisie, Sahabi (1999a) argues as follows. Marx was involved in a deep critic of the mid nineteenth-century advanced European industrialized economies in which the mass level production had been already achieved. Having solved the production problem, in such a society, the main concern, hence, was how to export the surplus product, on the one hand, and how to distribute the income to achieve a just society, on the other.

Conceiving capitalism as a system which will be ultimately realized in all societies, Marx did not find it necessary to study in detail the backward Asian and African nations. In other words, it was thought that the outcome of examining the historical developments of Western European countries could be generalized to other societies.

Mainly involved in analyzing developed capitalism, on the one hand, and observing an intrinsic relationship between underdevelopment and dependency, on the other, Marx, effectively, failed to consider the main problem afflicting the backward societies i.e., the insufficient production relative to the needs of a developing economy. Generally speaking, the essence of the necessities of a developing society, as opposed to a developed one, is to meet its basic needs by establishing an independent industrial production system through mobilizing its human and material resources. Expansion of production to meet the basic needs of the people, in fact, not only will improve its economic situation, but will also help it to get emancipation from imperialism, and even more, will act as a base for socio-political justice. This indicates the difference between today's developing economy and those which developed in the nineteenth-century.

The circumstances in the revolutionary Soviet Union differed from what Marx analysed. Insufficiently developed productive forces and the small number of the industrial proletariat, on the one hand,

and domestic as well as foreign political threats, on the other, left the new society with severe problems. Overcoming the prevailing problems, emanating from the shortage of production and the prevalence of poverty, and restoring a peaceful environment for the resumption of production, became the main concern. Lenin believed that it was the totality of the Soviet society, including its various classes, which faced imperialist threat. This affected his overall understanding of the situation in the third world too, where national interests crystallized in self-sufficiency and economic independence, were regarded over and above class interests. Lenin, consequently, concluded that the interests of the proletariat should be followed only in the context of the social consensus for a national struggle against foreign dominance. Under the prevailing circumstances, all the classes which could free the country from economic dependence on importation, were considered to belong to a vast national front. Lenin's emphasis was to involve the national bourgeoisie in an anti-imperialist struggle. Even more, the strategy of the non-capitalist way of development of the post-Stalinist era did not negate the attempts of the national bourgeoisie to develop the economy.

Sahabi (1999b), then, adds that the situation in the post-revolutionary Iran resembled Soviet Union under Lenin. Weak manufacturing structure, low contribution of manufacturing sector to G.D.P, and small number of manufacturing workers did not let the labor-capital contradiction to be considered as the chief issue. The chaos in the production system of the post-revolutionary era was, more or less, similar to what prevailed in the Soviet Union in Lenin's era as well. The differentiating factor was, however, the oil revenues which had left a skewed income distribution and a vast amount of liquidity at the disposal of the middle and upper classes who were reluctant to invest under the uncertain conditions. The alternative ways available for the liquidity holders were any combination of transferring the resources abroad, consuming, and investing in foreign trade (importation of foreign goods).

All of those alternatives were to the detriment of national sovereignty. The only remaining path was to direct all the financial resources plus entrepreneurial skills towards the production of basic goods and services and promote the national bourgeoisie to produce for the betterment of the new society. As the production dilemma has not yet been resolved in Iran, hence, there remains enough reason to develop the national bourgeoisie. However, there must be some criteria to differentiate the national bourgeoisie from the dependent one. The following may be proposed: (a) contribution to self-sufficiency, (b) increase in productive employment, (c) directing the internal resources towards the production of basic needs, (d) reinvestment of the profit to boost economic development, and (e) educating and training the people as well as developing and mobilizing their potentialities.

However, the important point which must be borne in mind is that the function of the national bourgeoisie is fully dependent upon the nature of the political power. If concerned with the privilege of the national interests, the power structure will succeed in directing the production system in line with national interest. On the other hand, a national State would not succeed emancipating society if deprived of the social entrepreneurial skills and productive power. In Iran, a nationalist State, through taxing the national bourgeoisie, must expand the social justice which is now totally dependent upon unstable oil revenues.

4.7.2 RAZZAGHI AND THE CONSTITUTION OF IRAN

Razzaghi (1991) argues that the State has historically played a crucial part in the development of capitalism in Iran. After the British supported the coup d'etat in Iran in 1921, in accordance with the desire of British imperialism, the capitalist path of development was followed by the State. The increasing oil revenues were used to expand the economic infrastructure as well as establishing modern manufacturing industries in the context of the imperialist plans.

Therefore, the emergence and expansion of the exogenously induced capitalism, from its very beginning, due to the lack of popular support, needed State intervention, and such intervention ultimately acted in the interests of imperialism. The dependence of Iranian capitalism upon foreign dominant powers not only did not stop, but also continued to grow even when the private sector and a middle class emerged. Wealth and capital flight, brain drain and alienation, and ultimately, dependency in all aspects were the outcome of that process. While the coup of 1921 and the following twenty years of the Pahlavi rule led to the emergence of a capitalist pattern of development, the coup of 1953 and the following 25 years of authoritarian rule of the Shah provided the ground for the spread of private sector as well as capitalism in a manner such that dependence appeared as a structural characteristic not only of the Iranian economy, but also of Iran's social and cultural values.

The State, which emerged through promoting the capitalist way of development, expanded its domain through facilitating the spread of private sector. Based upon oil income, import substitution industrialization strategy, mainly in assembly lines, was actively promoted, which led to the prevalence of a dependent consumption pattern, whereas the export promotion strategy remained peripheral. All this led to a huge increase in the importation of goods and services, rising from one hundred million dollars in 1953 to twenty four billion dollars in 1978.

After the victory of the revolution, despite the open rejection of the capitalist system by the people, the dependent capitalist system was saved. Hence, although deprived of an organized and full-fledged state support, the dependent capitalist system of Iran, owing to the prevalent dependent consumption pattern, availability of considerable amount of financial resources, etc., continued its existence and even expanded in some areas such as foreign trade.

In proposing a model for an independent development of Iranian economy, Razzaghi argues that the value system of capitalism contradicts that of third world nations, and whilst eroding all hopes and resistances, alienates the people as well. On the other hand, the revolution in Iran, such as that in other places, revealed the fact that the contradictions of capitalism are too deep to be resolved in a way so as to guarantee its continuation. Therefore, to put forward an alterative model, some criteria must be borne in mind which are as follows: a) conformity with the prevailing culture and the value system, (b) the experience of other countries, (c) international circumstances, and more importantly, (d) the characteristic features of the domestic economy. He argues that, for the time being, the Constitution of Iran has provided enough value criteria to be followed and applied in order to establish an alternative system to substitute the current one. This is because anti-capitalist components of the Constitution not only reflect the attitudes of the people, but also, takes into account complexities of the prevailing situation.

Among those, article 43 is an important one. "In order to secure economic independence of the society and in order to eradicate poverty and deprivation and to meet the human needs in the course of its growth, while preserving its dignity, the economy of the Islamic Republic of Iran is based on the following criteria:

1. Providing the basic needs: housing, food, clothing, public health, medical treatment, education and the necessary conditions for establishing a family for all.

2. Providing the possibilities and opportunities of work for all towards achieving full employment and providing the means of work for all who are able to work but lack the means, in the form of cooperatives, interest free loans and through any other legal means in such a manner that neither is capital centralized or exchanged through the hand of particular individuals or groups nor does the government become an absolute great employer. These provisions

should be implemented in full consideration of the necessities governing general economic planning of the country in all phases of growth.

3. Organizing the economic program of the country in such way that the form, the content and the hours of work should be so regulated that each individual in addition to professional effort will have the opportunity and sufficient energy for spiritual, social and political self-development as well as for active participation in leading the country and enhancing his/her efficiency and initiative.

4. Regard for independent job selection, restrain from forcing people to a particular jobs, and prevention of exploitation of others labour.

5. Prohibition of causing injury to others, as well as monopoly, speculation, usury and other illegal or forbidden void transactions.

6. Prohibiting waste of resources in all areas of economy including consumption, investment, production, and distribution.

7. Utilization of science and technology and training of skilled individuals as needed for the development of the economic advancement of the country.

8. Prevention of foreign domination over the economy of the country.

9. Emphasis on increasing agricultural, animal and industrial production in order to secure public needs and to achieve a self-sufficient state free from all dependence in this regard". (The English translation of all of the Constitutional Articles provided in this part, has been quoted from the following source: Constitution of the Islamic Republic of Iran, published by The Ministry of Culture and Islamic Guidance, 1985).

To realize such a system, the Constitution has considered several responsibilities for the State. Those tasks include almost all aspects of the life and, in fact, the realization of a vast variety of ideals is contingent on how the State undertakes its responsibilities. The only warning concerning the State is, however, about its change to "become an absolute great employer" as put in the noted article.

According to Article 3, the government has to fullfil some certain tasks so as to provide the ground for achieving the goals of the other article. Article 3 is as follows.

"The Government of the Islamic Republic of Iran is responsible for the attainment of the objectives envisioned in Article two and will apply all its possibilities for the realization of the following:

1. Creation of a favourbale environment for the growth of ethical virtues...

2. Raising the level of the general knowledge of the public in all fields through correct use of the press and mass media and other means of communication.

3. Providing free education and physical training for all at all levels; facilitation and generalization of higher education.

4. Enhancing the spirit of research, enterprise and initiation in all fields of scientific, technical, cultural and Islamic areas through the establishment of research centers and encouragement of scholars.

5. Complete rejection of colonialism and prevention of foreign influence.

6. Obliteration of any kind of despotism, and monopolistic tendencies.

7. Securing political and social freedom within the limits of law.

8. Participation of all people in determination of their political, economic, social and cultural destiny.

9. Elimination of all inadmissible discrimination and creation of fair possibilities for all, in all material and spiritual areas.

10. Establishment of a correct administrative system and elimination of unnecessary organisations.

11. Complete reinforcement of the foundations of national defence...

12. Laying the groundwork for a sound and just economy, based on Islamic regulations, aiming at creation of comfort, elimination of poverty and all kinds of deprivations regarding food, housing, jobs and hygiene as well as generalization of social insurances.

13. Securing self-sufficiency in service, technology, industry, agriculture and military affairs and similar areas.

14. Securing the comprehensive rights of individuals whether women or men and providing just legal security for all and equality for all before the law.

15. Expansion and enhancement of Islamic brotherhood and public co-operation among all of the people.

16. Adoption of a foreign policy based upon Islamic criteria, brotherly commitment to all Moslems and unsparing protection for the under-privileged and deprived peoples of the world".

Some other tasks of the State have been mentioned in other articles. According to Article 28 "...The government is obliged to meet the needs of society for various occupations by providing equal possibilities for all individuals to have equal job opportunities as well as equal possibilities for all to choose their own profession".

Article 29 states as follows. "It is a universal right of all to enjoy social insurance or other forms of security for retirement, unemployment, old age and disability, lack of guardianship, being a stranded wayfarer, accident and the need for health and treatment services and medical care. The government, in accordance with law and by drawing on national revenues, is required to provide such insurance and economic protection to each and every citizen of the country".

Article 30 mentions the following. "The government is obliged to provide free educational facilities for the whole nation with the end of the secondary school, and develop free means for higher education to the extent that the country may attain the state of self-sufficiency".

Article 31 states as follows. "The enjoyment of suitable housing is the right of each individual and each Iranian family. The government is obliged to provide for the implementation of this article, giving priority to those who are in more urgent need, particularly the villagers and laborers.

Some other tasks have been considered for the State as well. In Article 49 the following may be found. "The government is required to confiscate all wealth derived from usury, usurpery, bribery, misappropriation of public funds, theft, gambling, misappropriation of endowments, public contracts and transactions, sale of waste lands and natural resources, centers of corruption, and other illicit practices and should return such wealth to its proper owner, and in cases where the owner is unknown, the wealth should be submitted to the public purse...".

According to Article 50, protection of the environment is the other responsibility of the state. "In the Islamic Republic the protection of the natural environment, in which the present generation and future generations may enjoy a developing social life, is a public duty of all. Hence, all economic and other activities which involve pollution or irreparable destruction of the environment is for bidden".

The structure and composition of the economic system has been depicted in the Article 44. "The economy of the Islamic republic of Iran is based upon three sectors: public, cooperative and private.

The public sector consists of all large and major industries, foreign trade, large mines, banking, insurance, energy programs, large dams and irrigation networks, radio and television, post, telegraph, aviation, shipping and railways, whose ownership is at the disposal of the government.

The cooperative sector includes production and distributive cooperative companies and enterprises which are established in cities and villages according to Islamic criteria.

The private sector consists of those parts of agriculture, industry, animal husbandry, trade and services which complements cooperatives and government economic activities...".

Article 45 reveals the other resources belonging to the State. "Natural resources and national wealth such as waste lands or deserted lands, mines, seas, lakes, reed beds, natural woods, virgin land and pastures, heirless property and property of unknown ownership and public property restrored from usurpers are in the possession of the Islamic government which will determine the best way to utilize them in the interests of the nation...".

The vast resources and rights at the disposal of the State, according to Razzaghi, suggest that the State must be considered as the leader which radically changes the nature of the economy. The State through applying the other leverages, such as the yearly budgets and development plans, is able to determine the socio-economic destiny of the nation. Furthermore, regarding what has been envisioned as the roles and responsibilities of the State in the Constitution, one can, by no means, consider the State to be at the service of the private sector. It becomes much clearer when the Article 44 is considered which regards the private sector as the "complementary" of the public and cooperative sectors, and thus, bounded within limit imposed by the State. This picture is in sharp contrast to the function of the private sector experienced in the decades of the domination of the capitalism in Iran during which the State was always seen as the agent of the private sector. Now, however, the private sector has been recognized in the Constitution only if its function does not violate the principles explained in the noted articles.

It seems that what has been depicted in the Constitution concerning the role of the State in the economy is in accordance with the realities of the Iranian society. Taking cognisance of the small share (3 percent) of the capitalists and entrepreneurs running large-sized establishment (hiring 10 or more workers) in the total number of the employed people, or the very considerable share (40 percent) of the own-account worker, or the high number of wage and salary earners (50 percent) on the one hand, and the very substantial share (over 97 percent) of the small-sized industries (hiring less than 10 workers) in the total industrial units, or the very large share of the Private sector (94 percent) in owning the industrial units, on the other, we have to accept the following.

If the dependent capitalist way of development, with its detriments and injustices, may not be followed in Iran, then, by the same token, the centralization of all economic power in the hands of the State would lead to the hostility of the popular strata argues the State. Therefore, the best way, at the present, is to organize the vast number of the small industries in the forms of cooperatives – i.e., the other form of private property. Bearing in mind the noted realities and the principles it seems reasonable to accept the Constitution, which has an anti-capitalist essence, as an agenda for the present society. This is a society in which in order to achieve an equal, just, independent and developed economy, the State must undertake the principal role, while private activities remain bounded. In fact, it is in such a society that according to the preamble of the Constitution, "[i]n consolidating economic foundations, the principle is to alleviate the needs of human beings in the course of their growth and evolution, unlike other economic systems where the objective is concentration of wealth and profit seeking.... On the basis of this view, the economic program of the Islamic government is to prepare the ground for the emergence of diverse human creative forces. It is the responsibility of the Islamic government, therefore, to provide equal and suitable possibilities to create work for all human beings and to alleviate the essential needs towards the continuation of their evolution."

CONCLUSION

In this chapter, following the critical review of the role of the State in the economy in the context of the two alternative theories in the preceding chapters, we sought to examine the role of the State in the light of a radical perspective. After discussing the class-domination theory of State as against the class-mediation one, we responded to a number of serious questions arising from the presumptions of the latter one, and covered how the discussion of the State as an expression of class rule has been treated. To apply the radical theory to a transitional society, it was argued that an important component of the costs associated with the production process, insofar as private property-rights are recognized as legal, is the cost of coordination – i.e., the set of transaction costs. In order to justify theoretically the intervention by the State in the economy of a transitional society, as an alterative for the previously reviewed theories, it was argued that the transaction costs conception may be utilized. Putting it differently, we attempted not only to negate the false presumption of the "non political structure" of the market, but also, to substantiate that, contrary to what is believed, State intervention would be less costly as compared to market allocative system. In reviewing the contributions regarding the Iranian case, we studied two authors who believe that under the prevailing circumstances, the economic system suffers from major deficiencies and that the society is in the process of transition. Therefore, a national State, which is deeply concerned with disrupting the socio-economic as well as cultural dependence from imperialism, would be the right answer for directing the movement of society one step forward.

CONCLUSION

The object of the present thesis is to critically examine the economic role of the State in the light of the alternative theories. In order to accomplish the task of this thesis, we first conduct a historical study. The motivation behind that was to argue that the State – and not the market per se – has been mainly instrumental in stimulating the process of economic development. Britain, as an archetype of early industrializers, has been selected since it is where the market is supposed to have emerged spontaneously. Contrary to what is claimed on the "spontaneous" emergence of market, however, we have argued that viewing the market as a "natural" and ever-existing economic phenomenon with primacy over other institutions is a historically inadequate perspective. The real state of affairs unearthed by several economic historians is in sharp contrast to the conventional belief that State intervention emerged only because of the prevalence of market failure in the economy.

We have shown that from the beginning of the period under our study – i.e., thirteenth century, serious attempts were made by the State to overcome the relatively backward situation of British economy. Application of the import substitution industrialization strategy, a great increase in the legislative activities, protection and monopoly grants, and later infant industry policy all reflect the deliberately enforced will of the State to intervene in the economy. We have argued that the enforcement of the free-trade legislation was also initiated by deliberate political calculation, rather than through a spontaneous process, to overcome the depressive economic situation. We found that even during the free-trade period, the protection was stronger in Britain compared to the other protectionist economies.

Therefore, it may be concluded that, except for supplying basic necessities at local level as well as for luxury trade at international level, the market did not occupy an important place in the British economic life until the rise of capitalism, which was deliberately engineered by the State.

In reviewing the perception of the role of the State in the alternative theories, we began our task with critical analysis of the role of the State in the neo-classical theory. We criticized the various layers of the theory and revealed some important limitations concerning the role of the State. The recent attempts to substitute State intervention by some other remedies at the time the market fails, has been found to be invalid. Furthermore, we have concluded that ideas concerning the government-failure literature about the nature and ability of the State are based upon naïve assumptions and narrow definitions.

Based on the findings of the historical review in the present thesis we may also conclude that the role of the State in neo-classical theory lacks any root in history and, thus, has an artificial air about it. Furthermore, the theoretical problems associated with this particular perspective may not be overcome unless an alternative approach is adopted. The alternative should be the one which is historically justified and also is rich enough through the incorporation of new elements. In examining some contributions which have studied the role of the State in the Iranian economy in the framework of neo-classical theory, we have revealed their deficiencies based on the theoretical criteria which were studied in the first part of the chapter.

In moving one step forward, we critically analyse the role of the State in Keynesian Theory. In doing so, we have studied the theoretical foundations of the Keynesian revolution. We have shown that, through criticizing the nineteenth–century theory of State, Keynes changed his orientation and provided the ground for State interference. It has been argued that the economic philosophy of Keynes, in which the State is conceived of as guarantor of full employment, is a stark contrast to *laissez-faire*.

In pointing out the new stream of the literature concerning development economics, we have substantiated that all the contributions, impressed by Keynes's ideas, have recognized the crucial role of the State in the process of economic development.

Through reviewing some contributions criticizing the Keynesian conception of State, we have revealed their shortcomings and concluded that those may be overcome only by changing the discourse and adopting an alternative approach. We have also concluded that the contributions which have applied the theory of the State in Keynesian conception to the Iranian economy suffer from some short comings.

In approaching an alternative theory, the last part of the thesis reviews the role of the State from a radical point of view. As opposed to the interpretation of the modern liberal theories, we have argued for a ? radical perspective which believes in class-domination theory of State and also regards the State as a deeply embedded institution in society. It has been shown that the main deficiency of the class-meditation theory arises from its historically false assumption regarding the immutability of system of property relations which gives the State the role of mediating the conflicting interests of the various classes.

We have also made a preliminary attempt to provide a theoretical context in which radical State may fulfill its function as an economic instrument in a transitional society. We have argued that transaction costs would be lower under State intervention compared to the same costs under market mechanism. Some tasks of a radical State in an emerging economy have been pointed out as well.

Concerning the Iranian case, we have demonstrated that there are considerable justifications for a radical intervention of the State. However, the idea may not be practically realized unless the prevailing circumstances have been fully comprehended and the ground has been paved. The first task which has been recognized for a radical State is to resist the neo-classical ideas concerning the privatization and liberalization policies (which recently are imposed upon all developing countries in the guise of the IMF-WB policies). In doing so, we believe that a radical State must insist on the Acts of the Constitution concerning the role of the State in Iranian economy. Those acts are nowadays under heavy domestic and international attacks. There is great pressure to change them in a way to provide more economic space for big domestic private sector as well as international capital. We have argued that, at present, all efforts including the potentials of national bourgeoisie may be mobilized to establish an independent and national economy so as to move one step forward the anti-imperialist and freedom movement of Iran.

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