

Mercantilism Old and New

An Institutional Approach to the Study of Developmental States in Europe and East Asia

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Introduction

The advance of the New Institutional Economics (NIE) has had a tremendous impact in modern economic analysis. "Institutional economics" is now one of the most thriving branches in economics, after having been almost a term of abuse for more than half a century. That successful economic performance requires efficient institutions has become a widely accepted conjecture in economics. If institutions are defined as "those rules, norms and customs, and their enforcement characteristics, which define rights and obligations in human exchange"¹ it is almost trivial to say that they have an impact on a nation's capacity for economic development. Few would dispute that it is important to analyse how differences in economic organisation, are shaped by political, social, cultural, religious and legal conditions, i.e. by factors usually referred to under the rubric of "institutions"?

In large degree much of the current debate is not so much a debate on institutions and development as one of the role of the state. In the current development debate there is a demarcation line between those who explain underdevelopment as a problem of government interference in the market (the Public Choice approach and theories of the Rent-Seeking society), and those who explain success as result of efficient intervention and guidance of the market (the developmental state paradigm). To

¹ This definition generally corresponds to the definition presented by Douglass North. See, for example, North, D., *Institutions, Institutional Change and Economic Performance*, 1990.

some extent these differences are reflections of differences in real circumstances when the Third world is becoming increasingly polarized. A fundamental task then is to explain why in some cases efficient institutions are being established under the authority of development-oriented governments, whereas in others government intervention produces inefficient institutions which are a brake on resource allocation and economic growth.

The question addressed here is whether the New Institutional Economics provides a solution to this conundrum, whether it has enhanced our understanding of which institutions that breed success. It is argued that much of the writing on the state has a tendency to become superficial since focus is laid either on alleged harmful political intervention, as when explaining cases of economic failure, or on good governance or bureaucratic competencies, as when explaining success stories. In effect, in terms of proper institutional analysis "the cupboard is bare."²

The cardinal question is in what way the New Institutional Economics (NIE) may be helpful for analysing the rise of "developmental states". It shall be argued that the NIE does not represent one coherent school of institutional economics.³ The works of the Public Choice school and theories of the Rent-Seeking society follow strictly in the classical tradition: malfunctioning of the market is caused by "political failures". All institutions whose impact reach beyond the mere protection of "spontaneous order" (the free market) are by definition taken to be inefficient. In this perspective institutions are not endogenized into the models of the economy but are seen as tools, by which the economic system might be manipulated. Basically, the state is regarded as a mainly exogenous force and as a redistributive device used for the benefit of special interests, while the market itself is free of friction. So, in this brand of NIE disturbances in the efficiency of the market are primarily caused by state intervention.

² A phrase used by Theodore Schultz to denote the way by which reference to institutions was made by economists in the 1950s.

³ A contrary view is presented by Loewenberg. Loewenberg, A., *Journal of Theoretical and Institutional Economics*. However, according to this argument the characteristic feature of the NIE is its methodological individualism, which is also taken to be superior to structuralism. By this line of argument Loewenberg not only draws a imaginary border line between the NIE and Marxism, but also gives a false image of the NIE as a coherent school of economics.

The argument forwarded in this article is developed in stark contrast to this type of analysis. It holds that any theory of institutions and the developmental state must take as its point of departure the assumption of positive *transaction costs* in all kinds of human exchange, including economic exchange. A theory of the role of institutions and the state in economic development ought to be founded on a transaction cost approach.⁴ The argument is simply that much of the misunderstanding of which role the state ought to play *vis à vis* the market emanates from an inappropriate understanding of the market itself. In addition, Public Choice theory and the Rent-Seeking approach tend to perpetuate a erroneous conception of how processes of market integration have actually occurred in the real world, in the industrialization of Europe as well as in the current success stories of the Far East.

With a transaction cost approach endogenizing institutions into economic theory implies analysing the state as being part of the national market economy. The usual state - market controversy is based on a false premise if the state is *conceptually* separated from the market, at least if the national economy is taken to be the unit of analysis. When we discuss economic performance it is nearly almost the wealth and poverty of *nations* we have in mind. The nation is indeed a unit of analysis in empirical economics. Since Adam Smith economists have tried to explain the wealth and poverty of nations, they have worried about unemployment rates or the balance of trade of nations and they have been much concerned with the comparative advantages of nations. Still, the nation appears as a "shadow" in economic theory. Trade theory assumes the existence of national economies, but says little about why individuals arrange their economic integration within national boundaries, i.e. why a political unit such as the nation state also corresponds to an economic unit called the national economy.

Sustained economic development appears to be correlated with integration of economic exchange within national borders

⁴ Coase, R.H., Theory of The Firm, *Economica*, no 4, 1937. Coase, R.H., The Problem of Social Cost, *Journal of Law and Economics*, no 3, 1960. Major works by Douglass North on institutional economics include, *Structure and Change in Economic History*, 1981; *Institutions, Institutional Change and Economic Performance*, 1990 and (with B. Thomas) *The Rise of the Western World*, 1973. Two articles of special relevance for this particular context are: A Transaction Cost Theory of Politics, *Journal of Theoretical Politics*, No 2, 1990 and A framework for analysing the state in Economic History, *Explorations in Economic History*, No. 3, 1979, p. 249.

and, historically, the formation of nationally integrated markets has been a prerequisite for sustained economic growth. So, to choose the national economy as the unit of analysis is not merely to choose a convenient level of abstraction for laying of academic puzzles. The national economy exists in the real world and it should be analysed as a set of institutional arrangements for organising exchange.

The reason for the absence of the nation in economic analysis is that neo-classical theory is based on an unrealistic perception of the market, a perception in which transaction costs are assumed away. The problem with this is that by applying a theoretical model which do not account for transaction costs one cannot arrive at an understanding of the economic rationale behind the rise of the nation as a unit of economic integration. One can assume that national economies exist but one cannot explain *why* they exist.

In the following an account shall be given of the postulates about the role of the state made by the Public Choice approach and the theory of Rent-Seeking society. Basically both urge that economic decline in developing countries is due to government regulation of a kind which resembles the mercantilism of pre-industrial Western Europe. The postulate says that it was the free trade policies that succeeded mercantilism that developed Europe. It also says that free trade is the key to the miracles of East Asia. Against this it shall be argued that it is the East Asian NICs which bear institutional resemblance to European mercantilism. It is the "developmental states" of East Asia that can be analysed in terms of mercantilist policies of nation building and, vice versa, it was mercantilism in Europe that was the work of "developmental states".

The question of who is mercantilist or not is not a matter of semantics. The point made is that mercantilism, old and new, is a term which describes a strategy employed by the state for the fostering of a nationally integrated market economy. Furthermore, mercantilist regulation policies are implemented for the purpose of reducing transaction costs with national boundaries, not for purposes of private rent appropriation as is typically argued by Public Choice theorists. Thus, the mercantilist state is not a version of the predatory state, which is so common in Third world countries. On the contrary, the fact that it furthers national rather than private interests makes it the very antithesis of the predatory states.

Public Choice Theory and the Third World State

It is well-known that for long both research on developing countries and the practical implementation of development strategies were largely based on the premise of a benign state that could be expected to function as an efficient vehicle of economic and social transformation. Underdevelopment was in itself seen as a market failure. Private ownership and free trade were associated with the traits of underdevelopment: dependency, economic stagnation and unequal distribution of assets. It was quite logical then that central planning and state ownership became fundamental elements in the industrialisation strategies of a majority of developing countries. The theoretical orthodoxy saw the state as a potentially capable and fair economic agent, and as an efficient vehicle of economic growth.⁵ A paramount task for governments in developing countries was to command the process of nation building, politically and economically.⁶

Today, it is more common to regard Third world governments as "prebendalist", "predatory", "praetorian" or "mercantilist". Economic development is seen to be obstructed by a strongly interventionist and oppressive "vampire" state, whose main concern is to enrich "kleptocrats" such as politicians, bureaucrats and military commanders, or to favour some particular interest group or "distributional coalition".⁷ It is a commonly held view that the state has an inherent tendency to produce inefficient institutions, which inhibit an efficient allocation of productive resources. In fact, few would refute Douglass North's assertion

⁵ Development theory was heavily dominated by the so-called structuralist "school" in the 1950s and is associated with among others Gunnar Myrdal, Raúl Prebisch, Arthur Lewis, Hans Singer and Ragnar Nurkse. See, for example, Meier, G.M./Seers, D., 1984.

⁶ With few exceptions, it was the Marxists who criticised this view of the benign state. They saw the state as a political manifestation of the prevailing economic power structure which in itself was a fundamental element of underdevelopment. Baran, P., *The Political Economy of Growth*, Monthly Review Press, 1968.

⁷ Andreski, S., *Parasitism and Subvention: The Case of Latin America*, London, 1966. See also Olson, M., *The Logic of Collective Action*, Cambridge, Mass., and London, 1965; *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, New Haven and London, 1982.

that "the state is the source of man-made economic decline".⁸ In the new thinking a very strong postulate is being made namely that economic failure is normally due to state intervention into the market. It says that the state is not merely one source of economic decline among others, but *the* source. Governments cannot help to solve the problem of underdevelopment, they are the problem.⁹

Such postulates are associated with an abundance of theories about the negative effects of state intervention in the economy. Bhagwati and Krueger argue that state involvement encourages Directly Unproductive Profit-seeking (DUP) and Public Choice theory asserts that state involvement encourages rent-seeking activities which inhibit an efficient allocation of resources.¹⁰ They all share the view that the state is the ultimate source of economic decline.

Rent-seeking activities is a key concept in this line of analysis. Tariff-seeking lobbying, tariff evasion, seeking of revenues generated by tariffs, are all examples of rent-seeking activities. Such activities give pecuniary returns to those who engage in them, while producing no goods or services in a conventional social utility function. Since all resources that are used for rent-seeking activities are unavailable for productive purposes the total production possibility of the economy will actually be shrinking.

The basic idea is that since the market is in itself frictionless all economic problems are taken to emanate from actions undertaken by the state. The market has a tendency to create spontaneous order and social optimum. Since the state is engaged in distributing assets and in transferring resources, and since all resources spent on such activities are wasteful, it can be assumed that the state is wasteful whenever it intervenes in the spontaneous order of the market. From this perspective one derives the conclusion that the market can function efficiently only if liberated from these institutional imperfections. The policy recom-

⁸ North, D.C., A framework for analysing the state in *Economic History, Explorations in Economic History*, No. 3, 1979, p. 249.

⁹ Lewis, A.W., The State of Development Theory, *American Economic Review*, March 1984.

¹⁰ Bhagwati, J.N., Directly Unproductive Profit Seeking (DUP) Activities, *Journal of Political Economy*, vol 90, 1982; Krueger, A., The Political Economy of a Rent-Seeking Society, *American Economic Review*, vol 64, 1974.

mentation is obvious: government involvement in the economy should be minimised.¹¹

In this type of "institutional economics" average national productivity is taken to be inversely related to the "size" of the state. Privatisation, liberalisation and deregulation are the key words. Government failures are highlighted, whereas market failure is a concept which has been assumed away. "Bad governance" is stressed and there is little hope for long-term economic improvement without "less" and "more efficient" government, which, as it happens, are taken to mean the same thing. This is also the policy known as the Structural Adjustment Programme (SAP).¹²

It is argued that the severe economic crisis in sub-Saharan Africa can in the last instance be described as a crisis of a 'soft' albeit dirigist state.¹³ Similar arguments have been presented about the state-market relationship in Latin America. de Soto argues that the evolution of market economies in Latin America has been frustrated by a mercantilist state apparatus, which has as its main objective to allocate rents between various distributive coalitions.¹⁴ Basing himself on evidence from India, Srinivasan goes even further to argue that the *typical* Third world state is "pushed and pulled by lobbies and interest groups that are mostly interested in redistribution rather than growth and development".¹⁵

There is little doubt that the analysis has great appeal. The argument is indeed quite plausible as an empirically founded observation. Few would like to dispute that the notion of predatory states is valid for Africa, and who can deny that the Indian state is being pushed by lobbies, and that this must have some serious negative effects on resource allocation? In fact, "less government" might make perfectly good sense in these countries, if it helps demolishing predatory and harmful institutions which are established and upheld by the state. The implication of this is

¹¹ Buchanan, J.M., Rent-Seeking and Profit Seeking, in Buchanan, J.M./Tollison, D./Tullock, G., *op.cit.*, p. 14.

¹² This approach is clearly visible in the publications of the World Bank and the International Monetary Fund. See, for example, *Sub-Saharan Africa From Crisis to Sustainable Growth*, World Bank, 1989.

¹³ Bgoya & Hydén 1987

¹⁴ de Soto, H., *The Other Path*, New York, 1989.

¹⁵ Srinivasan, T., Neo-classical Political Economy, the State and Economic Development, *Asian Development Review*, no 2, 1985, p.45.

of course that the economic performance of African nations, or of India, would have been much better with either less predatory or less permeated governments.

But this is hardly a matter of controversy. The real issue is whether the extent to which states are predatory or penetrated can be related to the size of government and whether a distribution of special privileges to rent-seeking coalitions is incompatible with an efficient resource allocation and successful economic performance. Public Choice theory is quite clear on this point. Predatory states are always associated with big government and special privilege is always inefficient. From this follows of course that economies can perform well only if governments are small and if no special privileges are dispersed.

Public Choice Theory and the Developmental State

Then, what does this approach tell us about the success stories? Are they characterized by small governments or by the non-existence of special privilege? Surely, one does not need much theoretical training to infer that the East Asian NICs are characterised by "efficient institutions" and "good governance". The case is well established, not least by the famous World Bank study and it should be possible by now to derive appropriate theoretical conclusions therefrom.¹⁶ The conclusions drawn are extremely divergent, however. The NIC-miracle is seen either as evidence of the pre-eminence of non-intervention, or as an indication of the need for strong government involvement in processes of industrialisation.¹⁷ "Efficient" and "good" government can, thus, be taken to mean two different things, either that the state has intervened and guided the development of the market, or that optimal efficiency has been reached precisely because the state has not intervened in the economy.

Public Choice and Rent-Seeking theories are quite logically associated with the proffer that government control has been

¹⁶ World Bank, *The East Asian Miracle*, Washington DC, 1993

¹⁷ Johnson, C., *MITI and the Japanese Miracle: The Growth of Industrial Policy 1925-1975*, Stanford, 1982; Johnson, C., *Political Institutions and Economic Performance: The Government-Business Relationship in Japan, South Korea and Taiwan*, in F. Deyo (ed.), *The Political Economy of New Asian Industrialism*, Cornell University Press, 1987.

minimal and that the market has “ruled” without “opportunist” interference.¹⁸ Although much of these assertions have been disproved by empirical evidence the free-trade argument is continuously repeated. An intriguing example is provided by Deepak Lal’s bold statement that the correct policy lesson from the South Korean case should not be drawn from what the Korean government actually did (i.e. intervene) but from what it should have done (i.e. not intervened).¹⁹ Even by 1993 it remained possible for Nobel Prize winner Gary Becker to argue that non-intervention is the fundamental lesson to be drawn from the Four Asian Tigers. A formidable theorist, obviously Becker felt no need to present any evidence in support of this claim.²⁰

However, there are two versions of this anti-interventionist attitude. One says that government intervention is harmful and a brake on resource allocation, another says that in case the governments have actually intervened their policies have had no effect whatsoever.²¹ So, either intervention is a real (negative) force obstructing any positive measure taken by actors in the market, or its effects are illusory. Can it be both? Can it with reasonable credibility be charged that similar interventions have been harmless in East Asia and tools of embezzlement in Africa and Latin America? Perhaps it can, but in that case some factor other than the state and its policies will have to be brought in to explain the difference in outcome. In consequence, the entire argument about the state being *the* source of economic decline will be invalidated and made into an empty phrase.

¹⁸ Balassa, B., *The Lessons of East Asian Development: An Overview, Economic Development and Cultural Change*, vol 36, 1988; Hughes, H., *Catching Up: The Asian Newly Industrializing Economies in the 1990s, Asian Development Review* vol 7, 1989; Little, I. M.D., *The Experience and Causes of Rapid Labour intensive Development in Korea, Taiwan Province, Hong Kong and Singapore and the Possibilities of Emulation*. In Lee, E. (ed.) *Export-led Industrialization and Development*, ILO, 1981; Riedel, J., *Economic Development in East Asia: Doing What Comes Naturally*, in Hughes, H.(ed.), *Explaining the Industrialization Success of East Asia*, Cambridge University Press, 1987.

¹⁹ Lal, D., in Hughes, H.(ed.), *Explaining the Industrialization Success of East Asia*, Cambridge University Press, 1987.

²⁰ Becker, G., *Government, Human Capital and Economic Growth, Industry of Free China*, June 1993, pp. 47-57.

²¹ Dollar, C. and K. Sokoloff, *Industrial Policy, Productivity Growth and Structural Change in the Manufacturing Industries. A Comparison of Taiwan and South Korea*. Conference paper, Taipei 4-5 Dec, 1989.

However, there is yet another dimension to the anti-state thesis. Sometimes it is argued that the state is a monolithic predator, sometimes that it is an arena for rent-seeking lobbyists. Surely, it can be either way, but not both at the same time. A monolithic ruler is a dictatorial regime which neither needs authorisation nor accepts dictates from pressure groups. It cannot, however, be determined beforehand whether such a regime will turn out to be predatory or developmental in its outlook or, for that matter, whether either strategy will foster or inhibit economic growth.²² Rent-seeking coalitions, on the other hand, can only exert pressure on governments in case the power monopoly of the state is defunct. To say that such "bad governance" is the same as "big government" does not make much sense.

Gordon Tullock once argued that a turning point in South Korea's economic history occurred when President Park in 1961 eliminated the old class of politicians and bureaucrats, who had been penetrating the apparatus of government seeking their own selfish interest. They were replaced by development oriented and market-minded bureaucrats, who were more willing to encourage the growth of private enterprise.²³ On the face of it this seems reasonable enough but as an explanation it is devoid of content. Two implications followed from Tullock's argument. First, rent-seeking was minimised when a weak state penetrated by lobbyists was replaced by a monolithic and dictatorial government. Secondly, the developmental state is synonymous with the fostering of private enterprise. The unanswered questions are: why was a despotic monolith an improvement in Korea when monolithic states in Africa bring their societies to the edge of disaster by confiscatory tax policies?²⁴ Why would a strengthening of the political dictatorship produce growth enhancing policies in Korea if it is true, as Tullock also claims, that dictatorships as a rule tend

²² Public Choice theory assumes all governments to be predatory in principle. Only in exceptional cases have the evils of state intervention been escaped. Therefore, there is no need to distinguish between the *will* and the *ability* of the state. The teleological argument is that government intervention in the economy is bad simply because it is meant to be bad. This is a strange position indeed for anyone who believes in the rule of the invisible hand.

²³ Tullock, G., *Autocracy*, Dordrecht, 1987.

²⁴ North, D., A framework for analysing the state in history, *Explorations in Economic History*, July 1979.

to foster rent-seeking activities?²⁵ If promotion of private enterprise is the essence of developmentalism, why are not all governments developmental which favour private enterprise?

Even if we disregard the obvious fact that the South Korean state became more interventionist after the *coup d'état* in 1961 than before, we find that Tullock's view of the old regime is misleading. During the old order there was no excessive government intervention or aversion towards private enterprise, but the exact opposite. In fact, the principal-agent relationship was reversed to the extent that the state was little more than a reflection of interest groups present in the Korean economy. Economically powerful rural and urban groups had gained control over the apparatus of government and it was only by eliminating the influence of those groups that the new government could encourage the expansion of a competitive market economy. What it did was not to privatise the economy, since the state sector actually grew, but to *de-privatise* the state. Thus, the developmental orientation cannot be identified as promotion of private enterprise, but as a will to boost the growth of the national economy in opposition to private capitalist groups.

Having said this we find that it is precisely what the advocates of the "developmental state approach" argue namely that East Asian institutions are efficient because the state has been insulated from social forces. It has functioned as an autonomous entity *vis-à-vis* civil society including economic interest groups and classes.²⁶ Nonetheless, how accurate this may be it still needs explaining. We still need to explain why an insulated monolithic state turns developmental rather than predatory, why national development is given priority over private profit maximization. This will be done in the remaining parts of this essay in which the developmental states of East Asia are seen as nation-builders much in the same way as the mercantilist states of the early modern growth period of Europe. The origins of the mercantilist

²⁵ Tullock, G., *Journal of Theoretical and Institutional Economics*.

²⁶ Amsden, A., Taiwan's Economic History : A Case of Etatism and a Challenge to Dependency Theory, *Modern China* 5:3, 1979. Amsden, A., The State and Taiwan's Economic Development. In Evans, P., Reuschmyer, D. and T.Skocpol, *Bringing the State Back In*, Cambridge University Press, 1985; Wade, R., The Role of Government in Overcoming Market Failure: Taiwan, Republic of Korea and Japan. In Hughes, H. (ed.), *Achieving Industrialization in East Asia*. Cambridge University Press 1988; Wade, R., *Governing the Market: Economic Theory and The Role of Government in East Asian Industrialisation*, Princeton University Press 1990.

and developmental states are traced by means of a transaction cost approach to institutional change.

A Transaction Cost Theory of the Nation State

State intervention is often spoken of in terms of a one-way intervention of the state in the market. All activity by the state beyond the protection of property rights and the enforcement of voluntary contracts is defined as intervention. In the market all exchange of goods and services occurs on the basis of voluntary agreements between individuals. With this approach the necessary role of the state in the market economy is also taken to be its sufficient role.

One problem with this is that the concept of the market is used in an abstract theoretical way while the state is defined as a set of highly tangible institutional arrangements and functions. It is self-evident that it is problematic to measure the efficiency of real interference (by the state) in an abstraction (the market). A more serious problem is that conceptually the state institutions are held completely exogenous from the market.

A fundamental weakness in this conceptualization of the market is that no distinction is made between "market" and "exchange". Exchange between human beings takes place in all sorts of forms and with a variety of items exchanged. It can be economic and political and the items exchanged could be goods or services. Exchange can be organised in a variety of ways of which markets are but one way. Markets too could be arranged in variety of ways. Markets are different forms of institutional arrangements which exist to reduce the costs of exchange, the transaction costs. In more advanced forms of exchange the state is needed to formalise the rules of exchange, i.e. establishing of the market is codified by the state.

Thus, transaction costs are the source of both the state and the market. Economic institutions are established because of the presence of transaction costs in exchange relations. Transaction costs appear partly as information costs (imperfect or asymmetrical information) and partly as costs for carrying out exchange. They include the costs of establishing *contact* between economic actors (i.e. gathering and diffusion of information) as well as costs for establishing *contracts* and costs for the *control* of the enforcement of contracts. The more complex the exchange, the greater

the transaction cost and the more likely it is for institutional arrangements to be established in an effort to reduce these costs. Since the presence of transaction costs is the source of institutions, it follows that institutions will have to become more complex and formalised as the complexity of the economy increases.

Lowering of transaction costs means increasing the security in exchange. This means that the fundamental effect of institutions is to minimise uncertainty and to establish a relationship of trust between actors in the economy. Evidently, without some institutional arrangement which helps to establish conditions of mutual trust people will be unwilling to trade with each other. As markets widen and begin to become integrated with other markets it is necessary that property rights are formalised for the simple reason that trade is by definition an exchange of property rights. When exchange is personal, rights, including property rights, are understood and respected by way of custom. When exchange becomes impersonalised it is important that the property rights of the parties involved are formally defined, enforced and protected. Rule of law must replace personal rule.

Two *essential* conditions must, by definition, be fulfilled here: the right to private property (inclusive of the right to use and exchange property and the right to generate income from the possession of property); and respect and protection of agreements and contracts. Thus, the basic task of the state in a market economy is to establish and give credibility and legitimacy to laws, rules and other institutional arrangements which guarantee property rights and which protect the validity of contracts

The state is the ultimate guarantor for those institutions which make extended exchange and widening of the market possible. It is so because with the increased division of labour and with the widening of the market conflicts are likely to arise on matters of property rights and on the validity of contracts. In changing economies, there is a latent risk for conflict which call for to be reconciled by a "third party" which can enforce the rule of law.

However, the state does not originate in a vacuum; its actions and functions are reflections of societal processes and the power relations to which these lead. When exchange grows impersonal the state is impersonalised as well. As markets widen, exchange becomes impersonalised and the division of labour increases in principal two specialized functions are created in society, one economic and one that is directed towards exercising political power. The monopoly of violence is the ultimate guarantor of

political power. Increased division of labour with rising transaction costs creates a demand for violence to be exercised on a large scale basis. It is here the concept of nation comes in as the nation becomes the unit of both economic and political organisation. A nationally integrated economy needs a national state and a national state needs a national economy. Defending the nation does not only mean showing military strength, it can also mean that the state takes on the role to establish the nation as an economic unit in order to define and protect the property rights of its inhabitants against threats from foreign forces.

The nation state is present at two levels. On the one hand it is the ultimate guarantor of the institutional structure that enables economic exchange to take place within its borders. It is, in fact, quite natural that markets are arranged within nations and are protected by law by the nation state. On the other hand, the state is a nation state in an environment of competing nation states. The state is thus a protector of the "national interest" in a competitive political environment. So, the state is an arena where national and international forces collude and where politics and economics meet. In economic terms protecting the national interest could mean almost anything from aggressive trade promotion to adoption of an extreme self-reliance strategy. The point is, however, that the national economy is a unit of organising exchange for which the state is needed. Only if the regulatory framework of exchange treated all actors in the world equitably, irrespective of their national origin or place of residence, would it no longer be any point in talking about nations or nation-states.

It is here that we may find "the developmental state", i.e. an agent which works for the fostering of the wealth of the national economy in competition with foreign nations and for the exclusion of foreigners from the property rights of the national economy. It is also here that we find the economic nationalism under European mercantilism.

Thus, economically the nation state is a creation of a process of division of labour and widening of the market. It is part and parcel of a system of impersonalised exchange. The nation state can be monolithic and dictatorial but not personal. Medieval Europe consisted of tributary societies and its subjects complied to the dictates of revenue seeking rulers. The same was true for Imperial China and for major parts of the pre-capitalist world. Arbitrary rule and favouritism characterised such societies. Institutions were not established to facilitate impersonal exchange

since, as suggested by North, the ruler was deterred by a transaction cost constraint and a competitive constraint.²⁷

North's thesis is as a description of a society in which the reign of the state is a personal affair. It pictures the logic of the feudal states of Europe, of the dynasties of Asia and of the privatised predatory state in many present-day developing countries. However, the nation state is something different. The rise of the nation state is associated with the growth of impersonal exchange, widening of the market and the need to establish security of exchange.

The Old Mercantilism

In Europe the formation of the nation state was associated with the creation of national economy during the era of mercantilism. Sometimes the predatory and rent-seeking states of developing countries are equated with the mercantilist state. The mercantilist doctrine held that a nation's economic welfare could and should be secured through state regulation.

This strategy appears to have a lot in common with the policies of the predatory or rent-seeking states of Africa and Latin America. In the Public Choice literature mercantilism is seen as a system of special privileges distributed via political contacts.²⁸ The mercantilist economy was indeed politically controlled. Major economic activities were regulated by the state. The mercantilist state supplied certain economic actors with privileges through regulations, subsidies and licenses. This certainly encouraged the rise of an exclusive and privileged clique or traders and manufacturers.

That an analogy with mercantilism can be made both with the predatory state and with the developmental state is hardly coincidental. In hindsight, the mercantilist period has indeed been evaluated in those diametrically different ways. The mercantilist state-controlled and monopolised economy can be regarded in the spirit of Adam Smith as an arrangement that delayed the industrialisation of Europe and as a system that had to be removed before real expansion of trade and industry could occur.

²⁷ North, D., *A Framework for Analysing the State, Explorations in Economic History*, 1979.

²⁸ Ekelund, R and R. Tollison, *Mercantilism as a Rent Seeking Society*, College Station, Texas University Press, 1981.

In this approach, it is assumed that privileges and monopolies inhibited an optimal use of resources.²⁹ This is the view that became totally dominant in the classical political economy. As in the new political economy state intervention has been seen either as “a mischief or an illusion”.³⁰ It has also been seen either as “a system for forcing economic policy into the service of power as an end in itself”³¹ or as policy designed by “ignorant and self-interested cliques of merchants and manufacturers who feared without reason the competition of foreign rivals”.³² So, mercantilism is seen either as a monster or as an illusion, and sometimes as both.

The counter-factual thesis of this approach is that the economies of Western Europe could have modernised much earlier if the state had allowed free trade and free competition over borders instead of exercising political control over foreign trade. It is possible that so could have been the case. Of that we know nothing. What we do know is that Western Europe’s economic and political superiority over other parts of the world was established *during* the mercantilist era, not before or after. It is also clear, as is argued by Charles Wilson, that in the case of England it was the “coherence and rationality of the mercantilist economy which distinguished it markedly from the chaos of Spain or the Italian states and rendered it superior to that of France, or Sweden, or even Holland”.³³

Thus, one can also see the mercantilist era as a formative period for the institutions of the modern market economy. In this sense it is also possible to identify its modern equivalent in the development strategies chosen by the governments of the East Asian NICs. Although it may sound strange, and even disgusting to a true free-marketeer, limiting competition in international trade and granting special trade privileges seem to have been important for the fostering of national merchant classes in Western Europe. Within the system of privileges, merchants were free to run their activities as they wished because the political

²⁹ See, for example, Ekelund, R., and Tollison, R., 1981, Op.cit..

³⁰ Wilson, C., *Economic History and the Historian*, London Weidenfeldt and Nicholson, 1969.

³¹ Heckscher, E.F., *Mercantilism*, London, Allen & Anwin, 1934.

³² Hewins, W.A.S., *English Trade and Finance* (1892) quoted in Wilson, op.cit. p.66.

³³ Wilson, C., Op.cit., p.153.

establishment also made a profit. The state did not impede trade within its national borders, but encouraged activities that increased revenue which in turn enriched the political elite.³⁴ Mercantilism was more than an economic doctrine or policy; it was an institutional arrangement aimed at lowering transaction costs within the borders of the nation state. Thus, the function of mercantilism was to establish a systematic framework for arranging transactions so that a national market, as opposed to local, regional or international markets, could be secured.

In addition, furthering of the national market would be well in line with the political aspirations to consolidate the nation state as a political entity. This was, in fact, precisely the point raised by List and Schmoller in their defence of mercantilism. Both argued that political and economic interests went hand in hand, that they had to harmonise and that the nation was the natural unit for harmonisation. Schmoller argued that mercantilism "is nothing but state-making - not state-making in a narrow sense but state-making and national-economy-making at the same time".³⁵ Many monopolies were established to encourage the creation of new enterprises or the appearance of new trades. Via the monopoly trade the political élite could, at a low cost, appropriate a substantial part of the revenue. Thereby, the state had reasons of its own for promoting trade. Consequently, a symbiotic relationship was developed between the elites of the political and the economic spheres.

The emerging commercial class was neither oppressed by nor in control of the political sphere. Instead there was a *mercantilist partnership*, from which both economic and political actors could profit. In this mercantilist partnership the state guaranteed the property rights of traders and manufacturers at the same time as it restrained the dispersion of property rights by means of taxation and by the granting of privileges.

Those who argue that mercantilism is the source of Third world underdevelopment may be reminded that it was the non-mercantilist countries of Europe which lost pace and failed to develop in the 16th, 17th and 18th centuries. In Poland the landed gentry obstructed any attempt by the state to introduce mercan-

³⁴ See Hecksher, E.F., 1934, op.cit. A positive review of mercantilism was also made by Rosenberg. See Rosenberg, *How the West Grew Rich*, New York, 1982.

³⁵ Schmoller, G., *The Mercantile System and its Historical Significance*, London 1896, p.50.

tilist policies and in the end it turned against the state itself. National economic and political integration of Poland was thereby inhibited. In Germany, in contrast, it was the Prussian mercantilist state which led the way towards national economic and political unification.

Why was it that Europe's economic dominance was, in fact, consolidated during the mercantilist era? Free trade theory takes for granted that state regulations which discriminates among economic actors and encourages the rise of privileged cliques cannot increase aggregate utility. Obviously that is also the reason why Adam Smith and his followers have been so anxious to condemn mercantilism as a doctrine and policy which impedes trade. In fact, it is argued that mercantilism is an anti-trade oriented doctrine since its prime aim is to limit competition. The latter is no doubt true, mercantilism did indeed limit competition by proffering of special privileges. But, on the other hand, the mercantilist policies contributed to a *widening* of the market, and it surely cannot be taken for granted that such would have been the outcome of a non-regulated economy. In fact, in view of the transaction costs involved, it is unfeasible that a nationally integrated market could have been established without such regulation and limitation of competition. In line with Coase the mercantilist national economy can be seen as "super firm". Its aim was to widen the market by a reduction in transaction costs attained by limiting competition.³⁶

In judging the efficiency of the mercantilist institutions, it is necessary to differentiate between those which may have been efficient at a given point in time and those which may have been of more fundamental importance for the emergence of the market economy as such. In the short run, the foundation for a widening of the market economy in the West could be laid through a system of state control, that is, by favouring certain actors and discriminating others. In the long run, it is, however, hard to envisage that the extension of the market economy could have occurred without a gradual change in the regulatory framework so that the parties involved were offered "equal opportunities" to participate in the trade. This is, of course, a support for Adam Smith's argument that, in the long run, division of labour and competition are necessary components in the growth of the market. This does not, however, in any sense invalidate the thesis that in the process of economic nation-building it was necessary

³⁶ Coase, 1988. Op.cit, p.9.

for the state to intervene in order to unravel the transaction cost problem associated with market integration.

But what about rent-seeking under mercantilism? Surely the scope for corruption and rent-seeking must have been substantial within the system of allocation of special privileges. In this way the mercantilist state would be no different from the predatory Third world state. The problem with this analysis is that it focuses only on the "waste" incurred by state intervention and not on the possible gains attained by the reduction in transaction costs which follow from the same state involvement. This is the logical consequence of assuming away transaction costs. In fact, by definition mercantilism in England must have induced much more rent seeking than did the *liberum veto* of contemporary Poland. Nonetheless, England came out of the mercantilist era as a world power at the same time as the state of Poland ceased to exist. This can be explained with a transaction cost approach, not by the rent-seeking paradigm.

What remains to be explained, then, is why the actors in the political sphere were so determined to encourage the growth of trade and industry. Was it not more rational for the state to implement institutions which maintained *status quo*? To understand this, we must consider the political aspect of the nation state in a European context. Politically the nation state is not merely an institutional arrangement in the national arena, but also an actor in an arena where it competes with other nation states. Foreign rivals or military threats from abroad may make a no-growth strategy politically dangerous or even irrational. This fact became especially important for the development of an autonomous merchant class in Europe during the period of absolute monarchy. The political competition between European states was also important during the industrialisation wave of the nineteenth century. The mercantilist strategy was picked up again although packaged in the form of 19th century nationalism. Although *laissez-faire* was the dominant economic doctrine, economic-political practice in continental Europe seldom followed the ideals of Adam Smith. The practice of economic nationalism was more important than the principle of free trade. Struggles for national independence throughout Europe was one feature of this period. Another equally important feature was the colonial expansion and the national monopolies it created.

In many countries the state in 19th century Europe (and Japan) became actively engaged in attempts to speed up the process of industrial growth. This had little or nothing to do with a desire to

increase the welfare of the people, but occurred out of national necessity. To maintain independence and national sovereignty, political and military strength were a necessity, requiring in turn a strong economic base. In Japan after the Meiji Restoration this idea was expressed in an official slogan, "rich country, strong military" which can also be understood to mean "a rich country for a strong military."³⁷ The modernization attempts in Germany and Russia were both inspired by Friedrich List's political-economic doctrine, according to which the state must play a strategic role in harnessing the market forces and in formulating national economic goals.³⁸

The degree of economic nationalism in Europe was also closely related to the relative economic backwardness of each country. The economic backwardness on the continent in relation to England was a factor which brought out a desire among the political élites to develop their respective national economies. It was considered politically unsafe to leave the responsibility for increasing the national economic revenue solely to actors in the economic sphere. Since a developed economy was equated with a strong industry, it was important to force through an resource allocation that was advantageous for the industrial sector.

In Germany, Japan and Russia, the state became the leading actor in the economy and in its activities it was by and large guided by mercantilist ideas. In a short-run perspective these protective and discriminatory policies appear to have been quite efficient. Considerable economic progress was made through institutional arrangements which favoured certain actors and shut others out. With these policies Japan carried through its industrial revolution, Germany took over the role as Europe's leading economic power and Russia started a belated attempt to establish a market economy. The long-run perspective is somewhat more gloomy. In all three countries, political domination was secured over the economic sphere which led to all-the-more autocratic forms of control which in Japan and Germany gave rise to state capitalism under fascist regimes and in Russia to the

³⁷ Oshima, H.T., *Economic Growth in Monsoon Asia*, Tokyo University Press, 1986, p. 106.

³⁸ List, F., *The National System of Political Economy*, New York; Augustus Kelly, 1966.

Stalinist model of forced industrialisation.³⁹ In all of these countries, large-scale production was favoured; capital-intensive, heavy industry spearheaded by the arms industry. In Russia and Japan, the development of agriculture was gravely exploited and neglected which had the effect of locking up a large portion of labour force in activities which slowed down the average productivity growth in the economy.

A general conclusion that can be drawn from the European case is that external political competition is an important force behind the will of the political élite to engage economic development. No such push exist in politically closed, isolated and introverted systems. Here status quo policies pay off. A comparison with imperial China may be illustrative. Under China's centuries of isolation the power of central government was best preserved if the economic organisation remained unchanged. The Chinese imperial state had no incentive to establish institutions which lowered the costs of market transactions, since by maintaining status quo, the state could keep down its own transaction costs. Furthermore, central political authority was intertwined with local a political power vested in the landowning gentry.

The enormous size of China impaired an integration of the nation by means of trade. The creation of a national market economy would have involved political transaction costs of an enormous size compared to those of the small national states of Europe. Therefore also foreign rulers of China would rather resort to bureaucratic control than attempt policies which encouraged internal economic integration.

While the opening of China after the elimination of predatory bureaucratic rule made possible an unprecedented growth of trade and manufacturing industry it also led to a complete collapse of the Chinese state, paradoxically enough under the reign of a nationalist party, the Kuomintang. Political authority was lost to local entrepreneurs in violence. The total effect of the elimination of the nation state was an enormous rise in transaction costs which impeded market exchange and obstructed overall economic modernization. Therefore, when Communist rule was established in 1949, China was no more an integrated market economy than it had been a century earlier.

³⁹ See Moore, B., *Social Origins of Dictatorship and Democracy*, Boston: Beacon Press, 1966 and Gerschenkron, A., *Economic Backwardness in Historical Perspective*, Cambridge, Mass: Harvard University Press, 1962.

The New Mercantilism

Relative backwardness was *de facto* a primary force behind state intervention in the economies of the developing countries also after World War II. It is clear as well that national economic motives have constituted perhaps the most important force behind the economic metamorphosis of South Korea and Taiwan in modern times. In these countries, it has been considered elementary that the state must take on the role of the leading actor in the economy.

There was a time when South Korea and Taiwan were cited as exemplary followers of the motto that "he governs best who governs least". Today this interpretation is adhered to by few serious economists.⁴⁰ The existence of a strong, autonomous and developmental state is now usually recognised. However, the export promotion strategy is interpreted by Public Choice theory as a policy for trade liberalisation. A strong and autonomous state has been able to carry out a liberalisation strategy precisely because it has escaped becoming manipulated by lobbyists and vested interests. However, the theory does not match with facts. First, the export orientation strategy chosen by this autonomous state has not been one of trade liberalisation but its exact opposite: export promotion subsidies and import controls. Second, a substantial liberalisation did not occur until after 1987, i.e. at a time when the state had become decidedly less autonomous.

Two implications follow from this. The first is that mercantilism is a term much more appropriate than free trade for describing the trade policy. The second is that the developmental orientation of the state cannot be traced from an endogenous state-society perspective only. The state was obviously more autonomous before 1987 than after, but it was also less liberal. So, "developmental" means being mercantilist rather liberal, and mercantilism does not mean being pushed and pulled by vested interests and lobbyists but being engaged in building of the national economy. More than anything else it is Taiwan's and South Korea's external political vulnerability that has brought forth the desire on the part of the state to modernise the economy.

In both countries the mercantilist nation-building scheme has been embraced ideologically as well as in practice. The governments in South Korea and Taiwan have both discriminated against potentially competing imports by means of tariff barriers

⁴⁰ However, see notes 23 and 24.

and import controls which have been eased only gradually and reluctantly.⁴¹ In Taiwan in the 1950s high tariff rates and import restrictions were enacted to promote the development of industries such as textiles, flour, sugar, plywood, plastics, paper, cement, all of which were industries the government was anxious to develop. Import controls, foreign exchange control, high import tariff and multiple exchange rates were all policies associated with the import substitution strategy. One would think that when Taiwan in 1958 and Korea after 1961 turned toward export orientation such mercantilist devices would have to be abandoned. So was not the case, however. Right through to the 1980s, indigenous industries were being protected efficiently by means of import duties. In Taiwan the average nominal customs tariff on imported goods was as high as 55% up to 1974. In the 1970s the government undertook to encourage capital intensive industries. Petrochemicals, steel, shipbuilding, automobiles were regarded as key industries in the national economic strategy and received protection accordingly.

Many of the industries were developed under direct state ownership and an even larger number was developed by means of licences allocated to private firms. In 1945 there was no textile industry in Taiwan. Most of the firms established under government protection in the early 1950s were actually firms from the Mainland which had made the exodus to Taiwan together with the Kuomintang party. Also in industries such as cement, plastics, wire & cable and paper and pulp concessions were given to private firms with close political contact with the ruling KMT party.

Although it is true that Taiwan's effective rate of protection gradually has become considerably lower than in most other LDCs it is also true that until the 1980s the trade policy was more of an 'export *cum* protection' regime than a free trade regime. In fact, true trade liberalisation is a recent phenomenon. Tax and customs exemptions and rebates for exporting firms can therefore be regarded as elements in a trade-oriented, albeit predominantly protectionist trade policy. So, export promotion and protection

⁴¹ For example, Wu shows that as late as 1970 no fewer than 41% of all industrial goods were classified as "controlled", which means that they were protected from foreign competition. This control system was abolished almost completely in 1972, since which time customs duties are the only form of protection remaining. Wu Rong. I, Trade Liberalization and Economic Development in Taiwan, ROC, in *Social Sciences Development*, National Chung-Hsing University, Taipei, 1988

have been two sides of the same coin, they have been part and parcel of a strategy for national economic development. The enormous trade surplus accumulated over time would scarcely have come about without this interventionist policy. Moreover, it is only in this perspective that the persistence of an, according to conventional economic wisdom, unhealthy trade surplus could be explained. K.T. Li, one of the leading architects of Taiwan's industrial policy, gives the following explanation: "If we are to secure international financing for major industrial and infrastructure projects, we must maintain a sound fiscal condition and a substantial cushion of international reserves".⁴²

How can it be that so many still regard Taiwan and South Korea as examples of free trade when a mass of evidence point in the opposite direction? One problem is that the object of study itself, i.e. the state, issues statements about its own role which are often confusing and not seldom contradictory. Taiwan's political leaders are normally anxious to point out that they advocate market economy, competition, free enterprise and liberalisation. The empirical content of these concepts appears to be of minor importance. The concepts are rather used as slogans and as ideological window-dressing to Westerners.⁴³ In the 1980s, trade liberalisation became a catchword although it is questionable how many political leader and technocrats would accept or even understand the principle of comparative advantage.⁴⁴ So, the *Council for Economic Planning* has no problem with reproducing Gary Becker's misconceptions of the Taiwanese economy. On the contrary, such statements serve a political purpose and may therefore be exploited no matter how ill-conceived they may be. Then, ironically enough, free-trade interpretations of the Taiwanese economy can be part and parcel of a nationalist, state-driven mercantilist development strategy.

But what about rent-seeking? Has the state really been able to maintain a strongly autonomous position *vis-à-vis* private economic and political interest groups? The fact that trade liberalisation was slow indeed before 1987 although the political

⁴² Li, K.T., *The Evolution of Policy behind Taiwan's Development Success*, New Haven: Harvard University Press, 1988, p. 130.

⁴³ Chou, Y., From Neo-Mercantilism to Liberalization - The Role of Ideology in Revising Taiwan's Trade Policy, *Public Administration*, no 23, 1991.

⁴⁴ Chou 1991, op.cit. See also Chou Yu-je, The Role of the State in Revising Taiwan's Neo-Mercantile Trade Policy. *Chinese Journal of Public Policy Studies*, No 13, 1991, pp 31-57.

rhetoric said differently could, in fact, be interpreted as a sign of weakness on the part of the state. It might be that the rhetoric mirrored a true will to liberalise but that such attempts were blocked by vested interests in industry and in the bureaucracy. It is no secret that also in Taiwan there have been many official and unofficial channels open between government administrators and business leaders.⁴⁵ However, until recently Taiwan has been an autocracy ruled by an elitist party and by a president with powers “rarely conferred on any other head of state in the world”.⁴⁶ There is no reason to believe that Taiwan has not had its share of “wining and dining”, favouritism and even outright corruption, although it may not have reached such outrageous proportions as in South Korea. Nonetheless, although there is favouritism and discrimination one should not think that the government has bowed to pressures from private business-groups and distributive coalitions, at least not before the 1980s. On the contrary, the government has undertaken to encourage private enterprise and its own task in this has been to “protect domestic industries from external competition and to promote their competitiveness in the foreign markets”.⁴⁷ Charles Wilson’s portrayal of government-business links in 18th century England is equally valid for 20th century Taiwan: “Merchants might influence government; but they did not manage it. The decisions taken were those of government itself, composed as it was of men who believed that the business of government was to govern”.⁴⁸

The national development strategies in East Asia have encouraged market expansion and integration. Import substitution policies were applied on a home market that was growing vigorously, at first as a result of land reform, and later due to export successes. The home market’s growth dynamic stimulated internal competition despite the fact that foreign competitors were shut out. This took place not in accordance with the principles of free trade theory but followed *mercantilist* principles of

⁴⁵ Yu, Tzong-shian, *The Relationship between Government and the Private Sector in the Process of Economic Development in Taiwan, ROC, Industry of Free China*, October 1985, pp. 1-16.

⁴⁶ Tien, Hung-mao, *Origins and Development of Taiwan’s Democratic Change*, Paper presented at the annual meeting of the Association for Asian Studies, Washington, D.C., March 17-19, 1989. Quoted in Chou, (1991), *The Role of the State*. p. 38.

⁴⁷ Chou, 1991, *The Role of the State*, p.50.

⁴⁸ Wilson, *Op. cit.* p. 150.

external protection together with internal encouragement of market integration.

So, although one would think that under protection entry to business would have become more difficult the truth of the matter is that it became more easy. Indeed Taiwan's economy has a sector with large and state-sponsored companies which have entered into what might be called a "mercantilistic partnership" with the government.⁴⁹ On the other hand there is a sector of small and medium-sized companies which operate with little or no government support but via informal institutional arrangements. Firms in this sector have been able to finance their expansion without government backing.⁵⁰ They function efficiently as long as production costs and transaction costs can be maintained low enough to allow for production to take place on small scale basis. Thus, the mercantilist partnership between the state and a few private companies did not restrain others from entering. On the contrary, it paved the way for their entry.

The developmental state is autonomous, but autonomy *per se* cannot explain why the state has become developmental rather than predatory. Douglass North's predatory state, constrained as it is by high transaction costs and rivals for the reigns of power, exists in a closed system, in a world without other states. In contrast, the developmental state exists in a world perceived as one of highly competitive states. The more closed the system the more likely that predatory states are being perpetuated. The more severe the foreign threats, the more likely that the state takes a developmental orientation. "Developmental orientation" is synonymous with fostering of *national* economic development and in East Asia the demand for national development was brought about by the external communist threat imposed on the governments. In this we find a striking similarity with the mercantilist state of Western Europe which also materialised in a highly competitive environment.

⁴⁹ In his *Governing the Market*, Robert Wade presents a convincing case for the close co-operation between the government and the these larger companies. However this study offers little insight into the behaviour of the smaller companies in the sector which is found outside the government-sphere.

⁵⁰ The only real control to speak of is of course the fact that the official financial sector, which is state-controlled, is the sector where most of the loan capital is originally created. Shea, Jia-Dong and Ya-Hwei Yang, *Financial System and the Allocation of Investment Funds*. Conference paper Taipei 4-5 Dec 1989.

Conclusion

The mercantilist era was a formative period for the national economies of Western Europe. The mercantilist state established institutions which lowered transaction costs within national boundaries in order to facilitate economic integration. The principal goal of this policy was the protection and furthering of a national interest. Similarly, the developmental states of East Asia have undertaken to further economic development for the sake of protecting their national interests. The common factor which explains why it is Western Europe and East Asia that have developed in this way is that the states in both regions were pressured from abroad by competitive and dangerous neighbours. Thus, it was political competition in both regions that made it necessary for elites of both regions to protect national interest instead of furthering their own special interest which is so often the case both in history and in the present-day Third world.

The creation of a nationally integrated market economy has gone hand in hand with strongly interventionist government policies. This casts serious doubt on the validity of Public Choice theory and theories of the Rent-seeking Society. They offer no solution to the question of how to incorporate the state in a theory of economic development. Basically what they do is to repeat an old and familiar story that government intervention is a brake on the efficiency of the market, and that it, therefore, should be kept at a minimum size.

In this paper an attempt has been made to explain why some states produce and enforce institutions which lower transaction costs, while others fail to do so. It has been argued that in the real world outside the ivory tower of Public Choice theory the state is needed for the development of national economies. This is so in spite of the fact that it is equally true that in the very same world the state is often a major source of national economic decline.

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