2 SELECTIVE LITERATURE REVIEW

2.1 The Golden Age[1] and The Rise of The State

Conventional discussions of the role of the state have been conducted and centered around welfare economics with emphasis on market failure. In the market failure framework, the state is seen as the social guardian and its role is to correct for the failures of the market, using measures like public production, regulation, tax, subsidies, reallocation of property rights, etc. The early postwar years witnessed the worldwide rejection of the laissez faire doctrine that failed spectacularly during inter war period. Active state intervention to smooth the business cycle through the use of newfound Keynesian policy tools was deemed imperative. The old dogma of balancing the budget at all costs was abandoned. Budgetary policy was given the role of coordinating investment and savings in order for the economy to achieve full employment.

Also, in many countries the role of the state expanded much further than simple maintenance of the level of activity through aggregate demand management. Many states started intervening with a view to change the structure of their economies. For example, Japan[2] and France[3] combined sectoral industrial policy with centralized investment coordination through five- year indicative planning. Meanwhile, the state took an even more active role in many less developed countries (henceforth LDCs). The desire of the newly independent nations to acquire not only political but also economic independence put rapid economic development at the top of the political agenda. It was widely accepted that state-led industrialization was the fastest and surest way to achieve the aim. Not only was the traditional infant industry argument evoked to justify the strategy of state-led industrialization via heavy import protection and subsidies but also an array of new theories justifying the centralized coordination of industrial investment were developed within the emerging subdiscipline of 'development economics'[4].

Gerschenkron (1966), basing his case on the experience of earlier European industrialization, suggested that as a country embarks on a developmental process later and later, it needs to raise proportionally bigger and bigger amounts of savings[5]. Thus, there needs a more powerful institution for industrial financing, the state being the most powerful of such institutions. On a more practical front, the states in these nations were actually compelled to take the role of entrepreneur because these nations lacked a well-developed capitalist class that could take over the economic organizations left behind by the colonizers. The result was the emergence of a variety of new industrialization strategies in the LDCs, in which the state plays the leading role in manufacturing and infrastructure through its control over state- owned enterprises and financial resources.

2.2 The Neo- Liberal Upsurge

A series of events that started emerging from the late 1960s began to challenge the interventionist models established during the Golden Age. If the rise of the state in theory and practice in Golden Age was dramatic, its fall after the Golden Age was equally, if not more, dramatic. The consensus was dramatically overturned by the upsurge of Neo-Liberalism, which sought to end the mixed economy and re-introduce market principles to the extent that would have been unimaginable during the early postwar years. The state is no more assumed to be an impartial, omnipotent guardian and is now seen as a vehicle for political groups to advance their sectional interests. Hence, with the beginning of the monetarist[6] policies in the advanced capitalist countries, industrialist in most LDCs ran into trouble because of the critical shortage of foreign exchange, prompted by high interest rates, falling world demand and the debt crisis. Most of the LDCs found themselves difficult to survive the massive external shocks to the systems which were already finding it increasingly difficult to cope with the growing population and the increasing diversification of interests. Under the influence of the Bretton Woods institutions, these countries often opted for dramatic liberalization programs, but often unsuccessful.

It is also argued that the artificially cheap price of capital created by financial repression in the states' effort to promote import substitution industrialization (ISI), has led to lower savings and the adoption of excessively capital-intensive technologies, hence added to unemployment and income inequality. Besides that, the rent-seeking argument developed by Krueger (1974) and Posner (1975) asserts that the creation of entry barriers by the state leads not only to the standard deadweight welfare losses but also to additional 'waste' from expenditures on unproductive political activities, trying to influence the state in its capacity to grant the property rights.

2.3 Institutionalist Criticisms of The Foundations of The Neo- Liberal Analysis

Contrary to the popular belief, the Neo-Liberal doctrine is in fact heterogeneous. The biggest contradiction in the term neo-liberalism comes from the fact that it was born out of a marriage of convenience between neoclassical economics as the source of intellectual legitimacy and the Austrian-Libertarian tradition as the source of political rhetoric. But in return for the increased power of persuasion that they acquired by allying with the Austrian-Libertarian tradition, Neoclassical economics had to pay a heavy price. In order to maintain the alliance with the Austrian-Libertarian tradition, it has had to suppress its intervention streak, given the strong anti-statism of the latter[7]. Such suppression involves intellectually and morally indefensible practices like drawing an 'arbitrary' boundary around the state without acknowledging such compartmentalization. In short, their theories lay more emphasis on the 'political' rather than 'technocratic' aspects of economic problems.

One common feature of the neo-liberal theories is their deep mistrust of the state. It uncritically, or intentionally rather, assumes the state, or the bureaucrats as its components, always acts in its own interest. In addition, mistrust of collective action, on which the neo-liberal mistrust of the state is based, is also problematic. The neo-liberal preference for individual action to group actions has some awkward political implications. It is interesting to note that neo-liberals often attack 'interest groups', but after all, those interest groups are associations of individuals whom they regard as absolutely sacred. How can a consistent liberal deprive the individuals of the freedom to join a group? Indeed, the neo-liberals do endorse certain interest groups, such as private firms. If some interest groups are legitimate and others are not, what is the criterion to decide which group belongs to which category? Hence, policy conclusions drawn from models ignoring these facts are at best misleading and at worst pseudoscientific renderings of the model-builder's ideological conviction against the state[8].

The Neo-liberals believe that Government failures are, on the whole, more serious than market failures. It blames the state interventions for most economic ills and its prescriptions for economic problems consist largely of deregulation and reducing the economic role of the state to no more than that of a night watchman. However, the concept of market failure can mean a hundred different things to a hundred different people. One person may see a 'perfection' while another as 'failure' of the market. Therefore, only when we make our theory clear, i.e. what we think the ideal market is capable of doing, we can make what we mean by 'market failure' clear.

But, how much does 'market failure' matter, however we define it? It actually matters greatly for neoclassical economists, as neoclassical economics is economics about the market. The market is essentially the economy. Thus, if the market fails, the economy fails. If the economy fails, the state as the only 'legitimate' institution has to step in. In contrast, market failures may not matter so much for the institutionalist economists as they regard the market as only one of the many institutional mechanisms that made up the capitalist economic system. There are other institutions such as firms as institutions of production, the state as the regulator of the institutions. Therefore, focusing only on the market gives us a wrong perspective as we lose sight of a large chunk of the economic system and concentrate on one part only.

The market primacy assumption advocates by the neoclassical economist is also questionable. Economic historians have repeatedly shown us that the market mechanism was not an important part of human economic life till recently. In fact, the emergence of markets was almost always deliberately engineered by the state, especially in the early stage of capitalist development. Even in the case of the US, the supposedly free market economy, the state has intervened heavily in establishing property rights, which were critical for its success in early industrialization[9]. In addition, the US was the home of the idea of infant industry protection.

In fact, there is virtually no country, except Hong Kong, which achieved the status of industrialized country without some periods of heavy state involvement in the development effort. The exact forms of intervention varied, but the fact remains that successful development efforts involved substantial state intervention.

2.4 Literature Review on The Role Played by The State Via Public Enterprises

For the past two decades, the question of ownership and economic efficiency, or privatization rather, has become a central issue of policy debate among economists. The IMF and World Bank's argument for privatization is the poor economic performance and the inefficiency of state- owned enterprises and over- extension of the role of the state. The unfavorable assessments of public enterprises (henceforth PEs) and the role of the state in economic sphere have been echoed by some influential mainstream economists such as Balassa et. al (1986)[10] . The justification for the superiority of private ownership usually relies on the residual claimant theory and the dispersed knowledge theory.

2.4.1 Residual Claimant Theory

According to Demsetz (1997), modern production is often organized as team production, hence, interdependence among the individual's effort. As such, it is difficult to measure individual effort, and it therefore pays to have a specialized monitor who can ensure the individual member is putting maximum effort. However, who monitors the monitor? Here, it is argued that private ownership is superior over public ownership as private ownership, being the residual claimant to the profit of the enterprise, has an incentive to maximize profit.

However, it is important to note that residual claimant theory may justify the owner- managed firm, but does not give much support to private ownership in the form of modern joint stock company. Shareholders do not participate in the production process as members of the team and they are at information disadvantage *vis-a-vis* the managers whom they are supposed to monitor. Moreover, individual shareholders do not have the incentive to devote time and resources to monitoring the managers, given that any improved performance resulting from the monitoring effort is a 'public good', where those shareholders who do not contribute to such monitoring can also benefit.

This criticism is rebutted by the argument that even if shareholders do not act as ideal monitors, the stock- market will function as a monitoring mechanism. The belief in the efficiency of the stock- market as a monitoring device rests on the belief in the efficiency of the 'exit' mechanism in the product market. However, private ownership *per se* does not guarantee an efficient functioning of the 'exit' option in the product market. Many private monopolies are protected by natural and artificial entry barriers and customers may not in practice have a genuine 'exit' option.

The residual claimant theory is based on the behavioral assumption of pure material self- interest. However, without a well- established property rights system, the residual claimant would not have the incentive to monitor his 'team-mates', as his claim could not be enforced. Therefore, the fact that no legal system, including the property rights system, can properly function without some degree of moral commitment implies that in practice, the very existence of an efficient property rights system, which is necessary for the residual claimant theory to hold, depends on some departure from the model of self- interest.

2.4.2 Dispersed Knowledge Theory

According to the Austrian School, there is limited transferability of knowledge. The superiority of private over public ownership is based on the argument that the state is always more ignorant than individual private owners, as far as the latter's own business is concerned. However, this argument does not provide a general case for private ownership. The difficulty of utilizing dispersed knowledge is ubiquitous, and is not confined to public enterprise management. Also, competition, that plays an important role in the generation of the information necessary for effective co- ordination, is not an argument for private ownership *per se*. Product market competition will generate the same information regardless of who owns the enterprise concerned. This may include competition from other public enterprises, domestic private firms and also export market.

Meanwhile, the allegation that public enterprises are invariably inefficient cannot survive even at the elementary examination of facts. PEs are ubiquitous in mixed economies and are not simply confined to left- wing regimes. In addition, empirical evidence on the performance of PEs relative to private firms (henceforth PFs) in properly conducted comparisons- which control for the effects of industry, size, age, market power...etc.- is far from being either universal or conclusive.[11]

One of the reasons for the establishment and operation of PEs derives from macroeconomic considerations, that is, the nature of private investment in a mixed economy. Chang (1993) has argued that where public investment is part of a national plan, it is possible to take into account all kinds of criss- cross effects that would not be possible with private investment. Besides that, the state may have to step in to establish firms in many areas where the country may have a dynamic comparative advantage but the scale of investment required is too large for PFs to undertake. Apart from the issue of economic efficiency, there are cases where public enterprises pricing policy is used to achieve distributional objectives. This could save the high information gathering and monitoring costs involved in running the equivalent tax or subsidy schemes.

However, even though there is no rigorous empirical evidence showing the general inferiority of PEs, this does not mean that everything is fine with PEs or that there is no room for improvement. Immediately 'privatization' come as the best alternative to increase efficiency. However, can privatization actually solve the alleged problems associated with PEs' performance? Let us study the experience of Syarikat Air Johor (SAJ).

The privatization Master Plan (PMP) was introduced in 1991 to guide the implementation of the program. The privatization program, as embodied in the PMP, had five main objectives, namely, to facilitate economic growth; relieve the financial and administrative burden of the government; improve efficiency and productivity; reduce the size and presence of the public sector in the economy; and help meet the restructuring objective of National Development Policy (NDP). There are various modes of privatization, for example, the sale of assets, sale of equity, lease of assets, management- buy- out (MBO), build- own- operate (BOO) and build- operate- transfer (BOT). In the implementation of the privatization program, two approaches, namely the government- identified and the private sector initiated approaches were adopted. The private sector initiated approach was particularly aimed at recognizing and rewarding private sector initiatives and innovations in identifying projects for privatization.

The State government of Johor has taken the initiative to privatize its Water Work department in April 1999 with the establishment of Syarikat Air Johor (SAJ) holding. Among the objectives of this privatization are; to improve the capability of water supply in the future; to operate the production and distribution of water in a more efficient and cost effective way; and to ensure high quality water and sufficient water supply. The perceived benefits from this privatization are; to overcome the problem of water loss from 40 per cent to 20 per cent; adopt high technology system with efforts gearing towards research and development; obtain financial benefits in the form of tax, goodwill and the payment of debt (by the private sector instead of the government).

Upon the completion date[12], the company's ordinary shareholding shall be as follows:

Shareholders	
Lambang Optima Sdn. Bhd.	80%
YPJ Corporation Sdn. Bhd.	15%
Valuescape Sdn. Bhd.	5%

In addition to the rights available to the state government arising out of its equity participation in the company through YPJ Corporation Sdn. Bhd. and Valuescape Sdn. Bhd., the state government shall be allotted as fully paid the special share which entitles the state government to exercise the right set up in Appendix X111 of the contract.

In the evaluation of the performance of SAJ since the privatization, it was found that some positive actions have been taken[13] , among others :

1. The establishment of Central Purchasing Unit in June 1999

- help in the controlling and monitoring of cost through central purchasing.
- save cost by negotiation to obtain the best price.
- the re- negotiation of the chemical supply contract has resulted a saving of RM250,000 per annum.
- The re- negotiation of supplies and services contract. As a result, RM2.0 million is saved for the period of June 1999 to June 2000.
- Implement a more comprehensive and better cost and supply control system so as to avoid any wastage. To date, there is a saving of RM180,000 on meter recorder.

2. Increase in production

- As at July 1999, there was a decrease of 66 per cent on overtime, which was from RM660,000 per month to RM200,000 per month.

3. Improve in cash flow

- The SAJ managed to collect overdue bills totaling to RM29.0 million.
- The bill processing system has been upgraded and is more systematic than before privatization.

4. The establishment of Operation Center on 1st October 1999

- Operate 24 hours per day and 7 days per week.
- Decrease cost of wastage.
- Quicken the follow- up action.
- Improve on customer services.

5. Injection of capital

- As of February 2000, there has been an injection of capital totaling to RM120 million to help SAJ from being sued by their creditors.

From the experience of SAJ, although there seems to be an improvement on the performance of this company after privatization, however, this increase in efficiency can actually be done through organizational reforms. Therefore, we cannot actually conclude that the mere change of ownership would enhance efficiency.

2.5 Selective Review on The Studies Done on The East Asian Miracle Economies

The World Bank (1993), in its report on the East Asian Miracle, says that a fundamentally sound development policy was a major ingredient in achieving rapid growth in the East Asian Economies. According to the report, macroeconomic management was good, and stable macroeconomic performance has provided the essential framework for private investment. It also recognized that in most of these economies, in one form or another, the government intervenes, systematically and through multiple channels, to foster development, and in some cases the development of specific industries.

Policy interventions took many forms- targeted and subsidized credit to selected industries, low deposit rates and ceilings on borrowing rates to increase profits and retained earnings, protection of domestic import substitutes, subsidies to declining industries, the establishment and financial support of government banks, public investments in applied research, firm and industry- specific export targets and wide sharing of information between public and private sectors.

At least some of the mentioned interventions violate the dictum of establishing for the private sector a level playing field, a neutral incentive regime. Yet these strategies of selective promotion were closely associated with high rates of private investment, high rates of productivity growth. The question is, are some selective interventions, in fact, good for growth?

The report concluded that in Northeast Asia, in some instances, government interventions resulted in higher growth with equality than otherwise would have occurred. Nonetheless, in the newly industrialized economies (henceforth NIEs) of Southeast Asia, government interventions played a much less prominent and less constructive role in their success.

The World Bank, however, advocates that the government should intervene in resource allocations only when market failed to do so. In other words, they believe markets can perform the allocative function more efficiently. They also believe that selective interventions must be disciplined by competition, either via markets or contests.

Lall (1994) in his article titled ' The East Asian Miracle: Does the Bell Toll for Industrial Strategy', called for a re- examination of East Asian 'miracle Report'. According to him, the World Bank's study on the role of governments in Asian Miracle economies has strengths by acknowledging the extent of interventions and draws some conclusions on macroeconomic management, policy administration and education. On industrial policy, however, it is flawed.

The World Bank's study concludes that selective interventions (crudely put as 'picking winners'), in general, was nonetheless not really effective in meeting its objectives. Thus, the remarks of the Bank: governments should only undertake 'market- friendly' interventions and get economic 'fundamentals' right. Is this then the final word on industrial policy? Not on the basis of the 'miracle study' as the evidence presented is not complete. The theoretical framework for reviewing the efforts of industrial policy is inadequate and some logical implications of the arguments are not followed through. Hence, the conclusion on industrial policy is unwarranted and misleading.

The report also fails to address the market failures that affect industrial development and deepening, or to analyze how industrial strategies in Japan and Korea managed to overcome those failures. Hence, the conclusion in the report that says ' selective intervention were neither as important as their advocates suggest nor as irrelevant as their critics contend' is not justified, as the positive contribution of selective intervention has not been properly analyzed. It looks at each intervention separately rather than as part of an overall strategy. And so it is completely unable to evaluate its real contribution.

The World Bank's final argument against industrial policy in the study is that at the international scene, the wake of liberalization and the pressures exerted by the developed Western Countries have made many of the instruments of industrial policy increasingly constrained. However, Lall's (1994) argument was, if a valid economic case for intervention exists, surely the study should ask for a review and easing of those pressures (given its considerable influence in the international scene) and not otherwise. Therefore, it is self- evident that the World Bank's policy conclusions, supporting entrenched neo-liberal views, are biased at best and misleading at worst.

Meanwhile, over the past decade or so, another stream of literature has emphasized the directive role of the state in East Asia[14]. Research by Amsden(1985), Deyo(1987), Dornbusch and Park(1987) and many others[15] have underlined the importance of state intervention in promoting growth in the NIEs. According to them, the government has led, and not followed the market. The governed market theory says that: Government policies deliberately got some prices 'wrong' so as to change the signals to which decentralized market agents responded, and also used non-price means to alter the behavior of market agents. Various trade incentives and control instruments coupled with mechanisms to spread risk have allowed the governments to guide the market process of resource allocation, producing different investment and production outcomes than would have occurred with either free or simulated market policies. (Wade, 1990:29)

Tan Kock Wah (1999) exemplifies this view where he argues that the superior economic performance of the NIEs is largely attributable to governments which issue 'prescriptions' (identifying dos'), rather than 'proscriptions' (identifying don'ts). According to him, a proscriptive government will tend to stifle initiative, whereas a prescriptive government will tend to leave open areas where initiative can be exercised.

The importance of industrial policy is that it avoids haphazard self-contradictory policies, which hinder, more than promote the development of competitive industries in the economy.