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# Economic Institutions and Economic Growth in South Africa

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ECONOMIC INSTITUTIONS AND ECONOMIC GROWTH

IN SOUTH AFRICA

(TITLE)

BY

Lumkile Mondi

**THESIS**

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF

M.A. in Economics

IN THE GRADUATE SCHOOL, EASTERN ILLINOIS UNIVERSITY
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# ECONOMIC INSTITUTIONS AND ECONOMIC GROWTH IN SOUTH AFRICA

Thesis

Presented in Partial Fulfillment of the Requirements for the degree of Master's of Arts in Economics in the Graduate School of Eastern Illinois University

by

Lumkile Mondi, B.Com., B. Com. (Honors)

* * * *

Eastern Illinois University
1993

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Advisor
Department of Economics

FINAL DRAFT

# DEDICATION

To my sister Florence Nonkululeko and my lovely niece Phumeza.

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## ABSTRACT

The collapse of rapid growth in industrialized countries in the mid-1970s has suggested to scholars that Keynesian economic management is not the ultimate way to run a viable capitalist system. What has emerged from the crisis is the recognition that different capitalist countries have for long had distinctive patterns of development and alternative patterns of economic management.

One such form of economic management is neo-corporatism. The pillars of "neo-corporatism" are found in the tri-partite alliance between centralized trade unions, centralized employers' organizations, and the state. These institutions coordinate the levels of investment, wage, and employment in the economy to ensure structural change without high inflation or mass unemployment.

Another major form of economic management is the industrial policy approach. The supporters of industrial policy argue that the success of East Asian countries is due to centralized active role of the state in formulating a vigorous economic system which promotes capital accumulation, innovation, and productivity growth.

The recent rise of the New Institutional Economics

reminds us that the market is not the only nor even the predominant way in which our economic life is organized. As a third pattern of management, it emphasizes that non-market institutions are integral parts of socio-economic life and not unfortunate "rigidities" which have to be eliminated.

In this study, I apply the new institutional economics to assess the economic development of South Africa. I critically evaluate the role of markets and states in the development process. I emphasize the need for a democratic compromise to rid South Africa of deep social, racial and ethnic divisions. I argue that a democratic compromise may allow the state space for policy effectiveness. I conclude that a policy mixture of the state, markets and institutions may take South Africa back to higher levels of economic growth.

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# INTRODUCTION

The debate about the role of the state in economic development demonstrates the power of infinite repetition as a weapon of modern scholarship. Neoclassical economists argue that the more successful developing economies show relatively little intervention in the market and conclude that developing countries should shrink the size of state and remove many of its constraints on the market.

State interventionists argue that neoclassical economists have their facts wrong: the most successful cases show "heavy" or "active" intervention. They conclude that governments can, in some circumstances, guide the market to produce some better industrial performance than a free market, even in the absence of neo-classical type market failure. But neither side has been noticeably enthusiastic to specify just what evidence would be consistent with its position and what would not.

The New Institutional Economics asserts that the market is not the only predominant way in which our economic life is organized.[1] It has shown that non-

[1]Coase (1937), Coase (1960), Simon (1983) are the seminal works in this tradition. Williamson (1975) has established itself as a modern classic. For more recent theoretical developments, see Williamson (1985), Matthews (1986).

market institutions are integral parts of socio-economic life and not unfortunate "rigidities" which have to be eliminated. By applying the new institutional economics I critically examine the South African Political Economy. I contend that apartheid was created to redefine property rights and thus reduce transaction costs and improve productivity. However, the state failed to anticipate the unintended consequences of its institutional plan and in the face of new demands by Africans who were excluded, the apartheid institutional coordinating framework collapsed. I emphasize the urgent need for a democratic compromise to rid South Africa of social, racial and ethnic divisions.

In chapter one I critically evaluate the government failure, market failure, morality and political economy literature on the role of the state. In chapter two I introduce the new institutional economic theory of state intervention. Chapter three evaluates the development of South Africa. Chapter four and chapter five discuss the importance of institutional innovation and I argue that neither the state nor the market alone can solve the coordination problem of independent but interdependent agents. I conclude that a policy mixture of the state, markets and institutions may take South Africa back to higher levels of economic growth.

# CHAPTER 1

## The Role of State Intervention: A Literature Review

### Introduction

Coordinating economic activity of independent, but interdependent agents with divergent interests and dispersed knowledge is a puzzle for economists. Classical economists concern themselves with coordination within economic enterprises and between economic enterprises. Neoclassical economists focus specifically on coordination between economic enterprises with the market playing a crucial role. Welfare economists convincingly spell out why markets in some instances fail and what kinds of interventionist measures the state could play to correct them.

Recently economists have become critical of the conventional approach. The New Institutional Economics looks at not only market coordination but also on non-market coordination within and between enterprises. What has become clear is that effective coordination both within economic units and between such units can only be

achieved at a cost. By introducing the costs of achieving coordination, or transaction costs, the New Institutional Economics effectively breaks away from neoclassical tradition in which perfect coordination is achieved without any costs. By regarding the market as just one of many alternative economic institutions, the new institutional economics establishes that the efficient operation of the market depends on many other institutions. In particular, the state not only plays the role of ultimate guarantor of property rights and other legal forms, but also intervenes extensively in order to establish the market as an institution.

In this chapter the discussion is in four parts. In the first section I review the literature that is concerned with the failure of the market and potential remedies. Next I review the state intervention debate; should the state intervene when there is market failure? Then I review the literature concerning the role of the state: does the state serve some "public" or "social" purpose other than satisfying individual or group interests? Finally, I summarize the New Institutional Economics literature concerning the ability of the state to intervene effectively. I contend that the new institutional economics by recognizing that state intervention carries certain costs is able to avoid the naive view of state intervention as the ultimate solution

to the coordination problem. At the same time, by recognizing that allocating resources through the market is also costly, the new institutional economics is able to reject the biased view of government failure literature which argues that the cost of state intervention invariably exceed the cost of market transaction. Thus the seemingly "institution free" mechanism is sustainable only as part of the complex fabric of various institutions.

## 1.1 The Market Failure Literature

The market failure literature concerns not only the failures of markets to equate private and social costs and benefits but also the remedies to these failures.[2] Traditionally this literature concerns public goods, non-competitive markets, and externalities.

### 1.1.1. Public Goods

Goods and services are either private or public. Non-buyers cannot be excluded from consuming a public good whereas they can be excluded from consuming a private good. Because of the free rider problem, society tends to understate its preferences for public goods

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[2]Baumol (1965) is a classic exposition of the literature. See also Stiglitz (1988).

(Schotter, 1981; pp. 57-63). Therefore public goods are underprovided due to the free-rider or collective action problem (Olson, 1965; Hardin, 1982).

Individual rationality thus leads to collective irrationality, and it is argued that the state should intervene to provide public goods. Unfortunately Peacock (1979) argues that non-excludability is not permanent. Technological innovation can eliminate the "publicness" of some goods by solving the problem of non-excludability. Even if there is a public (collective) good, Olson (1965) argues that the public good may be provided without state intervention because it is likely that a small group of individuals who benefit from the public good will provide it unilaterally. Even in large groups when this condition does not obtain, state intervention is not always necessary because "selective incentives" in the form of private goods provided by the "political entrepreneurs" can overcome the free-rider problem by bringing individual cost-benefit structures in line with the social (group) cost-benefit structure (Olson, 1965; Popkin, 1979). These arguments do not allow us to conclude, however, that the public goods problem can always be solved by private initiatives; in some cases the use of state coercion (e.g. taxation) may be the only possible way to remedy the situation.

### 1.1.2. Non-competitive Markets

Where an individual producer's decisions affect the quantity and price in a market economy, collusive behavior eliminates perfect competition. But when monopoly and oligopoly prevail in a market, the quantity of goods supplied is smaller than in competition and consequently some of the consumer surplus is transferred to firms in the form of "monopoly profit" or rent; such transfers impose a "dead-weight loss" on society. Some argue that in these circumstances it is justifiable for the state to intervene by the use of regulatory agencies, dissolution, divorce, divestment, or public ownership (Chang, 1990).

A powerful argument against state intervention to "correct" non-competitive markets is based on the theory of the Second Best (Lipsey & Lancaster, 1956). If one monopoly element exists, it is sometimes better to introduce a second monopoly element to achieve efficiency. Reducing the number of monopolies to the minimum does not necessarily bring efficiency once monopoly has been introduced somewhere in the system. The theory of the Second Best maintains that rectifying suboptimal conditions such as monopolies in some but not all markets, may not necessarily improve the efficiency of the economy. Anti-interventionists argue that no gain is guaranteed by anti-trust intervention which does not

eliminate "distortions" from all markets (Peacock & Rowley, 1979). This argument, however, does not undermine the interventionist argument because the theory of Second Best does not imply that there can be no gain from such intervention, but only that it cannot be guaranteed.

Another anti-interventionist argument is that state intervention is a major source of market failure. For example, Friedman (1962) argues that, "monopoly frequently, if not generally arises from government support of collusive agreements among individuals". The implication is that the state should stop meddling with the market if it is serious about correcting distortions. In the words of Von Mises (1979):

> "it is absurd to see the government...point its finger at business, saying: `There are cartels, therefore government interference with business is necessary´. It would be much simpler to avoid cartels by ending government´s interference with the market - an interference which makes the cartels possible (such as protectionism)".

Although there can be no doubt that state-administered entry barriers are often a source of monopoly, many initially competitive markets have been transformed into non-competitive ones without collusion or state

intervention through business cycles, structural change, or even sheer luck. Indeed, if the assumption of self-perpetuating competitive markets is unrealistic, it may be pointless from the public policy point of view to argue for or against state intervention in monopolistic markets since there is no criterion according to which they are to be corrected other than the fictitious perfectly competitive market (Demsetz, 1982).

### 1.1.3. Externalities

Externalities exist when an individual´s activities affect the welfare of others. This leads to a discrepancy between the private cost-benefit structure and the social cost-benefit structure. Interdependence among individual activities cannot be a problem in itself, but where its effects are properly compensated for, there arises an "untraded interdependence", namely, externality.

This problem may be overcome by defining property rights more precisely and facilitating negotiations between the parties affecting and affected by externalities. However, it may be impossible to do so because of the "transaction costs" arising in acquiring information, in negotiating, and in enforcing contracts (Coase, 1960; Stigler, 1975). In the absence of such Coasean solutions when externalities exist the state is justified in intervening to ensure the provision of goods

in socially optimum amounts. For example, the state may intervene by subsidizing goods with positive externalities such as education, health, social infrastructure and research and development and taxing when there exist negative externalities (pollution).

Some anti-interventionists try to dismiss the externality argument for state intervention by assuming that the magnitudes involved are negligible. Baumol (1965) and others have pointed out, however, that the list of externalities can be extended almost infinitely. Production of most goods creates a negative externality in the form of pollution. Hirschman (1958) argues that many goods may additionally have positive externalities which he calls forward and backward linkages. For example agriculture supports industry by supplying raw materials. Hirschman would refer to this as a forward linkage. When industry supplies agriculture with fertilizer, Hirschman would refer to it as a backward linkage. Some economists even argue that the absence of some goods say basic foodstuffs, can create crime, a negative externality (Schotter, 1981). Once we begin to accept the pervasiveness of externalities, it seems questionable to justify market transactions at all. The important issue is not whether externalities exist or not, but to explore under what conditions market transactions should be adopted and under what conditions non-market institutions

including state interventions should be adopted, as the New Institutional Economics has recently shown.

Other anti-interventionists argue that correcting one set of externalities leads to another. Friedman (1962) has grave reservations against state intervention based on externalities argument or "neighborhood effects". He points out that intervention: (a) will in part introduce an additional set of neighborhood effects by failing to charge or to compensate individuals properly; and (b) creates externalities by reducing freedom. This is unconvincing since: (a) whether the gains from eliminating existing externalities are smaller than the losses from the newly-created externalities cannot be determined *a priori*; and (b) unsolved externalities also imply a loss of someone's freedom.

## 1.2 Morality, Paternalism and Contractarianism

An important element in the traditional interventionist argument is that the state, at the cost of efficiency must intervene in the market to achieve equity or welfare.

### 1.2.1. Paternalism and Contractarianism

These arguments for state intervention usually take

two forms. First, it is argued that the state should intervene to provide "merit goods" which society (as distinct from the preferences of the individual consumer) wishes to encourage (Musgrave & Musgrave, 1984; p. 78). Second, state intervention may also be justified if the society believes that the market is not an acceptable means of achieving a goal. For example, blood donations or police services are activities of this sort. In this case the state as social guardian should remove the activities from the domain of the market.

This type of argument is often branded as paternalism by those who believe in methodological individualism and its politico-philosophic counterpart, Contractarianism (for an exposition of Contractarianism, see Nozick, 1974). From the point of view of methodological individualism, paternalism is flawed in that it attaches an independent will to society which is no more than a collection of individuals. From the politico-philosophic point of view, the belief that the state should decide what and how individuals should produce and consume is a first step on the "road to serfdom" (Hayek, 1972). Those who believe in Individualism-Contractarianism argue that:

> "the individual and not the group should be the basic repository of rights and obligations. Thus, it

> is believed that "individuals should be allowed, within defined limits, to follow their own values and preferences rather than somebody else´s.....It is this recognition of the individual as the ultimate judge of his ends, the belief that as far as possible his own views ought to govern his action, that forms the essence of the individualist position" (Hayek, 1972, p. 59).

This position does not assume that mankind is egoistic or selfish or ought to be (Hayek, 1972; p 59). No other person or authority, however, can impose its own ethical judgement on the individual since the individual knows best his situation and options. Any interference with the making of individual decisions is seen as violating the innate right for freedom of the individual (Hayek, 1972, 1988; von Mises, 1929, 1979;Friedman, 1962).

If we would rather not introduce any exogenous ethical code other than the individual being the judge of her destiny, Contractarianism, whether of the Hobbesian or the Rawlsian variety, becomes the only consistent view of the state, or more generally, of politics. As Buchanan says,

> "if politics is to be interpreted in any justifactory or legitimatizing sense without the

> introduction of supraindividual value norms, it must be modelled as a process within which individuals, within separate and potentially differing interests and values, interact for the purpose of securing individually valued benefits for cooperative effort. If this presupposition about the nature of politics is accepted, the ultimate model of politics is Contractarian (Buchanan, 1986, p 240).

The ideal state is then the product of voluntary contracts between free individuals who gain from restricting the unfettered exercise of individual free will of individuals. Contractarianism in its most consistent form should be based on the unanimity rule. Otherwise, however fair the outcome of a politico-economic system may appear from some other point of view, it cannot be justified from the Contractarian viewpoint. Imposing a decision on individuals, however, violates the fundamental principle that individuals should be free to make contracts and not to be coerced to any transaction, however beneficial it may appear to an outsider.

### 1.2.2. What should the state do?

On the basis of Individual-Contractarianism, it is argued that any state intervention other than some "minimal" functions is illegitimate because it violates

individual freedom as the ultimate value in human society. According to Peacock and Rowley (1979), "Liberalism" is "prepared to trade off economic efficiency for individual freedom where such a policy conflict becomes apparent".[3]

Von Mises (1979) categorically states that "the government's only legitimate function is .......to produce security" (p 40). To him, any intervention is doomed to invite more intervention leading eventually to socialism. There is no such thing as "the third way" (von Mises, 1979).

Except in areas which can be justified on Contractarian grounds and intervention in the non-exchange economic activities, such as production services, Hayek (1972) argues that state intervention is bound to erode individual freedom. Competition and its prerequisite, freedom of entry, are seen as the best means of coordinating the economy "not only because in most circumstances it is the most efficient method known but even more because it is the primary method by which our activities can be adjusted to each other without coercive or arbitrary intervention of authority" (Hayek, 1972; p. 36). That is, state intervention is

[3]The Liberalism of Peacock and Rowley is Libertarianism. They argue that this argument should be differentiated from Paretian arguments, because the latter are ends oriented whereas the former is process oriented.

objectionable primarily because it violates the fundamental values of Individualism and hence Contractarianism.

According to Buchanan (1986) the state functions that can be justified on Contractarian grounds are found in three levels of collective action. The first level is enforcement of the law. The second level is financing and providing public goods and services. The third level involves changes in legislation or in the rules of the game. Unless there is an unanimous case for changes in the basic rules of the game of society, the role of the state should be the enforcement of the rules of the game through protection of property rights and the enforcement of voluntary contracts and provision of public goods.

Milton Friedman states that "the role of government....is to do something that the market cannot do for itself, namely to arbitrate, and enforce the rules of the game" (Friedman, 1962; p 27). This view is similar to that of Buchanan, but Friedman is much more generous and more vague about state intervention than the strict Contractarians. His list of legitimate functions of the state include maintenance of law and order; definition of property rights; service as a means whereby people modify property rights and other rules of the economic game; adjudication of disputes about the interpretation of the rules; enforcement of contracts; promotion of

competition; provision of monetary framework; engagement in activities to counter technical monopolies and to overcome neighborhood effects widely regarded as sufficiently important to justify government intervention; supplementation of private charity and private family in protecting the irresponsible; whether madman or child (Friedman, 1962; p. 34). Denouncing any moral judgement other than narrowly defined individualism as the Contractarian economists tend to do is as meaningless as citing moral reason for state intervention without discussing the role of morality in our social and economic life.

### 1.2.3. Some Thoughts

Individualism is not a "scientific" view free of values; it is just another form of morality. Individualism also assumes that each individual knows best her interest and the constraints she faces, but this view is also not without problems. First, there are individuals who even the Contractarians do not regard as wholly responsible (madman and children). The borderline, however, between the "normal" and the "abnormal" is a thin one, as Friedman admits (Friedman, 1962; pp 33-34). Thus who has the right to decide who is responsible and who is not? Second, there is no "intrinsic reason why individuals should always pursue their own good or why

they would do so better than others could do for them". As Goodin (1986) notes, people make decision with incomplete information, with ignorance of their future preferences, with ignorance of the full consequences of their own actions, under deceptive decision-making frameworks and with a desire to avoid responsibility for risks. The existence of the implicit preferences (e.g. reckless drivers and drug addicts are not to be seen as acting in their best interests) is another case in point. In such situations, it is not clear whether we should regard individual decisions as the manifestation of their preferences.

In Contractarian philosophy, it is argued that the state cannot be regarded to be "above" individuals, since it is a product of free contracts among independent individuals. Contractarians hypothesize a "state of nature" in which all individual are free to make contracts but compete against everybody else; this leads to the need for the imposition of an extra-individual authority through voluntary contracts in the form of the state to prevent socially undesirable forms of competition.

The "state of nature" scenario is, of course, fiction. During the history of humankind, the choice has been between one form of authority or another, a choice between anarchy and authority, as the Contractarians put

it (Nozick, 1974). Even a cursory look at the history of the last few centuries reveals that modern states were built by rulers and not by freely-contracting individuals. Thus it is in contradiction to historical fact to argue that market transactions brought about the state. The market is a newer social institution, newer than other forms such as the state. As Polanyi (1957) persuasively puts it, historical experience shows us that,

> "the road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism. To make Adam Smith `simple and natural liberty´ compatible with the needs of a human society was a most complicated affair. Witness the complexity of the provision in the innumerable enclosure laws; the amount of bureaucratic control in the administration of the New Poor Laws which for the first time since Queen Elizabeth´s reign were effectively supervised by central authority; or the increase in governmental administration entailed in the meritorious task of municipal reform....... Administrators had to be constantly on the watch to ensure the free working of the system. Thus even those who wished ardently to free the state from all

necessary duties, and whose whole philosophy demanded the restriction of state activities, could not but entrust the self-same state with the same powers, organs, and instruments required for the establishment of *laissez-faire*" (p. 140).

Most Contractarians are not so silly as to believe in the "state of nature" as an historical reality. Buchanan argues that the Contractarian argument is an *ex post* conceptualization or legitimization of the political process as complex exchange relationship and not an *ex ante* moral justification of the existing political order (Buchanan, 1986; p. 247). He thus admits that the Contractarian argument is not based on actual history but on some arbitrary belief. Nozick (1974) tries to defend the state-of-nature explanation saying that,

> "we learn much by seeing how the state could have arisen, even if it did not arise that way. If it did not arise that way, we also would learn much by determining why it did not; by trying to explain why the particular bit of the real world diverges from the state-of-nature model is as it is" (Nozick, 1974; p. 9).

This is peculiar logic. Since it is definitionally impossible that two or more different end states arise

through the same process, it is hardly justifiable to introduce one of them as a "potential explanation" (as Nozick calls it) of the other. Of course, there may be some heuristic value in the exercise, but this advocacy based on heuristic value can only be fully justified when the "as if" explanation is complemented by the "as it was" one, unless it can be shown precisely why the "as if" explanation is superior to the "as it was" one.

More importantly, Contractarianism does not guarantee a minimal state. If there is an unanimous belief, for example, among the members of society that market transactions like blood donation are not morally acceptable in some areas, for example, taking such activities out of the market may be justified even from the Contractarian point of view. What if the individuals in the society gather together to write a new "social contract" which endorses an interventionist state? It is not satisfactory to argue for a minimalist state on the assumption that individuals will opt for a minimal state if they are given a chance, unless we can show that individuals are wealth-maximizers and that the free market will ensure them to maximize their wealth; this is a common assumption in economics, but nothing more than an assumption.

## 1.3. The Political Economy Literature

The Political Economy viewpoints, both on the left (Marxists) and the right (Chicago School) of the political spectrum, have for long criticized the Market Failure approach for too readily assuming that the state will act like Plato's Philosopher King and serve the public. In what follows I will examine three arguments that question the assumption that the state serves the public: the autonomous state approach, the interest group approach, and the self-seeking bureaucrats approach.

### 1.3.1 The Autonomous State Approach

The view that the state should be regarded as "a dynamic independent force" with its own objective function which is distinct from that of the society as a whole is not new (Findlay, 1990; p. 195). Originating from Marx's *Eighteenth Bruimaire of Louis Bonaparte* (Marx, 1934), the Marxist tradition recognizes that a state may acquire "autonomy" from society if no class is powerful enough to impose its will on it.[4] One strand in the recently popular Neoclassical Political Economy goes a step further and characterizes the state as a "predator" which as a monopolist develops property rights

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[4]For Marxist theories of the state, see Miliband (1969) and Jessop (1982).

and a tax system to maximize its "profit" or net revenue (tax minus expenditure), even at the expense of social productivity (see Colander, 1984; Mueller, 1979; Findlay, 1990).[5] Neoclassical Political Economy recognizes that revenue-maximization by the state is an exercise in constrained maximization, since the threat of "takeover" by an alternative ruler from within or from without of the country imposes a "competitive constraint" (see North, 1981; Findlay, 1988).

The view that the state may act as an entity with its own will is a fascinating one, especially when the traditional simplistic interest group approach has treated the state as a black box in which interest groups feed their "policy inputs" (Skocpol, 1985). The approach, however, is not without problems.

First, the approach naively treats the "autonomous" state as a unified entity. As recognized even by one of the earlier proponents of the predatory state approach, the richer institutional context of the modern polity with a bureaucracy and a working legislature makes it difficult to apply this simplistic model to the analysis of real life examples (North, 1990). In fact, the most

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[5]According to Neoclassical Political Economy, what differentiates the market from the polity is not the different behavioral principle of the participants but the different constraints that they face. One of the many names of this emergent school is the economics of politics (Buchanan et al., 1978), Neoclassical Political Economy (Colander ed., 1984).

distinctive characteristic of the modern state is the development of institutional bounds on *arbitrium* (Poggi, 1990). In particular, the "necessity of developing agents to monitor, meter, and collect revenue" (North, 1990; p. 190) introduces a complication in the form of the conflict of interest between the ruler who wants to maximize net revenue and the bureaucrats who want to maximize the budgets of their own bureaus.

Second, talking of state autonomy in abstract does not help us understand real life problems. We must look at state autonomy as a matter of degree which depends on the issues. Different states may have different degrees of autonomy in different areas. The Swedish state for example may be less autonomous than the Korean state in influencing investment decisions of capitalists, but it may be more autonomous in taxing them. Whether or not one should assume autonomy of the state depends on the country one looks at, the time period one wants to study, and the areas of policy in which one is interested.

### 1.3.2 The Interest Group Approach

Another group of arguments which questions whether the intentions of the state serve its own interest rather than society's is what is called the interest group approach. This approach sees the state as "an arena within which economic interest groups or normative social

movements contend and ally with one another to shape the making of public policy decisions" about "the allocation of benefits among demanding groups" (Skocpol, 1985). Since the most powerful groups will be the most able to affect the decisions of the state, state economic policies will be inevitably biased towards them.

The most representative of these theories is the "regulatory capture" theory of the Chicago School. According to Stigler (1975), the pioneer of this theory, "regulation is acquired by the industry and is designed and operated primarily for its benefits" through subsidies, entry restrictions, restrictions on substitutes, subsidies to complements, and price-fixing. Political control over this process is limited by the infrequency of voting and the high cost of acquiring information on the side of voters (Laffont and Tirole, 1988). Introducing the problem of collective action (Olson, 1965) in a more explicit manner, Pelztman (1976) argues that the reason why producers and not consumers capture the regulatory agency is that their smaller number makes collective action easier. This version of the interest group approach prescribes that the best way to avoid possibility of regulatory capture is to deprive the state of the power to regulate.

Some Marxists have argued along similar lines, although with different political connotations. They

argue that the state whose existence depends on the reproduction of the dominant mode of production in society has to serve the interest of the economically dominant capitalist class in that society if it is a capitalist system (Miliband, 1969). In the simpler version of the theory, the state is seen to defend the capitalist class interest even at the cost of individual capitalist's interests. In this view, the solution to the problem of divergence between "public interest" and the objective of the state is to overthrow capitalism and rid the system of class divisions and power so that the "public" will become the whole society.

The interest group approach is useful as a broad framework to understand politics since it enables us to see how "the public" is not a homogenous entity but is made up of diverse groups which struggle with each other to affect the decisions of the state. Apart from some of the sophisticated Marxist versions, however, this approach has shortcomings.

First, many versions of the approach do not adequately discuss the problem of collective action. As pointed out by Olson (1965), and Hardin (1982), the traditional theories of interest groups (both pluralist and Marxist varieties) have too readily assumed that all existing interests will be represented. Even if people have identical preferences, however, they are not

necessarily able to act them out due to the difficulty of collective action. Studies in the tradition of the theory of collective action have shown which groups can assert their interests depends on how large the group is and whether it is feasible to devise some selective incentive/sanction scheme. In addition, the frequency and duration of the interaction among the members of the group and ideology (North, 1981) also is one important factor in successful collective action.

There is also the problem of "agenda formation". It is not true that all interests can be organized, once the configuration of the group is such that the free-rider problem can be overcome. How interests are represented depends on which issues are more easily put on public agenda. Social norms (ideologies) prevent some issues from appearing on the agenda for public action; thus it is almost impossible to organize an interest group around such issues. As Kitching (1980) has pointed out,

> "Certain kinds of argument, powerful though they may be in private deliberations, simply cannot be put in public forum although both individual material interests and the interests of particular groups and classes are still essential forces at play in the politics.....the form in which those interests are publicly expressed and argued over allows for a real

`distance´ to open up between political and public debate and those interests" ( p. 61).

The motivation and the capacity of the state also become important variables in determining what kind of policy alternatives can be discussed, adopted and implemented because government leaders and the bureaucrats often take initiatives well beyond the demands of social groups (Skocpol, 1985). In other words, the existing form of politics, the structure of the state apparatus, the prevailing ideologies etc., all affect what kinds of interest groups could and would be formed (Skocpol, 1985).

Third, most versions of interest group approach do not adequately deal with the process of interest groups politics. Rather, their analysis is "structuralist" in the sense that the outcome of interest group politics is seen as predetermined by systemic parameters. Given such a static view of politics, it is more than natural that the proponents of the approach think that the problem of "biased representation" will never be solved without destroying the existing social structure (for example, a return to the minimalist state or a Socialist Revolution). However, what matters in reality is not just whether a particular social structure let some groups dominate but also the nature of the process of gaining

such dominance. For example, in some South Asian countries mobilization of clientilist groups has become a major channel for the distribution of profits, with some detrimental consequences for capital accumulation (Bardhan, 1984). As another example, in Latin America the fractured nature of the society produces a volatile pattern of capital accumulation where a growth cycle starts only to be quickly disrupted by hyperinflation. Thus a major social upheaval like a military dictatorship austerity program must occur to permit growth to resume (Fishlow, 1990). Interest group politics may be properly understood only when the particular process of contest for political and economic rights in the society concerned is analyzed in detail.

### 1.3.3. The Self-Seeking Bureaucrats Approach

This theory is based on the postulate that bureaucrats are in no sense different from individuals in pursuing their own interests. It is absurd to believe that one and the same individual will behave altruistically in the office and behave egoistically after office hours. It is assumed that the bureaucrats are budget-maximizers. Niskanen (1973) argues, for example, that "among the several variables that may enter the bureaucrats motives are salary, perquisites of the office, public reputation, power, patronage, output of

the bureau, ease of making changes, and ease of managing the bureau". All except the last two are positive functions of the total budget of the bureau during the bureaucrats tenure (Niskanen, 1973). Since the bureaucrats derive utility from higher salaries and greater power of their bureaus, it is rational for them to maximize the budget of their bureaus rather than to optimize social output.

Although the vote-maximizing behavior of politicians may impose some constraints on the size of the budget (because politicians who have to be re-elected do not want high taxes), the outcome is likely to be in favor of the bureaucracy. This is due to the fact that the politicians are at informational disadvantages concerning the cost function of the bureaus, not only because they lack the expertise to estimate such functions but also because state bureaus which are in monopolistic positions have no criterion to gauge their efficiency (Mueller, 1979). The politicians, even when they are somewhat public-minded, are limited to monitoring the bureaucracy according to the crude criterion that the total cost of state expenditure should not exceed total benefits. It is thus argued that the rational and selfish bureaucrats produce goods and services in more than socially optimal quantity.

The self-seeking bureaucrats approach can be

criticized on the following grounds. First, the scope for the realization of bureaucratic self-interest through overprovision of public goods and services differs according to the institutional setting and the political process around the bureaucracy. For example, if bureaucrats are recruited through strict tests (as in Japan or Korea), it is more difficult to expand bureaus than when a higher official can recruit anybody whenever she wants. Also, if the state acts as a "predator", it has an incentive to underprovide rather than overprovide public goods and services (Eggertsson, 1990) and thus mitigate the tendency of overprovision due to the bureaucratic self-seeking. Even in societies where the "principal" is the diffused public, bureaucrats are not totally free to do whatever they want. Given its claim to be a "public" agency, the bureaucracy is more vulnerable to what are termed "voice" checks - say, media criticisms - than private firms are (on the concept of" voice", see Hirschman, 1970). Historically there have been institutional developments within modern states that keep bureaucrats from wielding arbitrary powers such as competitive exams for appointment; auditing of the expenditure; the principle of equality of citizens before the law; expectation that office-holders will operate on the basis of the law, their superiors' directives, and their own "science" and "conscience"; surbodination of

the bureaucracy to ultimate political decisions (Poggi, 1990; pp 75-6).

More importantly, bureaucrats can and do act in a fashion which is not solely self-interested. Often bureaucrats think of themselves, and act to promote it. One such reason is that "public-spiritedness", "altruism" and so on are often held as a genuine principle and not as a thin veil to disguise self-interest. Second, bureaucrats are constantly asked to conform to the organizational objectives of the state and are always under some degree of pressure to promote the "national" or "public" interest.

As the interest group approach emphasizes, groups in society engage in struggles to ensure property rights over productive assets, to claim more resources from the state budget, to restrict property rights and the distributive claims of other groups, and in this process, try and sometimes succeed in influencing the state to their advantage. It would be problematic to interpret every policy as an outcome of interest groups politics because the state not only responds to interest groups demands but often takes initiatives for good or bad reasons. In this respect the autonomous state approach which treats the state as an entity with its own objectives is a useful conceptual approach. The state apparatus, however, is made up of bureaucrats who act as

the "agents" of the ruler. The principal-agent problem makes it impossible to assume that the state is a unified entity without looking at individual cases in terms of the strength of the hierarchy within the bureaucracy, independence of the high-ranking bureaucrats, the prevalent ideology within the bureaucracy, the recruiting method, and so on.

There can be no presumption that the state will act for the public interest, as is usually assumed in standard Welfare Economics. It is equally inadequate, however, to employ another sweeping assumption as to the objectives of the state, like net-revenue maximization or budget-maximization. What kind of objective function the state operates under depends on the kind of interests that can be formed and be acted out as a pressure on the state, the resistance of the state to these demands, the objectives of the top politicians, the strength of control over the bureaucracy, the strength of the hierarchies within the bureaucracy, the means of recruitment of bureaucrats, and the prevalent ideology within the bureaucracy and a host of other factors.

## 1.4 The Government Failure Literature

The information problem and rent-seeking are two important arguments against state intervention. When the state contemplates a policy, it needs to spend resources to collect and process information in order to formulate the possible alternatives and make decisions. Even after the decision the state needs to collect and process information necessary to monitor compliance of the lower level bureaucrats, on the one hand, and of the groups and individuals at whom the policy is targeted on the other. Part of the information problem is that of insufficient information. According to this argument, the state simply "does not know better" about the future course of events; this information can only be gathered at prohibitive costs.

The theory of rent seeking argues that state intervention incurs not only information costs but also costs in the form of diversion of resources into "unproductive" activities by private agents to capture rents generated by state intervention (Buchanan et al, 1980; Colander, 1984). In this section I will introduce the New Institutional Economics approaches of controlling the information problem and rent seeking through organizational innovations.

### 1.4.1. The Information Problem

An important dimension of the information problem is informational asymmetry called the principal-agent problem (Stiglitz, 1988). There are two types of informational asymmetry in relation to state intervention. First, there is informational asymmetry between the top decision-makers and the lower level bureaucrats within the state apparatus.[6] The classic example is the prevalence of "shortages" in socialist economies due to the attempts of the managers of the state-owned enterprises to secure enough inputs by understating their technological capabilities (Ellman, 1989). Second, there exists informational asymmetry between the state and the policy "target" entities such as firms, income groups, and individuals. A good example is the existence of firms under infant-industry protection which persistently fail to grow out of "infancy" in many developing countries. Whatever its source, informational asymmetry means that the state may not be able to effectively implement its policies unless

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[6]In this sense the self-seeking bureaucrats approach is also partly an information argument. However, it is included in the Political Economy literature because of its emphasis on the difference between the objectives of the public, or the top politicians, and the bureaucrats. Asymmetric information problem would exist even if the bureaucrats genuinely want to serve the public interest, because of the limited scope for knowledge transmission (Hayek, 1949 and 1978).

it spends enormous resources to overcome the asymmetry (Chang, 1990). Although the information problem is a serious handicap to effective state intervention it can be exaggerated.

Problems of information collection and processing exist for state intervention only because the rationality of individuals who make up the state apparatus is "bounded" (Simon, 1983). According to Simon (1983), individuals are rationally bounded when they have incomplete information about alternatives. Overcoming the limitations of individual rationality is the *raison d'etre* of human organizations, including the state apparatus (Stinchcombe, 1990). If this is the case, it is unreasonable to criticize the state for having "insufficient" information while assuming that private organizations know everything they need (Chang, 1990).

Concerning the problem of asymmetric information within the state apparatus, note that the problem exists in any organization of reasonable size, not only within the state apparatus. The fact that organizations including the state develop and function reasonably well shows that there are ways and means to mitigate the principal-agent problem; one way, for example, is by designing appropriate organizational structure and promoting organizational loyalty. Asymmetric information, moreover, may exist between the state and the policy

"target" groups, but it also exists between the parties in private contracts. The fact that private transactions which involve high informational asymmetry are conducted routinely shows that there are ways to control this problem as well as through organizational innovations.

### 1.4.2. Rent-Seeking

Another argument against state intervention is that when the state creates rents, economic actors expend resources to pursue these rents, but these expenditures are "wasted" from society's perspective. It should be emphasized that rent seeking is different from profit seeking. Profit-seeking activities refer to taking advantage of market opportunities in order to increase one's legitimate profits. The resources expended on rent seeking, however, are said to be spent on attaining profit from inefficiency such as in a state-franchised monopoly position.

There are several problems, however, with the rent seeking theory and other conceptions of created waste. First, this conception of waste assumes that the prevailing structure of rights is correct. Rights change only when there is a challenge to or competition for a right. This inevitably involves the expenditure of resources. To label such expenditure as "waste" presumes that rights should not be changed, that the status quo

structure of rights is in some sense "natural". Buchanan does as much in the following passage:

> "So long as governmental action is restricted largely, if not entirely, to protecting individual rights, personal and property, and enforcing voluntarily negotiated private contracts, the market process dominates economic behavior and ensures that any economic rents that appear will be dissipated by the forces of competitive entry....If, however, governmental action moves significantly beyond the limits defined by the minimal or protective state, if government commences, as it has done on a sweeping scale, to intervene piecemeal in the market adjustment process, the tendency toward the erosion or dissipation of rents is countered and may be wholly blocked....Hence, attempts will be made to capture these rents, and the resources used up on such attempts will reflect social waste....Rent-seeking activity is directly related to the scope and range of government activity in the economy" (Buchanan, 1980; pp. 8-9).

The state is in the business of rights creation and recreation. There is no *a priori* basis upon which one can declare one rights arrangement "natural" and others

unnatural. There are no rights apart from the state. By enforcing certain claims and rejecting others, the state *de facto* determines who has rights and who does not. Because the state is the source of all rights, it has the power also to change rights, to remove rights from one group and give them to another. It is the very function that Buchanan is protesting against in saying, that rent seeking emerges under normally predicted circumstances because political interference with markets creates differentially advantageous positions for some persons who secure access to valuable rights (Buchanan, 1980; p.11). However, Buchanan fails to realize that the market system was not created out of a vacuum. Rather, the market system evolved due to rent-seeking behavior on the part of individuals and groups who were "losers" under the mercantile system. That is, the structure of rights was altered in their favor. As Commons (1934) has noted:

> "In Jurisprudence this expansion is reflected in the expansion of common law from the protection of tangible property and persons in an age of violence to the protection of business and positions (that is, intangible as well as tangible property) in the peaceful expansion of markets. In politics it is the mass movements of individuals, organized or unorganized, which bring about the transition from

the prerogative to sovereignty, from personal government to the collective bargaining of King, landlords, and merchants, then of corporations, then of employers and employees. Together, these made possible the further evolution, in the Eighteenth and Nineteenth centuries, of those incorporeal and intangible properties, whose value consists, not in their physical uses but in the going business and jobs of going concern" (Commons, p. 314).

Thus while the market is made out to be the naturally efficient system, a standard from which by comparison waste is measured, there is no inherently natural structure of rights. This is rather a device used to imbue the advocated rights structure with an aura of "correctness" where no such thing is possible. Since all legal change involves an artificially created transfer by the state, it is seen as wasteful under the neoclassical definition of waste. Since there is no *a priori* reason to label any other structure of rights "correct" *vis-a-vis* all others, there is no reason that any given expenditure of resources can be labelled "wasteful" apart from a particular view of the world with its associated normative forms (Medema, 1991).

Second, the determination that these rent-seeking expenditures are wasteful from a social perspective

because they do not increase the value of social output is also presumptive of the form of the social welfare function. Resources expended in getting the right to vote for women and blacks are wasted from the neoclassical economic point of view, but this assumes that the value of output that would have been generated by those dollars is more important than for all citizens to have the right to vote for those who represent them in government. Further, if we assume that individual utility functions have items besides the value of social output as arguments and we further assume that the social welfare function is the weighted sum of the individual utilities of all the members of society, assumptions certainly consistent with neoclassical economic theory, then one cannot say, even within a given rights structure, that rent seeking is wasteful. Brooks, Heijdra and Lowenberg (1990) have demonstrated that expenditures by those seeking rents go into the pockets of others - middlemen, such as lobbyists, and those who grant the rent-producing right. These revenues increase the utility of those receiving them, and hence increase social welfare under the assumption that social welfare is some function of individuals' utilities. Thus, resources expended on rent seeking are only wasted subject to a specific rights structure and a specific, non-utility-based social welfare function associated with competition.

Even with the assumption of a given rights structure and a given social welfare function, there are at least two types of situations where rent seeking cannot be considered wasteful. The first is where such expenditures are information-enhancing. The second is in the presence of X-inefficiencies or other non-profit-maximizing behavior. For example, assume management engages in a form of satisficing behavior such that they must satisfy a minimum profit constraint to keep shareholders happy and hence to keep their jobs, and that the difference between this position and the profit maximization position is "wasted" in the form of managerial perquisites. Then, the opportunity to attain some sort of rent-garnering position presents itself and resources are expended to that end while still satisfying the minimum profit constraint.

Since rents are inevitably created and reallocated through changes in the rights structure as well as through changes in inter-agent relations in society, we need to move toward an analysis which assesses the impact of alternative rights/rent (institutional) structures. When we recognize the ubiquity and inevitability of rent seeking, the idea of waste assumes at best a secondary role. If we cannot prevent, or even minimize, rent seeking activities, then whether or not such activities are wasteful becomes much less interesting. This is

especially important when the idea of rent seeking as waste is used as an argument for so-called "small government".

In the public policy realm, the decision as to whether to alter social arrangements should be made in the light of the merits of the claims of competing interests. It is the rent-seeking process that brings to light these competing claims. The issue is not more versus fewer rents, but rather rents for whom. The resolution of this issue depends on the goals that are set for society, and how different distributions of rights fit in with these goals.

## Conclusion

I have discussed various attempts of coordinating economic activity. Neoclassical economists assume an instantaneous and costless recontracting with the coordination problem solved at no costs. Welfare Economics convincingly spells out why markets may fail and what kinds of interventionist measures the state can employ to correct them.[7] However, as many economists

[7]Market failure does not necessarily mean that state intervention is the solution. As the New Institutional Economics argues, the history of capitalism is full of institutional innovations to deal with the failures of the market to coordinate individual activities. The rise of the factory system, the rise of

from across the political spectrum argue, welfare economics is based on a naive set of assumptions about the nature and the ability of the state. Even if we do not accept the Contractarian argument that the state as the product of a social contract among free individuals has no right to intervene in the market, we still have two thorny questions: does the state really serve the public interest, and what if the state cannot achieve what it sets out to do?

Responding to the above questions I examined four approaches - namely, the autonomous state approach, the interest group approach, and the self-seeking bureaucrats approach - and concluded that none of them on its own can provide generalized assumptions about the objectives of all states, regardless of the time and space where they exist. I suggested that in order to establish a reasonable set of hypotheses concerning the objectives of a particular state we should look more carefully at the process of interest group formation and collective action as well as the operation of the bureaucracy in the particular system of political economy in which the state is operating. In doing so, the insights from all the four approaches reviewed can fruitfully be used. However, we are still unable to suggest how government failure may be

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joint stock companies, the rise of multidivisional firms, the rise of vertical integration and conglomeration are but a few of such innovations (Langlois (ed), 1986).

remedied other than by non-intervention. Does it mean that we are condemned to accept failing markets in favor of failing governments as the lesser of the two evils? The New Institutional Economics, by recognizing the market as just one of many alternative institutions and that state intervention carries certain costs, breaks away from the conventional wisdom in which perfect coordination is achieved without costs. In this framework, the state and the market are among many possible economic institutions or coordinating mechanisms which incur different transaction costs in order to resolve the coordination problem (Pagano, 1985). In the next chapter I introduce the transaction costs of the New Institutional Economics. Then I will tackle the South African industrial development as a real problem to apply the theories developed in this chapter and the next.

# CHAPTER 2

## The New Institutionalist Theory of State Intervention

### Introduction

Development processes of developing countries are considerably different from those of the industrialized countries, in both the speed of development and the productive and organizational structures of industry emerging from them. Furthermore, these differences in the speed and character of industrial development are to a considerable extent the results of institutional arrangements different than those in an established industrialized country. In addition, the intellectual climate within which industrialization proceeds, its "spirits" and "ideology", differ considerably among developing and developed countries.

Development is a most important challenge facing developing countries, and coordination of economic activities is a central issue in development. In chapter 1 I discussed the role of the market and the state and argued that both carry certain transaction costs. In this chapter I introduce the new institutional economics

theory of state intervention. The new institutional economics seeks to demonstrate that institutions truly matter in developed and developing countries. Each distinct organizational structure affects incentive and behavior and institutions are legitimate objects of economic analysis. First, I define institutions and recognize the eclectic nature of the new institutional economics. Second, I trace out the concept of bounded rationality. Third, I expressly introduce the notion of opportunism and explore the ways that opportunistic behavior is influenced by economic organizations. Finally, I discuss the role of transaction costs in economic organizations.

## 2.1. Defining Terms

Although institutions are central to development, a good definition of institutions is still missing. Important characteristics of institutions are the degree to which they are (a) organizational, that is, the extent to which organizations and institutions coincide; (b) formal; (c) created at a specific time and place by a specific means, as opposed to having evolved from more diffused sources; (d) embedded in, as opposed to differentiated from, other institutions; (e) universal as opposed to particularistic in the interests they serve; (f) creating as opposed simply to maintaining a certain

public good; and (g) technologically linked (Nabli & Nugent, 1989).

For the present purpose an institution is defined as a set of formal or informal constraints which governs the behavioral relations among individuals or groups. Formal organizations, such as the state, trade unions and employers´ organizations are institutions because they provide sets of rules governing the relationships both among their members and between members and non-members. Likewise, markets, such as stock exchanges, labor markets, credit markets, wholesale markets, and *spazas,* are institutions because they embody rules and regulations, formal or informal, which govern their operation. Explicit or implicit contracts are also institutions in that they lay down rules which govern specified activities involving parties to such contracts. Similarly, cultural rules and codes of conduct are institutions because they constrain the relationships between the corporations and the state. In the following sections I examine the limitations of the neoclassical economic theory in examining the development process in developing countries using what will be identified as the new institutional economics.

## 2.2. The Neoclassical Assumption of Economic Behavior

Traditional economic theory postulates an "economic man," who, in the course of being "economic" is also "rational." This man is assumed to have knowledge of the relevant aspects of the environment which, if not absolutely complete, is at least impressively clear and voluminous. He is assumed also to have a well-organized and stable system of preferences, and a skill in computation that enables him to calculate which of the available alternatives permit him to reach the highest attainable satisfaction.

Recent developments in economics and particularly in the theory of business firms have raised great doubts as to whether this schematized model of economic man provides a suitable foundation on which to erect a theory. I suggest that the global rationality of the economic man should be replaced with a kind of rational behavior that is compatible with the access to information and the computational facilities that are possessed by institutions and individuals in the kinds of environment in which they operate.

### 2.2.1. Bounded Rationality

Rationality denotes a style of behavior that is appropriate to the achievement of given goals within the limits imposed by given conditions and constraints (Williamson, 1975 & 1985). A theory of rational behavior may be concerned with the rationality of individuals or the rationality of organizations or both. The classical theory of the firm in its simplest form provides a useful standard for comparing and differentiating rationality. In the theory of the firm, the given objective is to maximize profits subject to demand and cost functions. To do this there must be perfect knowledge of the constraints (Simon, 1983).

Bounded rationality is the cognitive assumption on which the economics of transaction costs relies. An economizing orientation is accepted by assuming the intended rationality part of the definition, while the study of institutions is encouraged by conceding that cognitive competence to achieve rationality is limited (Williamson, 1985). Thus rationality is bounded. Under this framework, more study of both the market and non-market forms of organizations is requisite. How do the parties organize so as to utilize their limited competence to best advantage? Views to the contrary not withstanding, the set of issues on which economic

reasoning can usefully be brought to bear is enlarged rather than reduced when bounds on rationality are admitted (Williamson, 1985).

The theory of economizing under bounded rationality takes at least two forms. One concerns decision processes, and the other involves governance structures. Transaction costs economics is concerned with the economizing consequences of assigning transactions to institutions in a discriminating way. Since interaction is not costless, the cost of planning, adapting, and monitoring transactions need to be considered (Williamson, 1985). Which institutions are more efficacious for which type of transaction? Since information and rationality are limited, opportunism occurs which decreases efficiency and equity.

### 2.2.2. Opportunism

Opportunism refers to the incomplete or distorted disclosure of information when there are calculated efforts to mislead, distort, obsfucate, or otherwise confuse (Williamson, 1985). It is responsible for the real or continued condition of asymmetry which complicates the problem of economic organization. The literature of transactions costs emphasizes that conditions that are subject to *ex post* opportunism will benefit if appropriate safeguards can be devised *ex ante*.

As Williamson (1985) puts it, "rather than reply to opportunism in kind, the wise prince is one who seeks both to give and receive 'credible commitments'."

One of the implications of opportunism is that the 'ideal' cooperative form of economic organization that is characterized by trust and good intentions is very fragile. Such an organization is easily invaded and exploited by agents who do not possess those qualities."High minded" organizational forms that presume trustworthiness and are based on nonopportunistic principles and thus are rendered unviable by the intrusion of unscreened and unperalized opportunists (Williamson, 1985). Such an intrusion of opportunistic agents can be avoided according to theory of transaction costs.

### 2.3.1. Transaction Costs

Transaction cost economics is part of the new institutional economics. Although transaction costs economics applies to the study of economic organization of all kinds, I focus on the state as an institution since it affects markets and relational contracting. I extend the transaction cost approach to political exchange to explore the interaction of political and economic institutions in the development of polities and the economy.

Transaction costs can be understood as embracing all the costs that are connected with (a) the creation or change of an institution or organization and (b) the use of institutions or organizations. The creation, enforcement, and the restructuring of institutions and the "rules of the game" in an autonomous community represent activities which are associated with the first kind of transaction costs (Furubotn & Richter, 1991). Adam Smith (1776) noted that these costs increase with the increasing development and complexity of civilization. Following this classic categorization, the three basic "duties of the sovereign" are to provide for defense, the legal system and "public works and public institutions". In addition there are expenses of running the state (Smith, 1776). These transaction costs are still largely neglected in the discussion of neoclassical economic theory.

The second type of transaction costs has been given relatively greater attention because economists tend to be more interested in the problems of firms and markets than in constitutional questions and problems of government infrastructure (Coase, 1960; p. 15). In commenting on Coase´s interpretation of market transaction costs, Dahlman (1979) has offered the following observation:

"A natural classification of transaction costs consistent with Coase´s definition can be obtained from the different phases of the exchange process itself. In order for an exchange between two parties to be set up it is necessary that the two search each other out, which is costly in terms of time and resources. If the search is successful and the parties make contact they must inform each other of the exchange opportunity that may be present, and the conveying of such information will again require resources. If there are several economic agents on either side of the potential bargain to be struck, some costs of decision making will be incurred before the terms of trade can be decided on. Often such agreeable terms can only be determined after costly bargaining between the parties involved. After the trade has been decided on, there will be the costs of policing and monitoring the other party to see that his obligations are carried out as determined by the terms of the contract, and of enforcing the terms of the agreement reached. These, then, represent the first approximation to a workable concept of transaction costs: search and information costs, bargaining and decision costs, policing and enforcement costs" (pp. 147-48).

Thus, according to Dahlman transaction costs are (a) the costs of initiating contracts; (b) the costs of concluding contracts and; (c) the costs of monitoring and enforcing the performance of contracts. Since there is no framework which allows us to integrate institutional analysis into political economy, the key to developing such an analytical framework is the underlying costs of exchange.

Political rules broadly specify the hierarchical structure of the polity, its basic rules, and the specific characteristics of agenda control. Economic rules define property rights. Property rights are the bundle of rights over the use and the income to be derived from property and over the ability to alienate an asset or a resource. Given the initial bargaining strength of the decision-making parties, the function of rules is to facilitate economic and political exchanges. The existing structure of rights and character of their enforcement defines the existing wealth maximizing opportunities of the players which can be realized by either forming political or economic exchanges.

## 2.4 Political and Economic Institutions: A Rejoinder

According to the transaction cost theory of the new institutional economics, institutions that evolve to

lower these costs are the key to the performance of economies. When transaction costs are absent, the initial assignment of property rights does not matter from the point of view of efficiency because rights can be voluntarily adjusted and exchanged to promote increased production. But when transaction costs are substantial, the allocation of property rights is critical.

In the historical growth process there is a tradeoff between economies of scale and specialization on the one hand and transaction costs on the other. In a small, face-to-face peasant community, for example, transaction costs are high because specialization and division of labor are severely limited by the extent of markets defined by the personalized exchange process of the small economy. In a large-scale complex economy, as the network of interdependence widens the impersonal exchange process gives considerable scope of all kinds of opportunistic behavior and the cost of transacting can be very high. In industrialized societies complex institutional structures have been devised. These strcutures such as elaborately defined and enforced property rights, formal contracts and guarantees, corporate hierarchy, vertical integration, limited liability and bankruptcy laws, were devised to reduce the uncertainty of social interaction, in general to prevent transactions from being too costly and thus to allow gains from productivity of large scale

and improved technology to be realized.

### 2.3.1. How New Institutions Emerge

North (1981) has explained economic growth in Western Europe in terms of innovation in the institutional rules that governed property rights. In this view, as in the Marxist history, property relations which were socially useful at one time become "fetters" on the further development of the forces of production and an appropriate redefinition of political institutions becomes necessary. New institutions that allow an increase in gains from trade by economizing on transaction costs including gains from new production or exchange which were unprofitable under earlier high transaction costs and market failure emerge. Institutions are perceived as systems that help individuals process information and manage uncertainty by establishing rules, norms and habits.

### 2.3.2. An Institutional Economics Framework

Hodgson, (1988) proposes a theoretical framework of the new institutional economics through his analysis of the firm. Firms, according to Hodgson, are created to overcome problems of "structural uncertainty." Structural

uncertainty not only motivates the emergence of the firm, it also describes the environment faced by the firm when it searches for information about the quality and prices of products and labor. To reduce uncertainty in the management of their internal affairs, firms nurture the development of cooperative and trustful relationships among their employees and encourage organizational loyalty. These functions are achieved by the firm's ability to establish and enforce rules, develop norms, and offer training programs.The emphasis on rules and norms is applicable to political institutions. Rules and norms play a crucial role in political arena since the main function of political organizations is conflict resolution. The agreement to follow the rules and accept outcomes of the process ensures the existence and utility of political organizations. The effective political institutions are those that maintain acceptable rules, and not necessarily those that produce optimal policies. Participants in political organizations are therefore likely to direct their efforts toward changing rules and norms and not short-term utility maximization. Just as the firm was created to preserve the power of entrepreneurs, political institutions allocate political power. The difference between political and economic organizations might be related to the difference in the ownership and distribution of political versus economic

power and the manner in which these two types of powers can be mobilized, utilized and observed.

In chapter three I discuss how the state in South African shaped economic organizations by manipulating and enforcing property rights through a system of apartheid. I attempt to bring out the theoretical points made in this chapter and chapter 1 to show how institutional theoretical framework could be presented in a real life situation. I argue that the apartheid institutions have becoming "fetters" to further development of the forces of production and that new institutions should emerge. I show that the South African state actions not only created pressures for change that caused actors to look for new organizational forms, but they also constrained and influenced how actors selected different forms. In chapter four I suggest that a political compromise may reduce the high transaction costs and uncertainty, laying a foundation for potential investors.

However, this study is limited by the fact that institutional policy analysis lacks a theory that explains which type of political organizations will emerge and by which criteria they should be evaluated. Because of this weakness in the new institutional economics framework some elements of the theory of institutions are not integrated in the discussion about South Africa.

CHAPTER 3

# The Political Economy of South African Development

## Introduction

Industrialization of backward countries is dominated by the Marxian assumption that it is the history of advanced countries or established industrial countries which trace out the road of development for the more backward countries. "The industrially more developed country presents to the less developed a picture of the latter" (Marx, 1961). But one should beware of accepting such a generalization too wholeheartedly. For the development of a backward country may tend to differ fundamentally from that of an advanced country (Gerschenkron, 1962).

The realization that there are different paths to development influenced policymakers in developing countries to design policies in terms of the attainment of specific and identifiable goals which were consciously selected in accordance with particular societal assets, capabilities and institutional constraints. The South African state set out to attain high levels of economic

growth by excluding the African majority through the introduction of a system of apartheid (pronounced apart-hate) (Neame, 1963). The state believed that by relocating Africans to the reserves, South Africa would remain pure and Africans would only come to white areas to supply labor and retreat back (Neame, 1963).

By applying the theories of state intervention and transactions costs developed in the previous chapters, which acknowledge the diversity of institutions, I critically examine the South African political economy. First, I present a brief overview of the historical origin of South Africa and its economic performance while evaluating the mainstream interpretation of its development. Second, I discuss the different interest groups that rallied around the state particularly the white trade unions and capitalist organizations and how the relationship between the state and interest groups has been changing overtime.

I contend that apartheid was created to redefine property rights and thus reduce transaction costs and improve productivity. However, the state failed to anticipate the unintended consequences of its plans. The rapid economic growth of the South African economy in the earlier part of its development mobilized the African population. Consequently, different organizations representing different sections of the African majority

emerged to undermine the state plan and increase transaction and information costs. In the face of new demands by the African majority who were excluded, the apartheid institutional coordinating framework broke down. The political instability and declining productivity increased the monitoring costs forcing the state to negotiate a new political dispensation. New institutions must allow Africans to participate as equal partners. I contend that political democracy will provide stability and thereby minimize risk, transaction costs and information costs attracting potential investors and laying the ground for a sustainable growth path.

## 3.1 A Brief Historical Overview of South Africa

Until the late nineteenth-century, much of southern African history could be told as a story of complex and protracted turf wars. But diamond and gold mining changed all that. By the end of the century, the region was far too important to the global capitalist economy to be left to the locals. In a final and brutal exercise of coercive power, the British imperial government set about subordinating all political communities in the region and constructed a central state.

Creating this state required both a practical

negotiation of central power with the existing power centers in the region, political as well as economic, African as well as settler. Afrikaners (Dutch settlers) were incorporated with the British into a single more-or-less democratic community in a way which cements the alliance between the economically powerful English speaking whites and the politically powerful Afrikaners. African kingdoms were incorporated into the governing structures through a modified scheme of indirect rule and recognition of certain political authorities within the "tribal system". Under the scheme the Crown acting through local commissioners assumed an overlordship in the name of a fictional "Supreme Chief".

If those parts of the African population that were progressively integrated into the capitalist economy had been incorporated into the political community in the way in which the working classes were elsewhere, a fully national state might have been created in South Africa. They were not. A division of a citizenship and sovereignty marked by race and serving to justify coercive labor practices and white supremacist racism was created instead. Apartheid was pre-eminently a racist system of controls on movement and residence, framed within a state ideology interpreting political and social rights in terms of nationalist principles relating people to places. In an attempt to improve the economic position

of the poor Afrikaners, the National Party (NP) plan was designed to banish Africans to poverty stricken residences called Native Reserves or Homelands which were geographically specified. Malan in 1948 outlined the apartheid policy in respect of the Africans as follows:

* The Native Reserves must be retained and made suitable for carrying a larger population by protecting the soil against erosion and over-cropping and by teaching the Native to make the best use of his soil by applying better agricultural methods. Possible additions must only take place in judicious fashion and after thorough investigation.

* In urban areas inside the European areas Natives must be domiciled in their own residential areas with proper attention to good housing and other healthy accommodation conditions. Only Natives who have been assured of work will be admitted, and the detribalized ones among them will at all times receive preference. Newcomers from the Native areas or from the European platteland must be regarded as temporary workers and those in excess must be repatriated.

* In view of their possession of their own national

home in the Reserves, Natives in the European areas can make no claim to political rights. The present representation of Natives in Parliament and in the Cape Provincial Council must therefore be abolished. Representation in the Senate must however continue by the election of three European Senators by different Native councils and further through three others nominated by the government because of their particular knowledge of Native affairs, as is now the case. These representatives must form a standing and permanent committee on Native Affairs. They must however have no vote on questions of confidence, or on the declaration of war or on measures affecting the political rights of non-Europeans. The present existing Natives Affairs Commission must give way to a more effective commission of experts.

* The present existing Native Advisory Council must be abolished and in its place a system of self-government on the first-rate and well-tried example of the Transkei Bunga called into being - a system which will keep proper account of the natural groupings among the Natives themselves based on the territorial, historical, racial and linguistic differences between them. This will give to the Natives that opportunity of living out their own

aspirations which under the present system are being withheld from them and which in their dissatisfaction makes them willing prey of the Communist agitator.

* For higher education separate provision must be made for Natives and their admission to European institutions together with European students must end.

* Administratively all Native interests including education must rest with the department of Native Affairs and the necessary sub-departments.

According to Neame (1963) the NP was influenced by two factors, namely, the declining number of the white population and the rising militancy of African nationalism. According to this scheme, different nations were entitled to sovereignty over their own homelands, and members of these nations were entitled to rights only in these homelands. In international terms, apartheid is the norm, not the exception. The United States Immigration and Naturalization Service is typical of countries throughout the world, for example, with its myriad of largely unaccountable (from the perspective of those subject to it) and frequently demeaning procedures,

rules, and paperwork and its network of offices and operations resembles nothing as much as the pass system of apartheid. More than a million immigrants are apprehended and removed each year; all others who would seek to enter and work are subject to a system of control over movement and residence.

The Group Areas Act gave the NP space to redefine property rights restricting residency and mobility of Africans and thus reducing uncertainty of social interaction. The resulting state that has been formed over the last century or so in the south of Africa is part imperial and part national. And the experiences of those subject to its various aspects are fundamentally different. The vast majority of Africans in the region have experienced central state power as a clear imposition. The imperial state excluded and brutalized its subject African population fostering a sense of alienation and a desire to destroy its institutions.

One preoccupation of policymakers throughout the twentieth-century history of South Africa has been the question of securing African labor. Indeed, legitimizing the coercion and control of African people as a source of labor has been a fundamental factor in institutionalizing the South African state. The concern with labor generally had three aspects: first, devising strategies and justification to acquire native labor in the capitalist

economy; second, controlling the allocation of labor between sectors of production; and third, ensuring the exploitability and reducing the cost of labor (Ashford, 1992).

For most of the time until the 1970s, these policies were devised in a context of generalized labor shortage. Since the 1960s, and increasingly throughout the 1980s, there have been more people seeking to labor in South African capitalism than the number of available jobs (Simkins, 1983). Throughout the period, institutions of the state such as "Homelands", which were strategies for extracting cheap labor supplies for indigenous African societies, were effectively transformed into dumping grounds for people deemed "surplus" to the requirement of South African capitalism. Did the South African state achieve what it had set out to do?

## 3.2. South Africa in Development Perspective

South Africa is regarded as a medium-sized middle-income developing country. It has one of the most uneven income distributions in the world, and a rapid population growth estimated at 2.5% per annum between 1950 and 1980 (Simkins, 1983, p. 114). Social indicators reveal in Table 3.1 that the country has more in common with lower middle-income countries, such as shorter life expectancy

at birth and higher infant mortality rate.

South Africa experiences many of the problems typical of countries that have just started industrializing such as rapid population growth, powerful forces making for urbanization, great inequality, political and social instability.

### 3.2.1. Inequality and poverty in South Africa

The high level of racial income inequality and the wide urban-rural income differentials indicate that poverty is widespread and concentrated within the black population. Poverty is particularly prevalent in the informal settlement and in the non-metropolitan regions (Wilson and Ramphele, 1989). The exact level of poverty, defined as the percentage of the population falling below a poverty line income (R400 per month), is difficult to estimate. Conservative estimates indicate that in the mid-1970s over 60 per cent of the population of the homelands and over 30 per cent of the black population of the metropolitan regions were in a state of poverty. By contrast, approximately 4 per cent of the white population was estimated to have been in a state of poverty in the 1970s (Wilson and Ramphele, 1989). According to Simkins (1984), this pattern will not have changed significantly through to the present time.

TABLE 3.1

South African development status in international perspective

| Countries | Per capita income | % share of manufacture in GDP | Life expectancy at birth | infant mortality rate |
|---|---|---|---|---|
| Low income | $ 330 | 14 | 62 | 94 |
| Mid. income | 1360 | 23 | 65 | 51 |
| S. Africa | 2470 | 24 | 62 | 67 |
| U-mid. inc. | 3150 | 25 | 67 | 50 |
| Indus. | 18330 | 30 | 76 | 9 |

SOURCE: World Development Report, 1992.

TABLE 3.2

Racial disparities in income, living standards, and benefits from government expenditure.

| | Black | White |
|---|---|---|
| State per capita expenditure (primary and secondary level) (1988/89) | R655,96 | R2,882.00 |
| Matriculated labor force (% of labor force) 1985 | 2.2% | 53% |
| State social pension (1989/90) (average annual value) | R1,655.10 | R3,334.50 |
| Income per person (1988/89) | R521 | R3,297 |

SOURCE: South African Institute of Race Relations Survey 1989/90

Inequality in South Africa largely follows racial lines. Table 3.2 shows some intergroup inequality. The extreme racial inequalities which characterize the South African economy are the basis of demands for redistribution by the African National Congress (ANC). The inequality reflected in Table 3.2 is rooted in inequality of opportunity in the market economy. The main causes of inequality can be found in the distribution of employment opportunities and the level of joblessness, the level of earnings in different types of occupation, and the distribution of the ownership of wealth and the returns earned by different forms of wealth. The limited access to education facilities to Africans limit their mobility forcing them to unskilled low paying jobs.

In South Africa as throughout the world, the ownership of personal wealth is always more narrowly concentrated than the distribution of all incomes, and the white share of personal wealth has been estimated to account for over 80 per cent of total personal wealth. This is a major factor causing and perpetuating income inequalities. But the state also directly affects inequality through its allocation of education, health, pension, housing, urban infrastructure and other resources. These inequalities crucially affect human capital and thereby market outcomes. For more than half

a century, the state has influenced the pattern of distribution in the economy. In order to solve the poor-white problem, the state legislated legislation favoring employment of whites, such as the Colour Bar Act. Differential investment in human capital by the state also had a marked effect on the subsequent skewness of income distribution between groups.

### 3.3. The Economics of Apartheid

Different scholars have attempted to understand the impact of apartheid on economic growth. To understand the impact of apartheid on economic growth it is necessary to consider its history. Many current development problems have their basis in South African history and are not solely the consequences of recent secular economic stagnation. Neoclassical economists argue that the South African economy has grown at a "remarkably rapid" rate from the 1940s to the 1970s (Houghton, 1964; p. 162). Radical economic historians contend that apartheid was a unique system of social control designed to boost economic growth and industrialization in South Africa (Wolpe, 1977; Davies, 1991; pp. 20-22). More recent studies suggest that apartheid assisted economic growth from 1948 until the early 1970s, but began to constrain

it thereafter (Gelb, 1987; pp. 33-34). It has also been argued that the South African economy is currently in a structural slow-growth 'crisis' which is a function of the apartheid system itself (Pillay, 1986). The new institutional economics places the failures of the apartheid economy on the fragmentation of the apartheid institutional framework in the face of new demands by the African majority who were excluded.

Since apartheid is such a pervasive social system it influences the economic growth performance of South Africa. Moll (1990) argues that given South Africa's resources and capabilities as, say, of 1948 when the Nationalist Party came to power, her aggregate growth-performance since then has been singularly unimpressive, quite apart from the social inequalities and poverty, under-urbanization, unemployment and the skills constraint to name but a few. The low rate of economic growth of the last decade and half has accentuated and intensified many of these long standing problems. The failure to expand employment in the modern sectors due to the low growth and increasing capital intensity has been politically destabilizing; political destabilization always reduces growth prospects.

TABLE 3.3.

Manufacturing growth in Some Selected Developing Countries (average annual growth rates).

| | 1963-72 | 1973-78 | 1979-88 |
|---|---|---|---|
| South Africa | 6.8 | 1.3 | 1.6 |
| Korea | 18.3 | 24.7 | 11.7 |
| Brazil | 6.7 | n.a. | 1.5 |
| Chile | 4.1 | -2.9 | 2.7 |
| Greece | 9.7 | 4.3 | 0.4 |
| Mexico | 8.7 | 7.4 | 0.0 |
| Singapore | 17.0 | 7.1 | 6.8 |
| Spain | 10.8 | 3.3 | 1.5 |

Source: UN, Growth and World Industry, 1973; UN, Yearbook of Industrial Statistics, 1979 & 1988: World Bank, World Bank Development Report (various years).

The deterioration in the South African economy can be gauged from Table 3.3. The turning point in the mid-1970s can be seen clearly from this table. The high economic growth of the 1960s carried through the first half of the 1970s. The international recession following the oil price shock did not immediately affect South Africa. Exacerbating oil shocks were initial signs that the apartheid scheme for reducing information and transaction costs was beginning to fail. But once the economic downturn had begun, there was no return to previous high levels of economic growth. In the second half of the 1970s, South Africa could on average grow just about enough to keep up with population growth. The level of growth was also boosted by the "mini boom" caused by a large gold windfall in the 1979 to 1981 period, but the underlying problems of manufacturing weakness and low levels of industrial exports, rising government expenditure (partly with long term returns, e.g education) and social pressures for higher wages and better living conditions re-emerged once the gold price fell.

In terms of relative economic performance, the South African economy fell from its moderately successful seventh ranking (1960-1970) among 20 developing countries to an indifferent fourteenth position (1970-1980). Since

population growth at 2.5% per annum in the 1970s exceeded the GNP growth of 1.3% per annum, per capita incomes has been declining roughly 1.2% (World Development Report, 1982). The aggregate rate of profit in the manufacturing sector declined since 1948, and severe declines were recorded in the period 1981-1986 (Moll, 1990). This deterioration in economic performance can be attributed to the increasing resistance against apartheid both domestically and internationally and to the adverse international developments and inappropriate domestic economic policies. Institutional arrangements to reduce transaction costs must be mutually beneficial to both sides of the transaction or they will fail. There was increasing evidence to Africans that arrangements were no longer mutually beneficial.

Low economic growth rates led to even lower growth rates of employment. Since 1975, the South African economy's capacity to absorb its rapidly growing labor force has dramatically been depressed; the labor force has grown by about 4.6 million since then, although formal employment has only increased by 1.1 million. Thus three and half million more people were forced to be dependent on the informal sector and subsistence agriculture or to remain unemployed (McGrath & Van der Berg, 1991). According to McGrath and Van der Berg (1991), blacks were more seriously affected than the

other groups; low growth ensured that poverty increased for them although wages were rising due to the strong bargaining by the trade unions.

The non-racial trade union movement grew tremendously in the 1970s as the manufacturing base grew. There emerged a layer of educated Africans who were entering industry with skills. McGrath and Knight (1977) have argued that in South Africa, wage increases for black workers in the 1970s were a result of institutional pressures and interventions and a rising skill composition of employment, rather than a result of market scarcity. The low rate of growth of employment in the 1980s has restricted the gains from economic growth to a smaller and smaller share of the population. Furthermore, although there are signs of emerging integration in the labor market, particularly in capital intensive industries such as chemical and automobile, black workers still remain crowded in lower skilled occupations while white workers dominate in the managerial, technical and supervisory grades of employment (Hindson and Crankshaw, 1990). Integration seems faster in recent years and particularly in multinational corporations. These companies have been forced by various employment codes such as the Sullivan Code for US multinationals to provide for equal employment opportunities. This has had a trickle down effect as major industrial companies

realize that to compete effectively in the market they need to rid out the "bottlenecks".

### 3.4 Interest Groups and Apartheid

In Chapter 1, I argued that interest groups politics may be properly understood only when the particular process of contest for political and economic rights in the society concerned is analyzed in detail. In this section I concentrate on the white trade union movement and big business who have had a role in influencing state policy. The analysis of African interest groups is beyond the scope of this paper and I will treat them as one represented by their umbrella body, the Mass Democratic Movement (MDM). The MDM is a loose alliance of African interest groups, including the ANC, the churches, African capitalists, the trade unions and many others.

The nature and activities of the interest groups are strongly influenced by the sociocultural environment within which they exist. In South Africa this environment is a culturally heterogeneous society governed by a minority apartheid regime. The existence of racial and ethnic interest groups reflects the clash of interest, whose structure is reinforced by apartheid legislation. It is important to keep in mind that the activities of certain interest groups reinforced racial and ethnic

cleavages and the structural rigidity of the political system.

The majority of the South African interest groups are functionally specific organizations promoting and defending the goals of particular segments of society. The most prominent commercial interest groups are the Afrikaanse Handelsinstituut (AHI) and the Association of Chamber of Commerce (ASSOCOM). The South African Federated Chamber of Industries (FCI) and the South African Chamber of Mines represent industry and mining sectors. The commercial and industrial groups are concerned with a capitalist economic system and take an active part in the ongoing debate about the economic aspects of the implementation of apartheid. They also articulate the interests of employers in the private sector.

The right-wing white trade unions have been the vehicle of Afrikaner political aspirations.[8] The history of the implementation of the NP labor policy in the 1950s and 1960s abounds with examples of its extreme sensitivity to the sentiments and interests of the organized white workers.

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[8]In 1923 the NP under Hertzog and the Labour Party - established in 1919 as a political wing of the trade unions - under Cresswell entered into an election pact. The NP won the 1924 elections and Cresswell became the minister of labor. This alliance took different forms as the years passed electing the NP in 1948 and disappearing from the scene thereafter.

The formal channels of access to the bureaucracy include a large variety of statutory boards, commissions and councils which not only provide a forum for negotiation between the bureaucracy and the interest groups, but also an integrated part of the executive arm of the central government. These boards, commissions and councils are usually constituted in such a way that they are representatives of relevant interest groups. Examples are numerous: control boards of agricultural commodities, the National Transport Commission, the South African Medical and Dental Council.

Generally, the channels of access described here are not available to black associational interest groups, although meetings with government officials do take place. Africans rejected the homelands as appendages of apartheid which they resisted from the onset. This has been an anathema to apartheid. As the South African economy grew, the network of interdependence widened the impersonal exchange process giving considerable scope for all kinds of opportunistic behavior by bureaucrats and increasing the costs of transacting. The lack of legitimate institutions through which Africans could channel their interests has been the source of social and political instability. Consequently, the apartheid institutional coordinating framework has broken down in the face of new demands by the African majority that have

been excluded. New institutions must allow them to participate or problems will continue. In the past decade the strong apartheid alliance of the white trade unions, white capitalists and the minority NP government witnessed the crumbling of their institution with disbelief as Africans mobilized domestically and internationally to isolate South Africa and force the state to the table to negotiate new institutions for a new democratic South Africa with Africans as equal partners.

## 3.5. Porous State Intervention?

Evidence shows that state intervention in South Africa was pervasive during its development process. Naturally, some neoclassical economists have tried to put forward explanations of the South African experience which try to reconcile the existence of state intervention with the growth of the economy.

Bhagwati has proposed a theory of prescriptive state intervention in an attempt to resolve the dilemma of an interventionist state in a rapidly growing economy by characterizing the Korean state as a "dos" (prescriptive) state, as opposed to a "don'ts" (proscriptive) state (Bhagwati, 1982). According to Bhagwati (1982), "although

a prescriptive state may prescribe as badly as a proscriptive state proscribes, a proscriptive state will tend to stifle initiative whereas a prescriptive state will tend to leave open areas outside of the prescription where initiative can be exercised".

On a superficial level, it is hardly objectionable that an obstructive state will not be very helpful for business, and by implication, economic growth. However, on closer examination there are problems with the theory of porous state intervention. In a world with scarce resources and therefore faced with opportunity costs, doing something means not doing something else. In this world, saying "*do*" A is often equivalent to saying *"don't" do 'not A'*. There can be no presumption that saying *"do" A ("don't" do 'not A')* will allow more initiatives than saying *"don't" do A ("do" 'not' A)*. A prescriptive state can be as stifling as a proscriptive one, since it can make private enterprises do many things against their will that they are left with little resources to do what they want, even if these activities are not explicitly forbidden (Chang, 1990). Likewise a proscriptive state can allow a lot of initiative if it proscribes against only a few things. If we adopt the Liberal concept of negative freedom, we may say that one has less freedom under a prescriptive state than under a proscriptive one, because private enterprises with a

government prescription are coerced to execute the prescription, whereas the private enterprise with a state proscription are not coerced into any particular action and therefore can chose the best option from whatever is not forbidden by the state, and thereby exercise "initiatives" (Chang, 1990).

The South African state actions have been relatively mixed. In the period after the World War Two there was a strong focus on heavy and chemical industries, with the public enterprises taking a lead in directing investment in less risky and more profitable consumer goods industries such as Armscor, Eskom, Iscor and SASOL. However, in the late 1980s the state attempted to privatize some of its industries giving the private sector more choices for initiative, an action vehemently opposed by the labor movement. It has not only been the state that has been prescriptive, it is reported in economic journals the and magazines such as Forbes that most business activities are prohibited unless expressly approved by the board. Thus it can be argued that the South African state has been proscriptive without serious qualification.

## 3.6. Was the Apartheid Bureaucracy Self-Seeking?

The apartheid system created institutions which were to lower costs and lead to economic advancement for whites. These costs included those of information, negotiation, monitoring, coordination and enforcement of contracts. To minimize these costs the state created a bureaucracy including the military and the police. To the extent that the apartheid system is based on economic rationality, that is, the system works to increase the incomes of those groups whose votes are important for the polity, the bureaucracy is used for redistributive purposes rather than for the maintenance of law and order or the provision of services to the public. The activities of the bureaucracy are of the directly unproductive profit-seeking (DUP) type (Bhagwati, 1982)

The economic effects of creating a DUP bureaucracy can be analyzed with the aid of the model developed in Lundahl (1982). To the extent that the resources going into DUP activities consist of skilled labor and capital that would otherwise have been used by mining and manufacturing, white farmer interests stand to gain for draining mining and manufacturing of skilled labor and capital depressing the unskilled wage rate as well. Africans move into the agricultural sector where the return to both land and capital increases. The loss of

skilled labor hurts mining and manufacturing capitalists since this tends to exert downward pressure on the return to capital. The transfer of industrial capital into bureaucratic activities increases the factor's marginal revenue product in mining and manufacturing, but to the extent that this transfer is affected by taxing the capitalists, the gain is wiped out.

The most interesting effects of creating the apartheid bureaucracy are those on skilled wages. The increased demand for skilled labor emanating from the bureaucracy creates an upward pressure on the wage level, but this effect is swamped by the loss of capital in the sector, assuming that the wage paid to the bureaucrats equals what they would earn working in mining and manufacturing. If so, this could contribute to an increase in the pressure from white labor unions to keep Africans out of skilled jobs in order to boost the wage level again. Thus not only will unskilled Africans lose from the reduction of their wages caused by the loss of capital and skilled labor in mining and manufacturing, but crowding effects may be present as well.

## 3.7. State-created Rents and Industrial Development

If the world operates like the model of perfect competition, the governments of developing countries should not deliberately seek to develop new industries, because it means, *ceteris paribus*, a less efficient use of resources. However, the fact that an industry is unprofitable in a developing country at present prices does not mean that it should not be promoted, as the success of the Korean steel industry and the Japanese automobile industry testify (Amsden, 1989).

In the context of late development, whereby a country develops on the basis of borrowed technologies, if a technology can be put to work, the industry could become much more profitable than in the more developed country where the technology originated. This is partly because the borrower does not necessarily pay the full cost of developing the technology but also because they can combine the technology with cheaper labor. Of course, not all producers who borrow technology become more cost-effective than the lenders of technology, and are often less cost-effective than the latter. The firms in the late-developing countries do not have access to the "social capital" (skill of the workforce and infrastructure), for which the latter of developed

countries do not pay the full cost (Abramovitz, 1986).

The industrial policy measures used by the South African state are not radically different in kind from those often associated with economic failure in many developing countries. One danger of industrial policy is that it may, by opening up opportunities to acquire wealth through unproductive activities such as influence peddling or the diversion of entrepreneurial efforts away from productive activities. This is the rent-seeking argument. Rent-seeking costs are fundamentally transaction costs expended in the process of seeking rents and involves activities like information collection, influence peddling and bargaining, and have to be strictly differentiated from the rent itself, which is a pure transfer. Therefore, the mere existence of state-created rents, and the opportunity of rent-seeking do not mean that resources will actually be spent on rent-seeking. For example, if the firm can acquire rents through bribing and if there is little "second-tier" rent-seeking, the actual amount of resources "spent" on rent-seeking may not be large.

The South African government has been subject to interest group influences, particularly that of the conglomerates and white trade unions. Although the practice has produced some undesirable distributional consequences, limiting the opportunity of rent-seeking to

the conglomerates seems to have reduced rent-seeking costs in South Africa. When a small number of people have exclusive access to rents, rent seeking activities will be less frequent and of smaller magnitude, because others may not join the rent-seeking contests, knowing that they have little chance of success to influence the state. The fact that conglomerates have a stake in multiple markets also reduces rent-seeking costs by the "bundling of issues".

Even when the potential "waste" of rent-seeking is fully realized, rent-seeking is not the biggest danger of using state created rents for industrial development. Once a rent is created, it is highly likely that an "entry barrier" will be set around the "rent market", which will discourage the potential entrants from spending resources to dislodge the incumbent. A more serious danger of state-created rent is that state intervention may protect or even encourage inefficient producers or production methods, with long lasting efficiency consequences.

The most serious problem with industrial policy is that, once implemented, state-created rents may be difficult to withdraw due to political pressure. The existence of "infant" industries which refuse to grow such as Mossgas is another case in point (Bell, 1984). As emphasized by economists like Marx, Schumpeter and many

others, the beneficial role of rents, as means to lure and force firms into more productive activities, hinges on the fact that no rent accruing to the innovator is permanent (Chang, 1990).

The South African state finds itself at crossroads because of the constitutional negotiation with the African representatives. Consequently, the key role that the state has played in directing the economy has diminished. It remains to be seen what role the state is going to play during transition to democracy and what new institutions are going to be created to ensure smooth institutional changes.

## 3.8 Can A Singular Political Community Emerge?

President F. W. de Klerk and Nelson Mandela of the African National Congress (ANC) agree: The present administration from which South Africa's African majority is excluded must be replaced by a provisional government by 1994. But while they concur on the need for a more broadly based provisional government, they cannot even agree on a name for it. De Klerk's governing National Party (NP) refers to a transitional government, while Mandela's ANC prefers to talk of an interim government of national unity. Can a nation be built, fashioned

according to the Western European templates that overlaid the great nineteenth-century political ideologies of nationalism, liberalism and socialism?

The negotiation process deadlocked in May 1992 on how much majority of an elected national assembly would be needed to ratify a new constitution. The de Klerk bloc wanted a 75 percent majority. The ANC had wanted a 66.66 percent majority, but compromised to 70 percent after behind closed doors. However, the agreement was not forthcoming. The reason was simple and compelling: Neither side was sure of the extent of support it would win in the scheduled election to the national assembly; both were anxious that they might have given too much (Laurence, 1992).

The continuing violence and the desire of all parties to reach a speedy solution resulted in an all party meeting in March 1993 to resume talks about talks. The Pan African Congress (PAC - an exclusivist African nationalist movement) and the Conservative Party (CP - an exclusivist Afrikaner nationalist party and the official opposition in the apartheid parliament) who had earlier boycotted the meetings about talks attended. Though parties are still far apart, they have committed themselves to a peaceful resolution of the South African conflict. Dangers of coercion in a reconstituted South Africa are still looming, however. First, the creation of

an all inclusive political community within a unified democratic state will require repression of those who would foster exclusive nationalisms, but such repression only furthers the cause of nationalism. Second, protection of the fiscal base of the state, the capitalist economy, will require repressing many of the classes of those who are currently excluded from the formal economy. Some ameliorative measures are likely to be put in place, but no large-scale and fundamental distribution can occur without the agreement of big capital. That is not likely to be forthcoming. But repression of such demands can foster the emergence of destabilizing revolutionary movements.

## Conclusion

The realization that there are different paths to development influenced South African policymakers to design policies in terms of the attainment of specific and identifiable goals which were consciously selected in accordance with particular societal assets, capabilities and institutional constraints. Institutional arrangements used by the apartheid regime were a rich mix of private and public instrumentalities. The state played a big role in overcoming the "poor white" problem in South Africa.

However, the World War Two boom which had the South Africa manufacturing output growing at the rate of 7% per annum and the exclusion of African workers from particular skills and industries made the state's task an easy one.

However, the state failed to anticipate the unintended consequences of its scheme. With the high manufacturing output growth huge numbers of Africans were assimilated into the formal economy and in the process mobilized themselves into organizations. These African organizations undermined the state plan and increased the transaction and information costs for the state. In the face of these new demands the apartheid institutional coordinating framework crumbled. New institutions should allow African to participate as equal partners.

Since South Africa stands to benefit from a democratically elected government with the scrapping of sanctions and the opening of markets in the African continent there are opportunities for state deployment of industrial promotion. If the incentives are correctly structured by the state and if international demand for tradable goods is buoyant, possibilities of a sustainable level of growth are eminent. Even if other strategies provide a simultaneous impetus for growth, like inward industrialization, a successful export performance will be a necessary condition for growth in the long run,

given the high propensity to import in the South African economy.

On the level of macroeconomic performance the need to raise the level of investment is clear for South Africa, as it is a necessary condition for higher growth of output. For investment, a climate of stability and confidence must prevail, and there must be a commitment on the part of the government to policies that foster economic growth. Also the international and the South African experience shows that the excessive ongoing use of debt cannot be made of foreign savings. Borrowing from abroad can, however, provide the cushion necessary for reviving a process necessary for economic growth. Foreign borrowing can provide space to revive domestic investment before domestic savings recover. However, all these possibilities depend on the stability or evolutionary transformation of different institutions in South Africa. What institutional forms can allow South Africa to achieve a sustainable level of development at low transaction and information costs? This is the subject of the next chapter.

# CHAPTER 4

## Rethinking the Role of the State and the Market

### Introduction

In this chapter I argue that a necessary but not sufficient condition for more rapid development in South Africa is the innovation of efficient political institutions. Since South Africa is experiencing deep social, racial and ethnic divisions there is an urgent need for a political compromise. A compromise may ensure state effectiveness and flexibility in responding to both domestic and international challenges facing a democratic South Africa. First, I discuss the world economic conditions and then discuss different prescriptions that could be redundant by a democratic state. Second, I discuss how Sweden, Denmark, and Norway overcame their strong societal divisions and low economic growth rates at some stage of their development and what lessons South Africa can learn from their experience. Finally, I discuss the urgent need of a political compromise and the importance of innovating political institutions as the new institutional economics argues. I conclude that for South Africa a political system remains an arena for new

innovation in economic policy and institutional analysis of the polity and the economy underlines the obstacles that stand in the way of a compromise. Furthermore, economic performance is not entirely a matter of fate or the product of iron laws in economics but the institutions that effect the performance of the economy and distribute power in society are ultimately artifacts of political action. They are constructed out of political struggles and from time to time may be recast.

### 4.1. Conditions of the World Economy

The world economy today is no longer in an expansionary phase. There has been a dramatic fall in the demand for unskilled labor and raw material per unit of industrial production. Consequently, developing countries in the 1990s face an external environment more hostile than in any previous decade since the Second World War (IMF, 1992). They are doubly squeezed on trade and on capital. Growth in world output slowed from 4.1 percent in 1970-79 to 2.6 percent in 1980-87. Terms of trade for non-fuel exports from developing countries deteriorated from 1.1 percent per year decline in the 1970-1979 to a 1.7 percent decline in 1980-87 (UNCTAD, 1987). Protection in developed country markets has increased since the

early 1970s, accelerating in the early 1980s to the point where by 1986, 21 percent of manufactured goods imported into the US and Europe were restricted by quantitative barriers (UNCTAD, 1987). Wade (1990) argues that this protection is being applied with special discrimination against developing countries. Meanwhile the microelectronics revolution has reduced the advantage of cheap labor sites, slowing the inflow of direct foreign investment to developing countries at large (Wade, 1990).

On top of these trends has come a sharp increase in the volatility of the international economy due to the slow progress of the Uruguay Round of talks and therefore much more uncertainty facing developing countries governments and producers. With the internationalization and deregulation of financial markets, financial capital is ricocheting around the world. Governments´ ability to control is diminishing, and long-term investment is depressed.

Faced with these new dangers and opportunities, what broad lines of economic policy should South Africa follow? Developmental state planning policies and export oriented industrialization of the East Asian kind will have a smaller effect than they did in East Asia, if for no other reason than the less favorable conditions of the international economy. On the other hand this does not mean that free market policies with no intervention are

the better alternative. Institutional innovation as the new institutional economics argues may provide opportunities for successful development.

The new institutional economics attempts to transcend the structuralist developmental economics which downplayed the role of markets in the development process. At the same time, it also attempts to transcend subsequent neoclassical resurgence that interpret all successful development episodes as the outcome of free markets. To propose market-oriented and state-led development as alternatives is simply ahistorical and misleading. All successful cases of "late" industrialization have been associated with significant degree of state intervention (Deyo, 1987; Amsden, 1989; Wade, 1990). The problem for South Africa is to find the appropriate mixture of market orientation and government intervention consistent with rapid and efficient industrialization. Equally central is the issue of which set of institutional and political arrangements is compatible with the appropriate mix of state intervention and market orientation in the economy. Hence the institutional economics shift the problem from the state-versus-market dichotomy towards how these organizational differences contribute to the contrast in both policies implemented and the subsequent economic performance.

## 4.2. Institutional Challenges for South Africa

The apartheid state promoted itself as long-term solutions to the political order and as a best possible mode of governance for the South African society, especially when compared to the impotent and divided parliamentary democracies of Western Europe and to the prepotent and monolithic regime in the former Soviet Union (Ashford, 1992). From its inception apartheid had limitations. These limitations were in part imposed by the extant world ideas and by enduring domestic aspirations of the African majority, both of which implied that legitimate political domination could only be the expression of popular sovereignty or, in exceptional cases, a revolutionary mandate for a drastic social transformation.

Whites broadly speaking are increasingly opposed to the South African *arbetura* since conflicts and uncertainties have manifested themselves, particularly the ongoing violence between members of the ANC and Inkatha (an ethno-nationalistic Zulu organization). Some whites and a section of African homeland leaders who have benefitted from apartheid and the state economic policies, face challenges of either retaining or changing the status quo rules. Some actors within the ruling bloc

fear that the transition and political democracy are bound to lead to the withering of the white race and are bound to force at any cost a return to the "good old times" of "order", "social peace" and "respect for authority". The state is placed in a powerful position of providing information that will affect individuals whether or not a change in rules will produce a net benefit. Whether an individual perceives any benefits to be derived from a change in rules or not will depend on the objective conditions, the type of information that the current institutional arrangements generate and make available to individuals and the rules proposed as an alternative. Information about benefits must be first identified, organized and analyzed.

In South Africa, economic problems are political problems. Contemporary economic difficulties and the attempts to find solutions to them cannot be analyzed in isolation from associated political dilemmas. To be pursued effectively, any policy mix must be politically viable first and then economically viable. In the past decade group conflict intensified. Competition for a share of national resources grew as the increment of new resources available each year shrank. Faced with the new demands from the Africans who were excluded from the polity, the apartheid institutional framework began to fall apart causing both transaction and information costs

to increase. The state was forced to find another mechanism for managing political and economic conflict. With the increased conflict the National Party (NP) government has turned towards greater reliance on the market for economic resources and the apportioning of economic sacrifice.

However, the new institutional economics suggests that some aspects of the distinctions between state-led economic direction and a market strategy are illusory. Markets are themselves institutions whose effectiveness varies with the configuration just as the effectiveness of public policy does. Moreover, many markets depend on an auxiliary network of social institutions often generated and sustained by the state action in order to function effectively. Hence the withdrawal of the state can never be complete and precipitate attempts to accomplish it may impair national markets more than they help them. If markets tend to move toward a state of equilibrium, political initiatives may well determine whether that equilibrium is at high or low levels of productivity and output. Moreover, there is some evidence that market strategies may intensify the level of social conflict with which many governments will have to ultimately have to deal (Smith, 1991). Economic sacrifice as apportioned by the market has fallen predominantly on those who lack market power to protect themselves such as

young school leavers, immigrants, the unskilled and the older workers in declining sectors. Many governments have calculated that an underclass of this sort cannot pose a serious challenge to social order or their own electoral fortunes (Hall, 1986). Nevertheless, the potential of a market strategy remains uncertain in view of potential social unrest.

## 4.3. A Democratic Compromise.

The new institutional economics suggests five sets of structural variables for the course of a nation's economic policy: the organization of labor, the organization of capital, the organization of the state, the organization of the political system and the structural position of the country within the international economy. The kind of explanatory variables emphasized by the new institutional economics refer to precisely those features of the political scene that are likely to weigh heavily in the minds of the decision-makers. Perhaps South Africa could learn from European countries that were faced with more or less similar challenges in their stages of development.

### 4.3.1. The European Experience

The corporatist arrangements in Europe have their origin in the catastrophic changes of the 1930s and the 1940s. The concept of democratic corporatism refers to the economic and political organization of modern capitalism. It is distinguished by three traits: an ideology of social partnership expressed at the national level; a relatively centralized and concentrated system of interest groups; and voluntary and informal organization of conflicting objectives through continuous political bargaining between interest groups, state bureaucracies, and political parties.

The "historical compromise" that business and labor negotiated broadened conceptions of class interests to include an acute awareness of the fragility of the European state in a hostile world. An increasingly liberal international economy in the postwar years offered daily confirmation of that awareness (Katzenstein, 1985). International competition intensified, underlying the enormous benefits of limiting domestic conflicts over economic issues. Against great odds the small European states succeeded in restructuring the political bases of their regimes along corporatist lines. They did so through fits and starts. Experimentation prevailed over grandiose political plan or deliberate deficit spending (Katzenstein, 1985). Novel

policies created new political possibilities for forging alliances across different sectors of society: between farmers and workers, between workers and Catholics, and between blue and white-collar workers. In reacting to the Depression, political extremism, and the threat of war, political forces in the European states accommodated themselves to the need to overhaul rather than to defend or overthrow capitalist society. That accommodation provided the political foundation for a democratic corporatism which emerged fully after 1945.

The political alliance between farmers and workers, typical of all three Scandinavian states was formed in Sweden in 1932. That year the Social Democrats presented a program stressed the need for both public works and agricultural supports because workers and farmers depended on each other's buying power (Katzenstein, 1985). The breakdown of the Weimar regime in 1933 in the midst of an economic crisis impressed on Swedish leaders the need for quick and decisive action (Rustow, 1955). The Swedish business community acquiesced in a Social Democratic government higher labor costs, a relatively expansive fiscal policy, and a growth of welfare services in exchange for labor peace, the continuation of private control over property and capital markets and openness to the world economy (Gourevitch, 1984). This was a "historical compromise," Swedish-style, between business

and labor.

Although the Social Democrats came to power in Denmark earlier than in Sweden, Danish political developments were on the whole rather similar (Oakley, 1972). The Depression brought Danish agriculture to the brink of collapse and increased unemployment among industrial workers to over 40 percent by 1933 (Katzenstein, 1985). Government proposed legislation fixing wages for one year, but support for the proposed legislation required political concessions to political opponents. An agreement included a further 10 percent devaluation, a variety of policies designed to help agriculture as demanded by farmers and support of the Social Democrats wage legislation, and a variety of new social programs stressing relief and public works.

Social Democracy in Norway was much more radical than in Denmark (Larsen, 1948). Its success, however, in forming a new societal alliance with agriculture was remarkably similar. Following the Danish example, the Norwegian Social Democrats adopted a program stressing job creation, welfare reform and agricultural subsidies. The party campaigned in 1933 with the slogan "work for all". Its program was rewarded by the party´s best-ever showing at the polls. The unions responded; they decreased strikes to give the new policies a chance of success. In 1935 the Social Democrats made a formal

agreement with the Agrarian party to support the reform program and pragmatism became the order of the day. The rapid transformation from labor radicalism to reformism and the urge to form a lasting alliance with agriculture received a powerful stimulus from the fascist tendencies of farmers supporting the Conservative party and from the support of extreme right-wing movements who appeared to be gaining support in the early 1930s. In Norway, as in other small European states, the deterioration of international and domestic conditions strongly reinforced the pressure of cooperation.

New political alliances also emerged in Belgium, the Netherlands and Switzerland. In these three countries, labor movements, though weaker than those in Scandinavia in the mid-1930s, also pushed hard for the adoption of concerted crisis plans. The debate over political options and the implementation of concrete crisis measures resulted in the same outcome as in Scandinavia: new political alliances between different social sectors, alliances that provided the political foundation for the democratic corporatism of the postwar period.

### 4.3.2. Lessons for South Africa: Democratic Corporatism and Institutions.

If the postwar period history of these economic and social policies and their implementation tells us anything, it tells us that institutions count. Types of political economies predict the kinds of policies governments adopt; even more, how effectively and persistently policies are implemented. The linkage of major economic and political actors in corporatist bargaining systems facilitates policy linkages; it encourages those tradeoffs that improve economic performance. Channels for talk become channels for consistent action. The countries' postwar experience illustrates why democratic corporatism need not necessarily be considered an anathema to the left who associate all corporatism with the repression or exclusion of labor (Katzenstein, 1985).

South Africa faces similar conditions as the European states in the 1930s and 1940s. There are such deep social and ethnic divisions that political compromise is crucial. Business, labor, conservative and progressive political parties must impose strict limits on domestic quarrels and face the challenges of the changing world. If South Africa is to overcome her

social, racial and ethnic divisions then the importance of centralized and concentrated institutions is necessary. The importance of centralized and concentrated institutions lies in their shielding a particular style of political bargaining. Bargaining is voluntary, informal and continuous. It achieves a coordination of conflicting objectives among political actors. Political sectors of policy are traded off one against another. Victory or defeat on any given issue does not lead to an escalation of conflict because a continuous sequence of political bargains make all actors aware that victory today can easily turn into defeat tomorrow. The predictability of the process enhances flexibility of the actors (Katzenstein, 1985). Hence democratic corporatism could bridge the social, racial and ethnic differences and ensure a sense of belonging so that South Africa could be counted in the world of nations.

Institutions of a sort outlined above highlight the complexity of the polity. The nature of interdependence has two sides, both the effects of interlocking institutional arrangements. On the one hand, the matrix of incentives facing most political actors; on the other hand, each policy is likely to have consequences beyond the initial sphere of action as a result of institutional linkage. The new institutional economics suggests that the actions of individuals will be affected by the

institutional structure within which they operate; but neither institutions nor actions are dictated by the existence of superordinate "system" with a status beyond that of the institutions themselves. Therefore the institutional structure should take priority over function in any explanation of political behavior (Hall, 1986).

Democratic corporatism should leave room for the political system, understood as a complex of political organizations that compete for office or the right to represent the views of social groups and the rules under which they operate. The configuration of a political system is important because it is the principal avenue through which the electorate can influence the direction of economic policy. Political parties, in particular, have played a role in the introduction of new economic policies. The ability to offer such solutions is an important source of political appeal, and as we have seen, the South African government was often mindful of them to build coalitions within the white electorate. Both the importance and the limits of the apartheid experimentation can be seen in many directions that the NP government embarked on over the past four decades. The attempts by the NP tell us something about the political system: it may be the single most important source of policy innovation. If Keynes played a crucial role in the

development of the system of economic management that bears his name, full acceptance of his ideas depended heavily on the advantages that politicians saw in them to affect class compromise as well as managing the economy. As in a complex tort case, it is difficult to apportion responsibility for innovation in economic policy precisely (Hall, 1985). Initially, new systems of macroeconomic management are usually devised by economists. But this is an instance in which we must distinguish between invention and dissemination. Just as the invention of a new machine was not as important to the industrial revolution as their dissemination, so the crucial step here is the one which popularizes a new economic idea and translates it into policy. Politicians not only exercise *de jure* control of that step, in many cases they take a much more active role in policy development.

This role has important implications for the policy dynamics because politicians respond to somewhat a different set of incentives than civil servants. In particular, they are much more mindful of the political consequences of policy for public authority and their own capacity to build social coalitions within the political arena. To the extent that politicians play a greater role in the process, new policies are likely to be selected as much for their social implication as for their technical

proficiency. These cases suggest that we might want to revise our understanding of how social learning takes place within the policy process. Social learning should not be seen as the preserve of the bureaucracy. It involves both officials and politicians. And if difficulties are from the technical successes and failures of past policies, politicians are more concerned with implications of policies for the broader moral visions of equity and efficiency that they present to the electorate. At the same time there is a need for checks and balances that monitor the performance of politicians. Politicians can also maximize their own interests or embark on ego trips that promote themselves at the expense of the country.

### 4.3.3. A Strangled Goose

South Africa faces a crucial choice of faster economic development and well defended civil and political rights. A democratic South Africa will have important consequences, both for the economy of the country and for the African economy. The size and stage of development of the South African economy makes this a challenge and an opportunity for the other countries of the African continent. In 1989 South Africa accounted for about 22 per cent of total GDP, 29 per cent of the total

merchandise exports, but only 6 per cent of the population of the continent (United Nations, 1992).

The financial sector is integrated with world financial markets, and South Africa is likely to become the center of Africa in the future. It also has scientific and educational resources that could make it an important growth pole for the continent. The regional relations will also be boosted by the ending of apartheid and the lifting of economic sanctions. The first signs are already there. Trade of South Africa with the rest of Africa increased by 40 per cent in 1989 and 22 to 30 per cent in 1990 (United Nations, 1992).

Despite the rosy picture presented above, South Africa faces more tougher challenges. The South African economy faces a 42.6 per cent rate of unemployment (The Economist, 1993). Chris Stals, the governor of the Reserve Bank of South Africa reckons that in the second half of 1992 the economy produced eight jobs for every 100 young people entering the labor market. This year it will produce none, and some of the people in work will lose their jobs (The Economist, 1993). In addition to the growing unemployment there is an urgent need for wage and pension parity. According to the Race Relation Survey (1991) unskilled white workers earn three times the wage of unskilled black workers. Therefore there is a need to reconcile these wage differentials. In circumstances like

these, says Zach de Beer, the leader of the Democratic Party, even if the Angel Gabriel were put in charge of the next government he would make a mess of it (The Economist, 1993).

In 1992 GDP fell by about 2%, compared with 0.5% in 1991 and 1990 and there is scant evidence of strong growth to come (IMF, 1992). Gross fixed investment after falling for ten years is down to a feeble 16% of the GDP, only just above the minimum level of 14% required to replace worn out machines. Gross savings is shrivelled in 1992 to an historic low of 17% (The Economist, 1993). Inflation is down, but mainly, confesses Derek Keys, the finance minister, because the economy is "buggered".

Some South African problems have been caused by an uninspiring world economy, the lackluster world price of gold and other metals and the political unrest and uncertainty in South Africa. Some local economists argue that over-concentration, plus a tax structure that favors wealth over income and profit has helped stifle the spirit of entrepreneurship (The Economist, 1993). In the long run the scope of growth is anybody's guess. Azhar Jammine, a renowned economist predicts big economic opportunities arising from "social upliftment", such as the construction of low cost housing and schools, and the provision of roads, sewerage, water and electricity for the African townships. Mr Kahn of South African Breweries

says the country should easily manage annual growth rates of 5% once it enjoys political stability and sound economic management. Given a political compromise, South Africa could begin to tackle its prostrate economy. The problem is that a prostrate economy may itself make a safe transition and sound government unattainable.

The recent commitment by all political parties to a peaceful resolution of the South African conflict brings South Africa very close to that goal. A democratic compromise could provide an opportunity for effective political institutions and other difficulties that will face a new democratic South African state will allow the state more breathing space for tackling these institutional issues. At the same time, the current conditions in the world economy increase the potential of institutional innovation to modulate the volatility of the world economy on the domestic economy to help firms compete internationally, and to force an early entry into information technologies. Firms set adrift by government inaction may relocate, or they may resort to squeezing labor costs and intensify work practice in order to avoid losing market share by enlisting the power of the state to do so. This higher premium on state policy raises the advantages of undertaking the organizational innovations needed to support them. Institutional innovation of the state bureaucracy enables the state to establish an

agency within the central bureaucracy whose policy measure is the industrial and trade profile of the economy and its future growth path (Wade, 1990).

Therefore what we learn is that for South Africa a political system remains an arena for new innovation in economic policy. Institutional analysis of the polity and the economy underlines the obstacles that stand in the way of a compromise. But it also reminds us that economic performance is not entirely a matter of fate or the product of iron laws in economics. The institutions that affect the performance of the economy and distribute power in society are ultimately artifacts of political action. They are constructed out of political struggles and from time to time may be recast.

## Conclusion

In this chapter I reviewed the present international economic problems. In reviewing the world economy I highlighted the slow growth of industrialized countries and noted the importance of exported manufactured goods by developing countries. What came out from the discussion is that developing countries need to concentrate on producing manufactured products to be internationally competitive. To reach the goal of being

internationally competitive, I suggested organizational innovation. I discussed the origins of the European states and learned that a political compromise is an important factor in overcoming domestic quarrels. I argued that one way to overcome social,racial and ethnic divisions in South Africa is through a political compromise. A democratic compromise calls on the state and its bureaucracy to play an effective role in industrial promotion.

Institutional innovation of the state bureaucracy may enable the state to establish an agency whose center is the industrial and trade profile of the economy and its growth path. Furthermore, I argued that state effectiveness is a function of the range of policy options and the flexibility with which those instruments are used. The desirable extent of state involvement can be measured by a comparative approach when there is a consensus about goals, leaving the resulting relative importance of public and private sectors to be determined as an outcome of the relative efficiencies of each sector. To measure the degree of state effectiveness goals to met could be specified as industrial organizations have shown. Policies that operate through market forces are more likely to succeed and therefore greater awareness of the complexity of policy-economy interactions provides a reason for caution in urging

policy interventions. What mechanisms of coordination are required for a sustained level of economic growth, the state, markets or institutions? In the next chapter I confront the coordination problem and provide some answers.

CHAPTER 5

The Market, the State, and Institutions and the Research Agenda

What is a useful way to coordinate economic activities of independent, but interdependent agents with divergent interests and dispersed knowledge? Classical economists concerned themselves with coordination within economic enterprises and between economic enterprises. It was neoclassical economists who focussed specifically on coordination between enterprises. By assuming implicitly a complete and costlessly enforced set of property and other rights underlying the market, the study of the struggle between social groups over the definition of the rights system was dropped from the research agenda (North, 1990). The hypothetical system of instantaneous and costless recontracting administered by the Walrasian auctioneer, and the coordination problem within the given system of rights was also assumed to be solved at no costs.

Recently economists have become critical of the conventional approach. The new Institutional Economics looks at not only market coordination but also on non-

market coordination within and between enterprises and at the determinants of scope of individual enterprises. What has become increasingly clear is that effective coordination both within economic units and between such units can only be achieved at a cost.

By introducing the costs of achieving coordination, or transaction costs, we effectively breakaway from the neoclassical tradition in which perfect coordination is achieved without any costs. In this new framework, the market is but one of many possible economic institutions, or coordination mechanisms, each of which incurs certain transaction costs of different types and magnitudes to resolve the coordination problem (Pagano, 1985).

By regarding the market as just one of many alternative economic institutions, we come to realize that the efficient operation of the market depends on many more institutional arrangements than those which are recognized in the neoclassical literature. In the process the state plays the role of ultimate guarantor of property rights and other legal forms, but also intervenes extensively in order to establish the market as an institution (Polanyi, 1957; Coase, 1988). The seemingly "institution-free" mechanism is sustainable only as a part of the complex fabric of various institutions (Chang, 1990).

By recognizing that state intervention carries

certain costs, I was able to avoid the naive view of state intervention as the ultimate solution to the coordination problem. At the same time, by recognizing that allocating resources through the market is also costly, I was able to reject the biased view of the government failure literature which argues that the costs of state intervention invariably exceed the costs of market transactions. Not only can the state fine-tune the price signals in a manner prescribed by welfare economists, but it can also supersede private transactions, change the institutions and values of the society, or even simply draw attention to a "focal point" (Chang, 1990).

The interesting point emerging from the discussion is that state intervention needs not be "expensive", as implied by the conventional discussion which equates a state with higher tax revenue as a more interventionist state. Some types of state intervention can improve the efficiency of the economy greatly at little cost because they have only very modest requirements for information processing and bargaining. Fostering credible commitment to the coordinated outcome among the parties involved need not involve financial transfers, although they may help the process.

The discussion on South Africa showed how the state shaped economic organizations by manipulating and

enforcing property rights. I discussed how political participants who were excluded from the polity directed their efforts toward changing rules and norms and not short-term utility maximization. I argued that apartheid institutions have become "fetters" on the further development of the forces of production and an appropriate redefinition of property rights is necessary. I suggested that a political compromise could minimize transaction costs and ensure stability which may attract potential investors.

Emerging from the discussion in the thesis is that neither the market nor the state, nor any other economic institution is perfect. Each institution has its costs and benefits. However, this should not lead us to an antagonistic position that therefore we should leave things as they evolve. The ultimate challenge is for each country to find an appropriate mix of the market, the state, and other non-market institutions in coordinating the activities of independent, but interdependent, economic decision-makers at the minimum possible cost. Such a challenge can be met through a process of empirical work encompassing markets, states and institutions.

Neoclassical economists have introduced econometric and mathematical tools to understand how the state

functions[9]. In their construction of an applied general equilibrium model two steps are followed. The first is to construct for a given period a "benchmark equilibrium data set", which is a collection of data in which equilibrium conditions of an assumed underlying equilibrium model are satisfied.

The second is to choose the functional form and parameter values for the model. They are chosen in such a way that the model is "calibrated" to the benchmark equilibrium data set. Depending on the functional forms used, the observed equilibrium may not be sufficient to determine uniquely the parameter values. Once the parameters are chosen, the model is ready to be used for policy analysis. Various exogenous variables can be changed, and the model can be solved for these changes. The difference between the solution values and the values in the data set are the estimates of the effects of policy change.

The general equilibrium model as suggested by neoclassical economists can help in overcoming the transition from theoretical work as I have presented in this study to econometric and mathematical models. The gap in this study can be filled by empirical research that attempt to integrate markets, states and

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[9] For models of political economy, see Whiteley (1980). Taylor (1980) has presented models of growth and distribution. For macroeconomic models, see Fair (1984).

institutions. However, econometric models should be used with greater caution, since there is no obvious way of testing whether the model is a good approximation of the truth.

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