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**"State versus market" debate is misleading**

The "state versus market" debate has been driven by the Washington Consensus agenda, and reflects two opposing sides: those who argue for liberalisation and deregulation as a "one solution serves all" kind of economic policy; and those that consider that development cannot result from markets alone and require a developmental State. The debate has received two major influences. On one hand, the neo-classical school, in particular but not exclusively through the Washington, has tried to provide the evidence that successful economic growth and industrialisation is determined by the degree of economic openness and trade liberalization, as well as the restriction of State intervention to the provision of human capital, infrastructures, economic stability and a competitive business environment. On the other hand, the "interventionists" have attempted to demonstrate that growth and liberalisation may not be associated (and if they are the causation is more likely to run from growth to liberalisation); and that successful industrialisation and economic growth depend on the interaction between the (developmental) State and private firms, with the former providing performance related incentives for dynamic economies, and coordinating competitive and complementary investment.

This debate contributed to the development, and application in the context of economic development, of particular sub-theories that discuss economic growth and the role of States and/or markets in development. These vary from versions of imperfect information theory generalised from the analysis of financial systems to other branches of the economy (the post-Washington consensus), to the theories of late industrialisation, institutions and technological capabilities. The debate inevitably had to lead to the discussion of the agents, States and markets, as so much of the results of the different approaches depend upon the nature and assumptions about States and markets. Thus, three different strains emerged in the literature: one concerned with the theorization of the market mechanism, one focus on the theorization of the State, and one that discusses the economic linkages that may evolve from State, market mechanisms and different economic activities. The first two can be called the "agents" literature, and the third the "economic". The "market" literature evolved into two directions: the quantity theory of competition, which argues that no matter how imperfect the market is, more market is better than less market; and the imperfect theory of competition, that envisages the market mechanism systematically achieving sub-optimal solutions due to imperfect information and uncertainty. The "State" literature developed into three branches: the "institutional", which studies the State as a process of organizational capacity building, how it links with systemic market failure and its role in promoting developmental policies; the "political", which discusses the State from the point of view of the political limitations and pressures that act upon it; and the "dynamic", which looks at the dynamic relationship between States and private agents.

The "linkages" literature fundamentally discusses the linkages between economic activities involved in economic development (ex., from import substitution or trade liberalisation to exports; from exports to market expansion, knowledge acquisition and sustained growth, etc). This literature is highly diversified, and can be categorised into different sets. One set of the literature discusses whether linkages are externalities or the fundamental essence of economic development (ex., is the link between macroeconomic policy and productive capacity and added benefit or costs, or the essence of policy making?). Another set of categories divides the literature according to the focus of the linkages. This involves the "fundamentals" literature, which discusses the linkages between arbitrarily and vaguely defined fundamentals (economic stability, human and social capital, de-regulation, etc), business environment and growth; the "trade" literature, which discusses links between agents, markets and outcomes

from the point of view of trade regimes and intensity; and the "production" literature, that studies linkages between different economic activities involved in the different stages of production (finance, technology, training, organization of the firms, etc). A third set of categories divides the literature according to whether linkages arise from markets or State policies. A fourth set divides the literature into the branch concerned with defining a deterministic, causal link between stages of industrialisation and economic growth (processes, or mechanisms of development), which might, in its extreme form, provide a blueprint for industrialisation and economic development; and the branch that studies linkages within specific economies and economic systems and how they may occur, according to economic capacities, problems and the agents involved.

There are two major problems with this literature, despite the fact that this debate has helped to uncover a huge variety of experiences and detailed accounts of successful and unsuccessful development processes. First, it usually takes agents as given ("linkages" literature), or linkages as given ("agents" literature), and rarely connects the two in any static, let alone dynamic way. Second, it is usually geared up around the debate "States versus markets", which, it is argued in this work, is misleading for two reasons: States operate through markets, and States and markets are subjected to the influence of the same forces; and the focus of the debate prevents it from developing into alternative policy thinking and policy making that can cope with the complexity of how specific, real economies function.

***Critique of the neo-liberal stance***

Neo-liberal economics is not really concerned with the functioning, the structure and the dynamics of the economic system and the particular roles of specific sectors in it, as it sees the economy as a sum of individual equilibrium markets for specific goods and services, which will interact with each other in ways determined by relative prices. As long as all markets are free from exogenously created distortions, each of them, and the economy as a whole, will be in equilibrium. Under special conditions, imperfections may arise in the market thus requiring the "market-friendly" intervention of an external agent, the State, for equilibrium to be regained. State intervention is, thus, the exception rather than the rule, and such intervention will have to be guided by what the market would have achieved in the absence of imperfections. This is, the exogenous intervention is efficient as long as it leads to what the market outcome would have been. Pursuing different outcomes would render resource allocation inferior to market efficiency. This is because the market mechanism optimises efficiency, such that any goals and outcomes that differ from what the market mechanism offers, or would offer in the absence of imperfections, are by construction less efficient. Thus, according to neo-liberal terms, economic efficiency can be measured by market efficiency, and this by the degree of regulation – if markets are inherently efficient and non-market mechanisms are inherently less efficiency or inefficient, then the degree of regulation is inversely related with economic efficiency.

Furthermore, neo-liberal economics argue that policy distortions reduce consumer welfare because it creates artificial scarcity through erroneous allocation of resources. The subsequent price rise due to trade barriers, unbalanced demand for labour and capital or excessive public expenditure is a hidden tax on private incomes and hit the poor more seriously that the other groups.

The first critique of the neo-liberal argument is concerned with its *central method of allocating efficiency claims*, which determines that by construction the market mechanism is efficient and non-market mechanisms are inefficient. There is nothing relevant or interesting about this, even less so when real world's institutions, actions, solutions and outcomes are to be measured against their equivalents in a hypothetical world.

The second is concerned with the *simplistic reduction of the notion of markets* to a sum of transactions between atomistic individuals (or firms), and therefore all analysis and policy advise are concerned with how free these individuals and firms are to trade their (endowed) assets on the margin. The notions of innovation, asset creation, socially structured industrial relations, capability development (with the exception of a very incipient reference to learning by doing), changes in the fundamental social and economic conditions due to political pressures or simply technical change, mobilisation of more resources for investment, are not part of the hypothetical market description, nor attempts are made to explain the distribution of assets through social groups.

The third is focused on the fact that *the notion of "market forces" is illogical and counter intuitive, and serves no relevant purpose*. On one hand, the hypothetical market is reduced to the sum of transactions between atomistic agents. Thus, these agents, being atomistic, are not the "forces" that drive the market. On the contrary, market (and economic) efficiency depends upon the agents being driven by the market (price takers). On the other hand, the actions of such agents, reduced to transactions, are supposed to create the market forces – competitive demand and supply. Thus, through transactions the agents create the market forces that drive their transactions, but are supposed to have no power over such forces. These agents are endowed with such an impressive level of cognitive capacity that they are capable of collecting, storing and processing all the available information about all transactions, with no time lags and at no costs to the agent, such that they can base their actions, timely, on perfect knowledge of supply and demand conditions. Yet, these agents are incapable of learning to control the market forces for their own gain and to devise the best strategies to create market power! Quite apart from the fact that it is highly improbable that such agents and dynamics do and can in fact exist, this description of a hypothetical world cannot say anything about the more common world were information is imperfect, growth and power are cumulative and agents are not atomistic nor individualistic.

The fourth argues that the neo-classical theory is *particular irrelevant during the process of industrialisation*, where the fundamental questions are how to mobilise and deploy new resources and create new capacities (industries, firms, skills, labour organization, technological, entrepreneurial and institutional capacities); how finance, trade and demand, employment, the exchange and the interest rates are associated with industrial strategy; and how industrial strategy fits in with the development of the economy as a whole. This is opposed to the neo-classical approach, which is focused on allocation of resources, at the margin, in a competitive environment. For example, an economy in the process of industrialisation should be able to export to sustain a virtuous investment-productivity-growth nexus through the creation of new capacities and skills and expansion of market access, rather than simply through shifting around existing, limited and narrowly defined capacities. Although exchange rate policy may help to shift existing capacities to production for export, it does not create new capacities nor does it expand market access. In addition, changes in relative prices may induce once for all shifts in resource allocation and economic gains, but unless new capacities are created economic gains are not sustainable. The real issue, thus, is not whether exchange rate devaluation shifts resources to production for export markets, but how to mobilise resources, guarantee their productive and efficient deployment in the creation of new capacities, develop the work force and the entrepreneurial capacities, etc, to generate fast, long-term sustained growth characterised by accelerated investment and technological progress, continuously increasing productivity, employment and skills, and improved income levels and income distribution.

The fifth revisits the *infant industry* argument, in that the neo-liberal argument is not capable of dealing adequately with economies of scale and scope, vertical integration, externalities and linkages from economic activity; does not account for significant lags between the time of taking and implementing investment decisions, starting activity, acquiring competitive advantages and being able to compete and expand into the world market; and cannot explain

why and how investment decisions regarding new activities, products and processes are made and implemented before comparative advantages are created, thus before a particular private rate of return on capital can be established with any acceptable level of certainty. For the neo-liberal school, firms, industries and markets are born efficient because they only begin operation in the presence of comparative advantages. In the real world, however, the economic efficiency of production processes is cumulative, has to evolve over time and is dependent on many factors, social, economic, technological and political that have to come together through conflict and learning. Thus, efficiency is not given or exogenously determined, nor inherent to any chosen course of action. It has to be made to accrue.

The sixth is concerned with recent developments in *labour market theory* that refute the notions associated with flexible labour markets. In particular: (i) no significant relationship has been found between the imposition of a minimum wage and the level of employment, and when a (weak) relationship is found, it turns out not necessarily negative; (ii) flexibility pressures on one side of the market, for example the ability to reduce the wage rate, may induce inflexibilities in other sides of the market, such as constraints to labour turnover, training and acquisition of technology; (iii) and flexible employment may actually increase the size of labour reserves in surplus labour economies. In addition to that, the structure and dynamics of the labour market are intrinsically and mutually associated with the structure and dynamics of the economy as whole, particularly with respect to the process of industrialisation. This is not only a matter of how fast the economy grows, how much aggregate investment is undertaken and how skilled the workers provided by the market are. But also which are the forces driving the economy and how they organise access to labour; which sectors are being promoted and which demands to they impose on skills, technology and investment; how industrial relations are developed and how they affect productivity and continuous education and training; and how much, what type of, and under which institutional conditions new employment is created. None of these issues is even conceived, let alone addressed, under the notion of a labour market described as the sum of individual transactions between an infinite number of workers and capitalists, the amount of which (how much supply and demand for labour) in determined by relative prices of labour vis-à-vis capital.

The seventh comes from the *new (endogenous) growth theories*, which attempts to explain long-term divergence of growth paths of different economies (an empirical observation that dismisses the claims of neo-classical economics). According to these theories, the long-term growth path divergence is due to cumulative growth associated with externalities between investing and innovating firms, as well as the positive difference between social and private rates of return on various types of economic, social and scientific infrastructures. Not only do the new growth theories call for State intervention to ensure that the economy moves into the optimal steady-state growth path (thus, acknowledging the possibility of more than one steady state), but they also dismiss standard neo-classical propositions in three other fundamental aspects: (i) the shape of the production function, as technology turns out to be endogenous, not readily available or easily absorbed, such that different firms and countries may operate under significantly different technological conditions; (ii) the introduction of scale economies even in the presence of continuous growth of capital stock and of the capital share of income; (iii) and that the returns on capital, and thus the direction of investment decisions, is no longer solely determined by its relative scarcity, but also by labour education and skills, the spill-over from labour education and skills, and the provision of, and externalities from, various infrastructures.

Finally, the eighth critique is concerned with the *consumer welfare* issue. On one hand, consumer welfare is not only associated with the prices individuals pay for their consumer goods and services, but also with the income they have and the institutional set of industrial and other socio-economic relations they are part of. If liberalisation reduces net employment, eliminates minimum wages, reduces real wages and creates employment uncertainty, the welfare of the consumer, particularly of the working people and the poorer, will be reduced in

both static and dynamic terms. In static terms, they will consume less than before, or nothing at all, irrespectively of the level of prices. In dynamic terms, aggregate demand may fall and with it will fall the incentive for investment and innovation, for long-term commitment to education and training, and a poverty equilibrium trap of low investment, low productivity, stagnation and unemployment may be achieved. Additionally, quite apart from not helping the poor, liberalisation may well benefit the consumers at the upper level of the market because their consumption patterns are more import intensive, and imports may become cheaper, at least in the short run, if trade is liberalised. Cheaper imports may or may not help the expansion of competitive production, depending on whether scarce foreign assets are productively invested, used to finance imports of essential wage goods or consumed by the upper group of consumers. Because discriminating policies in favour of investment are not consistent with liberalisation and deregulation, and foreign exchange is therefore freely available to those who can afford to pay, it is unlikely that cheaper imports will be readily translated into cheaper capital and intermediate goods for production.

Because of balance of payment constraints, liberalisation may be accompanied, or followed, by exchange rate depreciation. This will not deter the upper market consumer, and may well reduce investment further. Irrespectively of what happens to the exchange rate, the price effect of liberalisation on import is once for all – liberalisation does not tackle inflation but changes the price level. Therefore, liberalisation is more likely to hurt the consumer than to improve welfare, particularly those consumers at the lower middle and bottom of the income scale. If the economic reform intends to tackle poverty and consumer welfare, it is better to do so directly through various measures of income distribution, employment promotion, improving industrial and other socio-economic relations, and implementing policies that guarantee the virtuous circle of high investment, high productivity and high growth rates. None of these is provided through market forces alone.

These critiques point out to the fact that the theoretical arguments upon which neo-liberal economics sustains its notion of efficient markets are counter intuitive and, more importantly, they do not correspond to the way any economy functions and have little to contribute to the discussion of fundamental problems beyond allocation at the margin and deregulation.

Neo-classical economists have attempted to empirically validate their theoretical arguments by demonstrating that successful industrialisation processes followed the (neo-classical) predicted pattern of development from labour to capital-intensive industrial structures. This argument, however, suffers from severe weaknesses. First, the notion that there is only one successful path of development is very clearly rejected by aggregate statistical evidence and detailed case studies of industrialisation processes. Economic convergence analysis has demonstrated the uneven and divergent nature of international economic development, and that countries that specialise in labour intensive primary production systematically failed to industrialise and to move up in the income and development ladder. Detailed case studies have emphasised the large variation of development paths and experiences that have been followed by successful and by unsuccessful economies alike. These studies have also demonstrated that the processes through which scale and scope economies were constructed, vertical integration coordinated, technology absorbed and adapted, skills and capabilities created, industrial relations organised, finance guaranteed, market expansion and exports promoted, States and markets related, etc, are much more interesting and relevant specifications of development paths than is the neo-liberal simplistic notion of economic convergence through marginal changes in factor intensities. Most of the case studies also show how much learning by trial and error was involved even in the most successful industrialisation experiences. Thus, even if changes in relative factor intensity are part of the development process, it has to be explained why these changes happen in many different ways and with different impacts, and to discuss whether such marginal changes are central for real development processes.

Second, in the case of the East and South East Asian NICs, the speed at which economic upgrading was achieved was phenomenal. Even if one accepts the simplistic notion of progress through changes in factor proportion, the speed and magnitude of that change remains to be explained. Third, in all successful industrial and industrialising economies, investment and creation of new and ever more innovative and productive capacities played a far more important role in economic upgrading than marginal re-allocation of resources through changes in relative prices and factor intensities. Finally, even if one accepts that industrialisation follows a deterministic pattern of upgrading from labour to capital intensity, this does not necessarily validate a market-friendly vision of the development process. On one hand, neo-classical economics predicts a given path of development, but there are no sound theoretical and empirical arguments to establish that such a path results from the operation of a free price mechanism. On the other hand, there are very strong and sound theoretical and empirical arguments that show that irrespectively of the specific development path that has been followed, and the degree of success achieved, States and markets operated together in some dynamic way which was sometimes conducive to virtuous circles of investment and growth, and often conducive to pervasive and vicious circles of socio-economic failure and poverty creation. Thus, even if one accepts that the neo-classical simplistic prediction of economic upgrading is consistent with, and the dominant characteristic of real experience, to validate the neo-classical claims of market superiority one still has to prove that the process conducive to such an outcome is neo-classical in nature.

Given the fundamental weaknesses of the neo-classical theoretical argument regarding the inherent market efficiency, neo-classical economists turn to “political economy” arguments against State intervention. In particular, they question the capacity of the State to identify, decide, implement and monitor the impact of its socio-economic policies, due to incomplete and asymmetric information, skill shortage, inability to resist rent seeking from private agents, and the State’s predatory instincts. Thus, the argument is no longer that markets are inherently efficient, but that no matter how inefficient markets are, the State is worse.

It is true that the State needs detailed information upon which to justify its goals and policies and pursue their implementation, monitoring and revision. Information problems can and should be minimised, and the presence of imperfect information is an argument for action rather than inaction, not least because planning and coordination are justified as means also to cope with information uncertainty. However, the collection of information required for successful State policies is not necessarily harder than the collection of information required by private companies. The data requirements for sound public policy in manufacturing (which neo-classicists oppose) are not more difficult to collect and analyse than the data requirements for sound public policy in education, health and infrastructures, or for sound macroeconomic policy (which neo-classicists demand from the State). Additionally, the State may have institutional advantages over the private sector with respect to information, because of its access to various sources of information, its control over information systems, and its ability to establish legal procedures and mechanisms to collect information that can be reinforced through many different means. Including contracts for example. Moreover, as far as information is concerned, the State does not have to work against markets and the private sector, but with them. Finally, it is interesting to note that neo-classical economists raise the information problem with such passion when the aim is to question the capacity of the State, but they assume imperfect information away when the goal is to proclaim the virtues of the market.

It is also true that developmental policies are not always easy to identify, nor their whole impact in terms of benefits and costs is always immediately clear. Thus, the State, as private companies so often do, may choose wrong courses of actions. But this is hardly an argument against State policy and strategy. On the contrary, the presence of policy and strategy based upon sound data collection helps to prevent or minimise disasters and surprises because a planned course of action is more efficiently monitored and quickly revised than a random one.

On the other hand, any relevant and significant exercise on policy is bound to impose pressures to improve data collection and implementation and monitoring mechanisms. Moreover, as part of policy formulation and implementation, the State can and should use social costs benefit analysis to identify all possible benefits and costs and compare alternatives to find the most effective, easiest and less costly, but that provides equal certainty about outcomes. Finally, the exercise of industrial policy is also a learning process for the institutions and agents involved, from data collection and analysis to formulation, implementation, monitoring and revision of policy. Therefore, it is logical and likely that over time the quality of institutions and policies improves considerably as long as institutions get involved in relevant and significant policy making and are committed to learning.

Significant lack of skilled people hampers the State ability to collect and analyse information and formulate and implement policies successfully. Skill requirements increase with the complexity of the economy and public policy. Thus, a State committed to economic and industrial policy should acknowledge and tackle this problem very rapidly. However, the existence of the skill problem within the State institutions is not an argument for deregulation and liberalisation. On one hand, it is very likely that the entire economy suffers from skill shortages, not only the State. Thus, it may happen that the first and most immediate factor to address through policy is the need to raise standards and skills across the economy through education, training and promotion of spillover effects from skilled workers to less skilled ones, and between investing and innovating firms and institutions. This would require a system of incentives and institutional settings that favour long term commitment to skill and technological development, which cannot be brought about by markets alone due to static and strategic uncertainty. On the other hand, the fact that the State engages in relevant economic and industrial policy is an incentive to tackle the skill problem because of dynamic pressures, and helps to tackle the skill problem through learning.

Interest groups operate through the State, such that they influence, and are influenced by State strategies and policy. The State has to acknowledge the existence and influence of such groups and develop its capacity and strategies to avoid being captured and to prevent related rent seeking from creating social waste. On one hand, this may be done better through deliberate policy that allocates performance related rents according to strategy, thus eliminating the market for rents and minimising rent seeking. Strategy and policies may help to create and/or promotes alternative interest groups (for example, those interested in industrialisation and exports), to avoid the State capture by old, entrenched and conservative vested interests, or to prevent the concentration of economic power and oligopoly competition. On the other hand, markets do not mediate adequately between these different interest groups because they are dominated by the stronger ones; and market-friendly theories have little to contribute about this problem because they are based on the assumption that economic agents are atomistic and therefore they assume away political power or only deal with it within the narrow boundaries of imperfect competition and government failure. Furthermore, the push for liberalisation also reflects economic and political interests, particularly from the powerful groups that can reinforce their power through State withdrawal. Market friendly reforms also require a strong State that is able to resist pressures against and support pressures in favour of liberalisation, which can formulate, implement, monitor and revise its liberalisation strategies and policies and maintain social order at the same time that income and rents are redistributed – in brief, the orthodox theories do not provide the theoretical and methodological tools for the State to cope with its strong role during liberalisation.

The notion of a predatory State is confusing. It involves the idea that State institutions prey on the society's resources and wealth for the sake of the State and its officials, and that the State has the political capacity and interest to become predatory. The predatory nature of the State can be measured by the degree of generalised corruption, the magnitude of the fiscal deficit that constitutes a hidden tax on the income of the people and economic agents, the

unproductive and military share of public expenditure, etc. Quite apart from the fact that none of the above indicators is a necessary and sufficient condition for predatory activity, there are two logical problems with this argument. First, the notion that the State is predatory abstracts from the fact that interest groups operate through the State, and the State operates through the market. Hence, the State may be predatory to some groups while providing significant services to others. Even if an unusual number of political appointees and civil servants gain more than they should normally do in this process of promoting some interest groups at the expense of others, this process can only be clearly understood within a broader context of social and economic dynamics that involve the State and the markets. Second, a State that is systematically predatory creates tensions and pressures that will force it to be reformed or/and destroyed by social conflict and opposition. Unless political officials and civil servants have a very short time preference for private accumulation, a pure predatory activity is counter intuitive.

Although some could claim that recent experiences in some Sub-Saharan African and Asian countries prove the case of the predatory State and show how difficult it is to reform it, one is forced to acknowledge the existence of four more problems with this theory. First, no State that serves no purpose apart from enriching itself will last for long. Second, in identified examples of so-called predatory States, the State and the market worked together to create immensely powerful political and economic interests and accelerate capital accumulation at the expense of the working people and other social groups – thus, the State operated for and on behalf of specific interest groups rather than itself. Third, those powerful interest groups, which were not necessarily created by, albeit supported through the State, adopted "predatory" processes of capital accumulation and used the State to pursue their goals. Thus, it is not necessarily the State that is predatory, but the specific process of capital accumulation, which integrates both the State and the market. Finally, the number of "predatory" examples is very small.

At best, the predatory State is a very special case, which cannot be generalised and does not form strong evidence against State industrial and economic policy. On the contrary, clearly defined policies and targets are easier to monitor, such that State accountability to society is more likely to be more effective if State strategies, policies and targets are clearly spelled-out, and if the society is democratically empowered and organized to exert control over public policy and action. The "predatory", or otherwise, nature of the State can only be understood within the background of analysis of the process of capitalist accumulation, of which the State and the market form part. This raises a much more fundamental issue, that of the State's political power and will, which the neo-liberal school is not able to address.

### *Critique of the debate*

It has been shown that the neo-liberal arguments for market-friendly economics are theoretically poor and empirically unsound. Furthermore, the neo-liberal political economy of State intervention, which argues that no matter how imperfect the market is the State is worse, is a last resort attempt to dismiss, by definition, the social and economic role of the State. Does the critique of the neo-liberal arguments justify a State versus market divide? The answer is no, because of five main reasons.

First, the intention of the critique of the market-friendly approach is to demonstrate that this approach does not correspond to the way economies function, and therefore it does not provide an adequate basis for analysis of economic systems and functions and for policy, and it is not concerned with such an analysis of real economies but mostly with the generalisation of unsound, abstract theories about hypothetical institutions, states of the world, actions and outcomes. The intention of the critique is to move the debate about economic analysis and policy-making forward, beginning with the rejection of simplistic and poor interpretations of

the world as analytical working basis. There is no intention to reduce economic analysis and policy-making to a new set of hypothetical and highly simplistic blueprints based on hypothetical States versus hypothetical markets or, to put it in other words, to substitute an irrelevant analytical methodology for another equally misleading.

Second, in the real world the State operates through and with the market, and is influenced by, and influences, the same forces and dynamic processes of social conflict and capital accumulation present in the market. It does not mean that there aren't conflicts between State policy and the interest of other market forces, interests and outcomes, but that these conflicts result more from the existence of different interest groups and alternative outcomes and paths of development than from the fact that the State operates in the economy. In most cases, such conflicts cannot be solved in one direction or another without the systematic intervention of the State through policy, and what the State does, or does not, depends on the influences of different forces that operate through the State, on the real possibilities for policy, on market conditions and on the specific interests pursued by the State. Whether the intervention of the State is perceived to be efficient and conducive to virtuous circles of continuous growth and development, or pervasive and conducive to vicious circles of predatory behaviour, the State responds to economic and political conditions that are socially structured, and operates through the markets.

It is, therefore, misleading and strategically irrelevant to attribute success or failure to varying degrees of market (de)regulation or market-orientation of public policy. States and markets are not mutually exclusive, inversely related alternatives to each other. They influence and are influenced by each other, and influence and are influenced by the dynamics and outcomes of socio-economic relations and processes. Neither the State nor the markets are independent and insensitive to political and economic pressure and interests. The way States and markets operate and are related and the type of outcome they are capable of generating reflects such pressure and interests. Contrary to what neo-liberal economics argue, long-term, growth oriented public strategy and policy (such as industrial strategy and policy) are much more likely to generate constructive interactions between the State and the markets than short-term, stabilisation centred and "neutral", public good related public policies

This raises the third question, that of political will and power of the State. "Will" and "power" and quite different aspects: while "will" refers to the interest and policies the State is prepared to pursue, "power" refers to the political ability of the State to pursue such interests and policies. However, these aspects are closely related because they result from the influences that operate through the State: interest groups, the structure of the economy, the nature of the industrial and other socio-economic relations, the forces that drive the economy and the overall dynamics of capital accumulation. Nonetheless, it is important to bear in mind that there is a considerable difference between "will" and "power", because this difference is crucial in the process of policy-making, implementation, monitoring of impact and revision. This can be seen as a process of creating State (political) capacity: how can the State promote or create new interests, forces and market conditions that are supportive of socio-economic change and of a virtuous circle of growth and development, even when it has to work with, and sometimes confront, powerful established interests that have structured their patterns of accumulation around vicious circles of poverty and underdevelopment? Can the State impose radical policies from the start (for example, nationalization or fierce regulation and control) without generating severe economic shocks, or does the State have to increase its political and economic capacity through learning and promotion of alternative forces and interests? How strong and deep is the State involvement in economic activity, how much political leverage does this involvement give the State and what is its impact for the formulation and implementation of policy? In brief, the fundamental issues are that political power is a strong determinant of the State ability and strategy, it is strongly correlated with socio-economic conditions and interests and the way the State and the private sector interact, and it can be increased through strategically sought goals and policies by the State. Contrary to what neo-

classical economics argues, long-term industrial policy is more likely to create or increase the political capacity of the State, and to generate socially positive outcomes and externalities from the interaction between the State, the market and the social forces that operate through them.

Fourth, the State strategy has to prioritise the creation of administrate, informational and technical capacities within the State institutions that are required for economic analysis, policy formulation, implementation and monitoring, and impact assessment. Industrial and economic strategies and policies cannot be seen as being simply a set a rules, regulations and guidance for the action of private economic agents in the market – this is only a small part of the issue. Strategy and policies are also, and perhaps fundamentally, a guidance for the creation of new and more progressive and innovative capacity, both within the State and in the market. Therefore, contrary to what orthodox economics argues, capacity creation is endogenous to strategy and policy formulation and implementation, such that capacity is not a constraint but one of the determinants of the direction and priorities of the strategy and policy.

Finally, no matter how willing, empowered and skilled the State is, and how good its interaction with the market is, public strategy and policies can be no better than their feasibility. This, in turn, is determined by a wide set of conditions: the current industrial and economic structure, the dominant and driven forces of the economy, the level of skills and employment, the nature of industrial and other socio-economic relations, the machinery and technology in place and degree of time and technological depreciation, product market structure, capacity utilisation, the organization of the finance for the economy, etc. Contrary to what market-friendly economists argue, the formulation and implementation of strategy and policy can help the State and other participants in the market to improve their knowledge of the current socio-economic conditions, understand the changes that occur as a result of policy and other factors, and therefore continuously improve the effectiveness of strategy and policy.

The fundamental issues to retain are that States operate through markets; States, as markets, are sensitive to the political and economic interests and pressures that arise from the interaction between specific socio-economic forces; strategies and policies are not alternatives to markets but better ways of coping with, and mediating between, interests and pressures and creating alternative forces and new political, economic, technological, managerial and institutional capacities. Thus, a debate that seeks to find out whether the State or markets are more effective or needed, and in which precise combination, is inadequately specified, misplaced, misleading and irrelevant for the real world, not least because, irrespectively of the side one takes in it, the acceptance of the terms of the debate requires the acceptance of the organic separation and a-social nature of States, markets and economic processes. Because it is important to demonstrate that the neo-liberal arguments are weak and inadequate, it is crucial to advance the debate beyond the neo-liberal agenda of State versus markets, and towards the understanding and transformation of real economic systems, processes and functions.

**Concepts of economic policy**

How industrial policy is defined, quite apart from how it is formulated, implemented and monitored, reflects competing economic and political interests that choose to highlight some aspects of policy at the expense of others.

All policies of any significance have an impact on industrial performance. Macroeconomic policies, for example, have an impact on demand, interest rates and exchange rates, all of which have a direct impact on industrial performance through market access, costs of capital and intermediate goods and export competitiveness at the margin. Labour market policies,

through their impact on industrial relations, wage rates and the skills of the working force, also have a direct impact on industrial performance. This more global view of industrial policy calls the attention of analysis and policy to three inter-related factors:

- industrial policy is situated within the context of the economy as a whole and responds to a strategy – that of some form and path of industrialisation;
- many factors concur to influence which specific policies are adopted and/or chosen to be mentioned, and the why the impact of similar policies may differ substantially over time and across countries and industries;
- industrial policy takes place within the framework given by the specific economic and political structure and dynamics of capital accumulation.

Different industrial problems under different economic dynamics and structures may call for different strategies, policies, sequencing, instruments, institutional setting, etc. It follows that the definition of industrial policy, drawing upon the wide range of options available, should be specific to the problems to be addressed, which have to be identified and justified (pp. 16).

By contrast to seeing industrial policy in terms of instruments adopted by the government, industrial policy needs to be set in a much broader context, which requires an assessment of the economy of the economy and the rule of industry within it, in terms of structure and dynamics. This is the only basis upon which industrial policy can be adequately formulated (pp. 16). The formulation of industrial policy requires the specification of goals, objectives and strategies; the assessment of whether policies can be implemented, by whom and through which mechanisms; and the analysis of impact, including the revision of policy if necessary.

Reasons to keep a broader definition of industrial policy in the context of socio-economic objectives and strategies:

- objectives of industrial policy are set up by the overall economic and social program and by the role of industry within it;
- managing conflict of interest that arise from interest groups associated with the structure and dynamics of the economy as a whole;
- ability to understand and cope with pressures;
- assessment of the dynamics between different policies – policy nexus – namely with respect to relationship with macroeconomic policy, relationship with finance, relationship with trade, relationship with technology and R&D and relationship with other sectors (agriculture, etc);
- scope of industrial policy;
- avoidance of the tendency for other goals to take over and take an undue priority;
- impact assessment, not only if policies have been implemented adequately, but the assessment of the impact they have had (whether the desired objectives were achieved and at what costs) – cost benefit analysis.

**Implementation and monitoring of industrial policy**

The choice of policy does not mean that policy is adopted; adoption does not mean implementation; and implementation in a narrow sense that does not mean adequate implementation and the achievement of adequate (expected) impact. It is necessary that the benefits of a policy are made to accrue, rather than assume that they will accrue only by choosing, adopting and implementing a policy.

This involves that benefit are clearly identified and assessment is made of how to make them to accrue (for example, by establishing specific targets in contracts). Implementation and

monitoring should be concerned with putting adopted policies into practice in the narrow sense, but the most important concern is with the impact of policies on social (example, employment targets), economic (example, export targets), industrial (example, technology targets) and consumer (example, quality, standards and price targets) welfare, and that no corruption is involved in the identification of policy beneficiaries and targets, and in the assessment of impact.

Formulation, implementation, monitoring and assessment require three factors: data (collection and analysis), skills and motivation, and the determination and ability to overcome powerful interests and negotiate policy.

Policy is not only a collection of targets or instruments. It also requires:

- clear objectives;
- the definition of the mechanisms of implementation and monitoring;
- the definition of the agents and institutions with whom policies are going to be implemented and the mechanisms by which the State will convince those agents and institutions to participate;
- the penalties (which require clear targets, negotiated contracts and power);
- the indication of how circumstances are expected to change as a result of policy and other factors and what to do under different changing scenarios.

**Macroeconomic environment and industrial policy**

Industrial structure and performance, the choice of industrial policies and the impact of such policies on industrial performance depend upon a range of factors that vary with time, place and sector. Hence, industrial policy should not be narrowed or fixed, as it runs the risk of becoming sterile, static and irrelevant.

Through a variety of overlapping mechanisms – scale and scope economies, externalities, economic linkages, spin-offs, learning by doing, R&D, education and training, evolving entrepreneurship, etc. – investment and growth have the potential to be self-sustaining and mutually reinforcing (virtuous circle), with the inverse being the vicious circle:

Virtuous circle:

High I $\rightarrow$ High productivity $\rightarrow$ Fast growth $\rightarrow$ High I...

Vicious circle:

Low I $\rightarrow$ Low productivity $\rightarrow$ Slow growth $\rightarrow$ Low I...

Different economies function in different way, depending on their institutions, industrial structures, political processes, international economic relations, etc. Hence, to discuss the macroeconomic environment that can help to create a virtuous circle it is necessary to identify how specific economies function.

Macroeconomics and prospects for I:

- macroeconomic policy for investment tends to be heavily oriented towards targeting of business confidence, which is highly elusive and volatile. Additionally, quite apart

from the fact that the definition of sound macroeconomics is highly contentious, the outcome of macroeconomic policy is uncertain and the impact of such outcomes on business confidence is more uncertain still. Macroeconomic policy separated from clear development goals becomes focused on macroeconomic targets, which may affect growth negatively;

- capital flows suffer from many leakages before being translated into investment: a policy of high interest rates is attractive to short-term, volatile capital flows which add nothing to productive assets and capabilities; privatisation, mergers and acquisitions (M&A) and stock or property market boom may increase savings but without increasing investment in productive capacity;
- in the analysis of investment patterns, structure and dynamics, aggregate figures are far from providing useful analytical information. It is important to disaggregate investment by sector, industry, region and, if possible, other factors like origin, actual application, etc., depending on the nature of the analysis to be made.

***Finance and investment***

A crucial aspect of how macroeconomics affects investment is through the organization of the financial system and the financing of the economy. There are three approaches to the financial system. The *real resource* approach is concerned with identifying and financing the resource gap in the economy. Investment requirements consistent with a given growth rate are identified, and the difference between investment requirements and domestic savings provides the measure of resource gap that has to be financed by external flows of capital. This approach is not concerned with how resources are mobilised and deployed.

The *financial liberalisation* approach is concerned with ensuring as much liberalisation of the financial system as it remains consistent with macroeconomic stability. The argument is that liberalisation will result and higher interest rates and increased competition within the financial sector. As a result, savings increase, the quality of investment improves and more financial services are provided. This approach is not interested on the actual functioning of any specific financial system.

The *financial systems* approach is concerned with the information inefficiencies of the financial market that arise from the structural separation between lenders and borrowers and the subsequent information asymmetries that develop. The lender does not have complete information about he borrower, and therefore faces a certain degree of uncertainty to identify who is a bad or good risk, to assess if the loan is used for its purpose and to evaluate if the borrower reports correctly. The borrower faces uncertainty regarding the lender's behaviour in case of an unforeseeable and unfortunate time, what happens in the event of outcomes not completely covered by contract, and who is to bear unforeseen losses and gains.

This approach provides a theoretical critique of the financial liberalisation approach. It shows that financial liberalisation is a special case that works in the absence of information asymmetries and contractual costs; cannot explain the role of finance because it treats finance as simple another market and service; and has limited ability to explain the functioning of different financial systems and to suggest how to improve it by means other than de-regulation.

The financial systems also show that de-regulation may increase uncertainties and inefficiencies; tends to lead to short-termism and can lead to very high interest rates and reduce returns to lenders because only high risk business may be undertaken. Financial liberalisation may actually lead to greater concentration, greater instability, narrowing of provision of finance and higher capital costs. Financial systems call the attention for the need of regulation and for care to be taken with the method of monitoring.

According to this approach, most of the problems mentioned could be solved through a closer relationship between contracting parties, which helps to build trust and obtain information. Thus, the way banks relate to industry is crucial. It follows that a bank-based financial system, which allows for long-lasting relationships, is better than a market-based financial system. In this debate, bank-based versus market-based financial systems, the advantages of the bank-based system reside on the facts that banks take risks, firms remain loyal to banks, and between banks and firms long-lasting commitments are developed that reduce uncertainty.

This debate is criticised on the follow grounds:

- both systems are constructed in terms of different assets (short/long term, overdrafts/equity), regulations and degree of State intervention. However, the distinction between the systems is not sharp;
- the theories are also based upon a variety of functions undertaken over the life time of a project, but such functions are not sharply divided between the systems, but differ between banks, over time and across countries. For example, investment banks in Japan roll over short-term loans for working capital to industrial firms easily, whereas investment banks in the UK do not;
- requirements over the financial system differ over time and at different stages of development. For example, in earlier periods of industrialisation short-term credit for trade is crucial to industrial firms, whereas in advanced stages large corporations exert control over finance;
- interactions between industries and finance depend on broader socio-economic factors, rather than simply on the terms of the structural separation between industry and finance. For example, long-term employment policies in Japan forces firms and banks to re-finance and re-structure because social costs of bankruptcy are unacceptable;
- the theory is also based on a narrow base, general equilibrium, which depends on given economic conditions; for example, no account is made for who owns property and other distributional factors;
- the theory avoids the analysis of power and politics. Preservation of the system may take precedence over improvements within the system, particularly if changes in property rights are involved. Once policies are in place and if all banks participate none has incentive to withdraw; the problem is that banks on their own will not initiate the policy change. Interest within the financial system may block or promote particular non-financial policies according to their impact on State power and the financial system; for example, the system may block industrial policies that are perceived to affect how finance is mobilised and deployed and the profitability of the financial system. The financial system has the added power to influence and reflect business confidence, not least because of the interaction between finance and the whole economy, and the impact of stability indicators on financial dealings.

In brief, this discussion puts forward two views of the financial system: one in which the financial system is a set of financial institutions, assets, regulations and activities; and another in which the financial system is the means by which the economy is financed. This last view requires coordination between financial and other institutions and organizations (including firms) and how they mutually undertake financial functions.

An analysis of the financial system would require:

- how finance is raise and deployed;
- how finance is integrated with the rest of the economy;

- which financial markets are developed;
- competitive conditions and market power;
- business development: core activities? Vertical integration?
- which financial institutions and the role of large and small business in finance;
- orientation of driving forces of the economy (dominant interests): global, so no interest in vertical integration at home?

Financial reform should respond to the requirements of financing industrialisation and other growth-oriented economic activities:

- what to coordinate/which system;
- finance and supply of goods and services;
- the financial framework of industrial policy.

The lack of a consistent financial framework for industrialisation is not necessarily the fault of the Ministry of Industry, or any other particular department; it results from the problems of having many different department and institutions influencing industrial policy in an inconsistent manner, often responding to short-term problems and lacking a strategic view of the motives and context of their policies.

***FDI***

The analysis of FDI, and its impact upon the economy, should consider the following:

- data about level, asset composition, distribution (sectoral, regional and global);
- which are the determinants of FDI and the impact of policies to attract it (costs and benefits);
- how it affects the economy
    - savings – M&A, new capital, displacing capital, re-investment of profits or profit repatriation, where finance is raise (domestic or foreign markets) and under which conditions;
    - technology and technology transfers
    - power to influence policy;
    - structure of industry and vertical integration;
    - employment – net employment, depending on direct and indirect and displaced jobs;
    - forex – imports of inputs and exports of low value, low skills commodities. Net impact on forex;
    - spin-offs – depends on whether dynamic economies are internalised or shared with the domestic economy.
- It should be taken into consideration that one criterion/target (example, exports) may have trade-offs against another (example, technology transfers);
- How to make benefits to accrue and reduce costs?

**Trade policy**

Arguments for trade liberalisation: consumer welfare, political economy and efficiency (see debate in first section for detailed exposition and critique).

Five accounts to dismiss the theoretical argument for trade liberalisation:

- trade liberalisation and growth are not directly correlated. At best, trade and growth are correlated through exports and cheaper imports, but this does not necessarily require liberalisation, nor liberalisation necessary lead to more exports or the cheaper imports of capital and intermediate goods;
- impact of trade liberalisation on import price is once for all – inflation is not tackled, but the price level changes;
- exports need capacity, not only shifting around existing capacity – shifting would not expand markets;
- more important for exports is: demand, technology, R&D, finance, wages, stability and growth;
- capital account liberalisation is bad for industrial performance: volatility, speculation, short-termism, high interest rates, displacement of savings.

Trade reform should be related to other factors of the economy: structure and dynamics of sectors, how to restructure industries, and conditions for endogenous and exogenous productivity growth.