3
Efficiency, Efficient Institutions, and Globalization

3.1 Neoliberalism, rationality, and efficiency

Does globalization entail a demand for uniformity, or diversity, of the (political) economic institutions of nation-states? This is the question that has loomed large in the policy debate on the different approaches to the transformation of the Soviet-type economic system. It has also been central to the discussion over how far the prevailing Anglo-Saxon economic model is representative of capitalism, particularly when compared with the 'continental European model' and the 'East Asian model' – and particularly since the 2007–8 financial crisis that engulfed most of the advanced capitalist economies. In short, the question has been hanging over the project of neoliberal globalization.

Sometime in the closing years of the twentieth century, 'institutions' became a topical issue in the orthodox development policy-making establishments. The International Monetary Fund and the World Bank, in their flagship publications, both repeatedly stated that they had overlooked the importance of institutions in the 'transition to the market' (IMF 2000, World Bank 2002). Such statements were typically added with the caveat that the oversight was recognized only with the wisdom of hindsight, that is, everyone else had made the same mistake. Hence, the orthodox establishments should not be held responsible for the economic underperformance due to their policy deficiency. At any rate, however, this turn in policy stance does signify something fundamentally flawed with the canon of neoliberalism. Using the notion of an ahistorical, monolithic model of the free market economy as a representation of capitalism is bizarre. The orthodox establishments seem, belatedly, to have woken up to the recognition that 'capitalist economies differ in important ways in how they

regulate economic activities' (Djankov et al. 2002). This recognition, trivial as it might appear to be, reflects important developments in the real world. While the protagonists cite a range of specific events – 'the transition from socialism, the Asian financial crisis, and the European political and economic integration' – as main motivations for the recognition, it is the general process of neoliberal globalization that is the ultimate motivation.

The turn in policy stance also signifies the demise of the branch of economics known as comparative economic systems, and the emergence of its successor, the so-called new comparative economics. The older literature of comparative economic systems has been in a state of paradigmatic crisis since the collapse of the Soviet systems. At first sight, the crisis seems to have arisen from the sudden disappearance of its subject matter or 'anchor', the Soviet-type economic system. That is why a prominent protagonist (quoted in Bonin 1998, p. 2), in a cynical mode, so mutters: 'we are all economic historians now.' Yet, the crisis goes much deeper than that. The claim that the literature has come to a close implies ignoring the multiplicity of institutions and development experiences within the reality of capitalism itself. More precisely, it implies that, insofar as different institutions embody different developmental attributes, the attributes are all reducible to the free market model. Conversely, the central character of the literature is that it has ostensibly striven to use the free market model both as a summary representation of capitalism, and as a welfare standard by which to judge any alternative. The price of following such a theoretical approach is that the literature has thus far been unable to offer any insight to the following analytical issues: the endogeneity and exogeneity of institutional formation, the interaction between social and technological factors in the process of institutional change, and the impact of the interaction between different economic systems on development. Yet, it is conceivable that the enquiries into these issues are of paradigmatic importance for answering the policy and intellectual question of globalization as indicated previously.

Put in an intellectual context, the crisis of the comparative economic system is related to its position in neoclassical economics. The term 'economics,' in ordinary languages, is most likely to refer to 'the study of the economy.' Yet, mainstream textbooks in the neoclassical tradition typically begin with a different definition: that 'economics is the study of how people use their limited resources to try to satisfy unlimited wants.' In other words, in the fundamental sense, the neoclassical tradition of modern economics defines the nature and boundary of the

discipline in terms of its distinctive methodology, that is, individualistic rational choices and their equilibrium, rather than its subject matter. The literature of comparative economic systems is an exception. It defines itself in terms of subject matter, and takes the existence of the subject matter as given. There is thus an intrinsic tension between the methodology of the literature (the neoclassical framework of individualistic rational choices and their equilibrium) and its subject matter (the multiplicity of institutions and development experiences in the real world). What follows logically from the neoclassical framework is the claim that there exists a uniquely optimal set of institutions and thereby uniquely optimal development paths. Yet this claim has appeared to be delusive with respect to the reality of neoliberal globalization.

It is precisely in the attempts to cope with the indicated tension between methodology and subject matter that the new comparative economics has emerged. Understandably, this new literature has been subject to diverse convictions. Some protagonists aim at preserving the neoclassical framework at a more fundamental level, while some others aim at transcending the framework to arrive at a new theory of institutions and development. The present chapter purports to review critically the emerging literature of new comparative economics, with an emphasis on highlighting the relative strength and weakness of its various strands. Specifically, the exposition that follows is intended to show that attempts that adhere to the neoclassical tradition are likely to lead to dead ends, while those encompassing collective rationality represent more promising directions. On this basis, it is submitted that the development of comparative economics requires an incorporation of objectified institutions and paradigmized technology into its sphere of enquiry. And there are important lessons to learn from classical political economy and its modern presentations in this regard.

3.2 What's new with the new comparative economics?

What is the theoretical underpinning of the demand imposed by globalization on the political-economic institutions of nation-states? This question is at the heart of studying institutional uniformity versus diversity under globalization. And it is the focus of the development of the new comparative economics.[1]

Three main theoretical strands may be discerned in this new literature: namely, the application of 'new institutional economics,' the extension of the 'new political economy,' and the development of 'comparative institutional analysis.' The first two strands, because of their adherence

to the framework of individualistic rational choices, are broadly defined in the neoclassical tradition. The main difference between them is that, in line with the distinction made by Douglas North and associated scholars, the first strand focuses on issues of institutional arrangements while the second strand focuses on the institutional environment (Smyth 1998a provides a critical review of the theoretical implication of North's taxonomy). The third strand has attempted to incorporate both individualistic and collective rationality in the analysis of the formation, evolution, and developmental attributes of institutions and economic systems as a whole. It has sought to derive the economic properties of institutions from accumulated empirical case studies, rather than taking as a starting point the presumption of a universally applicable, uniquely optimal (or most efficient) model of institutions. This third strand is thus not at ease with neoclassical economics.

3.2.1 Coping with globalization: The new institutional economics

With respect to the first theoretical strand, the exemplar is Gregory and Stuart (1999). This has been perhaps the most popular textbook for decades in comparative economic systems, and was also, not by coincidence, the first to use the term 'new comparative economics.' Since its sixth edition, published in 1999, the book has abandoned the traditional 'black box' approach to the study of economic systems – that is, treating an economic system as no more than a variable, which together with policies and environmental factors jointly determine economic outcomes such as growth performance. Instead, it seeks to apply theories of new institutional economics to the comparative analysis of conceptual models of capitalism and socialism. These include theories of property rights, transaction cost, and principal-agent relations. The general character of the application is to conceptualize the overarching task confronting any economic institution or system as one of facilitating voluntary exchange and thereby achieving efficient economic outcomes. Hence, an economic institution or system is understood to consist of a range of information–incentive arrangements by which to facilitate the exchange between rational individuals with the objective of minimizing the cost of problems such as shirking, opportunism, adverse selection, and moral hazard.

It is noted that the principle of voluntary exchange between rational individuals is of central importance to the previous theories. These are all connected to the famous Coase theorem, which states that when property rights are well defined and transaction costs are zero, rational individuals will organize their transactions in ways that achieve

efficient outcomes. And the concept of efficiency thereof need not always be confined to allocative efficiency. In the Alchian and Demsetz (1972) model, the best known of the property rights theories, there is the concept of the residual, which is the outcome of production rather than pure allocation. In Williamson (1985), the representative work of transaction cost economics, we find explicit recognition of the importance of tacit knowledge learnt from the production process and from co-operation. On the whole, these theories offer insights to the formation and evolution of efficient institutions, and, by extension, of efficient economic systems.

But are efficient institutions really reducible to individualistic rationality? There are two fundamental problems with new institutional economics. First, it is logically flawed to analyse institutional formation and change solely in terms of the principles of the market. Even if it is true that individualistic rationality forms the basis of efficient institutions, it is still necessary to clarify the precise mechanisms by which the exchange between individuals can be brought into equilibrium. The market as an entity (e.g. the market for corporate control), rather than as institution-free principles, must be proved to be able to work in a way that is faithful to individualistic rationality. This is unlikely to be possible, given the existence of information asymmetry/incompleteness, transaction cost, unequal power relations, etc. Hence while extremists like Alchian and Demsetz (1972) claim that market-produced institutions are optimal, more eclectic scholars such as Williamson (1993, 1995) and North (1994, 1997) tend to argue that they are at most 'comparatively efficient'.

Meanwhile, the second problem with new institutional economics concerns the very concept of efficiency itself. The claimed causality between individualistic rationality and efficiency hinges on the assumption that the sources of efficiency are at least potentially exchangeable. Put another way, a specific technological paradigm is assumed, whereby the determination of the level of and change in efficiency is either exogenous to the working of institutions or confined to individualistic learning. This is a very restrictive assumption, although whether or not it is valid is ultimately an empirical question. The point to note is that so long as the validity of the assumption is not proven, economic institutions – and, by extension, economic systems as a whole – that are faithful to the theories of new institutional economics cannot have prior claim to comparative efficiency, let alone optimality (Chapter 4 will provide an elaborate exposition on institutions and sources of efficiency).

3.2.2 Coping with globalization: The new political economy

The second strand that seeks to answer the questions of globalization concerns the extension of theories of new political economy. The focus of this strand is on comparing the politico-legal arrangements of nation-states in the regulation of economic activities, on the assumption that these arrangements are fundamental determinants of institutional formation and change, and thus economic development. Moreover, in line with a prominent thesis of neoliberal political economy, this strand considers the government (taken to be synonymous with the state) as in nature no more than a collection of self-interested bureaucrats, which interact with the 'political market' (the existence or otherwise of election and its precise forms) to produce politico-legal arrangements. In this way, these works offer to construct a theory, confined to individualistic rational choices and their equilibrium, of endogenously-determined economic institutions as well as politico-legal arrangements (Beck et al. 2003; Djankov et al. 2002, 2003; Glaeser et al. 2001).

To answer the question of institutional uniformity versus diversity, the new political economy devises an analytical framework that involves the trade-off between market failures and government failures. The analyses of two particular issues are illustrative of this strand. The first concerns the relative efficiency of two arrangements, the court vis-à-vis regulatory agents, in the enforcement of laws or contracts. It is argued that regulators, compared with judges, are typically faced with stronger but more biased incentives for enforcement. Hence, in the context where the costs of verifying the circumstances of specific cases and interpreting statutes are high, enforcement by regulators, which have more lopsided but powerful incentives, may be a more efficient arrangement. The opposite conclusion can be reached, however, in the event where factors such as government transparency, press freedom, and bureaucratic efficiency are lacking – that is, where the likelihood of government failures is high. Meanwhile, at a much broader level, the second issue being analysed concerns the relative efficiency of governance by common law vis-à-vis civil law. In the final analysis, this again involves the trade-off between market failures and government failures. It is argued that common law provides better protection to private property rights, while civil law offers a greater scope for government intervention in economic activity. Hence, in circumstances where the potential of market (government) failures is greater, civil (common) law may be a more efficient system.

It appears that the new political economy does allow for institutional diversity, but only within a tight limit. To see the point, note that the trade-off as illustrated previously has been reconstructed by Djankov

et al. (2003) to form a general theory of efficient institutions. In this theory, market failures have been generalized to what the writers call 'private disorder' (infringement of private property rights by private agents), while government failures have been generalized to so-called dictatorship (infringement of private property rights by the government). The four common strategies of social control over business – private orderings, private litigation, regulation, and state ownership – are viewed as points on the institutional possibility frontier (IPF) of a particular nation-state. These four strategies, ranked in terms of increasing state power, are considered to be associated with progressively diminishing social costs of disorder and progressively rising social costs of dictatorship. Now, as Figure 3.1 illustrates, for a given IPF, precisely which of the four strategies (and thus the associated institutional arrangements) is the most efficient depends on the slope of the IPF, that is, the level of development of the market relative to that of the government. This delineates the scope allowed for institutional diversity. But note that, in the figure, both the vertical and horizontal axes are defined in a negative way, as distances from a state that is free of 'social losses.' This state refers to a world with perfect property rights, which defines institutional uniformity.

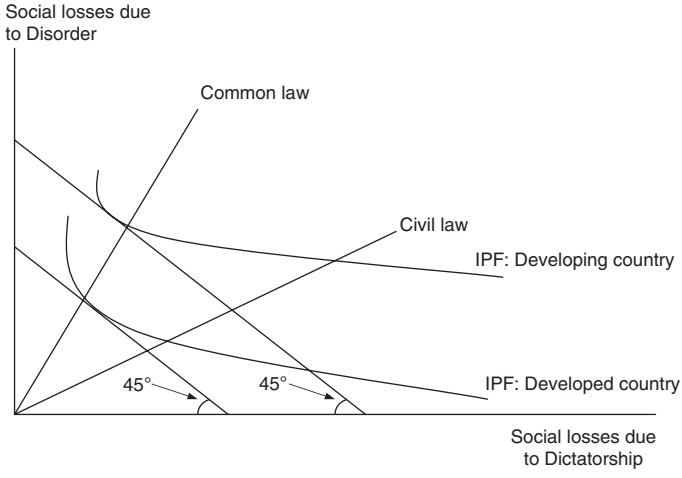

Figure 3.1 The comparative (in)efficiency of market failures and government failures

Source: Djankov et al. (2003).
Note: IPF = institutional possibility frontier. The 45° line indicates total loss minimization. The origin position of the graph represents a state with perfect property rights.

The two afore-mentioned problems with new institutional economics, regarding the claimed optimality of institutions that are faithful to the principle of individualistic rational choices and their equilibrium, also apply to the new political economy. Insofar as the claim is over comparative efficiency, rather than optimality, the problem concerning the market as an entity will be less serious. But the theory would then need to prove that its conceptualization of the state – as no more than a collection of self-interested bureaucrats – is well-established. This is very doubtful, because its treatment of the state-society relationship is simplistic and it says nothing about the importance of inter-state relations. In this theory, the relationship between the society and the state is viewed as no more than a principal-agent relationship constructed via a formalistic 'political market,' while important issues such as ideology, legitimacy, and functioning to ensure the reproduction of existing social relations are simply ignored. Needless to say, alternative concepts such as 'the state as a committee for managing the common affairs of the dominant social class' or 'the developmental state' are not considered worthy of contemplation in this theory (for a review of the vast literature on the political economy of the state, see Sawyer 1989, Chapter 10).

The problem regarding the flawed concept of efficiency is even more serious in new political economy than in new institutional economics. In the former strand, the concept is strictly referred to allocative efficiency. This is clearly illustrated by Beck et al. (2003), who in effect argue that efficient politico-legal systems are arrangements that embody maximum flexibility to accommodate 'financial needs' and therefore to foster 'financial development.' This is the extreme form of the argument that perfect property rights are the optimal state, because 'by encouraging people to invest in themselves and in physical capital, such security [of private property rights] fosters economic growth' (Djankov et al. 2003, p. 596). The claimed equality between financial development and overall economic development hinges on the assumption that the sources of efficiency are marketable, an even more stringent standard than that held by new institutional economics. Yet given alternative technological paradigms, institutional arrangements that offer maximum flexibility to financial interests could be imparted with short-termism, resulting in a state where the logic of speculation prevails over that of creation in the economy. Such arrangements could cause insufficient effective demand at the macro level, as Keynesian economics has posited, and could hinder improvements in productive efficiency at the micro level. The claim

over optimality by the new political economy would then turn out to be no more than delusion.

3.2.3 Coping with globalization: Comparative institutional analysis

The third strand that seeks to answer the questions of globalization concerns the development of comparative institutional analysis. The ambition of this theoretical strand is to incorporate both individualistic and collective rationality in analysing institutional formation and change. Crucial to the theory is the recognition that bringing individualistic rational choices into equilibrium requires a process of interaction characterized by evolutionary games. The games are evolutionary because, in taking place in real time, their players learn: individuals are not endowed with complete information about the objective structure of the games. At any time, game players have only incomplete cognitive views regarding the structure of the games, that is, they only have 'subjective game models'. It is only when actions taken by the players, based on their own subjective game models, are mutually consistent that their views 'can be confirmed by the observed reality jointly created by their action choices and reproduced as a guide for their further action choices' (Aoki 2001, p. 3).

An institution, then, can be conceptualized as a system of self-sustaining shared beliefs of the players about the structure of the game that they actually play. It is the joint product of individualistic and collective learning, or, the equilibrium of the co-evolution of the traits of individuals and the convention of behaviour. In this way, an institution is both endogenously created and objectively extant. And an efficient institution corresponds not to individualistic rationality per se, but rather to some particular combination of individualistic rational choices – that is, collective rationality. The same reasoning applies to economic systems as a whole, for each system is understood as 'a coherent set of institutional arrangements' formed on the basis of the co-evolution of shared beliefs and individual traits (Aoki 1996).

The previous summary clarifies a key feature of comparative institutional analysis, which is that, concerning institutional formation, the equilibrium of individualistic rational choices can be brought about by a wide variety of mechanisms, of which the market is but only one. This allows the theoretical strand to avoid the problem of market failures, which, as indicated earlier, poses a serious challenge to the theories of both new institutional economics and the new political economy. But having a broader set of possible mechanisms for achieving equilibrium

also implies the more difficult task of constructing a theory of efficient institutions. At stake is the question as to what are the parameters upon which the co-evolution of shared beliefs and individual traits is based. Put another way, what factors would guide co-evolution towards the kind of equilibrium in which efficient institutions are created? It appears that the comparative institutional analysis approach offers no explicit, well-developed answer to the question. At one level, this lack indicates a reservation over the notion of uniquely optimal institutions – that is, a recognition of the multiplicity of experiences in the real world and an anticipation for constructing a theory of efficient institutions via accumulated case-studies of experiences. Yet at another level, it also reflects an intrinsic weakness of the theoretical strand. While recognizing that the parameters upon which the co-evolution is based are the paradigmized technological conditions and the globalized social conditions (Aoki 2001, Chapter 15), it stops short of explicitly exploring these conditions. The theorization, in the main, focuses its attention on the sphere of exchange. This makes it impossible to construct a general theory of efficiency, and therefore of efficient institutions.

3.3 In the lens of techno-economic paradigms

The enquiry into objectified institutions and paradigmized technology lies at the heart of classical political economy. This stands in contrast to neoclassical economics, which seeks to derive its theories of institutions and development from the construct of ahistorical, universal, rational individuals. This contrast has important ramifications in the field of comparative studies of economic systems. As a matter of fact, in the relevant literature, neoclassical economics, while being predominant, has never been the solely existing approach. There are two discernible alternatives in the classical tradition.

One approach, drawing on David Ricardo, mainly concerns issues of objectified institutions. It focuses on the analysis of the social conditions that determine the pace and direction of the reproduction of the economy. More concretely, a central thesis of modern neo-Ricardian (or Sraffian) economics posits that the scramble for the surplus product of the economy between different social classes determines the system of relative prices, the path of economic growth, and the sustainability of the economy and the existing social relations (Dutt 1990, Ch. 2–3; Sawyer 1989, Ch. 8–9). Meanwhile, a second approach, drawing on Adam Smith and Karl Marx, concerns mainly issues of paradigmized technology. It conceptualizes an economic institution, and the

economic system as a whole, as an arrangement by which to re-integrate the division of labour in the society. And because the division of labour is not only the commonest characteristic of all modern societies but also the most fundamental cause of productivity improvement, the developmental attributes of economic institutions can thus be assessed in this light (Putterman 1990; Sayer 1995).

It would be useful to go a step further to clarify the relationship between the earlier two approaches, in terms of theories of efficient institutions. The starting point is the concept of efficiency, which is defined as productivity improvement and thereby economic development. In the broadly defined literature of growth theory, productivity improvement over the long term is often considered to emanate from three sources: allocative efficiency, economies of scale, and economies of scope, which give rise to different forms of technological progress. Theoretically, it could be argued that these different sources of productivity improvement could ultimately be traced to two different principles of the division of labour. Economies of scale stem from the deepening of the detailed division of labour à la Smith (the separation of conception and execution). Technological progress thereof is equivalent to producing new information, which is made possible by the deepening of the division of labour within a given cognitive framework. Economies of scope, in contrast, stem from the deepening of the social division of labour à la Marx (the integration of conception and execution to produce a complete commodity). Technological progress thereof is the production of knowledge, which is generated by individual as well as collective learning, that is, the process of exploration between deepening the given cognitive framework and selecting a new cognitive framework. Finally, allocative efficiency, while involving the production of a complete commodity and being thus based on the social division of labour, hinges on the peculiar assumption that what is produced is exchangeable, that is, information rather than knowledge (Chapter 4 will give an elaborate review on these relevant theories). Thus, the theoretical approach that focuses on the division of labour and its re-integration can be interpreted as a theory of efficient institutions at the micro level and in the sphere of production. The theoretical approach that focuses on the reproduction of the economy, meanwhile, can be interpreted as a theory of efficient institutions at the macro level and in the sphere of income distribution and exchange.

Now, recall from the previous section that common to all the neoclassical strands in comparative economics is the conceptualization of an institution as an information-incentive arrangement governing

the exchange between individuals. And because the equilibrium of the exchange between individualistic choices is considered to be the necessary-cum-sufficient condition for optimal (or at least comparatively efficient) outcomes, the efficiency attributes of institutions can thus be assessed accordingly. Compared to theoretical approaches that are in the classical tradition, neoclassical theories of efficient institutions are seriously wanting because they reduce production to exchange at the micro level – that is, they must assume, in a very restrictive way, that sources of productivity improvement are marketable, or at least potentially exchangeable between individuals. This assumption is clearly of much less intellectual value than the explicit theoretical expositions of the classical approaches. Nevertheless, it is of note from the previous review that the classical approaches, while making the sources of productivity improvement endogenously-determined, have also had to leave institutional formation and change exogenously-determined. This is reasonable, given the recognition of the multiplicity of collective rationality and that collective rationality must be history-specific in nature. Yet such recognition need not preclude enquiries into the possibility that, within the confine of historical conjunctures, objectified institutions and rationality (individualistic as well as collective) could follow a path of co-evolution towards comparatively efficient outcomes. In other words, the synthesis between the classical approaches and the comparative institutional analysis approach might offer scope for developing theories of history-specific efficient institutions.

One possible direction for developing theories of history-specific efficient institutions is to resort to the notion of 'the social force of production' in Marxist economics. There is a well-known thesis in historical materialism which states that, at the most general level (i.e. in an anthropological sense), the development of the force of production is the fundamental cause of social change (Zhang 2002). Yet within the confine of historical conjunctures (i.e. in the sense of political economy), the force of production must be social in nature. With reference to capitalism, Harvey (1982, p. 100) puts it this way: 'in the same way that use value becomes re-integrated into political economy as *social* use value, so the purely physical idea of productive force is re-integrated into political economy as the power to create surplus value for capital through material commodity production.' The power to produce surplus value must be qualitatively different from the power to produce for human needs. The reproduction of labour power, which is a core component of the productive force, must involve a complex social process embodying the specificities of income distribution, the pattern

of consumption, and so on. Similarly, the invention of new scientific understandings, and their application to the labour process, must necessarily be integrated into the dynamics of the prevailing social relations (Lin et al. 2002).

The importance of employing the notion of the social force of production is not just that it entails an explicit exposition of production and productive efficiency, which is conspicuously lacking in neoclassical economics. By viewing the social and technical aspects of the labour process as integrals of a unified whole, the notion also marks a distinctive feature of Marxist economics vis-à-vis Sraffian economics. Namely, the thesis that the surplus product of the society is the outcome of a joint social and technical process, rather than that of a purely technical process. And, in the Marxian view, the functioning of socio-economic institutions is to govern both the production and distribution of this social surplus product. This thesis has underpinned a range of theoretical approaches in modern radical economics: theories of techno-economic paradigms, the theory of the social structure of accumulation, and the concept of the regime of accumulation in the work of the French Regulation School. It is of note that a notion commonly used by these approaches to characterize twentieth-century capitalism is Fordism. This notion is a good illustration of the integrated treatment of the social and technical aspects of the force of production. For the social aspect, Fordism consists of 'big business, big unions, and big government.' For the technical aspect, it consists of the application of Taylorist techniques and scientific management, together with the combination of dedicated machinery and standardized parts for mass production. The integration of the two aspects gives rise to a pattern of economic development that is based on a particular technological paradigm and the corresponding demand conditions (Harvey 1989, Part II; Kotz 1994; Nell 1998, Parts I and V).

It should be noted that the previous exposition is not meant to be a general theory of efficient institutions. Insofar as Fordism is/was comparatively efficient, it is/was so only within the confine of certain historical conjunctures. As a tradition in Marxist theory, and as all strands of modern radical economics have stressed, in the process of institutional formation and change the interaction between the social (class relations) and the technical (paradigmatic change) is no more than conjunctural. It is one thing to say that the expansion of the force of production requires, in a functional sense, certain social conditions; it is another thing to say that the conditions would be actually available. Considering the experiences of more efficient alternatives to

Fordism – the case of the stylized Japanese firm, the case of the 'Third Italy', etc. – Best (1990, Ch. 5–7) and Sabel (1982, Ch. 4) both note that they are products of specific historical processes. Referring to the emergence of capitalism in general, Harvey (1982, p. 27) notes: 'how and why did it ever come about that the owner of money finds a labourer freely selling the commodity labour power in the market place? The relation between capital and labour has no "natural" basis – it arises as the result of a specific historical process.' This stands in sharp contrast to neoclassical approaches, which typically seek to construct general theories of efficient institutions on the basis of some universal characteristics of human nature.

3.4 Institutions and the limits to capitalist transformation

In the scholarly literature, there are two extreme views on the developmental impact of globalization. Neoliberalism considers globalization as a promoter of development, and this is based on the neoclassical theory of economic growth (the thesis of convergence) and international trade (the thesis of factor price equalization), and, ultimately, on theories of efficient capitalist institutions. The dependency view, in contrast, considers globalization as a promoter of underdevelopment (meaning negative development). This is based on theories of unequal exchange and forced specialization, and, ultimately, on theories of the exploitative and crisis-prone nature of the capitalist system.

Each of the two extreme views has its difficulties in coping with experience. Neoliberal protagonists have boldly claimed that 'capitalism typically produced growth and wealth' (Djankov et al. 2003, p. 596), but this claim must be qualified by an extremely selective reading of history. It is almost a consensus in the literature of empirical studies that, over the last century, there is no evidence of a levelling convergence of growth rates and thus levels of per capita income (Weeks 2001). More to the point, the last two decades of the twentieth century were part of the era of globalization, yet these were precisely what have come to be known as 'the lost decades of development.' As Easterly (2001) has observed, development was lost in this period despite the fact that the vast majority of developing countries (and countries of the former Soviet bloc) actually implemented policy reforms in the direction of transition towards the free market economy. Meanwhile, along with the general stagnation of economic growth in the developing world, in the era of globalization there has been a trend of growing disparity

among major regions – a trend of uneven development. East Asia, which among developing economies is certainly not the least integrated into the world market, is perhaps the only region that has closed its income gap with advanced capitalist economies. And China, which has undergone a process of progressive marketization since the late 1970s, has achieved a magnitude of poverty reduction that outweighs the developing world as a whole (implying that the developing world excluding China has indeed undergone an underdevelopment process in the absolute sense). The experience of uneven development appears to contradict the dependency view.

What explains the trend of general underdevelopment, as well as that of uneven development? An influential answer from neoliberalism, known as the thesis of 'conditional convergence,' ascribes the observed stagnation of growth in the developing world to 'bad policies,' that is, policies that obstruct the functioning of the market. The conclusion that follows, then, is that it is not capitalism that has caused underdevelopment, it is the insufficient development of capitalism that has caused it. In contrast, an alternative explanation, exemplified by Weeks (2001), focuses on the competition between capitalist and semi-capitalist economies. It is contended that the nature of the competition is such that it tends to produce divergence rather than convergence, because capitalist innovations and hence growth require the existence of capitalist social relations. This phenomenon, called 'primary uneven development,' is posited to be qualitatively different from the competition between predominantly capitalist economies, that is, 'secondary uneven development,' which exhibits fluctuations between convergence and divergence dancing to the tune of the general process of system-wide capital accumulation. Weeks' arguments are in the same spirit as Krugman's (1981) formal, two-stage model of imperialism and uneven development. In the model it is argued that in the stage of international trade capitalistic industries kill off less-capitalistic industries, while in the stage of international capital flows industries are re-built in less-capitalist economies. A logical conclusion from both Weeks and Krugman is that divergence will cease to be the dominant tendency when capitalist globalization is completed, although it will be the dominant tendency before then.

The previous argument hinges on the question as to whether capitalist globalization can ever be completed. A prominent thesis in radical economics posits that capitalism as a history-specific system would not necessarily reproduce the same social relations everywhere across the globe, and that, once being integrated into the world market,

non-capitalist (or semi-capitalist) social relations would become part and parcel of the capitalist system. Non-capitalist institutions would then be perpetuated by the dynamics of the general process of system-wide capital accumulation. This thesis is shared by some strands of dependency theory (the notion of lumpen development), of structuralist Marxism (theories of the articulation of modes of production), and of the Chinese theory of the semi-feudal, semi-colonial social formation. The general thrust of the thesis is that it is in the spirit of the conjunctural view on institutional formation and change. Yet validating the thesis requires a corresponding, explicit theory of the dynamics of the general process of system-wide capital accumulation. Two further theses in radical political economy, concerning capitalism in general and in the era of neoliberal globalization in particular, are of relevance in this regard.

The first thesis, reviewed in Chapter 2, is that of the new international division of labour (NIDL) first raised by Fröbel et al. (1980). The thesis identifies three factors as main determinants of the consequence of spatial expansion of capitalism in the second half of the twentieth century. First, there is the expansion of the reservoir of wage labour, following the incorporation of increasingly wider parts of the globe into the capitalist system. Second, there is the development of the Taylorist production system, and this development, by de-skilling work, ensures labour productivity in 'world factories' of the late developing world being equal to or in excess of that in advanced capitalist economies. Third, there is the development of the means of transportation and communication, which makes it possible for industry not to be tied to specific locations. The combination of these three factors, according to the NIDL thesis, creates a development trap wherein developing economies are forced to specialize in low skill/technology industrial activities and receive low compensation for workers. The main mechanism through which the development trap is created is the transfer of surplus from developing economies to capital-exporting developed economies – in line with the famous Lewis model of the consequence of unlimited supply of labour. Subsequent developments along the line of the NIDL thesis, such as in the work of the French Regulation School (e.g. Lipietz 1987), emphasize the unlimited supply of labour and lack of domestic mass-consumption markets as both cause and consequence of the development trap. The message remains that the development trap is antithetical to the perceived pattern of economic growth in advanced capitalist economies, where productivity growth via deepening of capital, plus demand expansion due to increased compensation for workers form a virtuous circle.

The second thesis on the dynamics of system-wide capital accumulation comes from the literature of historical capitalism: the thesis of the long-period, systemic cycle of capitalism. Referring to the second half of the twentieth century, it is submitted that there is a transition from the phase of expansion in production activities to one of financial expansion (Arrighi 1994). Prima facie, this transition follows the secular trend of decline in aggregate industrial profitability, although the explanation of the profitability decline can vary: it may be result of the paradigmatic shift in technology (the neo-Schumpeterian explanation of the Kondratieff long wave), the intrinsic tendency of capitalism (the Marxian explanation of long wave à la Ernest Mandel), the tension between the paradigmatic shift in technology and existing socio-economic institutions (the social structure of accumulation explanation of long wave à la David Gordon as well as the general thesis of the profit squeeze), or some syntheses of these. In connection with the transition is a process which Harvey (2005, 2010) calls 'accumulation by dispossession'. This is a tendency progressively to incorporate productive resources across the world into the capitalist system, a process that is essential to the international movement of capital in the pursuit of high profitability. And high mobility of capital requires high flexibility on the part of the productive system, that is, the minimization of fixed investment and the maximization of surplus-value production. Yet, as will be explained in detail in the next chapter, the behavioural flexibility of the productive system could arise from two types of institutional arrangements. One consists of flexible institutions constructed on the basis of the detailed division of labour to minimize labour cost; this is characteristic of the 'low skill/technology, low income' model. Another consists of rigid, or long-term oriented institutions constructed on the basis of the social division of labour, where behavioural flexibility arises from collective learning and horizontal co-ordination. This is characteristic of the 'high skill/technology, high income' model.

The previous exposition can be represented by Figure 3.2, whose theoretical reasoning is taken from the next chapter of this book and whose formalization is based on Bowles and Edwards (1993). The central message that arises from Figure 3.2 is that, in the context of integrating themselves into the world market, latecomer economies may have some scope to choose between two different paths of development. The constraint imposed by the world market is represented by given levels of the unit labour cost, which industries of latecomer economies must strive to attain in order to survive the pressure of competition. And the unit labour cost (ULC) is, by definition, equal to the wage rate (w) divided by

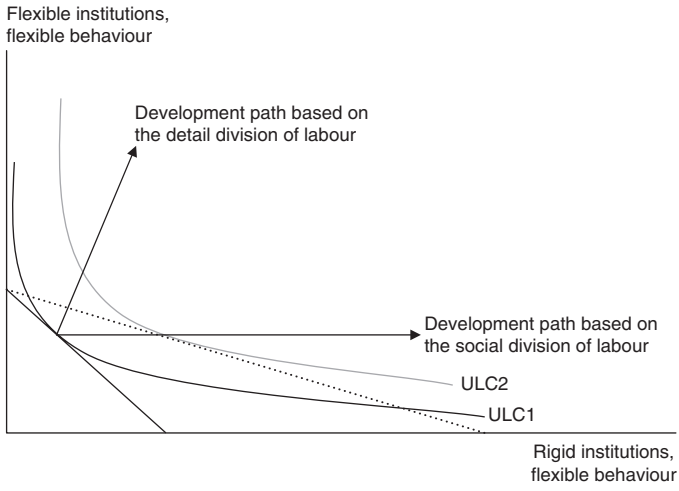

Figure 3.2 Two development paths: Detailed versus social division of labour

Note: ULC = unit labour cost = $w//Q = w/(ed)$, where w = wage rate, Q = output, e = Q per unit work done (i.e. labour productivity), d = work done per labour time (i.e. work intensity). The tangent lines of the graph represent the social cost of different combinations of 'flexible institutions, flexible behaviour' and 'rigid institutions, flexible behaviour,' which, in turn, are determined by the interaction between technological change and social relations.

the product of output per unit work done (e) and work done per labour time (d), that is, ULC = $w/(ed)$. One way to achieve a particular given level of the ULC is by utilizing the unlimited supply of labour, that is, by keeping down the wage rate w or by raising the work intensity d, or both. This corresponds to the 'low skill/technology, low income' model. And, as indicated before, this is made possible by flexible institutions that follow the principle of the detailed division of labour. In contrast, an alternative way to achieve a given level of the ULC is by raising the labour productivity e. This is made possible by capital deepening, or by long-term oriented institutions that follow the principle of the detailed division of labour. This corresponds to the 'high skill/technology, high income' model. In addition to protecting workers from the welfare lost due to deskilling and increased work intensity, this second model, by promoting the growth of labour compensation and hence the formation of domestic mass-consumption, also helps to alleviate the problem of demand deficiency that is characteristic of world development in the era of globalization.

Theoretically, there does not appear to exist an overwhelming logic of capital accumulation on the world scale to determine which of

the previous two models must be the prevailing outcome. From the standpoint of individual capitalists, cost minimization is the overwhelming logic and hence the temptation of the (creation and exploitation of) unlimited supply of labour is irresistible. From the standpoint of total capital, however, demand consideration is of equal importance, and this could act as a restraint on the international and national attempts to push for adopting the 'low skill/technology, low income' model. Empirically, in view of the application throughout the developing world of policies pertaining to the Washington Consensus – particularly policies to privatize the ownership of productive assets and land, to liberalize the labour market, to deregulate financial activities up to the point of opening up the capital account and floating the exchange rate, and so on – it appears that the ruling establishments of the international political economy have worked to serve short-term sectional interests, rather than the interests of total capital. The establishments might have been captured to a significant extent by speculative financial interests, and this might be a significant factor accounting for the observable worldwide crisis of late development (Wade 1998, 2008; Wade and Veneroso 1998a).

The phenomena of uneven development still need explanation. Specifically, the explanation of the development experiences of East Asia and China, the exceptional cases of world-wide underdevelopment, require identification of the main factors based on which the two entities have escaped the indicated development trap. In the case of East Asia, as will be explained in detail in Chapter 5, an explanation that is in line with the previous exposition contends that developmental success has been based on a range of long-term oriented institutional arrangements that exhibit behavioural flexibility, and thus foster productivity improvement and income growth. The formation of these institutions owes much to specific historical circumstances, including the ideological orientations of the states, particular forms of domestic social mobilization in relation to the Cold War, and the favouritism provided by the United States for Cold War considerations. Turning to the case of China, as will be explained in detail in Chapter 7, a similar thesis concerning the development pattern has been developed in the literature. The main factors that have shaped institutional formation and change, though, are significantly different from East Asia. Instead of US favouritism, it is the ability of the Chinese state to resist the demands of the international political-economic establishments that has enabled it to escape the indicated development trap as well as the type of financial and economic crisis that engulfed East Asia in the

closing years of the century. And it is the legacy of a revolutionary society that has underpinned the long-term oriented institutions and the corresponding domestic demand condition, which are the ultimate driving forces of the sustained rapid growth. On the whole, in both of these two exceptional cases, neither the development patterns nor the underpinning institutions are reducible to the universal, ahistorical construct of individualistic rationality.

3.5 Summaries and conclusions

In addressing the directions for the development of the 'economics of transition,' Douglas North (1997, p. 2) states: 'A set of political and economic institutions that provides low-cost transacting and credible commitment makes possible the efficient factor and product markets underlying economic growth.' This statement, whatever qualification it might have, is typical of neoclassical economics because of its focus on exchange between the choices of rational, optimizing individuals, and on the success of the market as an entity for bringing the exchange into equilibrium. The same spirit runs through all the neoclassical approaches to comparative economics, despite the varied degrees of allowance for possible failures of the equalising function of the market. It applies too to local markets as well as the global market, thus underpinning the claim that globalization is a producer of efficient institutions and thus a promoter of development.

This chapter has provided a critique of the neoclassical approaches, as well as an attempt of its own to explore the impact of capitalist globalization on institutional formation and change in late development. Its starting point is the theoretical argument, advanced by the comparative institutional analysis approach, that efficient institutions are products of collective rationality, instead of being reducible to individualistic rationality. Further exploration into the nature and determinants of collective rationality draws on a range of theses in radical economics about objectified institutions and paradigmized technology. The substantive argument that emerges from this exploration is that capitalist globalization – if it strictly follows the principle of the market (i.e. the logic of financial interests) – is more likely to result in underdevelopment than development. A range of institutions that contradict the prevailing logic of neoliberal globalization will be needed in order to avoid the development trap.

In this context, it seems possible to submit a more concrete argument concerning the political economy of institutional formation and

change in the context of late development. In relation to the notion of behavioural flexibility generated by rigid institutions, which is considered to underpin the sustainable model of development (i.e. 'high skill/technology, high income'), a conceptualization of state power in the spirit of Marxian theory appears to be of more value than the formalistic, neoliberal concepts of 'disorder' and 'dictatorship.' For, as will be explained in detail in Chapter 4, rigid yet efficient institutions constructed on the basis of the social division of labour require mass participation, together with appropriate state power for ensuring collective rationality. Within the confines of capitalism, and as exemplified by the East Asian experience, this takes the form of a certain degree of mass mobilization mainly at the firm level, together with the state serving as 'a committee for managing the common affairs of the capitalist class.' In the case of China, meanwhile, a higher degree of mass participation in economic and social affairs, coupled with a similar 'developmental state,' accounts largely for the record of sustained rapid growth. The existence of these 'anti-systemic conditions' (to paraphrase the literature on historical capitalism), then, while being interpreted as producing no more than undesirable disorder and dictatorship, is arguably necessary for late development in the context of neoliberal globalization.