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The Theory of the State

Introduction
Almost all the arguments in favor or against a specific aspect of globalization are analyzed by appeal to some form or other of the economic theory of the state. It is possible to find a precise relationship to this theory in cases when it is not argued explicitly. There is no unique theory of the state in economics. There are several approaches. The objective of this chapter is to provide a comprehensive survey of these approaches that helps to understand the issues relating to globalization in the rest of this volume.

There is a typology of the interaction of business and government, consisting of three models, according to Frye and Shleifer (1997):

1. **Invisible hand.** In this regime, the government does not conflict with free initiative. It is not corrupt, relatively efficient and benevolent, without authoritarian measures. The allocation of resources is by the private sector while the government provides the most essential public goods, such as law and order, some regulation and the enforcement of contracts.

2. **Helping hand.** There is significant involvement by bureaucrats with the activities of the private sector, promoting some firms and eliminating others. The bureaucracy actively designs and implements industrial policy. These bureaucrats resolve most disputes and are related with the businessmen. There is relatively limited and unorganized corruption. The extreme version of this model is known as the *iron hand*, being found in Korea and Singapore.

3. **Grabbing hand.** There is the same but less organized intervention in this model as in the helping hand. There is a large bureaucracy with significant independence and pursuing its own interests, including receiving bribes. There is no well-structured policy design. The bureaucrats are almost independent of courts and can impose their decisions and regulations in active pursuit of their self-interest. The widespread lack of organization results in lack of legal process, resulting in private enforcement of contracts.

Frye and Shleifer (1997) argue that these are ideal types not to be found purely in reality. In practice, there will be mixtures of these three types of models.
Data for small business in Warsaw and Moscow are more consistent with the invisible-hand model in Warsaw and the grabbing-hand one in Moscow. The approach to regulation of business taken by government appears to determine the success or failure of similar reforms.

The theory of the state is the case for and against government intervention in the economy. The invisible-hand model is the analytical foundation of mainstream economics, an ideal model without government intervention. The first section below considers the conditions required for the first best of efficiency and welfare. The effort to develop this model spread over two centuries after Adam Smith (1776). An important discovery in economics is the theory of second best, which shows that when there is a market failure that prevents the first best, it may be difficult to find out theoretically or empirically the second-best outcome. A practical approach is the field of applied welfare economics, known more popularly as cost-benefit analysis. It provides limited solutions in a number of practical cases. The public interest view postulates that the government should intervene when the free-market economy cannot attain the first best in order to improve the efficient allocation of resources. A significant case for global intervention by the government is based on public goods, which would not be provided by the private sector. There is a section focusing on the theory of public goods, which have to be provided by the government. Another breakdown in the model of perfect competition is imperfect information, that is, when some economic agents have more information than others, as is the case of banks about their clients relative to investors and depositors; clients also have information about the true state of their financial situation not known by banks. The intervention by the government may not be successful, causing government failure.

The work by Coase (1960) on transaction costs raises interesting issues on the role of the government. An important aspect of the work of Coase (1937) is the initiation of the field of the NIE. A major development is the theory of capture of regulatory agencies by the regulated industries and other aspects of the economic theory of regulation. The theory of rent-seeking argues that there is significant waste of resources in seeking market power from regulators and in maintaining that power. The final approach considered in this chapter is the view of disclosure and regulation, consisting of theoretical propositions and rigorous empirical research, providing an alternative to the interpretation of the role of the state in economic activity. The chapter is completed with a summary of the approaches.

The first best of efficiency and satisfaction

Adam Smith (1776) launched economics with his Wealth of Nations. This is a book rich in numerous analyses of the interactions of humans in economic affairs. It would be interesting to learn what Adam Smith would think of the contemporary interpretation of his concept of the invisible hand. The proposition is that individuals in seeking their self-interest promote the public good (Smith 1776, 477):