

## **Comparison between North and Olson's Theory of State and Its Enlightenment to the Formulation of Industrial Policy**

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### **Abstract**

*This article summarizes the main contents of the national theory of the two masters of economics, D.G. North and Mancur·Olson and compares the similarities of their national theories, mainly compares the origin of the country, the nature of the state of violence, the nature of the ruler's self-interest, the relationship between state power and economic development and other aspects of the same, and further comments on their different views on some of the main points of view and practical significance. Finally, some suggestions are put forward when formulating a national industrial policy.*

**Keywords:** State; D.G. North; Mancur·Olson; Industrial Policy

### ***Introduction***

The state has always been one of the most important organizational forms in human social activities. Any individual's behavior is directly or indirectly influenced by the state's behavior. At the same time, people's collective behavior will become the will of the state to a certain extent. Therefore, it is one of the important contents of politics, sociology and economics to study what the country is, how the country is formed, and what the country can do. Since 1960s, a large number of new institutional economists (such as Coase, North, etc.) began to use modern economic theory to study the country, forming a different theory of the relevant countries. North's theory of institutional change can be used not only for property rights and ideology, but also for the interpretation of the state, his theory developed neoclassical economics and made an outstanding contribution to economics in methodology. From the perspective of the origination of gangs and the correlation between the degree of development of interest groups and the vitality of the state, Olson reveals the internal root of the rise and fall of the country. This article summarizes the main contents of the national theory of D.G. North and Mancur·Olson and compares the similarities of their national theories, mainly compares the origin of the country, the nature of the state of violence, the nature of the ruler's self-interest, the relationship between state power and economic development and other aspects of the same, and further comments on their different views on some of the main points of view and practical significance. Finally, puts forward some suggestions for formulating a national industrial policy.

### ***1. A Brief Account of North's and Olson's State Theory***

The basic role of the state is to define property rights and exercise property rights. Property right is essentially a kind of exclusive right, the transaction is the most basic unit of market activity, and the premise and basis of the transaction is the definition of property rights. The efficient property right system can promote economic growth, and the inefficient property right system is bound to become an obstacle to economic growth. North regards the state as a kind of organization which has the comparative advantage of violence, because of its comparative advantage in violence; the state has a natural monopoly in defining and exercising property rights.

At the same time, as a kind of organization, the state is the same as the organization of the enterprise, which is restricted by the cost and benefit in decision-making of action, and the goal is to pursue the maximization of its own interests. From this perspective, the state is to pursue their own monopoly rent maximization of the action group. Historically, there has been a persistent conflict in the ownership structure that provides effective ownership structures that reduce transaction costs, promote economic growth, and provide maximum rents. It is this conflict that is the root of a society that cannot sustain growth, in other words, there are inherent contradictions between the two goals of the state, rooted in the contradiction between the establishment of an efficient property rights system and the realization of the maximization of the interests of the rulers. The establishment of an efficient property right system is conducive to the maximization of social output, but may not be conducive to the maximization of rent. Starting from its own interests, the state is often possible to establish and maintain an inefficient property rights system, which is known as the "North Paradox", is also the core content of the theory of the state of North.

In his last book, *Power and Prosperity*, Olson adopted the theory of predatory theory for the origins of government, and constructed a very interesting model (whose inspiration is said to have been due to a book about Feng Yuxiang). "Bandit" is divided into two types: "roving bandits" and "stationed bandits". Olson was puzzled: "roving bandits" occasionally to grab, succeeded to leave; "stationed bandits" repeatedly plundering the same person. Why does the people prefer to accept the rule of the "stationed bandits" (I believe that this view implies a premise, in the Olson model of its natural state is similar to Thomas Hobbes's "man-to-man war" anarchy)? Ridden with all kinds of "roving bandits", the roving bandit predatory is a "tragedy of the commons".

As the zone was occupied by different roving bandits, roving bandits implemented the policy of killing chickens that lays the golden eggs, the consequences may not be borne by their own. In this case, draining the pond to catch all the fish is the most favorable choice. When a bandit leader strong enough to steadily occupy a piece of territory and plundering the monopoly power, then the "roving bandits" became "stationed bandits", his actions have also changed. "If roving bandits found that this area controlled by them is ridden with thieves and made the production unprofitable, or because the residents here is not stable and have moved out, so the income of the area will be reduced, they soon have nothing to plunder. They then turned robbery into charging for protection, maximizing benefits by providing protection to the local population, which was conducive to their plunder, as well as against the plundering of other gangs. In the case of other conditions equal, the better the local commercial and residential environment, then the greater the income of the protection fee, so they will actively provide some public goods. In Olson's view, self-interested and rational leader of the roving bandits gradually turned into a stationed bandit, as is done under the guidance of an invisible left hand. They put on the crown, claiming to be the emperor, the emperor, the king or the monarchy, anarchy was replaced by the state of the state, Olson's assertion of the national origin of the gang is a classic.

## **2. Comparison between North's and Olson's Theory of State**

### **2.1 About the Origin of the State**

In the study of the origin of the state, North thought that there are two popular theories, "the state theory of contract" and "the theory of plunder and exploitation". The state theory of contract has a long history. It is a very influential theory in the West since sixteenth Century. Since Ronald Coase, the state theory of contract has been based on the transaction cost analysis method and has become an important branch of the New Institutional Economics theory. The premise of the state theory of contract is the average distribution of power, without considering the power factor; it is possible for the voluntary exchange among the participants. Coase believes that in the case of zero transaction costs, regardless of the wealth distribution effect, the voluntary participation of the participants will produce Pareto effective results. Under the research paradigm of transaction costs of the New Institutional Economics, the organization is a form that can save transaction costs, and the state is also an organization form that can save transaction cost- the origin of the state. On the origin of the country, North did not specify.

Olson evaluated Coase Theorem and transaction cost analysis method, on this basis, he constructed a "bandit-gang model" to explain the origin of the state. At first, the bandit gang was plundering-roving bandits, who ignored the output of the whole society. However, if they turned roving bandits into stationed bandits, plundered in a wider range of fixed areas, they will be concerned about the production activities within the area, because they can get more income from the stable social production; that is to say, they have a greater share of interests.

With the increase of violence ability of organization, the "stationary bandit" has gradually become the ruler-the state generates. Members of the community get rid of anarchy get out of the greater gains, so they are willing to accept the ruler's rule. These political entrepreneurs are not as predicted by the state theory of contract, passively elected by the social contract of all members as the state's agent, but actively used power to achieve their goals.

## **2.2 About the nature of the state**

On the issue of what is the essence of the state, North and Olson has a certain consensus – power. In North's view, "the state is an organization which has comparative advantage in the exercise of violence, the state's right to tax voters determines the extension of its geographical territory. North believes that the key to understanding the state lies in the potential use of violence to achieve control of resources. Leaving the right, in particular property rights, we can't provide a useful framework for state analysis. Olson believes that "the question of rights is the holy grail of state theory", when "roving bandits" become "stationed bandits", that is, "the use of destructive rights becomes the use of constructive rights", social production activities will be improved.

Olson and North have different opinions about the significance of the existence of the state. From the point of view of the efficiency of the national system, North emphasizes on the continuous adjustment of the national form. The adjustment demand comes from the relative price changes of the factors caused by the technological progress (innovation and knowledge). The factors that restrict the adjustment are the transaction cost and the threat of the competitors. So even if the ruler is rational, the system will often appear inefficient state; Olson believes that when the state system appeared inefficient state, often is caused by the irrational rulers (fatuous rulers). From the beneficiary organization, North believes that the rulers often consider the interests of the rulers and potential competitors; Olson believes that the rulers consider the interests of all citizens, because of its "co-benefits." From the social norm, North thinks that "a social sound ethical code is to cause the social stability, the economic system vitality adhesive", emphasizes the formal system (the national system) and the informal system (social standard) the coordination question; While Olson emphasizes that large groups can only organize collective action through appropriate selective incentives, social norms (group norms) are only a kind of effective selective incentives.

## **2.3 About the Definition of Property Rights**

In the definition of property rights, Olson and North's point of view also has the essential difference. Olson cited the reasons why rulers might abuse power. When the ruler gains more from the tax than from the predatory gain, he will take effective property rights and contract system, but this situation requires the ruler to have a long-term vision, if the ruler is short-sighted, short-term plunder will be better than long-term tax. North believes that when there is a mutually beneficial trading space in the political market, participants can design a variety of organizations, such as the court, the congressional committee, etc., in order to reduce transaction costs, reduce transaction uncertainty. "The emergence of property rights is a consequence of the growing tension between the expectations of the country's rulers and the efforts of both parties to reduce transaction costs". From this we can see that Olson only considered the necessity of establishing the property right from the time span, but North found a balance between the state and the three party games.

## **2.4 About Democracy**

In Olson's view, the emergence of democratic society is purely accidental; and through the analysis of the theory of North, it is not difficult to see that the democratic society is the result of evolution - "inevitable." Olson argues that when there is no individual or group leader who is able to turn him into a dictatorship, democracy is likely to occur simultaneously. North believes that the elements of knowledge and technology leads to the changes of relative prices enhance the bargaining power of all voters, which may lead to change the rules, so that the population increase in income or voters may force the rulers giving up certain rights he rules. Democracy is often the result of external threats to the rulers. Moreover, in Olson's view, if possible, the society will slide into "authoritarian" state, but North believes that with the social research, democracy is the direction in the future.

## **3. Comment on the Theory of the State of North and Olson**

In North and Olson's view, the state is a double-edged sword, both the impact of economic growth and social progress, but also the root of a country's decline. From the analysis of group behavior, Olson believes that in the modern society, the public policy of the state to develop economic development should be the result of the participation and consultation of every member of society.

However, in reality, no country can really do this. Because social negotiation is usually not a negotiation between the masses, but between the social groups, and further talks between the leaders of social groups. Some groups, because of their complex composition, scattered distribution, and indefinite form, cannot form any group and thus are excluded from social consultation. In this case, the organization established social groups of special interest groups or "interest group" will take advantage of their own group, take all kinds of direct or indirect means, and continue to exert influence on the policy process of the government. In this way, the content of the policy and the results of the implementation, it is inevitable to focus on the interests of the people of this part of the organization and ignore the interests of the majority of the community. All people with common interests can form equal groups and obtain Pareto optimality through comprehensive consultation, such countries do not exist. Moreover, small groups tend to have a strong ability to organize group behavior, and over time, the number of small groups and organizations are increasing. Any organization can adopt two ways for the benefit of its members: one is to improve the efficiency and the total output of the whole society, so that the members share increases; the two is as far as possible to gain a greater share for its members. But in reality, the choice of special interest groups can only be the latter rather than the former. Because the former "free ride" behavior is serious, so the smaller group is more concerned about the latter, that is, to maximize the overall interests of the community in the fight for a larger share, regardless of the overall interests of the community is to increase or decrease.

Olson pointed out that the disadvantages of the "profit-sharing group" first is the inefficient use of resources, this inefficiency is first characterized by the slow nature of decision making. Secondly, the inefficiency of "profit-sharing group" is also reflected in the exclusion of new technology. Profit-sharing groups tend to interfere with the development of new technologies in their respective economies and impede their growth, thereby reducing their growth rates. Again, the profit group increased the complexity of the legislation, so that the government's functions continue to expand, the scope of government intervention in the community has repeatedly expanded, become bloated, inefficient. In short, the "profit-sharing group" has changed the distribution of the driving force of social development, the power to increase production is reduced, and the power to attempt to acquire more of the product is enhanced; compensation for the sale of goods and the sale of labor is reduced, and the reward for evading or using legal, political, and bargaining and complex agreements increases. In Olson's view, the rise and suppression of profit group is the key to the decline and development of a country's economic growth.

North pointed out in the book "the rise of the western world": "efficient economic organization is the key factor of economic growth. The reason for the rise of the western world lies in the development of an efficient economic organization. Efficient organizations need to establish institutionalized facilities and establish property ownership; the individual's economic efforts continue to lead to a social activity, so that the personal rate of return is constantly close to the social rate of return. "Starting from transaction costs, north pointed out that the lack of efficient incentive mechanism in backward countries is an important reason for the slow economic development. The way to establish an effective incentive mechanism is institutional innovation (which is inherited by Schumpeter's innovative view); institutional innovation improves social productivity and economic growth by linking individual efforts and remuneration, personal goals and social goals. Because the transaction cost is mainly used for the coordination of the transaction behavior, and it is not used in the direct production process, the transaction cost can reflect the efficiency of a country's economic activities under the given conditions. The legal system of the underdeveloped countries is not perfect, the political system is unstable, the transaction risk is increased, the opportunism is prevalent, and the transaction cost is virtually increased, so that people do not have the incentive to seek effective output. Therefore, it can effectively promote the growth of output for a backward country through a series of institutional innovation to reduce transaction risk and reduce transaction costs. According to North's view, whether the state can effectively implement the property rights, when the factor market relative price changes caused by the knowledge and technological innovation, whether the property right structure of the state can be adjusted accordingly is the rise and fall of a country root.

North and Olson's theory of state can find a lot of evidence in human history, I think there is no need to demand a perfect theory that can explain all the phenomena of a state, I am afraid that there is no theory on the national issues can be perfect state, which is exactly as Popper said, the argument is complicated but the conclusion is clear. The economists and scholars who study the state system should not be debated as to why the theory can explain the reality. Instead, it should reveals government as a collection of systems, the direction of its efficiency and evolution, the way to improve the efficiency of property rights and economic growth rate.

And Olson and North used a different approach to the same basic starting point, collected a large number of arguments, and demonstrated the theory of the state to provide us with more research methods and ways. At the same time, it can provide the theoretical basis for the transformation of the Chinese government and the reform of the political system.

#### ***4. The Enlightenment of State Theory to Industrial Policy***

Olson regards the industry as the code of special interest groups, and the policy tendency of the industrial group is the most "predatory". Therefore, the formulation of industrial policy should avoid the influence of interest group as far as possible. North studied the causes of the formation of industrial groups - factor endowments, and the resulting industrial groups will seek their rights to obtain their interests. As a result, we can see that the industrial policy led by the industrial group is bound to harm the interests of the community.

How to introduce policies to stimulate the industry, Olson and North reminded us that the key lies in the sharing of benefits and balance and incentive. I think we should pay attention to the following points:

Firstly, constructing the preference of the participating subjects, especially the enterprises, the channels of interest demands. The ideal industrial system should allow the participants to have the opportunity to express their preferences and interests. According to Olson theory, given the industry group in the field of public choice on the opposite side to the appropriate preference, interest expression power, to a certain degree can balance or even inhibit the special interest group "plunder", and thus more conducive to promoting the development of society. Specific to the industrial policy, such as economic construction projects, giving citizens a certain preference, the opportunity to express their needs, improve their participation in the initiative, will help resolve the problem of economic policy is not appropriate. Therefore, it can be considered in combination with the local cultural model, in the case of the government to grasp the premise of specific industrial policies to deal with citizens and other opposition industries decentralization, allowing them to participate in the formulation of policies. According to North's point of view, bargaining power is uneven, to improve its balance of interests, will be an effective way to maintain social stability.

Secondly, it is necessary for the special interest groups to change or restrain "collective action" properly, so as to make the appropriate combination of regional culture training and supporting the "selective stimulation means" to reduce the unfairness of social development. According to the theory of public choice, "selective incentives" can avoid the phenomenon of "free rider" in the collective action to promote the initiative of the participants. Small groups can often achieve collective action through collective bargaining, and large groups often cannot be achieved, but if there is a selective incentive means, it may take collective action. Therefore, if we can develop a reasonable industrial policy, first of all, the social system (including the national system) should be fair to all economic entities.

Thirdly, adjust the cost - revenue budget line to improve the recognition of economic entities. As far as the formulation of industrial policy is concerned, although the main economic entities have a positive common pursuit, but all the main body of the same proportion of growth is difficult to achieve. Therefore, in order to mobilize the enthusiasm of the economic main body, the industrial policy must change the local industry and citizens of the cost - benefit budget line. This depends on the establishment of long-term, stable and reasonable compensation mechanism. Taking into account the impact of industrial policy, the group does not participate in the interests of individuals are often damaged, the central government has the power to require beneficiaries to share their benefits, and the specific implementation can be implemented through the differential price of public services. By increasing this part of the funds, the central government can further improve the compensation policy; improve the local government, the industry body and the income of citizens.

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