

Free Markets, Development and the Third World

by
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A reference to the comment on the validity of an economist's opinion by Joseph Stiglitz is significantly relevant in the context of this discussion :

"The burden of my remarks is to deal with what economic science has to say about the appropriate roles of the state and the private sector. It is an issue on which most economists will have a strong opinion. But if you ask a taxicab driver he will also give you an opinion. The question is, should our opinions as economists be listened to more carefully than those of the taxicab driver ?"¹

The point of this comment is not that an economist's opinion is not worth listening to. Rather his (her) opinion is better than a lay person's only to the extent that it is grounded in economic theory and empirical evidence.

This article attempts to enlighten the reader on what we as economists have learnt about free markets and development both from development history and from the growing body of development theory. It does so by synthesizing the contributions of some recent and not-so-recent articles on this topic. It is by no means a comprehensive review of the literature, nor does it find an exhaustive answer to the question posed in the title. It is hoped that it stimulates thought and provides new information to Sri Lankans interested in the role of markets and of the state in the economics of development.

The rationale underlying the liberalization of the Sri Lankan economy in 1977 was that the market mechanism should determine the allocation of resources in the economy and that government intervention should be minimal. The set of policy reforms undertaken included the removal of most domestic price controls, reduction of trade protection, unification of the ex-

change rate, devaluation of the rupee and moving to a managed float exchange rate system. Financial repression was eased and many restrictions on the capital market were removed. These policy reforms are similar to what has been subsequently described as the "Washington Consensus."² The 1977 policy reforms represented a departure from previous policies that emphasized price controls both domestic and international, state guidance of the economy in the form of incentives and restrictions, restricted foreign trade, and state-led industrialization through the establishment and management of state enterprises.

Sri Lanka was not alone in pursuing import-substitution strategies or restrictive trade policy and using prices to direct sectoral investment. Nor was Sri Lanka alone in implementing market-oriented reforms outlined above, some of which were subsequently undertaken by such unlikely countries as India and China. The question then is: why was there a tendency among developing countries to adopt the first set of policies (primarily in the 1960s and 1970s) and why has there been a move to the second "consensus ?"³

The purpose of this article is to explain the two policy approaches within the overall debate in development economics. Early contributors to development theory emphasized the problems of relying on the market mechanism in Third World countries. They argued that there was widespread "market failure" in developing countries, justifying government intervention. There has since been a recognition of the problems of state intervention giving rise to the term "government failure". While the debate is still on even today, there are a number of areas in which most schools of thought agree. In this article, we first attempt to explain what is meant by free markets. We

then refer to instances of market failure and the various arguments economists put forward in favour of and against state intervention. We also site some of the lessons from development theory and history. Finally we identify areas of agreement.

Free markets

When markets function well and are perfectly competitive, the optimal allocation of resources (at least from an efficiency perspective) is that which is performed by Adam Smith's invisible hand. Consumers pursuing the maximization of their own satisfaction, and producers pursuing the maximization of profit within a freely competitive market mechanism end up in a general equilibrium solution with (a) efficient allocation of resources among producers (b) efficient distribution of the commodities produced between consumers, and (c) efficient combination of products. This is a standard trend in welfare economics that seems often to be overlooked in countries like ours, because, we rush to comment markets do not function well here. In doing so we ignore some important behavioural features of markets.

It is worth looking at the textbook case of perfectly competitive markets in order to understand why they allocate resources efficiently. The key here is competition, or the absence of monopoly power. Because producers in freely competitive markets are price-takers, supply prices are close to marginal costs. Without barriers to entry, as more firms enter the market, costs are driven to their lowest feasible level and resources are used in their most efficient manner. Thus the price consumers pay in a competitive market is only the opportunity cost of the product. From society's point of view competition also minimizes waste and rewards factors according to their pro-

ductivity. The basic principle to be learnt is that competition whether in private or public enterprise is to be desired.

A Sri Lankan example of beneficial competition, though in an oligopolistic setting, is the market for mobile telephones. Initially when monopoly power was high the cost of a telephone and rates for calls were prohibitive, and only the very rich could afford a mobile telephone. As more companies entered the market prices came down sharply and are still continuing to fall making these phones more affordable. In addition, in this oligopolistic setting as firms try to increase their market share geographical coverage is gradually expanding making the facility available to more people.⁴

Market failure and reasons for state intervention

Nicholas Stern⁵ states several reasons for state intervention. The first reason is from standard welfare economics. The existence of externalities, missing markets and public goods as well as imperfect information, monopoly power and increasing returns to scale result in market failure: markets do not lead to socially optimal outcomes and there is potential for government intervention.

The second reason concerns poverty and deprivation. One may extend this to income distribution as well, although this is a little more contentious. The basic point here is that markets are efficient only within a given pattern of income distribution. Governments may wish to redistribute income, and at the very least have a responsibility to alleviate poverty. How this is to be done is another contentious issue.

Stern's third reason concerns basic rights. This sounds similar to the basic needs approach which argues that development should provide the life-sustaining basic human needs of, food, shelter, health and protection. Stern argues that governments should intervene in education and health, in order to protect the rights for them.

A fourth reason is paternalism—thus governments by banning drugs protect individuals from their addiction to drugs which they prefer. Compulsory pension schemes which force indi-

viduals to save now for the future are another example.

Finally, in the case of environment protection, governments act to ensure benefits of future generations.

These five reasons together make up a comprehensive list of situations when governments should intervene. While some neoclassical economists may agree that only some of these reasons are valid, one may conjecture that in development circles at least there is consensus that these reasons are adequate basis for government intervention.

To begin with we will examine two of these reasons. Consider first the case of market failure. Going back to welfare economics, in general equilibrium, the theory of the second best⁶ tells us that when one of the conditions to achieve a Pareto optimum cannot be achieved, we have to derive new conditions for optimality and satisfy them. For example, if there is imperfect competition in one market, competition in other markets will not necessarily give us the second-best solution. Given an existing distortion (s) that cannot be removed, one may have to add another distortion to improve welfare!⁷ Unfortunately, designing appropriate interventions are easier said than done. To paraphrase Harry Johnson, an appropriate second-best policy needs a first-best economist to design it, but such policies are usually designed by fourth-best economists and implemented by third-best administrators.

In the case of the second reason for intervention, we have clearer guidelines from economic theory. The Second Welfare Theorem asserts that under certain conditions, every Pareto efficient allocation can be achieved as a competitive equilibrium. This implies that whatever one's criteria for a good or just distribution of welfare, one can use competitive markets to achieve it. Prices play two roles in the market system: *allocative* and *distributive*. The allocative role of prices is to indicate relative scarcity; the distributive role is to determine how much of different goods different agents can purchase. The point of the Second Welfare Theorem is that prices should reflect scarcity. Distributive goals can be achieved by any lump sum transfers of wealth. This is nondistortionary,

because any Pareto efficient allocation can be achieved by a lump sum redistribution.⁸ Thus, economic theory tells us that if we want to provide food to the poor, rather than using price controls, we would give them a lump-sum transfer, which may be in-kind (such as food stamps) or cash.⁹

Development Theory

Let us now look at what development theory has to say on the subject. This brings us to the argument of the structuralist or development economics school or what Adelman and Morris¹⁰ call the "modern development pioneers".¹¹ Adelman and Morris argue that "investment lumpiness, inadequate infrastructure, imperfect foresight, and incomplete and missing markets impede smooth resource transfers among sectors in response to individual profit maximization and provide the bases for the structuralist approach to economic development of the modern development pioneers." Developing countries are caught in a low-level equilibrium trap (Leibenstein, Rodenstein-Rodan and Nurkse) which occurs at low levels of physical capital and is maintained by low levels of accumulation and Malthusian population growth. Industrial production is subject to technical indivisibilities which lead to externalities (Rodenstein-Rodan and Scitovsky). Coordination failures make it difficult for countries to move out of their low income level trap.¹²

The thinking of this school contrasts with neoclassical development theorists such as Bhagwati and Krueger whom Adelman and Morris dub the "trade is enough" school. They emphasize that international trade can substitute for low domestic aggregate demand. Domestic and international liberalization is enough to bring about sustained economic growth and structural change. The problem that the modern development pioneers had with this view was (a) they were pessimistic about import and export elasticities and terms of trade movements required for trade to improve economies (Prebisch and Nurkse) and (b) they pointed out that (1) nonprice barriers would prevent intersectoral allocation of resources, (2) uncoordinated investments would still leave the economy in the low level equilibrium trap, (3) learning by doing implied the need for

infant industry protection, and (4) physical and social infrastructure are required to enable competitive domestic industry to emerge.

It should be noted that the modern development pioneers also eventually envisaged that developing countries would eventually have competitive domestic markets. They simply differed from neoclassical theorists as to how this should be achieved.

They also contrast with the Chicago endogenous growth or ("human capital is enough") school who identify low human capital endowments as the primary obstacle to growth. The policy implication of this school's theory is that investments in human capital and knowledge are all that governments need to undertake to move the economy from a low-growth to high-growth path. The same counter-arguments specified earlier apply here as well.

Thus we see that the primary disagreement between development theorists is regarding the extent and type of market failures that exist in developing countries. In other words the issue is an empirical question. Before we look at the lessons of history we need to consider one more issue: that of government failure.

Government failure

Also known as government policy failure, this refers to a situation where government policy does not do better than the market. To go back to the general equilibrium result referred to earlier, it has been shown¹³ that the socially optimal allocation brought about under free markets can also be obtained under perfect planning. If planners somehow are able to discover the prices that brought about the socially optimal result, and are then able to persuade economic agents to respond to these prices, the socially optimal outcome would result. The problem with this is the same as the complaint about free markets—perfect planners don't exist. Recent history has shown us this as well.

Government failure occurs because government has less information about consumers' tastes because of administrative inflexibility because individual incentives are hard to replicate in a

centralized system, and because government bureaucracy itself forms an interest group. As a result private sector interest groups lobby the government and try to influence policy through bribes. Such activities are known as rent-seeking behaviour.¹⁴

Thus the problem of market failure has to be set against the problem of government failure. Unfortunately, we have not been able to quantify rent-seeking very well, so we don't know how large a problem it is. On the other hand the literature indicates that a very definite problem of government failure exists.¹⁵ Thus it is not enough to say that governments should intervene because markets fail. Governments should also be able to do better than the market.

The lessons of history: a consensus ?

Several studies have demonstrated the lessons of history regarding the appropriate degree of government intervention.¹⁶ Different people read history differently, and it is not possible to state unequivocally what development strategy(ies) are upheld by historical evidence. An example is the so-called East Asian miracle. Neoclassical economists see it as a triumph of openness in international trade, the absence of price controls, and other distortionary policies. On the other hand, advocates of state intervention are quick to point out that there was industrial policy regime and intervention in financial markets.

Anne Krueger argues, in a 1997 article, that as economists developed and used better tools we understood better the nature of the problem. She concludes that this explains why more developing countries are adopting liberalized markets and free trade strategies.¹⁷ Her arguments are interesting and worth considering even though one may suspect that part of the answer to her question is simpler: he who pays the piper calls the tune.

However, in this article we will identify areas where economists agree (even from widely differing theoretical viewpoints).

1. Economists on both sides of the spectrum would agree that where markets function well, they should

be allowed to function freely. The disagreement lies as to how much market failure they are willing to allow and the consequent role for governments.

2. Free trade or openness to trade is important. Neoclassical theorists promote it for reasons of efficiency and development economists for reasons of market expansion. The empirical evidence seems to suggest that elasticity pessimism is unwarranted. In the long run the Marshall-Lerner condition is likely to hold, and trade balances can improve. Infant-industry protection is only a temporary phase (as in East Asia where it was successful, and as not practiced in Latin American where it was unsuccessful).
3. Poverty alleviation is the responsibility of governments. Neoclassical economists would argue that this should be achieved by lump-sum transfers from the rich to the poor, rather than by manipulating prices. Development economists would not disagree, but would probably view poverty alleviation as part of moving the entire economy out of its low-income level trap.
4. State provision of social and physical infrastructure: Social infrastructure would include education and health and physical infrastructure would include roads, power and so on.
5. Competition is important. "Giving a private firm a monopoly is not likely to improve efficiency as much as pitting a public enterprise against an open economy and subjecting it to competition."¹⁸ Thus ownership matters less than the environment.

This brings us finally to some lessons for Sri Lanka. They are:

1. Don't be shy of free markets. Theory and experience teach us that competition is desirable.
2. There is a role for government, as stated above, especially in poverty alleviation and in the provision of infrastructure. We have done well in social infrastructure, but

not so well in physical infrastructure. For example the percentage of our urban population served by electricity in 1982 was only 35 per cent which, was higher than in India and Bangladesh, but lower than in Indonesia, Malaysia, Thailand, Argentina, Bolivia, Brazil, Cote D'Ivoire, Liberia and Senegal. More significant is that only eight per cent of the our rural population is served by electricity which is lower than in India, Indonesia, Malaysia, Thailand, Bolivia, Brazil, Cote d'Ivoire and Senegal.¹⁹

3. Rhetoric and policy don't always match. For example, even though our international prices have been "liberalized" and the exchange rate nominally devalued, it appears that there is overvaluation of the rupee which results in an anti-export bias despite our export-oriented rhetoric.
4. Be sceptical about the virtues of government. The concept of government failure is not one that Sri Lankans are familiar with. A healthy scepticism in the ability of government should go hand in hand with our scepticism of free markets. We should undertake careful research before we embrace a position on either side.

Notes:

1. *Development Strategies: The Roles of the State and the Private Sector*. Roundtable Discussion, Proceedings of the World Bank Annual Conference on Development Economics, 1990. Joseph Stiglitz is Vice-President, Development Economics at the World Bank. At the time of the conference he was Professor of Economics at Stanford University.
2. Williamson, John 1990. "What Washington Means by Policy Reform" in John Williamson, ed., *Latin American Adjustment: How Much Has Happened?* Washington, D. C. : Institute for International Economics.
3. An analogous question is asked in relation to trade policy in Krueger, Anne, "Trade Policy and Economic Development: How We Learn" *American Economic Review*, March 1997, 87 (1), pp. 1-22.
4. Interestingly, the market for mobile telephones exists because of failure in the market for provision of land telephones, where there is monopoly power. As competition from Suntel and Lanka Bell takes new customers away from Sri Lanka Telecom, it is interesting to see that the latter's strategy has been to increase rates for existing customers. One wonders how long such a strategy can be successful.
5. Nicholas Stern, Professor of Economics at the London School of Economics. *Development Strategies: The Roles of the State and the Private Sector*. Roundtable Discussion. Proceedings of the World Bank Annual Conference on Development Economics, 1990.
6. R. G. Lipsey and Kelvin Lancaster. "The General Theory of the Second Best." *Review of Economic Studies*, 1956-1957, pp. 11-32.
7. Pari Kasliwal, *Development Economics*, Cincinnati, OH: South-Western Publishing, 1995.
8. Hal R. Varian *Intermediate Economics: A Modern Approach*. Second Edition. New York: W. W. Norton & Co. 1990, pp. 497-499.
9. Another argument against price controls is that they subsidize both rich and poor.
10. Adelman, Irma and Cynthia Morris. "Editorial: Development History and its Implications for Development Theory." *World Development*, 1997, 25 (6) pp. 831-840. Provides an excellent summary of the different schools of thought in Development Economics. This article draws heavily from it.
11. Name them.
12. Adelman and Morris, *ibid.* p. 831-832.
13. Lange-Lerner-Taylor Theorem.
14. Kasliwal, *ibid.* p. 258.
15. Deepak Lal. *The poverty of "Development Economics"*. Cambridge, Mass.: Harvard University Press, 1983.
16. Chenery, Robinson and Syrquin. *Industrialization and Growth: A Comparative Study*. New York: Oxford University Press, 1989; Morris, C., and I. Adelman. *Comparative Patterns of Economic Development: 1850-1914*. Baltimore, Md.: Johns Hopkins University Press. (Some of their findings are summarized in their 1997 article). Reynolds, J. "The spread of economic growth to the third world." *Journal of Economic Literature* (1983) 21:841-80.
17. Krueger, 1997. *ibid.*
18. Stiglitz, 1990. *ibid.*
19. *The East Asian Miracle: Economic Growth and Public Policy*. Washington, D. C.: World Bank, 1993