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MARKETS AND STATES: AGAINST MINIMALISM[1]

Introduction

If we call the doctrine that "correct" prices and markets play an important role in allocating resources efficiently and equitably, in promoting choices, in enlarging freedom, and in decentralizing power, *Pricism,* and the doctrine that efficiency, equity and liberty call for minimum state intervention *State Minimalism*[2] (or laissez-faire), the currently prevailing view is that the two go together: get the government off our backs and let there be markets! The thesis of this paper is the opposite: for the proper working of markets strong, and in many cases expanded, state intervention (of the right kind) is necessary. It is possible to favour a strong state, with a limited agenda. It would confine itself to ensuring that individuals, and the social groups in which they associate, can pursue their own purposes with a minimum of frustration. This is not the thesis of this paper. It argues for a strong state, with an expanded agenda, though a different one, differently implemented, from that which the state has commonly adopted in many developing countries.

The expression "getting prices right" has undergone a curious transformation. In the 1960s it was intended to point to the calculation of correct shadow prices in the face of "distorted" market or actual prices. Because market prices reflected all sorts of "distortions,"[3] it was the task of government to intervene and allocate resources according to the "right" shadow prices. The government had to correct the distortions caused by the free play of market forces. More recently the recommendation has been reversed. Now developing countries should get rid of state interventions in order to permit market prices to reflect correct opportunity costs and benefits. Distortions are now regarded as caused mainly (or only) by governments.

Gunnar Myrdal has made a substantial contribution to the analysis of these problems. Some relevant aspects of his work are discussed in the next section. A subsidiary thesis of this paper is that many distinctions, important for an understanding of the role of markets and the state, have been blurred in the neoclassical resurgence. The need for a fuller discussion of managing the transition from the wrong to the right type of state intervention, and for a normative political economy,

1 An earlier version of this paper, but without some important sections and arguments, appeared in Putterman, L. and D. Rueschemeyer (eds.): *State and Market in Development: Synergy or Rivalry?* L. Rienner, Boulder/London, 1992; another earlier version also appeared in a special issue of *World Development*; 21 (8), August 1993, pp. 1281ff, ed. by L. Whitehead.

2 The terms are due to Michael Lipton.

3 The widely used notion of price "distortions" is not as clear as it may seem. Distortion is the deviation of the actual from some natural, proper, legitimate, norm. But there is no reason to believe that laissez-faire prices reflect such a norm. In an economy already "distorted," an additional distortion may be an improvement. For reasons such as these, the notion that government interventions "distort" an otherwise correct set of signals and incentives is highly misleading. In the presence of such "private distortions," the addition of "public distortions" can be a beneficial corrective.

to complement positive theory, will be put forward. Finally, donor conditionality insisting on liberalization, deregulation, decentralization and privatization will be discussed.

Gunnar Myrdal's Contribution

The free, competitive market is a public good. Like other public goods, it calls for public or collective action to maintain it. When I worked with Myrdal's team on *Asian Drama,*[4] we emphasized the need to use pricing policy rather than direct controls long before the current fashion for getting prices right had swept the profession of economics. We thought it important for the government to organize markets so that they work efficiently, but we did not confuse price *policy*, measures to encourage competition and the creation of previously absent markets, with the unrestrained play of market forces. *Getting* the right prices is open to two different interpretations. In the words of Michael Lipton, *setting* prices right is quite different from *letting* prices come right from state inaction. Contemporary discussions frequently also confuse the question, how large should be the state in relation to total economic activity, with the quite different question, what policy instruments should the state employ and how should they be used?

In *Asian Drama* Myrdal criticised the kinds of government he called the "soft state", which was sometimes misunderstood. It is plain that his "softness" is quite compatible with a high degree of coercion, violence and cruelty. The Tamils in Sri Lanka, the Indians in Burma, the Chinese in Indonesia, the Hindus in Pakistan, the Moslems in India, the Biharis in Bangladesh – to take six states he calls "soft" – would not claim excessively soft treatment. "Soft states" also go in for military violence, both internal and external. Their "softness" lies in their unwillingness to coerce people in order to implement declared policy goals such as collecting taxes, punishing evaders implementing a land reform, and to resist the hard powers of caste, land ownership, and cultural barriers. This lack of social discipline is not the result of gentleness or weakness but reflects the power structure and a gap between real and professed intentions.

Although Myrdal is often regarded (and nowadays castigated) as an advocate of central planning and heavy state control, a reading of *Asian Drama* shows that he thought the Indian economy was over-regulated and ill-regulated, and that the number of discretionary measures should be greatly reduced. The book expounds what has since become the conventional wisdom of using prices and non-discretionary measures as policy instruments for the allocation of resources. This means including direct and indirect taxes and subsidies in the armory of policy instruments (as well as public services) rather than direct quantitative controls. It does not mean surrendering to the free play of market forces, if they reflect a highly unequal power, asset and income distribution. If these were given free reign, the process of circular and cumulative causation would ensure that those gain most who already have, and the have-nots would be deprived of what little they have.

Myrdal was not only prescient, and more discriminating and subtle than today's writers, in advocating the use of prices, but in an early article anticipated the public choice theory of political behaviour, including the role of pressure groups and

4 Myrdal, Gunnar: *Asian Drama, An Inquiry into the Poverty of Nations.* Pelican Books, Harmondsworth 1968.

deadweight losses arising from what came to be known as rent-seeking activities.[5] He advocated the institutional approach in the social sciences. He did not object to abstractions and rigorous theorizing nor turn to purely historical or purely empirical work, but meant the need to bring to bear all relevant knowledge and techniques on the analysis of a problem: economics, demography (of which he had an unduly high opinion), statistics, politics, sociology, anthropology, psychology, philosophy, history. He used to say that in an interdependent social system there are no economic, political, or social problems, only problems. The narrow focus on economic formulations serves, according to Myrdal, the interests of those who oppose reform. The neglect of some relevant areas of knowledge he called "opportunistic ignorance". The need for this multi-disciplinary approach has been vindicated by the current concern with the environment, "sustainable" development, the role of women, and the rising interest in cultural factors in development.

Myrdal applied his method also to the analysis of inflation, combined with widespread unemployment in the industrial countries in the 1970s and 1980s, and either coined or was one of the first to use the term "stagflation". He attributed the situation to the organization of producers as pressure groups, and to the dispersion and comparative weakness of consumers, to the tax system encouraging speculative expenditures, to the structure of markets and the oligopolistic methods of administrative pricing. He condemned inflation as socially highly divisive.

The approach favoured by Myrdal is neither Soviet authority and force exercised for central state planning, nor capitalist laissez-faire, but a third way: combining the use of prices for economic and social purposes, with a direct attack on attitudes and institutions (and on overcoming obstacles and inhibitions). Prices are to be used as the instruments of reform, including the promotion of greater responsiveness of agents to prices. This approach has a greater affinity to that of those nineteenth century socialists dismissed by Marx as utopian, who mapped out in detail what institutional and attitudinal reforms were necessary to improve society. Myrdal rejected both Marxism and neoclassical economics: the former because it believed that institutions (the super-structure) would be adaptable to the economic conditions (the base), the latter because it assumed institutions already fully adapted. Being neither adapted nor automatically adaptable, they have to be designed and planned. The difficulty, which Myrdal clearly saw, is that any instrument, even if used with the intention to reform, within a given power structure, tends to serve the powerful and to reestablish the old equilibrium. Even well-intentioned allocations, rationing, licensing and controls often reinforce monopoly and big business. In resolving this conflict Myrdal relied on the possibility of self-reform arising from the tensions between preferred and proclaimed beliefs and actions, as well as the empowerment of the poor.

Myrdal was preoccupied in many of his works with the conflict between ideals and reality, and with the question how, if the two conflict, one of them must give way. Much of conventional economic theory is a rationalization to conceal this conflict. But it is bound to reassert itself sooner or later. When this happens, either ideals will be scaled down to conform to reality, or reality will be shaped by ideals.

5 The Trend Towards Economic Planning. In: *Manchester School of Economic and Social Studies;* 19, 1951, pp. 1ff.

How to Make Markets People-Friendly

The World Bank has promulgated the need for market-friendly government interventions.[6] But free markets are neutral institutions, which can work for good or ill. Whatever may be said for their efficiency, they are not tender-hearted towards their victims. As Joan Robinson said, the Invisible Hand can work by strangulation. The question (asked in the spirit of President Clinton's "putting people first") should be on what conditions markets are people-friendly.

There are several ways in which government intervention can contribute to a more efficient functioning of markets. Not only should government provide a legal framework and maintain law and order, including the enforcement of contracts, property rights, etc. and pursue the correct macro-economic policies to ensure high levels of employment without inflation, and economic growth. It must also encourage competition by anti-monopoly and anti-restrictive practices legislation, by setting up competitive public enterprises, by trade liberalization or take over natural monopolies. There is nothing in the nature of free markets that either establishes or maintains competition. On the contrary, free markets make for conspiracies against the public, as Adam Smith knew. Yet, the virtue of markets depends on the existence of competition.[7]

In addition to safeguarding competition, the government can intervene in the processes of price formation, production and finance in ways that make markets work better for all. It can encourage the introduction of private markets for insurance. The government can make banks buy private insurance. The biggest risktakers would then pay the highest premiums. It can tax activities it wishes to discourage, e.g. pollution, certain types of short-term stock exchange speculation, or the consumption of cigarettes, and subsidize those activities it wishes to encourage, e.g. the use of public transport. It can intervene in preventing the growth of extreme regional inequalities and in town planning.

Government has a special role in promoting the development of human resources. By agricultural extension services it can improve the skills of farmers. By investing in physical infrastructure (such as irrigation to raise agricultural price elasticities or rural feeder roads to bring products to markets), it can provide the conditions for price incentives (such as devaluation) to work, and stimulate private investment. It has been widely documented that by raising profitability, public investment can "crowd in" private investment. By assisting in the design and strengthening of institutions (for land reform, information, credit, or marketing), it can contribute to the effectiveness of price policy. Some of these activities will be accepted by even quite extreme marketeers. The two questions are, whether a shift from present, often very inefficient, state activities to these efficient ones can be achieved by a minimalist state, and what the functions of the state should be after transition, once markets are working.

Perhaps the area of largest controversy is the state's involvement in the area of social services and its fiscal implications, and in changing the income distribution brought about by free markets. The problem here is not one of the failure of markets, but of their successes, responding to the signals of unequal income and asset distributions. The neo-liberals' view is that in any government's war on poverty,

6 *World Development Report 1991*. Oxford U. P., 1991.

7 There are clearly exceptions to this. Albert Hirschman has pointed out that an alternative to exit is voice. In: *Exit, Voice and Loyalty*, Harvard U. P., 1970, pp. 44ff; he writes that "raising hell" (voice) may have more impact on managers of public enterprises confident not to be let down by the treasury than losses.

poverty always wins. If we are concerned only with the need for government action to strengthen both the allocative and the creative functions of markets, such involvement would have to be justified not on grounds of social justice or human needs, but on grounds of human capital formation, of reducing barriers to income earning opportunities, and of promoting social stability.

Progressive taxes and social services are often said to be limited by fiscal constraints. The limits are not, however, lack of resources as military expenditures, often large in very poor countries, illustrate. They are neither technical nor economic but political.

It is important to distinguish between public and private production, provision, and finance. Various combinations of private and public can be applied to these notions. Education or health services can be privately provided and publicly financed, through vouchers for private schools or hospitals, or subsidies. Charging for the cost of publicly provided services (like university education) means public provision and private finance. The production of some of the components of the service can be sub-contracted by the government to a private producer. The optimum combination of producing, providing and financing depends on the particular circumstances of each case.

The proposition that pricism and state minimalism are incompatible is open to two interpretations. According to the strong interpretation, liberal markets require authoritarian regimes preventing trade unions from pushing up wages, and special interest groups from grasping rents. "A courageous, ruthless and perhaps undemocratic government is required to ride roughshod over these newly created special interest groups" writes Deepak Lal.[8] This interpretation points to the East Asian economies (and perhaps Pinochet's Chile), cited as the great success stories. But it is questionable whether these regimes are truly liberal in the economic sphere. Their dirigisme is to some extent, and with important exceptions, market-oriented or market-friendly. But if there is evidence of an invisible hand, it is surely guided by a strong visible arm.

According to the milder, more realistic interpretation, democracies and free markets can go together, although the ruthless efficiency of markets will then be tampered by the compassion of social provisions, as exemplified by the Scandinavian countries. The current debate about the effects of the welfare state on incentives to work and save, on the swollen welfare bureaucracy and on inflation is, of course, provoked by this experience. But our focus is not on the state's welfare provisions but on its interventions in the areas of anti-monopoly legislation, research and development, information, marketing, physical and social infrastructure, and human resource development, all of which are conditions for the efficient functioning of markets.

The state minimalists are prone to argue asymmetrically. They have said, correctly, that market failure is not automatically an argument for state intervention, for this may produce even worse results. But they forget that government or bureaucratic or state failure is not necessarily an argument for private markets, at least not until much more empirical evidence is produced that the outcomes of government action in a particular case are necessarily worse than those of markets.

Shapiro and Taylor have pointed to a peculiar asymmetry in these models, "whereby individuals coalesce to force a political redistribution, but do not do the same

8 Lal, Deepak: *The Poverty of Development Economics.* Harvard U.P., Cambridge, Mass., 1985, p. 33.

in the market place. The political arena is depicted full of lobbyists and cartel builders, while the economy is presented as being more or less subject to competition".[9]

A related asymmetry is that rent-seeking has been indicted almost exclusively as resulting from public action.[10] It is, however, equally common in the private sector. Private allocation of contracts to sub-contractors gives rise to rents in exactly the same way as import quotas. Adam Smith recognized businessmen's "conspiracy against the public" and "contrivance to raise prices", and landlords' and others' love "to reap where they never sowed". We would expect these observations by the father of market economics to encourage us to design strategies of state intervention to counteract these private rent-seeking activities. Instead, we are served today with two ideas: first, that rent-seeking is an entirely political phenomenon, and second, that the only way to reduce rentseeking is to limit government. Both are wrong, or at least unproven without considerably more empirical evidence.

Private and public action often have to go together. Prices have their impact on demand and supply only if complementary action is taken by the government. A factory may depend on a road, which is normally constructed by the government. Increases in agricultural output in response to higher prices may depend on irrigation or research into new varieties. The ability to use high profit opportunities may depend on the availability of information about inputs and markets, provided by the government. When the IMF recommended Tanzania to devalue, no attention was paid to the fact that the transport system had broken down and, however attractive the prices for farmers, their produce could not be transported to the ports. In South Africa, the "black" taxi trade is often upheld as a splendid example of the spirit of free enterprise. And so it is, if we accept the absence of an efficient, safe public transport system for blacks. With roads full of potholes and without public safety regulations, the accident rate is one of the highest in the world.

One example of the complementarity or symbiosis between public and private sectors is the "crowding-in" effect (in contrast to the normally assumed crowding-out effect of higher interest rates), according to which public investment, often in infrastructure, stimulates private investment. Various authors have estimated these crowding-in coefficients to lie between one and two.[11] The fact of crowding-in is now well established. The task of government is to raise the productivity of both public and private investment. There are many other non-price, non-market measures, such as research, information, or establishing appropriate institutions, which the government must take in order to make prices incentives bite.

Some might say that, while the combination of price and non-price measures is best, to get prices right by itself is at least a step in the right direction. This is not so.

9 Shapiro, H. and L. Taylor: "The State and Industrial Strategy". In: *World Development;* 18 (6), June 1990, p. 867. Another asymmetry identified is: While it is pointed out that bureaucrats have no special talent for running an economy, they are called upon to do so in the authoritarian state that dismantles controls.

10 See Krueger, Anne O.: "The Political Economy of the Rent-Seeking Society". In: *American Economic Review;* vol. 64, June 1974, pp. 291ff.

11 Blejer, M. and M. Khan: "Government policy and private investment in developing countries". In: *IMF Staff Papers,* vol. 31, 1984, pp. 379ff; Chakravarti, Sukhamoy: *Development Planning: The Indian Experience.* Clarendon Press, Oxford, 1987; Ortiz, G. and C. Noriega: "Investment and Growth in Latin America". Washington, DC, IMF, 1988; Barro, Robert: "A cross-country study of growth, saving and government". NBER Working Paper no. 2885, Cambridge MA, 1989.

Right prices by themselves, without the complementary public sector action, can be ineffective or counterproductive.[12]

Japan and South Korea are often cited as examples of successful private-public sector cooperation. It is sometimes said that the relation is supportive, not antagonistic. But looking more deeply into the nature of successful state interventions, we note that the state in Japan and South Korea, as J. Bhagwati put it, issues prescriptions rather than proscriptions.[13] They intervene by encouraging and promoting selected activities, not by prohibiting and restricting. Of course, to be able to get credit for only one type of investment, implies being prevented from doing another. Or to be prohibited from importing a good encourages domestic production. The distinction is not as clear-cut as it may seem.[14] The skill of these policies does not lie so much in the disputed art of "picking winners" as in creating winners. Korean ship-building was created without the existence of the requisite skills or raw materials, and today competes successfully with the previously preeminent Swedish industry. The highly successful Korean steel industry was created without indigenous iron or coal. Modern comparative advantage can be created by good government policies.

Japan uses government intervention to promote industrial productivity, by export incentives, barriers to protect the domestic market, low-cost credit to selected investments, and policies favouring business and education. In addition, there are numerous more covert policies to favour companies that move into government-approved types of production, such as commercial intelligence services, nationalistic patent policies, etc. The government practices an art despised and condemned by most US economists, who are minimalists, viz. industrial policy.

The South Korean public sector Pohang Iron and Steel Company (Posco) is one of the most efficient enterprises in the world, while the Steel Authority of India is a testimony to bureaucratic inefficiency. The Korean firm has financial autonomy, seeks to make profits, has clear objectives, operating independence and is open to potential competition from domestic rivals and imports, unburdened with multiple social objectives, and the incentive structure encourages it to export. The Indian Authority accepts losses, has confusing and multiple objectives, its finances overlap with the budget, it is subject to close political scrutiny and interference, its prices are politicized, and it is protected from competition through tariffs, import licensing and legal restrictions on domestic entry.

The East Asian success stories, moreover, illustrate that the same type of intervention, such as subsidized interest rates, that in Latin America have impeded growth, has been used by these governments to accelerate growth. The role of corruption and its control also contributes to explaining differential performance.[15] It is now generally acknowledged that "getting prices right" has not been the principal, and certainly not a sufficient, recipe for the success of East Asian countries, although their government interventions have been "market-friendly", and the markets have been "people-friendly".

Differences in the institutional arrangements of the relations between managers of public enterprises and the public authority are also important. Managers are given sufficient autonomy to get on with their jobs, while remaining accountable to the

12 Streeten, Paul: *What Price Food?* Macmillan, Basingstoke 1987, Cornell U.P. 1987.

13 Bhagwati, Jagdish: *Protectionism.* The M.I.T. Press, Cambridge Mass. 1988, p. 98.

14 Myrdal anticipated the emphasis on encouragement calling it "positive controls". An unfortunate term for controls suggest prevention.

15 See Myrdal, G.: *Asian Drama.* Penguin Books, Harmondsworth 1968, vol. II, part 4, ch. 20 and Klitgaard, R.: *Controlling Corruption.* U. of California P., Berkeley/London 1988.

public. With all the current talk about incorporating political variables in economic analysis, and endogenizing political change, there is remarkably little work done on how specific political and economic institutions function.

In Europe too, new forms of cooperation between local authorities, central government and firms have been evolving. In the Third Italy and in Baden-Württemberg methods of production called by some flexible specialization and by others diversified quality production have combined successfully markets, firms, and government.

There are different types of capitalism. One type, the Japanese and German, is characterized by close coordination between different firms, firms and banks, government and business, and employers and workers; the other exhibits little coordination and conducts its relations at arm's length between firms, no involvement of banks in the management of firms, and on the basis of hiring and firing. One commits its resources to long-term goals, the other is more concerned with short-run financial flexibility. One emphasizes "flexible specialisation" and product innovation, the other pre-set machinery whose performance does not depend on the skill of workers tightly controlled financially.[16]

Economists are trained in the study of the operation of economic forces within political, social and moral constraints. This approach has to be supplemented (and in some cases replaced) by the study of the operation and manipulation of political, social and psychological forces within economic limits. More fundamentally, the distinction between economic and non-economic variables may not be tenable if the aim is to understand society.

The Civil Society

States and markets do not exhaust the players in this game. Frequently, although they need each other, they also weaken and undermine each other. States damage markets by regulations, licensing, and red tape. Markets tend to corrupt governments. Therefore there is a need for the civil society. It can contribute to more constructive relationships between the two.

Private voluntary organizations have come to play an increasing role, next to governments and profit-seeking companies. Although they often claim to work without or even against governments, their contributions can sometimes best be mobilized by working jointly with governments. The most successful NGOs in the Third World, such as the Self-Employed Women's Organisation based in Ahmedabad, India, or the Grameen Bank or BRAC of Bangladesh, depend for their continuing and expanding (though not for their initial) operations on access to, and support and replication by, governments. Of course, in some situations their function is to criticize and exhort governments; or to fill gaps in government activities; or to do things at lower costs, with better results, and with more popular participation than governments. In other situations, when they promote their selfish interests, irrespective of the wider interests of the community, or when they reflect the dominant power of particular groups, government may be justified in trimming their influence.

The relationship between NGOs and governments can be understood as one of cooperative conflict (or creative tensions), in which the challenge of the voluntary

16 See Albert, Michel: *Capitalism against Capitalism.* Whurr Publishers, London 1993.

agencies and their innovative activities can improve both government services and the working of markets, helping to resolve tensions between them.

In some situations the state plays a passive role, only responding to the pressures of interest groups. The outcomes will then be determined by the power of these groups, which in turn depends on their size, age, motivation, and enforcement mechanisms. In other cases the state is more active, imposing regulations and restrictions that can give rise to competitive rent-seeking by private interest groups. In yet other situations, both the private groups and the state work together for common objectives.

Functions are divided between the state and civil society. The institutions of civil society – churches, trade unions, interest groups, action groups, the media and many others – are often quite undemocratic, in spite of their rhetoric. There is then a need for the empowerment of weak and neglected groups within them: women, the unemployed, ethnic minorities. There can be undesirable concentration not only of economic and political, but also of social power.

Though there is in the early stages of development a need to strengthen both states and markets, in fact they often tend to weaken and undermine each other. It is the institutions of the civil society that can intervene and inhibit such weakening and undermining.[17] Interactions between the state, markets and civil society are complex. Both too weak and too strong a state can discourage the growth of civil society. And too strong private organizations can undermine the power of the state, as in Sri Lanka, or in the ex-Soviet Union, and lead to the dissolution of society.

The Loss of Some Distinctions

Some important distinctions, drawn in the 1950s and earlier, have been swamped by the neoclassical resurgence. There is the already mentioned distinction between price policy, in which prices (including indirect taxes and subsidies) are used as instruments of policy, and laissez-faire, the free play of market forces without intervention to maintain competition, to supply infrastructure, and to look after the victims of the competitive struggle.

There is the distinction between markets and the private sector. Privatization of a public enterprise without the managerial and technical personnel, without competition, and without the provision of infrastructure and information can only raise false expectations, while markets can exist where public enterprises compete with each other or with private ones, as Renault in France, or public enterprises in Singapore.

There is the important distinction between motivations in the private and the public sector. Of course, self-seeking occurs in the public sector as well. What is so absurd is to maintain that this is the only motivation there. Each of us behaves differently in different settings: as buyers and sellers; as voting citizens; as supporters or critics of government policies; as moral agents when our conscience is aroused. Sometimes we exercise the option of exit, at others of voice. To level these distinctions down to a uniform selfishness, and to equate rational with selfish behaviour is not helpful to understanding or policy-making.

Even behaviour in the market has been grossly oversimplified by equating rational with selfish behaviour. All that it is necessary to assume for economic man to produce

17 Lipton, M.: "The State-Market Dilemma, Civil Society, and Structural Adjustment". In: *The Round Table;* 317 (1991), pp. 21ff.

stable equilibrium is rationality in the sense of constancy and consistency of behaviour. Selfishness can manifest itself in impulsiveness, inconsistency, inconstancy and irrationality. On the other hand, the perfect model of the rational person is the disinterested trustee administering funds completely unselfishly on behalf of others.

Finally, there is the distinction between centralized and decentralized government decision-making. Some of the criticisms made of a central bureaucracy do not apply to decentralized authorities (others do). They can enhance participation, especially of small entrepreneurs and farmers, be more responsive to needs, gather more information, be more transparent and accountable, and improve the quality of government activities. They can also raise more resources, because the benefits are more visible. On the other hand, decentralized control can reinforce local power elites which are less responsive to the needs of the poor than central groups. Decentralization can also aggravate inter-regional disparities. The task is to design a structure of decision-making that combines the informational and motivational merits of decentralization and participation with central control.

Against Dichotomy: The Unimportance of the Private-Public Distinction

Going one step further, it can be doubted whether the very distinction private and public ownership or management is relevant. Much of the discussion is conducted in binary terms: central planning versus free markets (which is not the same as private versus public ownership). Sometimes a spectrum between these two poles is considered, but the ideological values attached vary with the position on this spectrum. For example, Soviet-type planning is bad; therefore the nearer we are to free markets the better. But an intermediate position may be preferable to either end of the spectrum. It is also possible to add dimensions to the linear spectrum that render the value choices more complex: the degree of democratic accountability, freedom versus compulsion, centralized versus decentralized decision-making, the degree of involvement of voluntary organizations. A regime combining certain features of intervention with others of a free market may then avoid the failures of the two poles and be preferable to either extreme.

Hybrid institutions encouraging initiative and enterprise, that have to cover their costs, but are at the same time accountable to the public, can harness the best of both sectors. The British Commonwealth Development Corporation, e.g., is run autonomously on commercial lines. It has to cover its costs (and is to that extent subjected to market discipline). Its board consists of bankers and industrialists. It draws its funds mainly from the Exchequer, and its objective is to maximize development, not profits. It does not only lend funds, withdrawing once a project is completed and participation becomes most important, like all other development agencies, but also manages firms and projects. In this respect it is unique. It trains local counterparts and hands over control, management and ownership as soon as local people are ready, freeing its capital for new ventures.

There is also the large third sector briefly discussed above, neither private nor public, that consists of non-profit NGOs, that draws on the voluntary energies of its members, contributing often highly efficiently to GNP and to a flourishing civil society, essential for a democracy. Some libertarians (such as Mrs Thatcher) were eager to destroy this civil society, while reformers in societies in which it has been destroyed (such as Mr Gorbachev) tried to build it up. The strength of civil society and of NGOs in particular often lies not in opposing the public sector, but in cooperating with it. When faced with a predatory state, however, their function is to combat it.

Teaching at the Oxford Business Summer School many years ago I came across a truly self-made tycoon. He told us that the important distinction in business is between what he called "the institutions" and "private enterprise". By "institutions" he meant large firms, whether private or public, where ownership is divorced from control and management, and anonymous. "Private enterprise" stood for the small firm, owned and run by the head of a family and a few employees. The principles of running a large private sector company and a public enterprise are very similar. The spirit of truly free enterprise is best exemplified in the small enterprises of the informal sector. To bracket these with the large corporations under the heading "private enterprise" can be very misleading.

An Alternative Window

Some of the neoclassical theories regard the private sector as the source of wealth creation and the public sector as the domain of authority, exercised either benevolently or as a wasteful drain on resources. The distinguishing features of the state, according to this view, are that its membership is universal, and that it has powers of compulsion not given to other organizations.[18] According to some adherents of this view, many governments in developing countries have usurped the sphere of production, which should be left to the private sector. The remedy lies in the state withdrawing from this area, and confining itself to the protection of its citizens against external and domestic threats.

But it is equally possible to look at the same situation in a different way, with a different division of responsibilities. We may regard each sector, or better each sphere of responsibility, as creating different forms of wealth, and exercising different forms of authority and compulsion. According to this view, the private sector creates forms of wealth that can be sold for profit, the public sector those that, while also useful, cannot. Public goods are goods characterized by non-rivalrous consumption, so that one person's use does not detract from another's, and occasionally, though not always, non-excludability from the benefits whose costs are incurred by some. The classic example, given by John Stuart Mill, is a lighthouse (though its construction can, of course, be subcontracted to private firms). Armed protection, monetary and employment stability, an efficient market, or mass education are other examples of public goods, or rather services. Certain types of infrastructure, such as uncongested roads, or harbours, are non-rivalrous but not non-excludable. Providers can charge fees and exclude non-payers. But this means excluding some people the benefits to whom would exceed the costs of supplying them. When price discrimination is impossible, the alternative is for the government to provide these goods and services free, financing them by taxes.

Not all public goods should be produced, provided or financed by central government. Some can be supplied by local government, cooperatives, clubs or other interested private parties. Others, like a common currency, some observers would

18 See Stiglitz, Joseph E. et. al.: *The Economic Role of the State*. B. Blackwell, Oxford 1989, p. 21. Max Weber's classical definition of the state is that of a territorially-defined organization "that successfully upholds a claim to the monopoly of the legitimate use of physical force in the enforcement of its orders" (*The Theory of Social and Economic Organization*. Henderson, A. M. and T. Parsons, Free Press, New York 1947, p. 154).

take away from government control and put under the control of an independent central bank. Some need no institution or organization, and are free goods, like a common language, or trust. But given the two characteristics of public goods of non-rivalry in consumption and, normally, non-excludability, the government is one of the institutions particularly fit to produce, provide or finance some of these goods and services, particularly if no other institution can or will do so.

On the other hand, there are other reasons for public sector production than the public nature of goods. They include natural monopolies, if their regulation is less efficient, and merit goods, to which a high value is attached by the community, but which cannot be afforded by those who need them.[19] Or goods and services, such as the arts or museums or theaters, which are regarded as important, but would not exist if they had to rely wholly on private finance.[20] (There are also merit bads, or demerit goods, such as dangerous drugs, tobacco, alcohol and weapons, whose production or sale the government may wish to restrict or prohibit.)

Production is thus not confined to the private sector. Production of different things can and should therefore occur in both the public and the private sector. And the same is true of authority. The private sector exercises authority through work discipline, the public sector through the army and the police. The state's authority depends on widespread voluntary acceptance by the citizens. A worker can, of course, leave the firm and go to another, but citizens in many countries can also leave and move to another country. States are also constrained by both supra-national bodies (like the EU), and sub-national bodies, like provinces and municipalities.

The question as to whether the private and the public sector use their authority for the benefit of the public or wastefully, predatorily or exploitatively remains to be answered. Such shifts between the two perceptions about the role of the private and the public sector give, however, rise to very different evaluations. They reflect different ideologies, different ways of organizing, filing, and evaluating the same observations. The role of profit, of moral and aesthetic considerations, and of the use of force, will appear quite different according to which of these two perceptions one accepts.

Rhetoric and Practice

The academic and political rhetoric about the virtues of the market and the vices of the state is far removed from the actual behaviour of libertarian governments that profess to follow this rhetoric. While both the Reagan and the Thatcher administrations decried the role of the state, the role of public expenditure relative to GNP increased under both leaders. In 1990 the public sector in the USA spent 43 per cent of the national income. It was 40 per cent in 1980 and 38 per cent in 1970. This represents an increase of over 13 per cent over twenty years. It was the result of growing expenditure on defense, state security, social security, research and development and, above all, on growing interest payments on the rising public debt in an economy without a sense of direction. These expenditures, and particularly those on research, reflect three powerful collective sentiments to which libertarians succumb just as much as interventionists: collective fear (defense and, more recently, environ-

19 I am indebted to M. Lipton for clarifying the distinction between the private and public sector on the one hand, and private and public goods on the other. But he must not be held responsible for what I say here, for I suspect there is still disagreement between us.

20 Arts subsidies are often an elitist form of public spending. The most popular art forms are the least subsidized.

mental protection), collective greed (the desire to be competitive in international trade that leads to subsidies such as those to Sematech, the Pentagon-aided corporation consortium for improving the manufacture of semiconductors) and collective pride (the desire for international prestige reflected in Nobel Prizes).

There are two important areas in this debate. One is concerned with the problems of the transition from excessively interventionist to more market-oriented and people-friendly policies; the other is normative political economy.

Problems of the Transition

Much of the writing is concerned with how much state intervention, what kind and by what means, but much less with the important question as to how to manage the transition (1) from excessive to reduced state intervention, (2) from interventions in the wrong areas to those in previously neglected important ones, and (3) from one form (say reliance on quantitative controls) to another (reliance on prices as instruments of policy). This is a problem with which many countries are faced today, not only in Eastern Europe and Russia, and for whose solution guidelines are needed. If, for example, reducing public sector employment is implemented by not replacing people who leave, the best will leave and only the deadwood remain. If public sector salaries are kept too low, demoralization, added temptation to corruption and the search for additional outside jobs are created. What Robert Klitgaard calls incentive myopia[21] can be more damaging than an overstaffed public sector. If staff are just sacked without the provision of alternative jobs, unemployment and poverty are created, or the burden of maintaining them is thrown on others. The examples of Sri Lanka and China have shown that liberalization that raises output and average incomes has been combined with rising infant mortality rates and falling life expectancy. It may be that demobilization, the change from a war to a peace-time economy, has lessons to teach. In many respects the experience of the British economy in both mobilization for the war and demobilization after it, has been wrongly transferred to developing countries. But some aspects of it may be relevant. *More* transitional intervention may be needed in order to reduce, or, more important, change the form of, past intervention.

Neoclassical Political Economy

I have already mentioned the two basic ideas of neoclassical political economy: that rent-seeking is an exclusively political phenomenon (and does not occur in the private sector),[22] and that the only way to reduce rent-seeking is to limit government action. There are several criticisms of this position.

First, as already pointed out by Adam Smith, rent-seeking is just as common in the private sector. Government action may then be necessary to reduce or eliminate

21 Klitgaad, Robert: "Incentive Myopia". In: *World Development;* 17 (4), April 1989, pp. 447ff.

22 M. Lipton has pointed out that this belief depends on the view that private firms operate in "contestable markets", in which rents are constrained or eliminated by *potential* entry. Lipton's reply, with which I agree, is that this proposition is itself highly contestable (monopolies do exist), and that it applies to the public sector also, often indirectly. Private producers cannot compete directly with issuing an import licence, but they can substitute other goods for imports, which amounts to contestability.

it. Anti-monopoly and anti-cartel legislation, import liberalization, and the creation of competing public enterprises are examples.

Second, as Bhagwati has shown, in a situation where there are already many rent-seeking activities going on, the creation of additional rent-seeking opportunities by government intervention can be productive.[23] The alternative use of these resources might be even more damaging. It is an application of the Theory of the Second Best. The creation of new rents can reduce or altogether destroy existing rents and existing competitive rent-seeking activities, both in the public and private sector.

Third, as Lipton has argued, it is odd that the objection is not to the creation of rents (and thereby to reducing the share available for wages and profits, and with it the creation of incentives to generate surpluses), but to the creation of rents in forms that give rise to competitive rent-seeking. Efforts and resources are diverted from productive to non-productive activities, e.g. to acquiring an import licence. Had the import licence been handed to the brother of the bureaucrat, or had it been sold corruptly to a merchant, without competition, there would have been no social cost according to this theory. The theory does not seem to envisage any social gains from the fact that the rents are competed for rather than monopolized. In fact, the social costs of rent-seeking seem to arise only from competition for them, whereas corruption and nepotism appear to involve none!

Fourth, the theory assumes that all resources diverted to rentseeking from productive activities, if rent-seeking were to end, could be returned to these activities.[24] It is quite obscure what these resources, released from lobbying are, how they can be transferred to productive activities, what the costs of transfer might be, and how their productivity might be affected by the transfer. Are rent seekers capable of pursuing these alternative activities?

Fifth, Lipton again points out that the theory ignores the likelihood of rent-avoiding transactions (black or parallel markets, smuggling, and other illegal activities) as a response to rent-seeking opportunities. Such substitution is normally assumed in neoclassical economics, but appears to be excluded here. According to neoclassical political economy invisible feet trample on the beautiful work of the invisible hand. But smuggling is one way in which the invisible hand can defeat, or at least reduce, the destructive efforts of rent-creating and rent-competition-creating invisible feet. Of course, illegal markets are wasteful compared with open and free trade. But they may be regarded as less wasteful than distorted, regulated and restricted markets without these subterranean outlets.

The case for state minimalism is, of course, not based solely on rent-seeking. It is widely believed that in most developing countries the public sector and public expenditure are "overextended," hampering economic growth. Evidence does not confirm this. An econometric study, based on more than one hundred time-series and cross-country regressions, shows that government size and public expenditure are positively associated with economic growth, especially for developing countries.[25]

23 Bhagwati, Jagdish: "Directly Unproductive Profit-Seeking Activities". In: *Journal of Political Economy,* 90 (5), 1982, pp. 988ff.

24 Lipton, M.: "Agriculture, Rural People, the State and the Surplus". In: *World Development;* 17 (10), 1989, pp. 1561ff.

25 Rati, Ram: "Government Size and Economic Growth: A New Framework and Some Evidence from Cross-Section and Time-Series Data". In: *American Economic Review;* 76 (1), 1986, pp. 191ff. See also Colclough, Ch.: "Are African Governments as Unproductive as the Accelerated Development Report Implies?" In: *IDS Bulletin;* 14 (1), 1983, pp. 24ff, and "Structuralism versus Neo-Liberalism: an Introduction". Chapter 1 of *States and Markets: Neo-Liberalism and the Development Policy Debate;* Colclough, Ch. and J.

Obviously, there is enormous scope for more efficient reallocation and restructuring of public expenditure, in particular (1) to make it complementary to private expenditure, (2) to reallocate it from low to high-priority areas, and (3) to fill gaps left by private activity. But there is no evidence that the state is over-extended.

Normative Political Economy

Much of the recent criticisms of governments and states by the state minimalists, the neoclassical political economists, the theorists of rent-seeking and of directly unproductive profitseeking activities, and of public choice, have been concerned with explaining why and how inefficiency, inequity and deprivation of freedom arose; with the *positive* political economy, partly of government failures, and, more importantly, of government successes in pursuing its selfish interests at the expense of the public. They have been useful in explaining bad policies and the absence of reforms throwing light on regimes such as those of Amin or Marcos. It has been truly said that in many developing countries the Invisible Hand is nowhere to be seen.

But in explaining the evils of predatory governments, and by advocating free markets, they have once again reasoned the state away, and reestablished the division between economics and politics. The task of integrating the two would consist in showing how the government, and pressures on it, can be used for the objectives of development. This would also help to explain the successes of development, from Japan to South Korea, Botswana and Costa Rica.

On the other hand, there are examples of political regimes that represent and promote the interests of the poor. In Malaysia, political power lies with the poorer Malays, economic power with the Chinese and Indian communities. As a result, Malaysia has implemented policies that benefited the poor Malay community. In Zimbabwe, after power had shifted from a white to a black government, numerous measures were taken that favoured human and social objectives. For example, the share of primary education in total educational expenditure rose from 32 per cent in 1980 to 58 per cent in 1984 and real expenditure per head on primary education doubled.[26] In Malaysia and Zimbabwe influence does not go with affluence.

Much less interest has been shown in this *normative* aspect of the subject. James Buchanan, one of the founders of the public choice school, has, indeed, written on the processes by which efficiency is achieved, on voluntary contracts, institutions, decision-rules and constitution-making as guides to reform.[27] But there has been little interest in how to build up political pressures against the pressures for the destructive policies so well analyzed by him and his disciples.

Frequently authors from different schools attribute poor policies to "lack of political will". But it is futile (or tautological) to say that political will is lacking. This expression should be banned from political discourse. One does not have to be a behaviourist to think that behaviour is the manifestation of will. If the will to action is lacking, there is no point in asking for the will to have the will to action. This only leads either to an infinite

Manor (eds.), Oxford U.P. 1992.

26 *Adjustment with a Human Face,* Cornia, G. A., R. Jolly and F. Stewart (eds.), Clarendon Press, Oxford 1987, pp. 292ff.

27 Buchanan, J. M.: *Economics: Between Predictive Science and Moral Philosophy.* Compiled by Tollison, R. D. and V. D. Vanberg, Texas A & M U.P., College Station 1987; *Liberty, Market and State: Political Economy in the 1980s.* New York U.P., New York 1986. See also Sandmo, Agnar: "Buchanan on Political Economy: A Review Article". In: *Journal of Economic Literature;* xxviii (1), 1990, pp. 50ff.

regress or to the charge of hypocrisy. Political will itself should be subjected to analysis, and, for purposes of action, to pressures and to mobilization. It is more fruitful to think of how to create a political base for efficiency, equity and liberty; how to build up pressure groups, how to mobilize the poor, how to shape reformist alliances, how to recruit coalitions for progress, how to strike bargains, achieve compromises, forge compacts, resolve conflicts, or permit their tolerance, how to use persuasion, when to offer compensation to losers when total gains exceed total losses, etc. Amartya Sen has used the expression "cooperative conflict" for the relations within a family.[28] Similar relations exist both within the state and between it and pressure groups.

It might be thought that if such a normative theory had to be built on pure self-interest, no research would be needed, for people are very good in discovering and pursuing their interest. But we know from parables such as the prisoners' dilemma, the isolation paradox, the tragedy of the commons, social traps, and the free rider, that the pursuit of self-interest in society can be mutually destructive, and that there are ways of cooperation, apparent sacrifice and coercion that advance it. Moreover, there is no need to stick to the assumption of self-interested bureaucrats and politicians. Mobilizing the guardians for the poor and the trustees of rationality to put pressure on governments can produce good results even if governments were correctly analysed by the public choice school. Governments can also themselves initiate reforms either in their enlightened self-interest or from motives of public interest.

In analysing the sources of pressures on governments for reform directed at improving the lot of poor people, for example, six areas are worth exploring:

(1) Common or shared interests between rich and poor.

(2) Mutual interests and bargains between rich and poor, including the payment of compensation.

(3) Interest conflicts within the ruling groups that can result in benefits for the poor.

(4) Empowerment of the poor and participatory forms of organization.

(5) Organization of distinct "trustees for the poor" and "guardians of rationality".

(6) International pressures and support.[29]

Donor Conditionality, Pricism and State Minimalism

Structural adjustment loans have been given by the World Bank on the condition that recipients *liberalize, decentralize, privatize and deregulate*. Pricism and market-orientation have been combined with state minimalism, both in domestic and foreign policies. The change from exclusive project lending to programme lending with its macropolicy conditionality is the result of projects having gone sour because of wrong macro-economic policies. Policy conditionality was further supported by the belief that it would support like-minded domestic political coalitions in recipient countries.

Apart from the (superficial) double paradox that foreign donors are in a better position to know what is in the country's best interest, and that the country does not have to pay a fee for accepting this good advice, but gets rewarded with extra funds, there are five problems with this type of conditionality.[30]

28 Sen, Amartya: "Gender and Cooperative Conflicts". Working Paper no. 18, WIDER, Helsinki 1987, published in Tinker, I. (ed.): *Persistent Inequalities.* New York, Oxford U.P. 1990.

29 See Streeten, Paul: *Thinking About Development, The Raffaele Mattioli Lectures.* Cambridge U.P., 1994, Fifth Lecture; "The Political Economy of Reform."

30 See Streeten, P.: "Structural Adjustment: A Survey of Issues and Options". In: *World Development;* 15 (12), 1987, pp. 1469ff; "A Survey of the Issues and Options". In:

First, adjustment aid to mostly Latin American and Southeast Asian debtor countries is aid not to the countries but to the banks in the USA and other advanced countries, if the creditors are private banks and the alternative is default. This, of course, may have contributed to the conversion of the multilateral banks and a Republican US Administration to programme lending.

Second, policies, like projects, are substitutable and avoidable. The donor imposes a condition, which is met, but other policies circumvent the intended result of the condition. This is the macroeconomic equivalent of fungibility, which was regarded as an objection to project aid. In both cases the donor's intentions are frustrated. For example, the donor imposes as a condition devaluation, but subsequent inflation renders it nugatory. This happened in several African countries.

Third, donors' embrace of political groups advocating "correct" policies can be the kiss of death. An example was the pressure for devaluation on India in 1966.[31] It may be wiser to refrain from seeking such allies and to encourage correct policies by signalling quietly approval through the unconditional support of good governments.

Fourth, in view of our ignorance of the impact of these conditions, both in the transition period and ultimately, the premature crystallization of flawed orthodoxies should be avoided. The neoclassical doctrines are not scientific truths, and the ability of governments to implement them, even if they were such truths, and even if the governments were willing, is often in doubt.

Fifth, our confidence in the ability of the developing countries to implement the required macro-economic policy reforms has declined.

In the light of this, at least as much attention as to macroeconomic policies should be paid in the aid dialogue to project design and implementation, to institution- and capacity-building, and to narrowly defined human rights.

Concluding Remarks

The theoretical case for free, unregulated markets depends on many conditions, rarely existing in reality. Adam Smith is often cited as the authority for advocating laissez-faire and state minimalism. "Shakespeare did not say it, but it is true that some men are born small, some achieve smallness, and some have smallness thrust upon them. Adam Smith ... has had to cope with a good deal of such thrusting."[32] Adam Smith defended particular liberties, not liberty in general, and he objected to particular government interventions (especially in foreign trade), not to government intervention in general. One person's "freedom from" and "freedom to" implies restrictions on other people's freedom.

Adam Smith thought that the state should undertake three main tasks: defending its citizens; protecting every member of society from the "injustice or oppression of every other member of it"; and "erecting and maintaining certain public works and public institutions, which it can never be in the interest of any individual, or small

Structural Adjustment and Agriculture in Theory and Practice in Africa and Latin America. Commander, Simon (ed.), ODI, London, Heinemann, Portsmouth 1989, and Streeten, P.: "Program versus Project Aid: a Role Reversal". In: *Methodus;* December 1989, pp. 14f.

31 India *did* devalue, but domestic groups supporting devaluation lost credibility. There are, of course, examples illustrating the opposite, such as Belaunde in the 1960s. He escaped political opposition to land reform, which he advocated, by blaming the Americans, who made essential aid conditional on it. The Peruvian congress acceded eventually.

32 Sen, Amartya: "Adam Smith's Prudence". In: *Theory and Reality in Development; Essays in Honour of Paul Streeten.* Lall, S. and F. Stewart (eds.), Macmillan, Basingstoke 1986, p. 28.

number of individuals, to erect and maintain, because the profit would never repay the expense, though it may frequently do much more than repay it to a great society".

He also discussed extensively "the importance of social interdependence and the communal advantages of following 'rules of conduct,' even when they go against what he called 'self-love'".[33]

This essay is entirely in the spirit of Adam Smith. The provision of certain public works and certain public institutions permits a wide range of public interventions. Infrastructure, public education and help for the poor were certainly in Adam Smith's mind. Arguments from free riders to externalities are used today to justify them. Modern theory and events have added other justifications for state intervention. The theory of the second-best has shown that if one price is not competitive, intervention with all other competitively determined prices may be justified. The world of small producers has given place to one of large corporations and trade unions. Modern industry has polluted the environment. At the same time, Adam Smith saw that market failure is not necessarily an argument for government intervention. There are, it is hardly necessary to say nowadays, also government failures. But equally, though less widely noticed, government failure is not necessarily an argument for the market. Only pragmatic experiments can show when and where intervention is the lesser evil. For we have to act in this least bad of all feasible worlds, in which everything is for the n^{th} best. The challenge consists in designing institutions that combine an appeal to private initiative and enterprise with social objectives and public accountability.

Perhaps the most serious problems arise, as M. Lipton has reminded us, not from market failure but market success, not from government failure, but government success. If it were just a matter of correcting failures, the task would be relatively easy. But if the signals propagated by the market are based on a very unequal distribution of land, other assets, and income, *market success* in responding to these signals causes trouble. A. Sen has analysed famines and shown that often total food supply was adequate, but that the purchasing power (the entitlements) of a particular group of poor people had declined. In those conditions the market is all too successful in its signals, incentives and allocations, while people starve. Similarly, it is not government failure but *government success* (in pursuing the self-interested objectives of its officials) that produces the destructive results rightly deplored by the self-interest school and the state minimalists. What is needed then is fundamental structural change, a redistribution of assets and of access to power.

Abstract

The paper discusses the roles of markets and states in the spirit of Adam Smith and Gunnar Myrdal. Reviewing Myrdal's contribution to this problem frequent misunderstandings of his ideas are corrected. Distinctions important for understanding the roles of market and state blurred by neoclassical resurgence are clarified. The need for researching the transition to the right type of state intervention and for normative political economy is emphasised. The present combination of pricism, market-orientation and state minimalism by donor conditionality, a lynchpin of structural adjustment, is challenged in favour of a more realistic approach.

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33 Sen, Amartya: "Economic Methodology: Heterogeneity and Relevance". In: *Methodus;* 3 (1), 1991, p. 74.