

THE STATE AND THE MARKET ECONOMY

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The six following papers, listed according to date of publication, represent a useful contribution to the on-going discourse and debate about the role of the state in capitalist development - a debate going back to the beginning of what may be called modern economics¹.

1. OECF Occasional Paper 1: "Issues Related to the World Bank's Approach to Structural Adjustment - Proposal from a Major Partner", Oct. 1991

2. OECF, 30th Anniversary Symposium: Experience of East Asian Economic Development: Proceedings and Abstract, March 1992

3. World Bank, *Summary of Report on the East Asian Miracle*, September 1993²

4. Proceedings of the Symposium (December 1993) hosted by the World Bank and the OECF on the World Bank Report: *East Asian Miracle*

5. Issues Paper: Lessons from East Asian Miracle: Based on the OECF/World Bank Joint Symposium, 1993

6. OECF/RIDA, "The Role of the Government and the Response of the Private Sector: The pattern of Development in the Republic of Korea and Thailand", OECF Discussion Paper, 1994.

The debate on the role of the state in economic development acquired greater significance in the 1980s and the 1990s when, one after the other, developing countries in the world have come under the influence of the so called structural adjustment policies (SAPs) of the IMF and the World Bank. A basic position adopted by these policies has been that the reduction of the size and the role of the government and liberalization of market forces is the most effective method of achieving growth and development. The results of the adoption of these policies are rated good in a very few countries, modestly successful in a few more, but either disastrous or near-disastrous in many, particularly those in Africa. In response, certain donor countries themselves have begun to critically assess the validity of SAP prescriptions from the perspective of "partners" in the whole exercise of development assistance³. It is refreshing to note that Japan, being one of the largest donor countries and a country which successfully practised a growth strategy which, in many respect, differed substantially from the neo-classical *laissez faire* position, has taken up the task of looking into alternative growth strategies for developing countries.

OECF's position on the World Bank's approach to structural adjustment and its views about the role of the State in economic development have been spelt out in its occasional

paper of October, 1991, well before the publication of the *East Asian Miracle*. Four principal issues have been raised and discussed here.

I. Need for measures to promote investment in addition to SAPs.

II. Need for an industrial policy and the need to rethink the rationale for wholesale import liberalization.

III. Ineffectiveness of market mechanism in the financial sector and the need for policy-based, subsidized credit.

IV. The need to take aspects other than economic efficiency into consideration in implementing privatization programmes.

This 1991 study stresses that specificities of different countries have to be taken into consideration in the formulation and implementation of policies for them. This idea and the policy insight emanating from it that different countries may do well under different growth strategies, is further developed with special reference to Korea and Thailand, in the discussion paper no. 6 referred to above. The OECF paper of 1991 clearly questions the wisdom of excessive reliance on market mechanism in certain specific areas. Drawing from the Japanese experience, this report argues the case for intelligent state intervention, where the markets are not effective and efficient. Special mention is made of the need for intervention in areas like industrial policy and selective credit support, where intervention is normally not recommended in mainstream economic theorizing. The need to take the prevailing institutional conditions, including the availability of entrepreneurs, when privatization programmes are devised has been stressed. The report concludes with the comment that "what is now needed is a policy well balanced between efficiency and equity".

The papers presented at the OECF's 30th anniversary symposium and comments made by speakers at the symposium (item 2 in the list of publications above) provide substantial empirical support for the positions taken by the OECF in its Occasional Paper of Oct. 1991. The symposium had concentrated on two major themes which recur in the Japanese discussion of the role of state intervention in development: (1) policy of selective subsidization of credit for private sector denoted in different expressions like preferential financing policy (PFR) (Teranishi), policy based finance (Horiuchi), and policy credit (Ito) and (2) industrial policy.

On (1) above, Teranishi's theoretical presentation of the arguments for and against PFP, is useful for a critical evaluation of the results of the actual practice in Japan. Korea, Taiwan and Thailand - the four countries discussed in this symposium. Selective subsidizing of credit has been practised in a variety of economies. In fast growing countries of East Asia this appears to have been done according to a

planned policy framework, subject to careful monitoring, thereby achieving better results than in most other countries where credit subsidies have often been *ad hoc*, politically motivated, not properly monitored and therefore ineffective in achieving developmental objectives. In terms of replicability of subsidized credit in other countries, with results similar to those in East Asia, Sang Woo Nam's following statement needs underlining:

Government directed credit allocation may lead to better economic performance than a market based financial system *under certain circumstances*. The chance of success should be high when the economy is in *its early stage of development, with capable bureaucracies and a political leadership strongly committed to economic development*. Nevertheless the incentive structure imposed by the government should deviate as little as possible from the market-based system and it *should supplement, not replace, the market system* by redressing its shortcomings (Emphasis added).

These are indeed conditions of a high order for success. But in developing countries where these preconditions for success are not available, an attempt to gradually develop these institutional pre-conditions would bear ample dividends whatever is the fundamental policy thrust-market led or state led development.

Similar problems arise in respect of "industrial policy". This expression would cover such things as protection for infant industry, planned development and rationalization of industrial activity, export orientation and selective promotion of industry by picking future winners. This is an area which is much more controversial than PFP, even in a country like Japan⁴. The position promoted is an industrial policy which will facilitate private-sector-led industrialization.

The very subject of industrial policy is controversial, and the formulation and implementation of a long term industrial strategy is extremely difficult. Wide differences of opinion prevail in spite of the weight of empirical evidence presented on both sides of the ideological divide⁵. J. Linn, the Vice President of the World Bank, was naturally unconvinced about the merit of industrial policy. His argument appears to be that the apparent "success" of industrial policy and PFP in East Asia represents a "special" case which is inapplicable in other developing regions of the world. The major objection to assigning any significant industrial policy role to the government is that the necessary institutional preconditions for that are difficult to come by. If these preconditions are lacking, then the state will be ineffective not only in performing extra activities of "governing the market"⁶, but also in carrying out even the necessary functions of a *laissez faire* regime.

Yet, it would be an extremely difficult task to find any significant historical episode of industrialization where the industrialists did not receive benefits of state policies of protection and promotion which have gone beyond mere "facilitation". After the achievement of industrialization, it is easy for researchers to argue that, if not for the "industrial

policy", the country concerned would have achieved a higher rate of industrial growth. Both propositions, (a) that industrial policy helped and (b) that industrial policy hindered, are impossible to prove empirically as no counterfactual comparison is available.

Of the studies referred to, No 3 and the related principal publication in book form, have evinced some interest in Sri Lanka since its publication. Let me present my own comments about the World Bank position as reflected in the *Miracle* study first and then review the OECF contribution to the dialogue.

The World Bank study posits that superior accumulation, i.e. private domestic investment, combined with rapidly growing human capital, accounted for East Asia's success in rapid growth. There is no debate about this general statement. The debate is about "how this superior accumulation came about". The Bank's position is that most of the growth resulted from getting the policy basics or policy fundamentals right. That there was government intervention to foster development, thereby violating the dictum of establishing for the private sector a level playing field⁷ or a regime of neutral incentives is accepted. But the Bank study discounts the role of such interventions by arguing that "it is very hard to establish statistical links between growth and a specific intervention, and even more difficult to establish causality..., because we cannot know what would have happened in the absence of a specific policy...." It is argued that institutional and economic circumstances are of great significance in determining the success of interventionist policies.

Economic growth is conceptualized as a process that necessitates accumulation, efficient allocation and rapid technological catching up. Competitive discipline is required for these "growth functions" to be fulfilled. To market competition is added a "contest-based" competition. The success of selective interventions, it is argued, depends on whether or not they are implemented through a competitive system. Such a contest-based competition, like any other competition, requires competent and impartial referees - that is, strong technocratic, and administrative institutions. If they are not available, then, the argument runs, governments should keep away from the economy after creating the facilitating environment through putting the fundamentals right.

It is difficult to go along with this argument. Market-based and contest-based competitions require institutional frameworks for success. In both situations, therefore, the role of the government would extend beyond policy fundamentals - i.e. to develop the necessary market institutions in the former case and the necessary state institutions in the latter case. This is the fundamental point to be debated. The rest of the study (e.g. the comments about the use of multiple and shifting policy instruments by East Asian governments and the "pragmatic flexibility - the capacity and willingness to change policies" of these governments, careful monitoring of whatever policies were adopted) presents no difficulties and contains good common sense policy advice.

As lessons for other developing economies, the Bank study stresses the need to get the fundamentals right (high levels of domestic saving, broadly based human capital, good macroeconomic management, and limited price distortions). This obviously is good advice except that opinion will differ about the "methods" of putting the fundamentals right. Going beyond the fundamentals, the desirability of experimenting with and adapting policies to changing circumstances is accepted. But the study expresses inability to understand "why the governments in these economies have been more willing and better able than others to experiment and adapt... Here answers go beyond economics to include the study of institutions, and the related issues of politics, history and culture. Taking such questions into account complicates rather than simplifies the task of development". It would indeed be naive to expect that problems of economic development in pre-capitalist developing countries can be understood only through "economics" and that solutions to these problems can be worked out entirely through what economics considers "economic" variables. The task of development clearly is an extremely complex one and opting for simplistic solutions may, as it happened on many occasions, even lead to disaster.

To sum up, the neo-classical paradigm on which the World Bank and IMF base their development advice interpretes the East Asian growth successes as having been resulted from market-oriented policies in the early stages. With the increasing weight of evidence to the contrary, coming from independent researchers⁸ as well as from some connected with these international financial organizations, the argument that East Asian growth was entirely market-driven could not be sustained. I consider the World Bank study, the *East Asian Miracle*, as a response to this growing non-correspondence between neo-classical theoretical positions and empirical evidence.

The WB/OECF symposium (papers no 4 & 5 in the list) on the *East Asian Miracle* is said to have reached consensus on certain areas, yet leaving behind unsettled issues. As my comments above on the *East Asian Miracle* would indicate, there are some issues even among those categorized as "consensus subjects", which would be subjected to debate from the perspectives of developing countries.

Let me focus on what has been described in the summary paper (item 5) as unsettled issues, i.e. those requiring further analysis and research. These are listed below with my own comments on each:

a) The role of the government in economic development: should the government play a more active and catalytic role, particularly in the early stages of economic development? My reading of world economic history leaves no doubt in my mind that the answer to this question is in the affirmative, although I am quite aware of the objections to that position coming from neo-classical economic theory.

b) The effectiveness of industrial policy. I agree with the comment made by some that the *Miracle* has failed to properly assess the effectiveness of industrial policy in East Asia.

c) The need for greater attention to institutional dimensions of economic development. I have expressed my views on the subject above. I am strongly in agreement with the principal elements of the institutionalist critique of neo-classical theory and of the belief that both the market mechanism and the interventionist packages depend for success on the availability of the necessary institutional conditions.

d) The replicability of East Asian experiences. I am of the view that there is no single recipe for socio-economic development. In devising a policy package for development, it is necessary to be eclectic and pragmatic, rather than sticking to any single theoretical position.

By way of concluding this review, I would raise two general points. Firstly, both the World Bank's position regarding the role of the state in economic development, and the opposing views discussed here, consider the state and markets as separate autonomous entities. There is also the underlying perception that the state is an impartial arbiter in society. Both are questionable propositions. As the French "regulation school" shows, the state and markets have been historically and symbiotically connected with each other. The second proposition about impartiality of the state ignores the social basis of the state. The state-market interface, in any given society, is determined in accordance with the extent of development of forces of production and the nature of social relations of production.

Secondly, in countries like those of South Asia, characterized as they are by various ethnic, religious, linguistic, caste and other divisive social tendencies, and by peculiar political cultures developed over time, the role of the state requires to be conceptualized differently from how it is conceptualized in East Asian countries. In respect of the divisive characteristics noted above, the latter countries incorporate largely homogeneous societies. In South Asian countries, on the other hand, characterized as they are by structural disarticulation due to these divisive forces, the state's intervention to produce sustainable, well-dispersed and equitable growth appears to require steps beyond the purely "economic" ones like PFP and industrial policy. In terms of political culture, while East Asian countries appear to have been able to build "long-term sustainable economic growth" into the objective function of the political processes, in South Asian countries, political processes appear to be governed by short-term partisan objectives to satisfy the electorate in intermittent elections. In such an environment, government intervention in economic management must be accompanied by an effective programme of institutional reform, so that interventionist action will not be used to achieve short-term political objectives sacrificing the long term economic goals.

Notes

1. Adam Smith's theoretical contribution indeed was shaped by his ideology against the mercantilist type state intervention in the private economy.

2. This is the official summary of the principal policy research report: World Bank, *The East Asian Miracle: Economic Growth and Public Policy*, World Bank Policy Research Report, Oxford University press, 1993

3. See for example, SIDA, *Redefining the Role of the State and the Market in the Development Process*, 1993

4. In spite of the detailed documentation of the activities of MITI in its industrial policy role and the widespread belief that it could successfully guide Japanese industrialization, there are also points of view which are quite critical of MITI and industrial policy in Japan (see e.g. Komiya, Okuno & Suzumura (eds) *Industrial Policy of Japan*, Academic Press, 1988).

5. Consider, for example, the "proof" of ineffectiveness of industrial policy as given in the *East Asian Miracle* in Appendix 6.1 and the argument of Shiratori and Wade in joint WB and OECF *Symposium on The East Asian Miracle* that they do not have confidence in this "proof".

6. Using the now familiar expression as found in Wade, *Governing the Markets*, Princeton, 1990

7. The "level playing field" is not a real world construct though these international financial institutions place so much emphasis on this in their policy advice to developing countries.

8. The Bank study calls these views "revisionist" as if the ahistorical and neo-classical explanations, which the Bank seems to favour, are the fundamentally correct explanation.

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Fifth Bi-Annual Subaltern Studies Conference, Colombo, June 2,3,4 1995

CALL FOR PAPERS

The Subaltern Studies Collective in association with the Social Scientists' Association and the International Centre for Ethnic Studies is holding their 5th bi-annual conference in Colombo, Sri Lanka, between June 2 and 4, 1995. Subaltern Studies has now made a significant intervention in contemporary historiographical practice focussing attention on hegemony and power, resistance and insurrection, from the perspectives of non-elite segments of South Asian society. Part of the challenge has consisted in their critical readings of nonconventional social, cultural and literary texts to interrupt the authoritative representations of colonial discourse. The conference envisages a multidisciplinary engagement that critically advances this perspective by, among other things, bringing hitherto peripheralized objects and practices within the purview of the conceptual terrain defined by Subaltern Studies. Papers drawing upon South Asian material and working through such themes as identity, gender, violence, ethnicity, and communalism are solicited. Authors are encouraged to locate their discussions in the politics of the post-colonial present. The deadline for submission of (one page) abstracts is 10th Dec.1994.

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