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POLICIES FOR ECONOMIC DEVELOPMENT:

Why The Wheel Has Come Full Circle

by

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INTRODUCTION

For someone who has spent the last 30 years of their professional life thinking, advocating and advising on economic policy in numerous developing countries, the breathtaking shift from the plan to the market both in thought and action -- culminating in the events of 1989 -- has been astounding. As outlined elsewhere,[1] my own personal intellectual development mirrored these developments -- but fortunately in advance by a few decades! This shift in my own thinking- from advocating centralized planning to the application of second-best welfare economics (as embodied in the so-called Little-Mirrlees shadow pricing rules and their natural extension-the theory of optimum taxation) to the classical liberal economic package (outlined below) -- was due as much to my practical experience of various aspects of economic development in India, Sri Lanka, South Korea, the Philippines, Jamaica, Kenya, Brazil and China, than due to any new theoretical advances in the subject.

This experience underlined not only the poverty of "development economics" -- the subject of a popular book I wrote in the early 1980s -- but also of the mainstream neo-classical views of public policy based on the "nirvana" economics of identifying and redressing "market failures" on which I had been brought up and which I vocally advocated till the mid-1970s. Instead I increasingly found the ideas of the classical economists as refurbished by the neo-Austrians (e.g., Hayek) and the Virginia "public choice" school more resonant.

My first task in this address is to show that these classical prescriptions currently form the so-called "Washington consensus" on economic policy not only for developing but also for developed countries. So much so that if John Stuart Mill was resurrected today, he would find that there is little difference in this consensual economic policy package and what he had advocated in Book V of his <u>Principles of Political Economy</u>. For all practical purposes, along with all the literature on socialist planning, much of the neoclassical and Keynesian public policy literature, can it seems be consigned to the flames! For most governments, worldwide, irrespective of their political form, seem to accept that system of public policy (misleadingly) labelled "laissez faire", whose classical codification was provided in Mill's Principles.

Whilst I believe this provides a fair account of where the practitioners of development policy stand, it does not correspond to what is being peddled by many economic theorists as new arguments for dirigisme under the rubric of the "counter-counter revolution in development economics". Hence in this paper I want to both set out the consensual economic policy package -- in bare outline (Pt. I) -- and to explain why the wheel has come full circle (Section II). Then, I briefly examine the cogency of the arguments of the "new" dirigistes (Section III). I shall at various points be using evidence and arguments from the synthesis volume by Hla Myint and myself of a 21 country comparative study of The Political Economy of Poverty Equity and Growth (1996). In the final section I examine the continuing need for sub-Saharan Africa to adopt the classical liberal economic package.

I. REMEMBRANCE OF THINGS PAST

1. The "Washington Consensus"

Williamson (1990) outlined ten areas where policymakers and scholars in "Washington" were agreed on the policy reforms that were required in developing countries. These are:

(1) Fiscal Discipline: which impled "that except in a cyclical downturn an inflation-adjusted budget deficit in excess of around 1-2% of GNP is evidence of policy failure" (p. 10). Far from acquiescing in the Keynesian view that budget deficits expand aggregate demand, it is accepted that, they will merely crowd out private investment.[2]

(2) Public expenditure priorities: Public expenditure cuts rather than revenue increases are considered to be a better way of reducing budget deficits, whilst protecting expenditures on infrastructure and targeted subsidies to the poor -- particularly for health and education.

(3) Tax Reform: "There is general consensus that an efficient tax system is one with a broad base, sufficiently simple rules to permit effective enforcement and moderate marginal tax rates" (op. cit., p. 16).

(4) Financial Liberalization: Market determined interest rates through the "elimination of financial repression and of directed, subsidized credit flows, subject to adequate financial supervision and first achieving enough macroeconomic balance to prevent liberalization from leading to astronomical real interest rates" (op. cit., p. 21). This domestic financial liberalization to be followed by the removal of exchange controls and the liberalization of the capital account of the balance of payments.

(5) Exchange Rates: Establishing and maintaining a unified and competitive exchange rate.

(6) Trade Liberalization: Moving to a free trade regime, by first converting import quotas into explicit tariffs, and then lowering the tariffs gradually over time.

(7) Foreign Direct Investment: Willingness to accept foreign investment rather than to resist it on nationalistic grounds, particularly as it also brings in needed skills and know-how.

(8) Privatization: Governments should divest themselves of state enterprises both because private ownership improves managerial incentives and thence economic performance and to ease pressures on the fisc.

(9) Deregulation: Following the U.S. pattern of deregulating "airlines, trucking, natural gas, telecommunications, and (partially) banking ... to generally beneficial effect" (p. 31). Such deregulation to be combined with "prudential supervision of financial institutions".

(10) Property Rights: Establishing a well-entrenched system of property rights, as a prerequisite for a capitalist economy to function efficiently.

I have set out these ten elements of the "Washington consensus" in some detail, as their author is considered to be a liberal in the American sense, and if these are the very policies that I as a classical liberal would commend,[3] it should be clear that there is now a wide acceptance of the policies for promoting development across the political spectrum.[4]

2. The "Classical" Prescriptions

The "classical" resonance of these prescriptions can be readily seen from a summary of J.S. Mill's argument in Book V "On the Influence of Government" in his Principles. He begins by distinguishing the necessary from the optional functions of government. The former include the provision of law and order and a legal framework for delineating property rights, and for enforcing contracts. On the optional functions he first categorizes those government interventions which are "grounded on erroneous theories" (Ch. X). The most important of these are protectionism- though he does accept (mistakenly from the modern viewpoint and much to his later regret) the infant industry case for temporary protection -- usury laws, price controls and government created monopolies. But he also considers "it a great error to condemn, per se and absolutely, either trade unions or the collective action of strikes", as long as they are voluntary with no "attempts to compel workmen to join a union, or take part in a strike by threats or violence" and they do not seek to "effect objects which are pernicious" (pp. 300-01). Finally, he condemns any government attempt to limit "freedom both of opinion and of discussion", as harming prosperity by suppressing the inquisitive Greek spirit on which (what we would call) technological progress has depended. He then goes on to state the case for laissez faire, condemning in particular the Colbertian system of regulations which hobbled pre-revolutionary France.

He begins his chapter "Of the Grounds and Limits of the Laissez-Faire or Non-Interference Principle", by distinguishing two types of intervention. The first he calls authoritative interference, by which he means legal prohibitions on private actions. Mill argues on moral grounds that such prohibitions should be limited to actions that affect the interests of others. But even here "the onus of making out a case always lies on the defenders of legal prohibitions" (pp. 306-07).

The second form of intervention he calls government agency, which exists "when a government, instead of issuing a command and enforcing it by penalties, [gives] advice and promulgates information ... or side by side with their [private agents] arrangements [creates] an agency of its own for like purpose" (p. 305). Thus the government can provide various public goods, but without prohibiting competing private supply. The examples Mill gives are banking, education, public works, and medicine.

Most of the government interventions Mill allows belong to this second category. But he warns against their costs: they have large fiscal consequences; they increase the power of the government; "every additional function undertaken by government, is a fresh occupation imposed upon a body already charged with duties", so that "most things are ill done; much not done at all," (p. 309) and the results of government agency are likely to be counterproductive. In a passage that is prophetic, about the performance of many public enterprises in developing countries, he writes (p. 311):

> The inferiority of government agency, for example, in any of the common operations of industry or commerce, is proved by the fact, that it is hardly ever able to maintain itself in equal competition with individual agency, where the individuals possess the requisite degree of industrial enterprise, and can command the necessary assemblage of means. All the facilities which a government enjoys of access to information; all the means which it possesses of remunerating, and therefore of commanding the best available talent in the market -- are not an equivalent for the one great disadvantage of an inferior interest in the result.

On these grounds he concludes:

> few will dispute the more than sufficiency of these reasons, to throw, in every instance, the burden of making out a strong case, not on those who resist, but on those who recommend, government interference. Laissez-faire, in short, should be the general practice: every departure from it, unless required by some great good, is a certain evil. (p. 314)

But Mill also provides a bridge to the ideas that were later to undermine economic liberalism. The most important of these was the socialist ideal of "equality", which was used to develop a powerful antidote to the liberal tradition by Marxism and implemented as state socialism by the Bolsheviks.[5] Thus Mill allows various forms of government agency, many of which echo what later came to be recognized as causes of "market failure" that prima facie could justify appropriate government intervention. Such causes might be externalities in the provision of merit goods such as basic education, health, public services (like lighthouses and sanitation), and the need to supervise financial institutions against fraud, or to resolve various forms of what today would be called Prisoners' Dilemmas.

Mill also cited the relief of poverty as another possible reason for government intervention, but had noted:

> The question arises whether it is better that they should receive this help exclusively from individuals, and therefore uncertainly and casually, or by systematic arrangements in which society acts through its organ,the state.

Hence he argued

> the claim to help, ... created by destitution, is one of the strongest which can exist; and there is prima facie the amplest reason for making the relief of so extreme an exigency as certain to those who require it, as by any arrangements in society it can be made. On the other hand, in all cases of helping, there are two sets of consequences to be considered; the consequences of the assistance, and the consequences of relying on the assistance. The former are generally beneficial, but the latter, for the most part, injurious; so much so, in many cases, as greatly to outweigh the value of the benefit. And this is never more likely to happen than in the very cases where the need of help is the most intense. There are few things for which it is more mischievous that people should rely on the habitual aid of others, than for the means of subsistence, and unhappily there is no lesson which they more easily learn. The problem to be solved is therefore one of peculiar nicety as well as importance; how to give the greatest amount of needful help, with the smallest encouragement to undue reliance on it.
>
> (pp. 333-34)

This is a prescient summary of both the attractions and pitfalls of welfare programs, which have since been validated empirically (see Lal and Myint).

There are two points worth noting in this context. First, Mill like most of the classics was concerned with the role of public action in alleviating destitution and conjunctural poverty. These two types of poverty need to be distinguished from mass structural poverty[6] which has been the fate of mankind until industrialization offered an escape from the inexorable operation of the law of diminishing returns in traditional "organic" economies whose productivity was bounded by the fixed supply of land.[7] The only way to solve this problem of mass structural poverty is to initiate and foster intensive growth[8] -- the so-called indirect route to poverty alleviation. Relying on public transfers -- the so-called direct route -- is not a sustainable option, as these transfers are themselves predicated on growth, and as the examples of a number of transfer states in developing countries studied in the Lal-Myint study show, because of reasons of political economy, these transfers have ended up by damaging growth, by inexorably raising the tax burden on the productive sectors of the economy.

However transfers are required by those who are destitute or conjuncturally poor (for instance in a famine -- where food for work programs provide a solution as instituted for example, in the Indian Famine code by the British Raj). But whether these transfers should be public or private remains moot (see Lal (1995a) and Lal-Myint). As a general principle I have advocated that such public transfers should supplement rather than replace the traditional and effective forms of private transfers, e.g., by giving matching public funds to non-governmental organizations (charities) involved in these areas of poverty redressal (Lal (1995a)).

Second, whilst as Mill notes there is a case for government intervention in expanding the provision of merit goods like primary education and health, he was right to emphasize that this provided a case for public financing but not the public production of these goods.[9] Advice which is of continuing relevance in all three worlds![10]

Third, as regards public finance, the classics were advocates of Gladstonian finance[11]- again part of the modern policy consensus (but not for theorists -- see below). Whilst the gold standard provided the monetary constitution for maintaining free payments regimes as well as an automatic adjustment mechanism for the balance of payments.

This is enough, I hope, to show that in economic policies for development we are back to the classics. The question naturally arises: why has the wheel come full circle? It cannot be due to any advances in theory, for as we see in the third part, the high priests of the profession are still peddling dirigisme -- albeit clothed in "new" garb. The Lal-Myint study sought to provide an answer, by integrating the insights of the political philosopher Michael Oakeshott, the economic historian of mercantilism Eli Heckscher, and the empirical evidence for the 21 countries studied of the turning points in economic policy -- the liberal phases of which were correlated with a macroeconomic crisis for the state.[12] The following part provides a brief outline of this story.

II: FLUCTUATING FORTUNES

1. Oakeshott's Story

Oakeshott (1993) makes a crucial distinction between two major strands of thought on the State: the State viewed as a civil association, or alternatively as an enterprise association. Oakeshott notes that the view of the State as a civil association goes back to ancient Greece. The State is seen as the custodian of laws which do not seek to impose any preferred pattern of ends (including abstractions such as the general (social) welfare, or fundamental rights), but which merely facilitates individuals to pursue their own ends. This view has been challenged by the rival conception of the State as an enterprise association -- a view which has its roots in the Judaeo-Christian tradition. The State is now seen as the manager of an enterprise seeking to use the law for its own substantive purposes, and in particular for the legislation of morality. The classical liberalism of Smith and Hume entails the former, whilst the major secular embodiment of society viewed as an enterprise association is socialism, with its moral aim of using the State to equalize people.

Oakeshott (1993) notes that as in many other pre-industrial societies, modern Europe inherited a "morality of communal ties" from the Middle Ages. This was gradually superseded from the 16th century by a morality of individuality, whereby individuals came to value making their own choices "concerning activities, occupations, beliefs, opinions, duties and responsibilities" and also came to approve of this "self-determined conduct" in others. This individualist morality was fostered by the gradual breakdown of the medieval order which allowed a growing number of people to escape from the "corporate and communal organization" of medieval life.

But this dissolution of communal ties also bred what Oakeshott terms the "anti-individual", who was unwilling or unable to make his own choices. Some were resigned to their fate, but in others it provoked "envy, jealousy and resentment. And in these emotions a new disposition was generated: the impulse to escape from the predicament by imposing it upon all mankind" (p. 24) This, the anti-individual sought to do through two means. The first was to look to the government to "protect him from the necessity of being an individual" (p. 25). A large number of government activities epitomized by the Elizabethan Poor Law were devoted from the 16th century onwards "to the protection of those who, by circumstance or temperament, were unable to look after themselves in this world of crumbling communal ties" (p. 25).

The anti-individual, secondly, sought to escape his "feeling of guilt and inadequacy which his inability to embrace the morality of individuality provoked" (p. 25) by calling forth a "morality of collectivism", where "'security' is preferred to 'liberty', 'solidarity' to 'enterprise' and 'equality' to 'self-determination'" (p. 27). Both the individualist and collectivist moralities were different modifications of the earlier communal morality, but with the collectivist morality in addition being a reaction against the morality of individualism which had emerged soon after the middle ages.

This collectivist morality inevitably supported the view of the State as an enterprise association. Whilst this view dates back to antiquity, few if any pre-modern states were able to be "enterprising", as their resources were barely sufficient to undertake the basic tasks of government-providing law and order and external defense. This changed with the creation by the Renaissance princes of centralized "nation-states" and the subsequent Administrative Revolution, as Hicks (1969, p. 99) has labelled the gradual expansion of the tax base and thus the span of control of the government over its subjects lives. Governments now had the means to be "enterprising".

Oakeshott (1993) identifies three versions of the collectivist morality such an enterprise association has since sought to enforce. Since the truce declared in the 18th century in the European wars of religion, the other two major purposes have been "nation-building" and "the promotion of some form of egalitarianism". These correspond to what Oakeshott (1993) calls the productivist and distributivist versions of the modern embodiments of the enterprise association, whose religious version was epitomized by Calvinist Geneva, and in our own times is provided by Khomeni's Iran. Each of these collective forms conjures up some notion of perfection, believed to be "the common good".[13]

This Oakeshottian taxonomy is sufficient in my view to think clearly about the links between ethics, economics and politics. The fog created by distinctions like negative and positive liberty and continuing attempts to reconcile these irreconcilable,[14] can be readily dispelled by keeping Oakeshott's distinction between these two visions of the State in mind. The State seen as a civil association does not seek to legislate morality, that as an enterprise association does. But this does not mean that the "order" promoted by the former is immoral. The sages of the Scottish enlightenment were clear headed on this.

2. <u>The "Morality" of the Market</u>

Both Smith (in <u>The Moral Sentiments</u>) and Hume recognized benevolence as the primary moral virtue. But they also recognized its scarcity. However, fortunately, as Adam Smith was at pains to show in <u>The Wealth of Nations</u>, a market economy which promotes a country's "opulence" does not have to depend upon this moral virtue for its functioning. A market order merely requires a vast number of people to deal and live together, even if they have no personal relationships, as long as they do not violate the "laws of justice". The resulting commercial society does promote some moral virtues -- hard work, prudence, thrift and self-reliance. But as these benefit the agent rather than others, they are inferior to the primary virtue -- altruism. Nevertheless, as these lower order virtues promote general prosperity, they do unintentionally help others. Hence the market economy is neither immoral or amoral. A good government on this classical liberal view is one which promotes "opulence" through a policy of promoting natural liberty by establishing laws of justice which guarantee free exchange and peaceful competition. The improvement of morality being left to non-governmental institutions. It would be counterproductive for the State to legislate morality. On the form of government which best promotes good governance they were agnostics.

I think this is as good and spare an outline of the case for the State viewed as a civil association as we need. But given its merits, is there some inevitable evolutionary process (as Hayek at times seems to argue) which will ensure that it will drive out the alternative vision of the State as an enterprise association. I can see none, and a thumbnail sketch of the rise and fall and rise of economic liberalism over the last two hundred years shows why.

3. Heckscher, Nation-Building and Mercantilism

The mercantilist system which provided the foil for Adam Smith's great work, arose, as Eli Heckscher has shown (in his monumental study of Mercantilism), from the desire of the Renaissance princes of Europe to consolidate their power, by incorporating various feuding and seemingly disorderly groups which constituted the relatively weak states they inherited from the ruins of the Roman empire, into a "nation". This was a "productivist" enterprise in Oakeshott's terms. The same nationalist motive also underlay the very similar system of mercantilist industrial and trade controls that were established in much of the post-war Third

World.

In the Third World the jealousy, envy and resentment which bred the European anti-individualist, was based not merely on the dissolution of the previous communal ties that industrialization and modern economic growth entails, but also because in these post-colonial societies, such emotions were also strengthened by a feeling amongst the native elites, of a shared exclusion from positions of power, during the period of foreign domination. It is not surprising therefore that the dominant ideology of the Third World came to be a form of nationalism associated with some combination of the productivist and distributivist versions of the state viewed as an enterprise association. Historically, both these secular collectivist versions have led to dirigisme and the suppression or control of the market.

In both cases of "nation-building" (in post-Renaissance Europe, and the modern Third and Second Worlds) the unintended consequences of the similar system of mercantilist controls instituted to establish "order" was to breed "disorder". As economic controls became onerous people attempted to escape them through various forms of evasion and avoidance. As in 18th century Europe, in the post-war Third World, dirigisme bred corruption, rent-seeking, tax evasion and illegal activities in underground economies. The most serious consequence for the State was an erosion of its fiscal base and the accompanying prospect of the unMarxian withering away of the State. In both cases economic liberalization was undertaken to restore the fiscal base, and thence government control over what had become ungovernable economies. In some cases the changeover could only occur through revolution -- most notably in France.[15]

But the ensuing period of economic liberalism during the 19th century's great Age of Reform, was short-lived in part due to the rise of another substantive purpose that most European states came to adopt -- the egalitarian ideal promulgated by the Enlightenment. Governments in many developing countries also came to espouse this ideal of socialism. The apotheosis of this version of the State viewed as an enterprise association were the communist countries seeking to legislate the socialist ideal of equalizing people. The collapse of their economies under similar but even more severe strains than those that beset less collectivist neo-mercantilist Third World economies is now history, though I cannot help remarking on the irony that it took two hundred years for 1989 to undo what 1789 had begun!

4. Rights Chatter, Capital Markets and Government Activism

It would appear as in the mid-19th century that the classical liberal order has won out. But is this current world wide "Age of Reform" likely to be more permanent than its 19th century predecessor? There are auguries -- both favorable and unfavorable.

To take the latter first. The desire to view the State as an enterprise association still lingers on, as part of social democratic political agendas in many countries. It has ancient roots and is unlikely to die. It has now adopted a new voice, which Ken Minogue has labelled "constitutional mania". This emphasizes substantive social and economic rights in addition to the well-known rights to liberty -- freedom of speech, contract, and association -- emphasized by classical liberals. It seeks to use the law to enforce these "rights" based partly on "needs", and partly on the "equality of respect" desired by a heterogeneity of self-selected minorities differentiated by ethnicity, gender and/or sexual orientation. But no less than in the collectivist societies that have failed, this attempt to define and legislate a newly discovered and dense structure of rights (including for some activists those of non-human plants and animals) requires a vast expansion of the government's power over people's lives. Their implementation moreover requires -- at the least -- some doctoring of the market mechanism. Then there is the global environmental scare and the population scare.[16] Finally the U.N. has taken up the cause of the world's poor and is seeking to establish a worldwide welfare state through a U.N. economic security council.[17] Classical liberals can clearly not yet lay down their arms!

There is however, one major aspect of the changes which have occurred in the last decade which gives some reason for hope. This is the growing integration of world capital markets, which has tied the hands of national government's in their pursuit of various forms of activism.

After the unwinding of the first liberal international economic order (LIEO) with the catastrophes of the period spanned by the two world wars, capitalism has triumphed with the reconstruction of a new LIEO. In this new LIEO, full-blooded Keynesian is dead. As is increasingly accepted by many governments around the world, unemployment is normally of the classical variety as Pigou and Robertson maintained, and the NAIRU can only be reduced by removing impediments (mainly created by public policy) in the efficient functioning of the labor market.

But the hankering after some form of Keynesian tinkering is likely to persist- as Hayek clearly saw late in his life [18] -- as long as there is a government monopoly of money, in a world unable or unwilling to accept the rigors of the 19th century gold standard. He saw that ending the political management of national monies, must form an essential element of a refurbished classical liberalism. For unlike many economists who continue to assume that the State is benevolent, Hayek like the classical political economists and contemporary public choice theorists, recognized that it was more likely to be predatory -- especially in its modern democratic form.[19] Hence his proposal for abolishing the government's monopoly of money. As he put it:

> In a world governed by pressures of organized interests, we cannot count on benevolence, intelligence or understanding but only on sheer self-interest to give us the institutions we want. The insight and wisdom of Adam Smith stand today.

Today, I would argue, the global integration of capital markets aided and abetted by the revolution in communications brought about by the computer and its accessories, is in effect bringing about this denationalization of money.[20] For whilst there are striking parallels between the 19th century, and post-World War II golden ages, the second was -- till recently -- marked by capital and exchange controls. Combined with the discovery by all the combatants in the First World War that the costs of war could be financed through deficits funded by their central banks, the stage was set for Keynesian policy to flourish in the two decades after the second world war.

The destruction of the world capital market in the interwar years, and the continuance of capital and exchange controls (in the U.K. till 1987) allowed predatory democratic states to squeeze "capital" in the interests of "labor" in the Keynesian decades after the second world war. The removal of these controls and the integration of capital markets in the 1980s has destroyed this option. When even Sweden has to abandon its "middle way", because Swedish companies fight shy of holding their country's debt, the public borrowing route to finance government activism is closed. Whilst the near universal tax revolt in OECD countries, means that this path too has become perilous.

Finally, with currencies floating against each other, with their relative value determined as much by capital than trade flows, there is in effect already competition amongst national monies, which limits any single government's ability to act as the currency monopolist of yore. In effect money has become denationalized. It is the bond market -- not any money supply or nominal expenditure target -- which increasingly informs the principal authorities whether national money supplies should be loosened or tightened. Whilst any hint of the danger of the future inflationary financing of public borrowing, is reflected in raising the current and future costs of servicing government debt. The recent trend towards Gladstonian rectitude in managing the public finances is thus, no longer a matter of choice but necessity. With massive global flows of capital triggered at the press of a button, government's are now faced with an instantaneous international referendum on their fiscal and monetary policies. Thus, as classical liberals have always sought, governments are now tied to the mast against the siren voices of their predatory instincts. The Central Bank (or Treasury) proposes but the money market disposes!

III. THE EMPEROR'S NEW CLOTHES

1. <u>The "New" Dirigisme</u>

But these interpretations of the new world economic order that is emerging will appear odd to the high priests of our profession, two of whom have announced a "Counter counter revolution" in development thinking (Krugman (1992)), and a "new" development economics based on the imperfect information interpretation of "market failures", which allows all number of beneficial government interventions to correct them (Stiglitz (1986)). They have been joined by the so-called "market governance" school of political scientists and economists (Johnson, Wade, Amsden) who see in the enlightened dirigisme of the Far Eastern super performers -- Japan, Korea and Taiwan -- practical refutation of the utility of the "Washington consensus", and who find a useful role for governments to "get prices wrong" (Amsden). Even the World Bank (1993) seems to have fallen for some of this new dirigisme, even though its conclusions are not supported by its analysis (Little (1994)).

I want very briefly to counter the arguments on which this "new" dirigisme is founded. The first point to note is that the arguments being touted as "new" are anything but. For those of us who have been around for sometime they are merely old wine in new bottles. The basic analytical framework is still based on the need for government intervention when one or other of the conditions for the existence of the Utopian state of perfect competition are not met, and hence there is ostensibly "market failure". This justification for <u>dirigisme</u> has always seemed bizarre to me (see Lal (1983, 1987)). To compare "competition" in any actual market economy with an unattainable ideal, is in Demsetz's useful phrase (1969) a form of "nirvana" economics. It is true that many modern day general equilibrium theorists have claimed that all they are doing is to give precision to the claims of the classics on the virtues of the market (Arrow and Hahn).[21] But as Blaug (1987) points out one needs to note:

> the subtle but nevertheless unmistakable difference in the conception of "competition" before and after the "marginal revolution". The modern concept of perfect competition, conceived as a market structure in which all producers are price-takers and face perfectly elastic sales curves for their outputs, was born with Cournot in 1838 and is foreign to the classical conception of competition as a process of rivalry in the search for unrealized profit opportunities, whose outcome is uniformity in both the rate of return on capital invested and the prices of identical goods and services but not because producers are incapable of making prices. In other words, despite a steady tendency throughout the history of economic thought to place the accent on the end-state of competitive equilibrium rather than the process of disequilibrium adjustments leading up to it, this emphasis became remorseless after 1870 or thereabouts, whereas the much looser conception of "free competition" with free but not instantaneous entry to industries is in evidence in the work of Smith, Ricardo, Mill, Marx and of course Marshall and modern Austrians. For that reason, if for no other, it can be misleading to label classical economics as a species of general equilibrium theory except in the innocuous sense of an awareness that "everything depends on everything else"
>
> (p. 443)

2. Neo-Classical Public Economics

The continual assertion by theorists (e.g., Dasgupta (1980), Hahn (1984), Sen (1983), Stiglitz (1995)) that the justification of the market is provided by the two so-called Fundamental Theorems of Welfare Economics derived within the Arrow-Debreu framework is bizarre. For it is child's play to show that because of incomplete markets, external effects and the existence of public goods, "market failure" defined as deviations from the perfectly competitive norm is ubiquitous, but the corollary that this then requires massive corrective public action is highly debatable to say the least.

It is well-known that the major cause for incomplete markets is imperfect information (see Lal (1983), Greenwald and Stiglitz (1986)). This causes problems of incentive compatibility as Hayek noted at the start of the "planning debates" in the 1930s, and is now accepted even by our theorists (see Dasgupta (1980), Stiglitz (1995)). Thus a command economy on Lange-Lerner "market socialist" lines is ruled out.

But the hope is still held out that a full optimum, or (less ambitiously) various Pareto improvements can be achieved by the government implementing a system of optimal taxes and subsidies. This "optimal tax" basis for the "new" dirigisme is set out in Stiglitz (1995), and its theoretical base is claimed to be the working out of this optimal tax structure in Greenwald and Stiglitz (1986). Its relevance is however strictly limited. First, because its implementation raises questions both about the character of the mandarins required to implement these "optimal taxes", and second, because in a dynamic economy the optimal structure will have to be continually changing and the requisite information will not be readily available to the authorities -- as Hayek (1945) noted a long time ago.[22]

On the first question concerning political economy, Greenwald and Stiglitz note in a footnote:

> It might be noted that we ignore any discussion of the political processes by which the tax-subsidy schemes described below might be effected. Critics may claim that as a result we have not really shown that a Pareto improvement is actually possible" (note 7, p. 234)

Quite!

Whilst on their claim:

> that there exist Pareto-improving government interventions ... [and] that the kind of intervention required can be simply related to certain parameters that, in principle, are observable. (p. 231)

they are in their concluding comments forced to concede:

> we have considered relatively simple models, in which there is usually a single distortion (one kind of information imperfection, one kind of market failure). Though the basic qualitative proposition, that markets are constrained Pareto efficient, would obviously remain in a more general formulation, the simplicity of the policy prescriptions would disappear. Does this make our analysis of little policy relevance? The same objection, can of course, be raised against standard optimal tax theory. (Some critics might say, so much the worse for both.) Though simple expositions of optimal tax theory often focus on the case of independent demand curves, in the general case, one needs to know all the cross elasticities of demand, and these are seldom available. What is worse, if one abandons the unrealistic assumption of the standard optimal commodity tax formulation (e.g., Diamond-Mirrlees (1971), with their assumption of 100 per cent pure profits taxes,

> no restrictions on commodity taxation, and no (progressive) income tax), then the informational requirements on the government are even greater. (p. 258)
>
> Quite!

To those of us who misspent our youth on advocating the second-best shadow pricing Little-Mirrlees rules which were the precursors of this "new" dirigisme, its policy irrelevance is hardly surprising.[23]

3. "New" Growth and Trade Theories

The other "new" theories of: (a) endogenous growth (Romer, Lucas) and (b) trade in the presence of monopolistic competition (Brander and Spencer; Helpman and Krugman) which are being touted as providing justifications for dirigisme can be dealt with more summarily.

On the "new" growth theory we need only note that neither theorists (see Solow, Stern) nor practitioners (see Pack) have found it persuasive. In its so-called AK version it is a reversion to the Harrod-Domar model. Whilst there is little evidence to support the purported externalities to human capital and "knowledge" as asserted by its proponents (see Lal-Myint).

On the cross country regressions based on the Heston-Summers data set, which have proliferated in the journals (e.g., Barro (1991)), apart from their fragility (Levine and Renelt), they at best establish the statistical case for growth rates being determined by good policy (Barro (1994), Sala-Martin). But the regressions themselves cannot conclusively establish what these policies are! The Lal-Myint study by examining the economic history of 21 developing countries whilst endorsing the role of good policy in determining the efficiency of investment, which more than its volume is found to be the major proximate cause for the differences in growth rates, also identifies these policies. They echo the "Washington consensus" and the classical prescriptions.

The "new" trade theory has been neatly encapsulated by Baldwin (1992) in a refurbished Baldwin "envelope". This shows that part of its case for intervention is another variant of the classic terms-of-trade type argument, whilst another part is a variant of the infant industry argument for the domestic promotion of industry (but not its protection). As the practical irrelevance of both types of arguments have been discussed threadbare in the trade and welfare literature[24] these "new" arguments for protection and industrial policy are mere theoretical curiosa.

4. Market Governance or Business Governance?

By contrast, many have found the case studies of supposedly successful dirigisme in the Far East of the market governance school more persuasive. Even the World Bank (1993) has leaned towards them. As I have discussed the former in detail in Lal (1993), and Little (1994) provides a devastating critique of the latter, I need only emphasize a number of points.

First, it is undeniable that these governments were dirigiste in many aspects of their trade and industrial policies. The question remains whether their undoubted success was due to, or despite this dirigisme. Little (1994) basing himself on estimates of social rates of return to investment for Korea (for which he had data) shows convincingly that they were inversely correlated with the degree of dirigisme. Whilst the World Bank Miracle study's empirics based on total factor productivity calculations, despite its circumlocutions, found that interventions in both Korea and Taiwan had little effect in altering the structure of production at the sectoral level, and that the least selective intervention in these and other Asian miracle economies -- the commitment to manufactured exports -- was the most successful. Thus despite the claims of the "market governance" school, these "miracle" economies vindicate policies of "getting prices right" rather than of getting them wrong!

Second, another more persuasive explanation can be provided for their industrial and trade policies (see Lal (1993)). Following some insights of Demsetz (1988) concerning the problem of control of business enterprises I have suggested that these and other countries were concerned with his problem as their industrial structure moved beyond the relatively labor intensive end of their ladders of comparative advantage. The problem is one of maintaining "beneficial control over resources in the presence of economies of size ... [which is related to the amount of private] wealth required to reduce the degree to which ownership is separated from control of these resources" (Demsetz (1988, p. 231). This agency problem arises as countries effectuate their emerging comparative advantage in more capital-intensive and ipso-facto larger scale enterprises.

There are three ways of overcoming this agency problem. The first is through sufficient concentration of private wealth, and some institutional means for its spread over a number of enterprises whilst maintaining control by some concentrated owners. The second is through foreign equity controlling local firms. The third is through public enterprises. Korea following Japan, sought to create concentrations of private wealth through the promotion of the "chaebol". The major instrument was long term subsidized credit to a select number of industrial groups, who were "chosen" by a relatively efficient dynamic monitoring process based on export success -- under a relatively neutral overall trade regime. But the resulting concentration of economic power has subsequently become a political issue. In Taiwan by contrast as the government was concerned with the political consequences of boosting the economic power of native Taiwanese, it chose the public sector route for capital -- intensive industries like shipbuilding and petrochemicals, but with the usual damage to profitability (Wade, p. 81). Finally, Singapore chose the third route, but its "neutral" trade regime ensured that the direct foreign investment was not of the "tariff jumping" kind. It was thus likely to be both socially as well as privately profitable (Lal (1975)). Then there is the "laissez faire" example of Hong Kong. Whilst Singapore did try to force the pace at which its industries were to move up the ladder of comparative advantage (with some dire results as in the 1980s recession) Hong Kong let its industrial structure evolve more naturally. If performance is judged by the productivity of capital then Hong Kong has been the more successful (see

Findlay, and of Wellisz; Lal-Myint; Young).

5. A Counter-Counter-Revolution?

This suggests that there is little merit in the "new" dirigiste case. So why has Krugman (1992) proclaimed a "counter counter-revolution in development theory". Because he claims the ideas of the old development economics based on the importance of increasing returns, and pecuniary external economies arising from the effects of market size, which underwrote concepts like the "big push" and "backward and forward linkages", have now been formalized and shown to be logically consistent. He claims the reason why it failed to persuade in its earlier incarnation was because of the failure to formalize the ideas in mathematics. But this is ridiculous. As his discussant Stiglitz rightly noted: "That we can write down a model of a phenomenon proves almost nothing. It does not make the idea right or wrong, important or unimportant" (p. 41). The reasons why the big push and linkages do note persuade were clearly set out in the detailed discussion by Little (1982).

Moreover we now have empirical evidence of the outcomes in countries which did try a big push. Four were included in the Lal-Myint study -- Ghana, and Madagascar in Africa. Brazil and Mexico.[25] The results invariably were disappointing if not disastrous. To promote such bad policies just because some theorists have been able to write down some algebra is not only puerile but wicked -- given the high costs that the poor people thus being experimented on suffer.

I conclude therefore that the "new" dirigistes have failed to provide any reasons for departing from the "Washington consensus" and, as I have sought to show, the classical prescriptions on which it is based. As with so much contemporary theory, as Peter Bauer has sagely remarked: "the emperor's new clothes are of the finest hue but there is no emperor within!"

IV. ESCAPING THE HEART OF DARKNESS

1. Relevance for Africa

In outlining the relevance of the current consensual policy package for sub-Saharan Africa, I begin with some stylized facts which explain the development disaster that has ensued in Africa. These concern its initial conditions on Independence, which were less bright than they appeared and which have influenced the subsequent economic and political outcomes.

2. Stylized Facts

A few noteworthy stylized facts about sub-Saharan Africa on the eve of its independence from colonial rule, in my view, essentially explain the development disaster that has ensued.

The first concerns relative resource endowments. This is an important explanatory variable in the Lal-Myint study.[26] Africa unlike the famous "Gang of Four" East Asian NIC's, is natural resource rich and relatively labor-poor. This as the Lal-Myint study shows has important implications for its efficient development path. One is that, the supply price of labor will be much higher in countries with relative abundance of natural resources relative to labor than in the labor abundant countries of East Asia. Thus if the former type of country tries to industrialize it might find that its comparative advantage lies on the relatively more capital intensive rungs of the ladder of comparative advantage.

This is very difficult given their limited human capital stock -- this is the second stylized fact -- the limited size of the domestic market and the lumpiness of investment in such industries which almost makes it inevitable that such industries, if they are set up will be part of the public sector. By contrast the task of starting industrialization on the most labor intensive rung of the ladder of comparative advantage, as in East Asia, is much easier. In this sense the blessing of the riches of "natural resources" can turn out to be a precious bane.

Even more so, as the exploitation of most natural resources produces rents. There is then a grave temptation to politicize their distribution; with the government either nationalizing their source (e.g., most mineral deposits) or else taxing them (e.g., through marketing boards), and using the resultant revenues to create politically determined income entitlements for their friends and collaborators. This is the third stylized fact.

But as the contrasting stories of two "resource rich" and in the 1950s comparable economies Ghana and Thailand show (Lal-Myint, Ch. 3), resource abundance need not in itself necessarily retard growth. It is only if for ideological reasons, or more commonly due to the fiscal deficits which emerge in the downturn in the primary product price cycles -- when revenues from natural resource rents fall but the political entitlements based on them cannot be rescinded -- the government keeps increasing the tax burden on the natural resource sectors that it can retard their growth. As the tax burden continues to rise, at some stage producers will seek to escape the tax net by returning to a subsistence economy. With the productivity of the "wealth producing" sector having been destroyed, and with its "prey" having fled to the bush, such predatory states have found that not only have they killed the goose that laid the golden eggs but have in the process also destroyed their tax base.[27] They are then faced with a fiscal crisis, and a balance of payments crisis. With no hope of domestic borrowing, foreign borrowing and grants can paper the fiscal cracks for a while. But when these sources of finance prove incapable of meeting the deficit created by the unchanged expenditure on entitlements, there is usually a resort to the printing press. With the ensuing rise in inflation, the "prey" reduce their holding from money -- eroding the base of the inflation tax -- and the government is then finally forced to tackle the basic cause of its endemic crisis -- the unviable politically determined entitlements. This is when economic liberalization is undertaken, basically to restore the tax base of the predatory government! This pattern has been observed in numerous countries (see Lal-Myint) and is of course also the pattern which led to the extraordinary events of 1989! This is our fourth stylized fact.

In Africa (see Lal-Myint, Ch. 3), this politically determined sequence of events is to be found in a number of countries, and it is basically due to the political behavior induced by their resource endowments. But as the contrasting stories of Ghana and Thailand, and Nigeria and Indonesia in the Lal-Myint study (Ch. 3), show, these outcomes are not inevitable, even in natural resource rich land abundant economies.

By contrast, labor abundant countries, irrespective of their political color will be part of a virtuous political and economic progression. Even a predatory state in such countries will recognize that its only resource is its people. Its tax base and hence revenues will depend upon their productivity. It will be in its interest to invest in raising the productivity of its human resources through education etc., because that is the only way in which it can raise its revenues. The country will then follow the East Asian type of development path, moving up the rungs of the ladder of comparative advantage, with increasing human and physical capital and rising wages.

Whilst, the development path for Africa was thus likely to be more difficult compared to East Asia primarily because of the former's natural resource riches, the further push given to dirgisme by economic nationalism -- our fifth stylized fact -- was not uncommon in most of the Third World. In this aspect it mirrored the mercantilism which was seen as an essential instrument for creating the nation states of post-Renaissance Europe (as discussed in Section II).

But in Africa, this task of nation-building, was complicated by the fact that the nation sates they sought to create were based on the arbitrary colonial boundaries emerging from the late 19th century scramble for Africa -- our sixth stylized fact. These boundaries in many cases cut across the traditional boundaries of tribe and ethnicity. It is ironic that Africa's post-colonial rulers have been reluctant to rethink the accidental pattern of territorial demarcation that was the result of European colonialism. Thus, after the Second World War, most of the countries in Asia or Latin America had historical boundaries which had cultural legitimacy in the eyes of their people, and thus the task of nation-building within them was not compromised by claimants "across the border". In Africa by contrast, the artificial colonial boundaries have provided a veritable feast for the four horsemen of the Apocalypse, as peoples put into administrative straitjackets which bear little relationship to their own sense of ethnic identity have fought on its behalf, or else fought against attempts to be submerged in states dominated by "other" tribes. The final irony, however, is that the only resolution of the Organization of African Unity which has been observed by all sub-Saharan states is the one which says that no state will seek to change existing territorial boundaries -- a colonial legacy!

I believe, this combination of six "stylized facts" is a sufficient witches brew to explain the sub-Saharan development disaster. To put flesh on this, the Lal-Myint study provides details for a few particular examples in a comparative context[28] which underline this thesis, as well as discussing one case (Mauritius) which shows that even in Africa these trends can be bucked.

3. <u>Conclusions</u>

The moral is clear. Africa needs to reverse its disastrous public policies which have impoverished its people. In land-abundant economies, the need for good governance is even greater than in labor abundant economies, because of the danger of the politicization of the distribution of natural resource rents. It is best to let these accrue to the private sector as their disposition by public sectors has been so disastrous in Africa.

But there is no necessary link between such good governance and a particular type of government -- namely democracy -- as the example of Jamaica discussed in the Lal-Myint study. The major case for economic liberalization -- which involves the classical economic package: balanced budgets, free trade, realistic exchange rates, and taxation just sufficient to finance public goods and merit goods -- of which education (particularly primary) and health (mainly preventative) -- are the most important -- is therefore that it allows the de-politicization of the economy. For politicization, apart from leading to the kelptocracies which have developed in so much of Africa, has also made the endemic ethnic disputes in the artificial boundaries of post-colonial Africa, deadly. Thus apart from the purely economic case in support of economic liberalization, the creation of true "nations" as well as civil societies in Africa is now dependent on it.

This liberalization will also reverse the decades long urban bias which has so crippled African development.[29] The immediate future of most of Africa lies, in my judgment with its peasant farmers -- particularly those producing export crops. But as the example of Mauritius shows where a combination of high population growth rates and the policy-induced decline in per capita income has led to a large reduction in the African wage level, labor intensive manufactures may become competitive in world markets.

As most of sub-saharan Africa painfully adjusts to redressing its past follies, there is now one beacon of hope -- post-Apartheid South Africa. Like much of the rest of Africa it too could let its natural resource riches become a precious bane -- particularly given the large pent up demands for public spending on the hitherto deprived black African majority. But unlike much of the rest of post-independence Africa, there are signs that South Africa has learned the lessons of the development disasters to its north. The ANC and particularly President Mandela have shown statesmanship in maintaining economic stability and resisting the inevitable calls for populist increases in public expenditure. Also unlike much of the rest of sub-Sharan Africa it has a much larger and well educated black middle class, whilst the ANC's attempts to reconcile the "white" tribe to black majority rule seems to have been more successful than anyone could have expected. This provides South Africa with all the necessary ingredients to be the first large sub-Saharan country to realize its immense potential. If this should happen, the demonstration effect would reverberate in the rest of Africa and lead to a healing of those self-inflicted wounds which have sadly left Africa appearing increasingly to much of the outside world as the Heart of Darkness.

ENDNOTES

[1]See Ch. 1 in Lal (1993).

[2]That public sector deficits in developed countries can crowd out investment in developing countries in a world where capital markets are increasingly integrated was argued in Lal and van Wijnbergen (1985).

[3]We have to note these two different senses of the term "liberal" because as Schumpeter (1954) noted: "The term [economic liberal] has acquired a different -- in fact almost the opposite meaning
-- since about 1900 and especially since 1930; as a supreme if unintended compliment, the enemies of the system of private enterprise have thought it wise to appropriate its label" (p. 394). But following Hayek (1960, p. 401) I am unwilling to use the manufactured term "libertarian" which has become common to describe classical liberalism in the U.S.

[4]To cite one more example from my side of the fence, my colleague Arnold Harberger (1984) summarized the elements of sound development policy -- based upon the experience of practitioners
-- in 13 very similar points, well before the Washington consensus had been established.

[5]Egalitarianism still retains its resonance amongst the technocracy. Some moral philosophers (e.g., Barry) have claimed egalitarianism to be a basic moral principle self-evident on intuitionist grounds. For a devastating critique see de Jasay.

[6]This tripartite distinction of different types of poverty is to be found in Iliffe (1987).

[7]See Wrigley for a perceptive discussion of how a move form an "organic" to a "mineral based" economy during the Industrial Revolution was essential for generating intensive growth, and why the classics (at least till Marx) thought they were still dealing with an organic economy. Hence their gloom.

[8]See Reynolds for the distinction between "intensive" and "extensive" growth.

[9]Thus as he states in On Liberty:

> unless, indeed when society in general is so backward a state that it could not or would not provide for itself any proper institutions of education unless the Government undertook the task: then, indeed, the Government may, as the less of two great evils, take upon itself the business of schools and universities, as it may that of joint stock companies, when private enterprise in a shape fitted for undertaking great works of industry, does not exist in the country. But in general, if the country contains a sufficient number of persons qualified to provided education under government auspices, the same persons would be able and willing to give an equally good education on the voluntary principle, under the assurance of remuneration afforded by a law rendering education compulsory, combined with state aid to those unable to defray the expense.
> (p. 161)

[10]See Lal (1989) for an application of this principle for the reform of U.K. higher education.

[11]Schumpeter (1954) lists three basic principles of Gladstonian finance: (1) Retrenchment means that "the most important thing is to remove fiscal obstructions to private activity. And for this it is necessary to keep public expenditure low". (2) Neutrality implies "raising the revenue that would still have to be raised in such a way as to deflect economic behavior as little as possible from what it would have been in the absence of taxation". (3) Balance refers to the principle of the balanced budget, or rather, since debt is to be reduced, "the principle that Robert Low ... embodied in his definition of a minister of finance: "an animal that ought to have a surplus" (pp. 403-05)

[12]This supported the speculations in Lal (1987) on the causes of economic liberalization.

[13]Sugden (1993) in his review of Sen (1992), makes much the same distinction between the two divergent views of public policy embodied in the technocratic "market failure" school and those of the neo-Austrians and the Virginia public choice school.

[14]For instance by Sen (1992) and his followers. Sugden cogently refutes Sen's view that classical liberals too are egalitarians as they are concerned with the equality of liberty!

[15]See Aftalion.

[16]See Lal (1995).

[17]See Lal (1995a).

[18]See Hayek (1978), Lal (1990, 1992).

[19]The model of predatory state is outlined in Ch. 13.2 of Lal (1989), vol. 1, whilst Lal (1990a) shows how democratic states are likely to behave like predatory ones.

[20]See Lal (1990b).

[21]It is equally surprising that the "Chicago school" as Kirzner for instance has noted "maintains that the competitive market economy displays systematic regularities only to the extent that it can be reasonably fitted into the perfectly competitive mold. Subsequent [to Frank Knight] generations of Chicago theorists would maintain that as a matter of fact the real world competitive market <u>can</u> so be fitted" (p.103). Thus we are now in the situation where the theorists on both sides of the "market-dirigiste" divide use the Arrow-Debreu model as their paradigm. It is hardly surprising given its real world and policy irrelevance that the voices of self-

styled theorists therefore carry so little weight today in public affairs.

[22]Newberry and Stern have advocated the application of this optimal tax theory to developing countries. But as they note it assumes that "the government has coherent, unified and largely benevolent objectives, captured in the social welfare function, and we search for ways in which the tools available to it can be used to improve the measure of welfare" (p. 653). That the theory is irrelevant for most developing countries is patently obvious as most of their polities do not even come close to these assumptions about their character. Whilst if a predatory state or rent-seeking society is accepted as likely, the optimal tax rules are no longer valid even within this framework (see Lal (1990a)). For a trenchant critique of optimal tax theory see Harberger (1987), who moreover notes that it is based on a philosophy of government -- the social engineering view-which differs from that of classical liberalism.

[23]See Lal (1980) for one of these exercises in irrelevance, and Lal (1993) Ch. 1, of how I came to eschew this public economics approach to public policy.

[24]See Baldwin (1992) for a restatement.

[25]Also see Lal and Maxfield for a detailed analysis of the Brazilian case.

[26]The study used a three factor multi-commodity model of an open economy due to Krueger, and extended by Leamer. In this model a richer array of efficient development paths emerges with changing capital and labor endowments, than in the standard two factor Heckscher-Ohlin model. See Lal (1993) Ch. 4, 14, 20 for various applications of the model.

[27]Tanzania, Ghana and Guinea have provided classic examples of this phenomenon.

[28]The African comprators are examined in the following country studies of the project. Rimmer, Mesook et al., for Ghana and Thailand; Bevan, Collier and Gunning for Indonesia and Nigeria; Findlay and Wellisz for Mauritius and Jamaica, and Pryor for Madagascar and Malawi.

[29]See Lipton; Iliffe; Collier and Lal.

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