State Intervention versus the Market: A Review of the Debate

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Résumé: *La remise en question de l'intervention de l'Etat dans la stratégie d'une industrialisation de substitution aux importations a été engendrée par l'échec de l'application de la théorie néo-classique à la pauvreté et au sous-développement des pays en développement dans les années 1950 et 1960. Auparavant une intervention massive de l'Etat même dans les pays capitalistes en développement a été considérée comme nécessaire à la réussite des politiques et programmes généraux fondés sur la modification des mécanismes du marché. Les raisons de cet échec ont été diversement interprétées par les différentes écoles d'économie politique, notamment par l'école radicale pour que l'échec de l'intervention de l'Etat dans cette stratégie doit être chercher dans les rapports entre la bourgeoisie locale et le capital international. S'il est normal de remettre en question l'intervention de l'Etat au vu des résultats obtenus jusqu'à présent, il est cependant important que l'Etat continue à intervenir dans cette stratégie, particulièrement dans les pays en développement.*

Introduction

The last fifteen to twenty years has witnessed a major shift in development theory and policy away from State intervention, import-substitution and central planning, towards the market mechanism, reduction in scope of government ownership, and towards export-oriented development strategies. This development has been precipitated or boosted largely by the emergence of conservative governments in the U.S., U.K. and some parts of Europe; by the pervasive economic crises in the developing world, and by the increasingly central role which international financial and aid organizations like the IMF, IBRD, USAID, etc. have been playing in shaping the economic policies of debtor countries. More recently, this trend has been underlined by the economic and political crises exploding in Eastern Europe and the Soviet Union, which has tended to be interpreted as a failure of State intervention and central planning.

In the context of these momentous developments, the need to review and discuss the theoretical debate on the role of the State has become urgent, and this paper is intended as a contribution to that debate. It focuses mainly on arguments for and against State intervention in the context of import-substituting industrialization (ISI), and on perceptions of the economic functions of the State, especially in the conditions prevailing in developing countries. The arguments which developed within the structuralist and liberal traditions in the 1950s and 1960s against free trade

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and the market mechanism are traced, and the counter-arguments that emerged in the 1970s and 1980s, re-asserting the case for the market, are also outlined. Within the political economy paradigm, various perspectives on the role of the State in the context of developing countries, and of the factors which explain its perceived failure, are presented and discussed.

It is argued that there is still a strong economic case for State intervention, although some of the problems and limitations of ISI and State intervention have to be taken on board. The importance of making a concrete study to avoid invalid generalizations and the perpetuation of myths is emphasized. The purpose of discussing these theoretical issues is to lay a basis for a theoretical and empirical analysis of particular forms of state intervention in particular contexts, which, it is argued, is necessary for a meaningful reappraisal of the frontiers of State intervention.

After the introduction, the second section of the paper discuses the debate for and against free trade and State intervention within the structuralist and liberal tradition. The third section discusses the political economy perspectives, while the fourth section concludes the discussion in the paper.

The Structuralist and Liberal Approaches

Early Arguments Against Free Trade

The earliest arguments for import-substitution and State intervention were made by H. Singer, R. Prebisch, G. Myrdal, and subsequently taken up by others. Singer, in 1950, argued that the international division of labour which consigned to developing countries the task of producing primary products, actually caused deteriorating terms of trade for them, and allowed the industrialized countries to appropriate most of the benefits. On the basis of the evidence of trends in international trade between 1870 and 1939, and on the strength of an assumption of a differential in income elasticity of demand between primary and manufactured commodities, he forecasted that these trends, rooted as they are in the structural characteristics of these countries, are likely to continue and will tend to reinforce the unequal distribution of the benefits of trade and investment[1].

Gunnar Myrdal argued that the spread effects of international trade had failed to materialize, and that the effects of international trade were mainly reaped by countries with large markets and a developed industrial base. Other "structuralists" during the 1960s argued that underdevelopment was not due to the shortage of capital, but more due to the unequal and

1 Blomstorm, M. and Hettne, B., *Development State in Retreat?* IDS/EADI Workshop, IDS, 1984; Singer, H.W., "The Terms of Trade Controversy and the Evolution of Soft Financing: Early Years in the U.N.", in Meier and Seers, 1984, op. cit.

exploitative trade relations which concentrated benefits on the already developed trading partners. Raul Prebisch and other economists in the Economic Commission for Latin America (ECLA), developed one of the most elaborate arguments for import-substitution and State intervention. They developed the centre-periphery scheme to show how the structure of production in the periphery is geared to serve the interests of central industrialized countries through the pre-occupation with primary commodity exports in the former. Technical progress and dramatic improvements in productivity in the center merely benefitted capital and labour in the center due to the existence, strength and bargaining power of labour, and dominance of capital. Contrary to orthodox theories of international trade therefore, the benefits from the rise in productivity were not transmitted to trading partners in the periphery[2].

As an engine of rapid economic growth, therefore, the expansion of primary exports was a cul-de-sac. Industrialization on the other hand enabled the production of manufactured goods which have a high income elasticity of demand. It also has the potential of boosting technological development not only in the industrial sector, but also in the domestic agricultural sector, thus boosting technical progress on an economy-wide level, and promoting employment in the national economy of the periphery. However, to generate industrial development in the periphery, in the context of a long-established and efficient manufacturing sector in the center, import-substituting industrialization was considered the only feasible form of industrialization. For it to be implemented, it was necessary to use measures of protection to give the domestic industries a head start. It was also considered important to use planning to create a rational balance between agriculture and industry, achieve a reasonable degree of national autonomy, attain an adequate level of capital accumulation, and make necessary investments in infrastructure[3].

Similarly, Furtado strongly supported the centre-periphery and development-underdevelopment schema because, in his view, the market mechanism, and specifically the static comparative advantage, worked in favour of the center. He also advocated industrialization in the periphery, which will enable a diversification of exports, expanded employment, and the growth of domestic markets. A planning mechanism is required to ensure that the process of development specifically addresses the problem of income inequality. To achieve these objectives, a conscious and purposeful government intervention is required. The role of the government is also

2 Prebisch, R., "Five Stages in My Thinking on Development" in Meier and Seers, 1984

3 Blomstrom and Hettne, op. cit.; Rosales, O., "The Assessment of the Structuralist Paradigm for Latin American Development and the Prospects for Renovation", *Cepal Review*, 34, 1988.

critical for ensuring technological development and strengthening the institutions of civil society[4].

Rosenstein-Rodan, in making a case for state-mediated industrialization, argued that the assumptions of neo-classical theory about the existence of a linear homogeneous production function, the absence of increasing returns to scale, an implicit assumption of a perfect future market for all commodities, are fundamentally mistaken. Moreover, the pre-occupation of the theory with equilibrium pre-empts a systematic study of the "pursuit curve", which involves an analysis of the process of movement towards equilibrium, which is really more relevant in real-life situations. On the strength of these criticisms, he therefore argued that in the context of the industrialization efforts of LDCs, it is necessary to provide investments in a wide range of complementary activities and industries if the increasing returns to scale engendered by the existence of pecuniary external economies are to be captured. Planning and State intervention are also required for establishing adequate levels of overhead capital, as well as for reaping technological external economies of scale, especially as it relates to the education and training of workers, which will not be adequately achieved through the market mechanism. He also supported the emphasis on industrial development, rather than agricultural expansion, because the former has a much greater potential for generating external economies of scale. Here again, the market mechanism is not geared to enable the development of these strategies, hence government intervention is crucial[5].

The major way forward, according to these writers, is for developing countries to embark on rapid industrialization. But they pointed out that these countries could not produce manufactured goods for export straightaway, because they could not compete with industrialized countries in their own markets; and there was not much point, they argued, starting to produce intermediate and capital goods, since they will require other intermediate and capital goods. The logical thing to do therefore, was to start producing consumer goods for which there was already a market. To produce these consumer goods, they needed to raise the relative prices of competing imports so as to allow their infant industries some breathing space. And it was argued that curtailing imports would create lucrative local investment opportunities, which would act as a premium mobile for further developments[6].

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4 Furtado, 1987.

5 Rosenstein-Rodan, P., "Nature Facist Saltum: Analysis of Disequilibrium Growth Process", in Meier and Seers, op. cit.

6 Bruton, 1970.

Hirschman also pointed out the substantial benefits that could be derived from forward, and especially backward linkages and for these to be realized, purposive policies had to be taken by the State[7]. In contrast to the big push, balanced growth and simultaneous policies approaches typified by Rosenstein-Rodan and Nurske, Hirschman's theory emphasized unbalanced and sequential growth paths, and disproportionality between different sectors, and between different sub-sectors of a sector; but this disproportionality can create dynamic stimulatory effects only in situations where the disequilibrium created powerful countervailing or compensatory forces to restore equilibrium[8]. Others pointed out that industries with high linkage effects are required to hasten the pace of industrialization, and it therefore made sense for the State to initiate investments in these sectors. More recent discussions have also attempted to provide an explanation of the imperatives of industrialization and State intervention in developing countries, within the perspective of economic and political circumstances of political independence in these countries, Sender and Smith for example, cite Gerschenkron and others who have convincingly argued that, wherever economic development in economically backward regions is being attempted while more developed nations existed, active State intervention is required to facilitate accumulation. And according to them, the historical evidence also indicates that the development of the manufacturing sector is generally associated with overall accumulation. However, developing the manufacturing sector requires a wide variety of forms of State intervention, including subsidies, protection, and policies designed to secure certain critical macro-economic balances. They argued that political independence and the rise of nationalism in developing countries provided an atmosphere in which the rising domestic bourgeoisie could exert considerable pressure on the State to implement measures of protection, subsidies and tax incentives to enable the expansion of private manufacturing production and to promote State enterprises, which apart from contributing materially to industrial development and filling strategic gaps, etc., can also provide a crucial source of private accumulation for the domestic bourgeoisie. ISI provided perhaps the only feasible means of securing a measure of monopoly for the local bourgeoisie through the securing of the domestic market; it also represented the only means of enabling their firms to undergo a learning process, to improve productivity and acquire technological know-how. To implement a successful ISI program however required the achievement of certain macro-economic balances: adequate levels of foreign

7 Hirschman, 1968.

8 Hirschman, A.O., "A Dissenters' Confession: The Strategy of Economic Development" in Meier, G.M. and Seers, D. (ed.), *Pioneers in Development*, Washington, World Bank, 1984.

exchange earnings to finance necessary imported inputs and smooth earning patterns so as to avert short-term crises; sufficient quantities of incentive goods to entice workers to higher productivity jobs and export commodity producers to increase output, and thus avert damaging inflationary pressures; sufficient resources to finance public investment at levels necessary for the sustenance of the ISI effort. To achieve these, it is necessary to attract appropriate levels of foreign finance and investment, and raise domestic finance in a non-inflationary manner (e.g. through constructing and operating an appropriate tax system). They argued that these balances cannot be attained through the accidental outcome of the market mechanism, but only through active and purposive State intervention[9].

By the end of the 1960s and early 1970s however, most developing countries were confronted with a wide range of economic crises, whereas the Newly Industrialized Countries (NICs), which were perceived to have emphasized an export promotion strategy, were generally experiencing far higher rates of economic growth. A number of critiques against the ISI model and state intervention thereby emerged.

Re-asserting the Case for the Market

One of the most elaborate and effectively orchestrated sets of arguments against the ISI model was developed by Krueger, Balassa, Westphal and others. The core of the critique centered around the multi-volume study sponsored by the National Bureau of Economic Research. In this study, it was argued that ISI, State intervention and wide-ranging distortions and inefficiencies are inextricably linked in theory and practice[10]. The implementation of ISI in LDCs has inexorably led to overvalued exchange rates, thereby dampening export incentives. This in turn caused a stagnation or decline in foreign exchange earnings, provoking stringent foreign exchange controls. Attempts to re-invigorate exports have generally involved bewildering sets of export incentive regulations, involving massive bureaucracies, and providing an irresistible impulse for evasions and circumventions. Moreover, due to the narrowness of domestic markets and the restriction of capital and machinery imports to license grantees at subsidized rates, monopolistic structures of production inevitably emerged, with little incentive for innovation, quality control, improved management techniques etc. In many cases, the firms also tended to be small, and therefore high cost, due to the loss of opportunities for utilizing economies of scale. Foreign exchange scarcities also caused widespread capacity

9 Sender, J. and Smith, S., *The Development of Capitalism in Africa*, London, Methuen, 1986.

10 Krueger, A. O. 1983a; 1983b; "Trade Strategies and Employment in Developing Countries", *Finance and Development*, 21, 2, 1984.

underutilization, which further impaired efficiency and productivity. Typical ISI strategies involved the use of quantitative restrictions and prohibitions, tariff barriers and duties and charges. Combined with currency overvaluation, these policies tended to breed smuggling, under-invoicing and over-invoicing, etc. which substantially undermined the effectiveness of the policies.

On the other hand, it is argued that the export-oriented industrialization strategy (EOI) is inherently more conducive to development than ISI. This is because it involves international competition, which will compel firms to pay attention to innovation, cost effectiveness, etc. Secondly, they claim that it is easier to rectify imbalances and excesses in import incentives under the EOI strategy because they are more visible, and more difficult to sustain in the face of political pressures. Thirdly, the strategy provides firms with unlimited opportunities for expansion, and therefore a capacity to exploit economies of scale. Afterall, the main instruments of the EOI strategy, which include export subsidies, credit subsidies and domestic tax exemptions, are generally less distortionary, and involve lower scales of State intervention.

They further argued that empirical studies have validated the superior growth performance levels of EOI strategies. They cited studies which indicate a positive and strong correlation between GNP growth rate and export growth rate; a positive association between change in exports/GNP ratio and change in GNP. Studies also showed that export-promoting countries generally appeared to have lower levels of factor market distortions than import-substituting countries; and that there is a negative correlation between effective rates of protection and labour coefficients used in production; hence EOI strategies, by promoting labour intensive methods of production in LDCs, might contribute to more equitable income distribution patterns, higher employment, higher rates of value-added at international prices, and more efficient resource allocation. But some of the empirical results cited also indicated that there is considerable room for improving efficiency, resource allocation and employment levels even within existing ISI strategies through incentives to producers to encourage a more optimum allocation of productive factors.

Referring to the export pessimism which was at the heart of much of the structuralist thesis, it has been argued that the extrapolations on declining terms of trade for LDCs, have turned out to be wrong. Citing studies by Kravis, Lipsey and Balassa, Balassa argued that, using price indices, the terms of trade for developing countries in general (except for oil importers), and for non-oil primary exports in the 1952-70 period, have improved as compared to that of manufactured exports; and that the terms of trade for low income exporters has improved in comparison to that of high income exporters. Thus the Singer-Prebisch secular stagnation thesis was proclaimed to have been repudiated[11].

It has also been pointed out that on the basis of the Net Barter Terms of Trade and Income Terms of Trade indices, there has been a wide range in terms of performance levels, between different countries in sub-Saharan Africa in the 1960-81 period. While Tanzania, Ghana and Zambia have been unable to expand their export volumes sufficient to counteract unfavourable Net Barter Terms of Trade trends, Malawi, Ivory Coast and Kenya have been more successful. Moreover, the overall share of sub-Saharan Africa's exports in world exports has declined precipitously for some important commodities in the 1960-80 period; and at any rate, for many commodities, Africa's share of world exports is so small that the income elasticity of demand was irrelevant as an explanatory variable for any observed stagnation in export earnings. Thus the Singer-Prebisch thesis was flawed[12].

Another major critique of ISI strategy which centered on its distortionary effect is provided by Corden[13]. First, he restated the well-known proposition that the first best policy for a small country (in the Samuelson sense) is free trade. Optimal tariff levels are appropriate only for large countries (which can influence world prices). Secondly, he pointed out that, even in the case of the infant industry argument which is often used to justify protective policies under ISI, tariffs are not the appropriate instruments. In this case, the reason why the market may not be relied upon to bring about an appropriate investment in human capital during the initial learning period is really due to imperfections in the capital market, due to either a bias against invisible investment, or due to excessively high rates of interest for long-term investments. The appropriate economic policy needs to be targeted sharply at the source of the imperfection, and in this case the first best policy would be to improve the capital market. The second best policy would be a general output subsidy. Tariffs would merely introduce other by-product distortions. In general, subsidies and taxes which are focussed sharply on the particular kind of distortion or imperfection in a market, are the correct economic tools to use; tariffs and other forms of protection which are so extensively utilized in the ISI strategy are inefficient, and generate other secondary distortions. A similar but differently nuanced argument is made by Lal, Little, Bhagwati and others; it identifies and focuses more sharply on State intervention as the major problem of the ISI strategy in developing countries. The argument is that, even if the export pessimism which informs the structuralist arguments in the 1950s is concede to, and

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11 Balassa, 1984.
12 Sender and Smith, op. cit.
13 1982.

even if some measures of protection can be justified in this context, the Nurske/Rosenstein-Rodana and Hirschman versions of ISI, with their pervasive and heavy doses of State intervention, need not follow. Most of the problems emanating from the implementation of the ISI strategies are attributed to this version of the strategy. It is contrasted to the market-oriented version advocated by Gottfried Haberler for example, which, while recognizing the need for protection, opted for across-the board tariff protection, which will still minimize distortions and allow market forces considerable latitude[14]. This approach, while recognizing the reality of market failure, also contends that the attempt by the State to intervene in order to correct for this failure, has produced bureaucratic failure of such dimensions as to be greater than the market failure it had set out to correct. Besides, such intervention incurs further costs associated with the acquisition and processing of information, implementation of decisions, etc. which would have been avoided if the market forces were allowed to function freely[15].

In a related argument, Krugman[16], focuses on the response of individuals to government policy. He points out that, due to the fact that individual economic agents develop rational expectations about the effects of government policies, they can either act to preempt them, or if they do not believe in the credibility of announced plans, can act in such a way as to frustrate them. Thus the case for the market is re-asserted, not because market failure is not recognized, but because the alternative to the market would produce inferior outcomes.

All these arguments on the ineptitude, inefficiency and bureaucratic bungling of the State assume that the State is motivated by the need to increase general welfare. But arising out of the literature on public choice theory, this assumption has been called into question. The "black box" of the State has been penetrated, and it is suggested that the State consists of selected politicians, who have a strong incentive to gear policies to election cycles. For example, if unemployment is an important problem in the economy, the government would increase the money supply in the period before the election, so as to achieve lower unemployment rates, even if this might result in inflation after the election. The bureaucrats on the other hand are motivated by the objective of maximizing their budgets. They use their power and control over information to continually expand the demand for their own services. Moreover, in civil society, various interest groups

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14 Bhagwati, 1984.

15 Lal, D., "The Misconceptions of "Development Economics", *Finance and Development*, 22, 2.

16 Krugman, 1987.

organize themselves, and through extensive lobbying, are able to prevail upon governments to enact policies which will be of material benefits to themselves. In the process of all this lobbying and jockeying, a wide variety of adverts, ploys, disinformation, etc. are deployed to confuse and mislead the general electorate so that the actual patterns and content of State activity are camouflaged. Thus it is a mistake to see the State as a benevolent and altruistic body, but rather as a collection of groups and persons seeking to maximize their own utility[17].

The Rosenstein-Rodan argument as a justification for government intervention is also challenged by Little on the grounds that, by arguing for the "big push" to generate demand complementarity, it assumed a closed economy where exports and import substitution do not occur; yet in advocating the setting up of a labour-intensive consumer goods production sector, it implied the existence of an open economy where capital goods and intermediate products can be imported. Hirschman's linkages, when administratively promoted, are said by Little to contribute to inappropriately capital-intensive methods of production. On the other hand, if they are not administratively promoted, they are indistinguishable from pecuniary externalities. In general, much of interventionist ISI and associated policies are dismissed as emerging more from nationalist fervour, a knee-jerk reaction to capitalist policies associated with former colonizers, and an uncritical copying of Soviet models, than from concrete and rational economic analyzes[18].

The property rights argument also associates public ownership with low effort levels. The idea is that, although members of the public who constitute the shareholders in public enterprises have a direct interest in the way in which these enterprises are managed, yet the cost of effecting any changes in the enterprise by any individual, which will first involve the acquisition of information, will be much greater than any personal benefits the individual may derive; privatization would thereby enhance efficiency by providing a strong motive for management to perform well[19].

There have also been cruder arguments against State intervention, mainly arising out of the ideological impact of the ascension of powerful conservative regimes in the U.S., U.K. and to a lesser extent in parts of Europe. Referred to as the "New Right", they argue that State intervention, especially in the form of public enterprises, is responsible for the relative

17 Mitchell, 1988; Dearlove, J., "Economists on the State", *IDS Bulletin*, 18, 3.

18 Little, I.M.D., *Economic Development*, New York, Basic Books, 1982.

19 Cook, P. and Kirkpatrick, C., 1986; Vavouras, I.S., "The Theory of Public Enterprises Restated", *Annals of Public and Co-operative Economy*, 59, 3, July-Sept., 1988.

economic decline in countries like the U.K., and that it arose largely out of the desire of politicians to bribe their constituencies. They reemphasize the political heritage of Adam Smith and John Stuart Mill as the more useful models of economic and social organization[20].

The implication of these arguments is to call for divestiture or privatization of public enterprises and a general review of the scope for State intervention. While the more intellectually serious arguments would argue in favour of a range of policies, from changes in ownership, to various forms of reform, decontrol and liberalization, the more overtly ideological approaches argue for more comprehensive and far-reaching reductions in income tax and welfare programs, wholesale privatization in all sectors, restriction or elimination of union power as a restraint on the operation of the market mechanism, and the promotion of widespread share ownership in the society.

The reduction of budgetary deficits and cuts in public sector borrowing have been other arguments for privatization.

The Dirigiste Response

The response to these arguments have also been varied. The arguments of the New Right approach are particularly vulnerable. Since the time of Karl Polanyi, it has been recognized that there is nothing natural, inevitable or spontaneous about *laissez faire*, or the unfettered market mechanism. Even during earlier, more competitive stages of capitalism, measures like social legislation, factory laws, unemployment insurance and trade unions have arisen to protect labour from the effects of *laissez faire*; land laws and agrarian tariffs have conditioned the exploitation of resources; central banking and management of the monetary system have been developed to control the issue of money and credit creation. "The road to the free market was opened and kept open by an enormous increase in centrally organized and controlled interventionism"[21]. Any calls for a reversion to some previous *laissez faire* ideal models, cannot therefore, at the intellectual level, be regarded as serious.

Others, notably, J. Xirinachs, have argued, in a direct response to the anti-dirigists that there is still a case for ISI and State intervention. One line of argument is that, even for the NICs, the State has played a crucial role in their strategy, and that the avowed success of their export promotion strategy was possible only because of the tremendous effects of a previous, and in many instances co-existing, import substitution strategy[22].

20 Wiltshire, 1987.

21 Polanyi, 1944, p. 140, Mjoset and Buhlin, 1985.

22 This argument has been imputed from Smith, S. and Sender, J., *The Development of Capitalism in Africa*, London, Methuen, 1986.

Datta-Chauduri, using the Korean example, has provided a strong case for this kind of argument. According to him, the bold step taken by the Korean government after 1949 to make a far-reaching redistribution of land was quite decisive in breaking the power of landlords, which had checked the emergence of the industrial bourgeoisie. The introduction of the Import-Export Bank, an export insurance and subsidy scheme, a system of tariff exemptions on raw material imports for export products, and a credit fund designed to finance up to 7% of export production costs were all initiated and implemented by the Korean government. When Park Chung Hee came to power in 1961, government intervention in the economy became even more central, with the taking over of the commanding heights of the economy, the forging of closer links between the State and private entrepreneurs, and the implementation of an effective regulatory mechanism for resource allocation in pre-defined directions[23].

Furthermore, the success of the NICs has been attributed to the changing international situation, which enabled an enhanced access to markets in the advanced capitalist countries due to expansion of world trade, increased access to international finance, and the increased relocation of production by MNCs in the developing countries. The NICs benefitted most from these developments due to the accumulation of technical infrastructure, which was made possible by the preceding period of ISI; the existence of pro-Western dictatorships, extensive State involvement with industrialization and the special relationship between them and the U.S.[24]. Besides, the results of a number of empirical studies on public enterprises in a number of countries has cast serious doubts on the assertion that they have been uniformly inefficient and ineffective[25].

Similarly, others have defended the main thrust of the initial structuralist argument against the prevailing neo-classical orthodoxy, while recognizing

23 Datta Chauduri, M. K., "Industrialization and Foreign Trade: The Development Experiences of South Korea and the Philippines" in Lee, op. cit., 1981.

24 Bienefeld, M., and Godfrey, M., (eds.), *The Struggle for Development: National Strategies in an International Context*, London, John Wiley, 1982.

25 See Gantt, A.H., and Dutto, G., Financial Performance of Government-Owned Corporations in Less Developed Countries", *IMF Staff Papers*, 15, 1968; Tyler, W.G., "Technical Efficiency in Production in a Developing Country: An Empirical Examination of the Brazilian Plastic and Steel Industries, *Oxford Economic Papers*, 31, 3, 1979; Trebat, T. J., *Brazil's State-Owned Enterprises: A Case Study of the State as Entrepreneur*, Cambridge, Cambridge University Press, 1983; Killick, T., "The Role of the Public Sector in the Industrialization of African Countries", *Industry and Development*, 7, 1983; Kirkpatrick, C.H., et. al., *Industrial Structure and Policy in Developing Countries*, London, Allen and Unwin; Saulniers, A.H., "Public Enterprises in Latin America: A New Look?", *ILAS Technical Paper Series*, 44, 1985.

that the implementation of the ISI in practice has either revealed important gaps in conception, or has generated other, not entirely foreseeable sets of problems. For example, three decades of ISI in Latin America, in spite of some successes, has failed to tackle, or has worsened balance of payments problems, unemployment and poverty, and has achieved only modest transformations in technology[26]. What is needed, therefore, is not a reversion to market forces, whose limitations have been convincingly demonstrated, but to a neo-structuralist paradigm, which recognizes and addresses the shortcomings of the structuralist paradigm and the ISI strategy that had been built around it.

It has also been argued that distortions in LDCs arise due to both State intervention and market imperfections. To make a case against import substitution alone, is to ignore the other source of distortions, and even if all State intervention is rolled back, according to the second-best welfare theory, there is no guarantee that welfare gains can be achieved, as long as there are distortions in other sectors[27]. And the argument that State intervention causes a greater loss of welfare than the loss in market failure it sought to correct, cannot be sustained in the abstract. Secondly, to ensure that the decisions taken under the free market today will bring about an intertemporally efficient allocation of investments, a perfect future market and perfect foresight must be assumed. But these assumptions clearly do not apply in the real world, and private agents must therefore base their decisions on a combination of past trends, patterns, and future extrapolations. In LDCs, where information is especially inadequate, institutional arrangements poor, long-term extrapolation especially unreliable, even hazardous, the decision of private economic agents may be very short-sighted, hence providing a case for government to stimulate investments in sectors important to the future. Hence there is a clear case for the State in LDCs to undertake socially desirable, long gestation projects, especially those associated with technological innovations, and which are critical to development. This of course does not derogate from its responsibility in the meantime, for improving institutional arrangements.

Another case for State intervention rests on the economies of scale argument, in which the State intervenes to avert private monopolies, or where the level of investment is beyond the capacity of the private sector.

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26 Rosales, O., op. cit.; French-Davis, R., "An Outline of A Neo-Structuralist Approach, *Cepal Review*, 34, 1988.

27 These kinds of arguments have been developed and discussed extensively in J. Xirinachs; *Re-asserting the Case for State Intervention: A Theoretical Critique of the Free Market Views on Economic Incentives and Development Strategy*, University of Costa Rica, February, 1985.

This argument has however been applied as a case for government ownership of infrastructural services rather than manufacturing industries.

The Hirschman linkages argument also still retains much validity. This is because the objections to it on the grounds that it generates capital-intensity is not founded on any theoretical grounds, so it is a matter for empirical validation. Secondly, if private monopolies occupy industries with substantial linkages, the distortion from this market power will in fact be transmitted to other related industries, and this provides a case for State intervention in production. It may be objected, *à la* Corden, that a suitable system of incentives can be provided to private agents in order to realize these linkages, without the additional distortive effects of State intervention. We will examine this argument shortly.

Another ground on which State intervention is justified in economic theory is the existence of externalities, in which private firms cause pollution for example or create externalities through staff training, but do not recoup the resulting benefits. Here again, it is often objected that the proper policy measure is not State intervention in production, but a system of taxes and subsidies.

The "discovery" by public choice theorists, that the State consists of different interest groups capable of acting together in common areas, and competing in other areas, may be new to neo-classical economics, but is really a regurgitation of the Marxist theoretical framework, and does not make an unambiguous case for the market. It reminds us that the State may not be acting in the interests of a commonwealth, but the market also acts to produce outcomes that are certainly not representative of "common" welfare.

The notion that the public sector is inherently less efficient, which is tied up with the property rights argument, cannot withstand a close examination. This is because of the well-known managerial utility functions which arose in the context of the separation of ownership from control in the modern private enterprise, which was for example extensively discussed by Galbraith[28], and which indicated that management in private enterprises could pursue goals different from the objectives of shareholders. And even in private enterprises, there are important limitations on the ability of individual shareholders, especially small-scale shareholders, to acquire the necessary information and exert sufficient influence on decision-making in private enterprises.

As far as the Corden-type argument for taxes, subsidies and administrative regulation as a more efficient response to monopoly, externalities, rigidities, factor market imperfections and other forms of

28 1972.

market failure is concerned, the problem is that all these administrative measures are also likely to suffer from inefficient administration. As Corden has himself acknowledged, the whole analysis of the use of non-distortionary subsidies rests on the assumption of a limitless availability of lump-sum taxes to finance the subsidies. It is not only that politics and poverty provide real and effective limits to revenue from lump-sum taxes in LDCs, but the efficiency and cost of collecting these taxes are also important factors. In most sub-Saharan African countries, it is possible to implement lump-sum taxes through levies on wage earners in the public and private sectors, on land-holding peasants, on market women, and on large-scale firms, relatively efficiently, using the existing administrative infrastructure. It is however much more difficult to tax petty traders, shopkeepers, landless peasants, service sector employees and entrepreneurs, and small-scale manufacturing and craft workers. It will require a substantial expansion of the administrative mechanism to locate these categories of people physically, and then to tax them efficiently. It is well known that a substantial proportion of income tax in many LDCs due from these groups is never collected. Moreover, it is on the implementation of effective and efficient subsidy policies that the greatest difficulties would be encountered. Subsidy schemes for fertilizers, irrigation equipment and farm implements, fuel, bread, rice, etc., have encountered enormous problems and incurred substantial costs due to the shortage of infrastructure, inefficient implementation, corruption and smuggling. The whole argument about the bureaucratic ineptitude and inefficiency of government is a misleading one. The government is called upon to abandon administrative controls under ISI, and instead to concentrate more on the use of tariffs, subsidies, taxes and incentives, which rely more on the market mechanism. But all these methods rely heavily on the administrative and managerial capacity of the State, and would flounder if ineffectively or inefficiently administered. In other words, the implication of such recommendations is the substitution of some forms of state intervention with others. Unless there is clear evidence to indicate that those forms of intervention being advocated are less likely to suffer from inefficient administration, or the consequences of their being poorly implemented on the rest of the economy are less serious, then there is no general case for the more market-oriented strategies. Intuitively, states which possess the financial, political and technocratic capacity to effectively implement the market strategies would also be able to intervene and operate public enterprises more effectively.

The implication of this argument is that it cannot be assumed, *a priori*, that more market-oriented approaches in LDCs will be more efficient and less prone to by-product distortions. In other words, although State intervention in production requires additional costs of acquisition of information and processing, and may generate managerial and operational inefficiencies, it is also true that systems of taxes, incentives, subsidies, etc., would entail administrative costs and will also be threatened by inefficiency. Which of the two is more costly and inefficient, and which will result in greater loss in economic welfare, cannot be settled on an *a priori* basis.

Corden has also pointed out that his analysis ignores the issue of income distribution, or assumes that it is at a desirable level from a social point of view. Apart from the fact that the income distribution in most LDCs would be considered grossly inappropriate by most measures, the lump-sum tax itself, because of the tendency to simplify the administrative difficulties involved in its collection, tends to be regressive, thereby worsening income distribution.

The Radical and Political Economy Approaches

The starting point for radical and Marxist analyses is that the State serves the interests of dominant classes, and is a crucial agent for private accumulation, especially in the underdeveloped countries. Much of the debate concerns itself with arguments on the particular patterns of class formation, the existence of the bourgeoisie and its sub-categories; comprador, national, commercial, managerial, etc., and which fractions have a greater grip on the State. Other important issues are the particular role and significance of international capital, whether the State is "soft", underdeveloped or overdeveloped the organization, strength, struggles and impacts of the dominated classes, etc.

Those who have focussed on the "soft" State in Africa (following Myrdal), argue that it is deeply affected by particularistic interest groups, and lacks autonomy from them, and that this leads to the ineffectiveness and inefficiency of the State. A transformation of this lack of autonomy may need to await the emergence and consolidation of entrepreneurs and modern professional associations[29]. A similar version of this approach perceives the State as a passive object of a predatory elite group which functions according to ethnic patron-client relationships; a relationship which completely overshadows class relations. It plunders the State for personal accumulation, and thus renders it ineffective and inefficient in pursuing genuine development goals[30]. In a similar vein, Hyden argues that the state in Africa is being assailed by various demands from particularistic interest groups, thus inducing "the economy of affection", in which clan, ethnic and regional loyalties and politics subvert the effectiveness of bureaucracy. For

29 Booth, D., "Alternatives in the Restructuring of State-Society Relations: Research Issues for Tropical Africa", in *The Development State in Retreat*? IDS/EADI Workshop, IDS, 1987; Joseph, R., "Class, State, and Prebendal Politics in Nigeria", *Journal of Commonwealth and Comparative Politics*, 21, 31, 1983.

30 Joseph, R., Ibid.

him, the only solution is liberalization and an increased role for the market, which will generate the emergence of constituencies with a powerful and vested interest in the consolidation of the market, which will in turn work against the primordial functioning of the State, usher market discipline, etc[31].

Others have contended that the State is primarily controlled by an alliance of the domestic comprador bourgeoisie and foreign capital; they explicitly or implicitly attributed the weaknesses of the State to the weakness or absence of a domestic national bourgeoisie. This is again used to explain the corruption, inefficiency and mismanagement that has become pervasive in so many African countries[32].

A critique of this approach instead emphasized the facilitating role of the State in the emergence and consolidation of the bourgeoisie in Africa through trade policies, direct investment in manufacturing and infrastructure, allocation of foreign exchange, licences, credit and other facilities, and a general expansion of the State sector[33]. A similar position was taken by Beckman, who argued that the State, as a "transnational project", is in fact busily promoting capitalist development, its actions determined not only by the relative impact of various fractions of the domestic bourgeoisie and international capital, but also influenced by the struggles of various segments of the oppressed classes[34].

Specifically referring to State institutions like parastatals, Sobhan argued that the extent of State intervention and its effectiveness is largely determined by the circumstances of the transition to independence and the relative strengths of the national, comprador, international and petty bourgeoisie, as well as that of the masses. Where a peaceful transition from the colonial power to a domestic bourgeoisie with extensive investments in the economy occurs, Public Enterprises (PEs) would occupy an important but not dominant position, and will be used effectively to facilitate private accumulation by the bourgeoisie. The effectiveness and efficiency of PEs will also be higher where the political system is decisively dominated by either the national bourgeoisie or the masses, but lower when there is a close contest for power[35].

Collins on the other hand, sought to explain the State and state action in West Africa as an outcome, not only of class forces, but also of complex

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31 Hyden, 1983.
32 Dutkiewicz and Williams, 1983; Forrest, 1982; Osoba, 1978; Usman, 1984; Turner, 1980.
33 Sender, J. and Smith, S., op. cit.
34 Beckman, B., 1982, 1983, 1985.
35 Sobhan, R., "Public Enterprises and the Nature of the State", *Development and Change*, 10, 1, 1979.

combinations of ethnic, regional and sectional factors. Thus the State sometimes supports domestic capital, or some fractions of it, and sometimes foreign capital; specific analyses of specific periods and actions are required to provide a sharp understanding of the State[36].

While the discussion in this tradition has been principally concerned with developing a clear and coherent theoretical and analytical framework for understanding the State and its intervention, its dimensions, its success or failure, much less attention has been devoted to addressing the contemporary debate of the State versus the market in the context of Africa. This is partly because some tend to regard State investments as eminently progressive, as injurious to private accumulation, as a move away from capitalism, and a paving a way for a transition to a more egalitarian and possibly socialist society. They therefore tend to vigorously support public enterprises and to argue for an expansion rather than diminution of the public sector[37]. However, this approach cannot go far because it simply ignores some of the theoretical and empirical contributions made in the context of the anti-intervention debates. On the other hand, when the inefficiency, mismanagement and ineffectiveness of State institutions are discussed, as in some of the approaches above, there is a tendency to argue that only a revolutionary transformation of the State can solve the problem[38], or simply to shrug it off on the grounds that the private sector in these countries is no better[39]. But the real and immediate alternative facing most of these countries is between various kinds of State intervention and various forms of the market mechanism, rather than between capitalism and socialism. Alternatively, it is argued either directly or indirectly that both the public and private enterprises in capitalist societies are instruments through which private accumulation is facilitated anyway. Even if public enterprises are inefficient and corrupt, and fail to carry out their objectives, it may only mean that various kinds of contractors, consultants, suppliers and bureaucrats will benefit from such inefficiency, and enhance their own private accumulation. So either way, accumulation goes on, especially if it is the case that such private appropriation or misappropriation results in increased private investment. But this approach ignores the basic premise that public enterprises, at least theoretically, fulfill important functions for capitalism at particular moments in its development, which cannot be

36 Collins, 1977.
37 Idris, 1986.
38 Toyo, 1984.
39 Dahiru, 1987.

performed by private capital[40]. These functions are similar to those discussed in the context of the neo-classical model, i.e., the establishment of infrastructure, generating linkages, technological development and research, inducing appropriate technologies, educating and training the workforce, and the provision of certain aspects of social amenities and provisions so as to try and ensure system stability. These functions are necessary for private accumulation, and yet cannot be provided, except by accident, by private capital. Thus the appropriation of the resources of public enterprises by private agents, even if invested, will not substitute for these functions. An appraisal of the performance of the State, especially of State enterprises, whatever else it includes, should therefore include measures which will examine its success in performing these wider functions. A re-evaluation of the frontiers of State intervention vis-a-vis the market should hence be based on the outcome of such analyses.

Conclusion

The theoretical and empirical studies of the last few decades, have clearly made a case for the thorough re-examination of the ISI strategies, have discredited many of the blunt administrative measures used, and have highlighted important difficulties with various forms of State intervention and public enterprises. They clearly reveal that a lot of generalizations and *ad hoc, a priori* judgements on the efficiency and effectiveness of the State are fundamentally flawed. In particular, ISI and State intervention have tended to focus on medium and long-term objectives; in the meantime, important macro and micro-economic issues have tended to be neglected. For example, it is generally true that tariff levels have been too high, too differentiated, and along with quotas and quantitative restrictions, have remained in place for too long. This has led to the emergence of inefficient firms within tariff walls which, by virtue of their monopoly power, have been able to realize substantial profits, and have little incentive for cost reduction, technological innovation, quality control, etc. Both private and public enterprises have been affected by this problem. Secondly, ISI strategies have in many cases, led to considerable currency overvaluation, weakening of non-oil primary export sectors, and along with spiralling costs of intermediate and capital inputs, have caused serious balance of payments difficulties. Also, the problems of control of money supply, effective rates of protection, real interest rates, have not been sufficiently addressed within the context of the strategy. Issues concerning efficiency, productivity, and

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40 The importance of this point is not diminished by the fact that in practice, particular State owned enterprises at particular times, may be established for all kinds of objectives which may only be partially connected with this theoretical function.

general economic and financial performance of public enterprises, have been glossed over. The neglect of these issues have had serious short and long-term implications for both ISI strategies and State enterprises, and on the efficacy of State intervention in general. However, these are general tendencies. It is important to realize that problems and distortions have manifested themselves in different ways, and to different degrees in different contexts. As is evident from the theoretical arguments within both the neo-classical and radical paradigms, the necessity for conducting concrete analyses of specific forms of State intervention in specified settings, as a pre-requisite for finding realistic means of addressing these problems cannot be overemphasized.

The more enlightened attack on State intervention would still recognize the validity of a large part of the traditional case for State intervention, such as imperfect or asymmetrical market for information, lack of a future market, the presence of externalities, public goods, merit goods, etc. Besides these, the case for State intervention for macro-economic policies on issues like investment, unemployment, inflation, money supply and credit system, etc. have never been substantially dented by the advocates of the market mechanism.

Overall therefore, there is still a strong case for State intervention, especially in the context of developing countries. In pursuing interventionist policies however, a number of important critiques and difficulties have to be reckoned with.