THE ROLE OF THE STATE AND THE PRIVATE SECTOR UNDER ECONOMIC LIBERALIZATION (THEORETICAL PERSPECTIVES)

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1. INTRODUCTION

The leading role of the state, i.e., regulation and control of the economy, was regarded as a natural and necessary ingredient in the development process. Such a strong belief, particularly in countries with socialist inclination, further led in the nationalization of private enterprises and expansion of state owned production and distribution enterprises. Regulation and control of markets - the commodity, factor, capital and money markets - were pursued as essential measures in promoting social welfare as well as accelerate economic growth.

However, the second half of the 70s and early 80s have witnessed a major disillusionment with the state as an economic agent. Following the first and second oil price shocks of the 70s several developments hard hit the fragile developing economies. Among these are: world economic recession, record high interest rates, a steep decline in the real prices of primary commodities that further deteriorated the terms of trade for primary commodities and mounting foreign debt burden.

These were accompanied by internal economic mismanagement and political instability that led to the worsening of the economic performance of most developing countries. Furthermore, the communist economies in Eastern Europe began to disintegrate.

These crises gave the opportunity for the resurrection of the advocates of 'private interest' and free market principles. Neoclassical paradigm preached that the operation of a free market system would ultimately lead to general prosperity for all participating countries. Economists of this school attacked the idea that government is a benevolent and rational agent; that the domestic market is superior to exports; and, that self-sufficiency is preferable to interdependence. They questioned the very idea of conscious long-term direction of the economy by the government. They contend that no matter how well it is organized and competent, government could not be better than the market.

In line with this, a program of economic liberalization, the Structural Adjustment Program (SAP) with a neoclassical spirit, to heal the ailing economies of developing countries was designed. And many developing countries adopted it.

However, the theoretical underpinnings of pro-market mainstream economic thought are not sound enough. Likewise, SAP has not succeeded in contracting state economic activities. Still the argument for the active role of the state in economic activities remains valid.

intended effect of a fiscal stimulus. Hence government intervention using this instrument has little importance.

v) **Treatment of Unemployment**: The labor market is seen as clearing almost instantaneously through movement of wages and prices. The remaining unemployment is regarded as voluntary, i.e., 'the natural-rate unemployment'. So contrary to Keynesian position, unemployment cannot be reduced by demand expansion. The implication is that economy wide demand management policies, particularly those affecting the labor market, could not be effective.

2.2 Other Theoretical Influences

Development of other related theories have also contributed towards the growing scepticism of the virtue of interventionism. Some of these include:

i) **Theories of directly unproductive profit and rent seeking**: Businessmen may try to persuade governments: to provide protection against competition, restrict import licenses (to enable them earn scarcity rent), provide them with subsidy. These activities contribute nothing to output. So rent seeking and DUPs are regarded as additional costs of actual or potential policy interventions and a further reason, therefore, why intervention in the face of a market failure may worsen rather than improve the situation.

ii) **Efficiency-equity trade-off**: Since costless, distortion free taxes (as lump-sum taxes) and subsidies are invariably not available to the government, policies which redistribute income (as progressive taxation) will necessitate departure from Pareto optimality, thus creating a trade-off between efficiency and equality. In other words the measure itself introduces new 'distortions' by affecting relative prices and incentives.

iii) **'Contestable' markets theory** argues that "while there may not be competition *within* a given product market there may be competition for that market, and that the possibility of new entrants is itself a constraint on the exercise of monopoly power". The essential condition is freedom of entry (and exit) to the market. So a monopoly exists if only this freedom does not exist, which implies that state anti-monopoly measures may not be needed as long as liberalized international trade and investment policies are pursued.

(iv) **The theory of 'public choice' and the 'predatory state'**: Public Choice theory (see Bates, 1981) argues that the general presumption that the state is benign in its intentions, acting on behalf of the public to maximise social welfare is naive; rather government, composed of politicians and bureaucrats, acts to serve its own interest.

The 'predatory state' using its legal monopoly resorts to violence to maximise its interest at the expense of public interest. In predatory-type situations "the state's appetite for revenues will tend

3.1 Theoretical Inadequacy

i) **Inconsistency between unemployment and instantaneous market clearing**: The validity of 'natural-rate' theory of unemployment (stating that very high unemployment rate could be natural) is viewed with scepticism. The difficulty to explain the inconsistency between the extreme assumptions of instantaneous market clearing and the observed high unemployment rate seems to be a fundamental neoclassical theoretical pitfall.

ii) **Unrealistic long-term expectation**: The bold but unrealistic assumption of the theory of rational expectation, i.e., the ability of individuals to assess economic phenomena ahead of time and thereby act accordingly is highly doubtful and has little practical value.

iii) **Lack of empirical evidence on 'government impotency'**: Attempts to prove government's impotence in macro management, for instance, the ineffectiveness of monetary policies, as this could be neutralized by the simultaneous stabilizing action of the private sector, does not seem to have much empirical support. Investigation to show the " impotence of government policy because of completely off setting behaviour by private agents (complete crowding out) are no longer regarded as successful, or even helpful.. Models which modify the **RE** and **NCM** assumptions, while retaining many other features, suggest there is scope for active government macro management" (Killick, p.22)

iv) **Implausible assumption of 'contestable markets' theory**: In the theory of 'contestable markets' too, extremely demanding conditions, including the complete absence of any legal, cost /sunk cost/ and other constraints must be satisfied for a market to be perfectly contestable. However, such conditions can hardly be satisfied in the real world. Hence in practice, anti-monopoly intervention is not reduced significantly.

v) **Inconclusive evidence for the relative efficiency of markets**: Another key issue is the relative efficiency of markets than state interventions, "... the evidence comparing the performance of private and public enterprises is far from uniformly in favour of the former; and the chief conclusion of analyses of the policy of privatisation or divestiture is that the degree of competition in an industry is a more important determinant of the economic and social efficiency of an enterprise than the nature of its ownership" (Killick, p27). And the development strategies of most successful economies in Asia as in South Korea, Taiwan, Singapore, etc., (even Japan) can hardly be examples for a free-market economy.

3.2 Lack of Relevancy

Further, the theoretical development in mainstream economics is primarily meant for the analysis of industrialized economies. It is wise to be cautious about policy advices to developing countries drawn on such theoretical grounds that may not be relevant to the socio-economic conditions of as the government? etc; that are less relevant in many developing countries characterised chiefly with structural constraints and rigidities.

The concerns of mainstream economics, include, inter alia, "the reassertion of the superiority of market allocations; rejection of Keynesian approaches and attempts to substitute monetarist solutions; a shift from distributional to efficiency priorities; and from a positive to a negative view of liberty" (Killick, p.38). The issues of positive versus negative liberty, of allocative efficiency versus distributional objectives, and individual versus social welfare are crucial in the choice of policy objectives in developing countries. Thus, policy prescriptions which fit well some industrial economies may be inconsistent with the social objectives in many developing countries.

3.3 Market Failure

The concept of 'market failure' reasserts the need for government intervention and refutes the view that most economic distortions are the result of such interventions. Market failure with respect to the three components of the price mechanism, i.e, the signalling, response and mobility can be seen both in their allocative as well as creative functions (Arndt, pp.219-222).

i) **Lack of Competition**: competition is the prime mover of the market. In the absence of effective competition economic activities in a free market result in monopoly situation, hence generating inefficient outcome. Quantity produced could be lower, and the profit maximizing price charged by the monopolist will be higher than the costs of production.

ii) **Provision of Public Goods**: As the driving force of private economic activities is profitability, the existence of certain desirable goods and services that could not be made profitable, such as defence, national security, etc., better known as 'public goods', would not be supplied by the private market.

iii) **Externalities**: Externalities are 'spillovers' created by economic activities that are not appropriable by or collectible from the producer. Since such external benefits or costs do not enter the calculations upon which production decisions are based, the market will produce either too little, where the externalities are net benefits (as education) or too much, where they are (net) costs (as pollution) compared with socially efficient output level. In this regard the market is inefficient.

iv) **Incomplete and Segmented Markets**: Markets being incomplete fail to produce (or produce inadequately) goods and services that people desire even though they would be willing to pay more than the costs of production. Common examples are various kinds of insurance and capital markets. Banks do not provide loans for activities regarded as state direct participation in the socio-economic activities and indirect intervention through policy instruments. Let us consider these issues further.

4.1 Direct Participation in Economic Activities

One form of intervention is the direct involvement of the state in production, distribution, and other services. This has two interrelated aspects: economic sectors in which state direct participation is regarded desirable and the extent/degree of participation. Perhaps, it might be ideal to consider the view of the World Bank (an organization essentially of neoclassical origin, but with some pragmatic inclination) on this.

The World Bank defines priority areas of economic activity for state involvement based on comparative advantage. Accordingly "the public goods that only the public sector can effectively provide which include defence, diplomacy, macroeconomic management, and a legal and institutional system that defines and enforces the rules of justice, property and commerce" are regarded as first priority areas. The second priority areas are the provision of "social, physical and information infrastructure: education, health, transport networks, public utilities, technology development and dissemination, and environmental protection" (WDR, 1988, p.52). Market failures are believed to be common in these areas.

Elsewhere, the report argues, government performance is inferior both on equity and efficiency criteria. So in all other activities, namely agriculture, mining, industry, energy, transportation, trade, financial and other services, the cost of government intervention outweigh potential benefits. So apart from the two priority areas government has to pull out of all other activities regarded as the domain of the private sector.

To the same effect Stern argues that "from the point of view of income distribution and protection, governments ought to be active in social services. From the point of view of rights, they ought to be active in education and health. From the point of view of market failure, they ought to be active in infrastructure, in roads, power, and so on. Where government should not be active - because non of these arguments apply - is in private production of hair pins, motor cycles, motor cars, and the like" (Stern, p.429).

So the interest is to banish the state from direct production, distribution, and financial sectors. But the assertion that the state is relatively inefficient in these activities is rather without proof. As discussed earlier the issue that the private sector is relatively more efficient is inconclusive. Theoretically, with the prevalence of a competitive market, a public sector enterprise, allowed fully to operate competitively in the market is likely to perform as efficient as the corresponding private sector enterprise in that same market. A study by Milward concludes that "there is no evidence of a statistically satisfactory kind to suggest that public enterprises in ldcs have a lower level of technical efficiency than private firms operating at the same scale of operation" (see Milward, R. in Cook & Kirkpatrick, (eds) as quoted in Israel 1990, p.7)). Other studies in always be the most important factor. Often the main issue is the existence of a competitive market rather than private ownership" (Israel, A, 1990, p6).

Of course, the state can and should pass regulations (as anti-trust, prevention of collusion or monopoly, etc) to create a competitive environment. However, in undeveloped markets its effectiveness is highly limited. The state needs to stay, and even expand, in the specific trade/sector where competitive operation is lacking. Conversely the state can afford to pull out of areas where competitiveness seem to thrive.

Related to this is identifying the sector or subsector the state may give more emphasis. On the one hand even in a sort of monopolistic situation, the state may not necessarily stay in the trade producing or distributing luxury items often meant for the consumption of the better-off minority group; on the other hand even in a fairly competitive market, the state may be involved in providing goods and services essential for the majority of the population to ensure a reliable provision from the point of view of welfare and development.

4.2 Policy Oriented Intervention

The other form of state intervention, apart from direct involvement in the process of production and distribution, is through policy instruments. This can be categorized into two:

* *institutional*: policies of discretionary control and restrictions
* *market oriented*: policies working through markets

As explained in the previous chapters, these two approaches underlie the main difference, from theoretical as well as practical point of view, between market pessimists and market optimists. In this section, the theoretical arguments provided in the preceding chapters are supplemented with experiences from different countries.

From neoclassical perspective, institutional oriented policies, ie, policies of direct control and restrictions, along with direct state involvement, are regarded as the root causes of the abysmal economic performance of most developing countries. So strong is the conviction of neoclassical adherents that:

> ...if, and only if they (market principles) are free to operate will industrial expansion succeed, that any departure from them, whether in theory or in practice, tends to be discredited, dismissed, disregarded, or disbelieved. If industrial expansion succeeds, success is typically interpreted as being a validation of market principles and the institutions financially supporting them. If it fails, failure is seen as the result of the violation of market principles, perpetrated by perverse institutions" (Amsden, A. 1989, p.139).

and from where, was also imposed. "In 1984, after successive waves of much advertised trade liberalization, over 50% of Taiwan's imports by value were still covered by quantitative restrictions of one kind or another" (Wade, R. p.254). Selective products were also offered fiscal incentives ranging from tax holidays to accelerated depreciation allowances. Taiwan also had selective credit controls - concessionary export financing and strategic industry loan - as well as selective sectoral allocation of foreign exchange.

In these countries governments heavily relied on discretionary controls to urge and encourage enterprises to take risks that would accelerate national development. Thus, from the perspective of national economic development, government-directed regulation using a package of non-neoclassical instruments, as export targets, import-protection, discretionary tax and credit subsidies, selective foreign exchange control and allocation, etc, proved to be a success.

On the other hand, as noted above, success stories, as in Hong Kong, that predominantly employed market oriented policies with little government intervention are also recorded. It is said that in Hong Kong even central banking functions are handled by the private sector.

Where does all this lead us? Policies of discretionary control and restrictions by governments are not distractive; market oriented policies are not altogether impotent. The choice between 'market' or 'control' is a doctrinaire one. An important decision is choosing a *particular instrument is more effective to achieve a specific target in a given sector or subsector of a particular economy.*

Some Important Measures of the State

In light of the above account on the issues regarding the direct and indirect state intervention in economic activities, some of the important measures that the state may implement can be highlighted.

Develop a clear cut policy framework for the effective operation of public enterprises

Given the political will of the state to allow the free play of public enterprises, a clear cut policy framework for more effective operation of enterprises that will remain in the public sector, in terms of objectives, degree of autonomy, accountability, etc, should be outlined. For a significant improvement in productivity of public enterprises political intervention should be minimized.

Create 'positive distortions'

To promote particular groups of economic activities, 'distortionary' policies may be appropriate. This could be oriented towards export, production or distribution in selective sectors or sub-

Regarding the former, what is most important, as discussed earlier, is to create a competitive environment rather than as change in ownership. Privatization should be undertaken not on ideological ground, - dismantling the economic power of the government for private interest -but on the premise that it will be more beneficial in the long-run for the economy. Hence, the capacity of the private sector from the point of view of capital, organization, etc., need to be examined before privatization is underway.

On the part of the public sector, some enterprises may be directly sold to the private sector, some may be leased and others may take other forms of partial privatization. Enterprises may require restructuring and/or be down-sized. The pricing and method of financing has to be worked out. All these aspects of the process require time and skill. Hence the shock treatment, i.e., the rush for privatization, unless meant for immediate revenue gain, may not produce the desired long term benefit to society.

The capacity and mechanism to monitor and regulate privatized units must be in place to ensure that the expected efficiency gain from privatization will materialize.

Conduct an effective dialogue with the private sector

Dialogue is to create a convergence (or consensus) in the activities of the state and the private sector towards the common goal of economic development. This requires understanding and appreciating the development objectives in time perspective, on the part of the private sector. The medium to long-term orientation helps the private sector to align its interest to that of the national interest. In the short term, this is particularly crucial when it comes to an economy with large peasant household sector. The dialogue should be oriented towards exchange of information and points of views, understanding the demand of the private sector, making explicit the intention and capability of the state, etc., such that the end result produces a reinforcement in the production and distribution activities as well as help to alleviate constraints associated in these activities. In general, private enterprises are willing to take risks if uncertainties are minimized. States' assurance of private enterprises that its actions are predictable, open and systematic reduces uncertainties such that private entrepreneurs would be encouraged to undertake risk involving projects.

In practice this is quite challenging. It demands the setting-up of a professional decision making core group or nerve centre and other sub-groups down the line that will keep a close contact and discuss with the private sector at different stages. It also requires a corresponding organized group of the private sector. It is fairly easy to organize private agents in the modern sector of the economy, for instance chamber of commerce, but not so easy when it comes to organize small and scattered individual agents like peasants, handicraft workers, etc., which requires a close assistance of the state, perhaps through agricultural extension workers, non-government organizations, etc.

materialized over a period of a year despite the issuance of investment licenses worth over three billions of birr. An attitude of wait-and-see seems to prevail on the part of private investors.

It is thus of utmost importance to appreciate that in a country such as Ethiopia, where the majority of the population, irrespective of nationalities or ethnic group, is languishing in chronic poverty development requires a central government devoted more to national causes and national economic development. To this end, central government should retain greater economic power that could enable it design and implement policies towards a balanced economic growth and regional economic integration.

In Ethiopia public interest largely coincides with private interest. With the overwhelming majority of the population being engaged in agricultural activities, national economic development necessitates the development of this sector. It is only the transformation of agriculture and thereby the significant improvement in the living standard of the rural society that could herald an internally dynamic economic development in this country. Thus if public interest is means the interest of the majority, then the only avenue to industrialization is development from the grass root, which implies that the best alternative for the state is to rally behind the rural society with an all out support, in every walk of life, intervening with conscious discretionary as well as non-discretionary policies. In this respect the role of the state and of the private sector would be inevitably reinforcing.

The markets in this sector are not only imperfect and could work adversely, but also missing - non-existent - in many cases and hence require state intervention for the improvement and expansion of the private sector itself.

6. CONCLUSION

Both theoretical debates and experience of countries regarding the role of the state and the private sector point to one direction. The issue is not one of a choice between government or market. "...the choice can not be dichotomized ... as a choice between relatively perfect governments and imperfect or inadequate markets ... or between relatively perfect markets and imperfect or inadequate governments. The choice in actuality is among imperfect markets, imperfect governments, and various combinations of the two" (Wolf, C.Jr., 1990). The choice concerns the degree to which markets and governments should determine the allocation, use and distribution of resources in the economy.

No country ever industrialized relying solely on market principles without state intervention. Even in Europe and North America protection had been the dominant strategy for industrialization since the early 19th century (see Roemer & Radelet, p60). In industrialized economies such as that of UK, France, etc., with well developed private sectors /markets/ a

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