MSSC (Economics) Programme - 2020
Micro Economics

State Market and People

An important attribute of successful economic policy making is a willingness to lean against a prevailing wind. Or to change the metaphor, when everyone is on the same bandwagon you can be sure that it is time for some of us to get off it. Research institutions were established to take a critical look at existing orthodoxies and create a forum where both advocates, and critics, could engage in honest and open debate. The hope is always that out of the clash between different schools of thought a better understanding of society would evolve so that economists are better able to prescribe remedies. Such was our experience during these last eight years with WIDER which from the outset strove to be a very broad church indeed, where economists of all persuasions-neo-classical, Keynesian, structuralist, and monetarist-, and other social scientists- anthropologists, historians, philosophers and political scientists- could find a ready home. The only condition was that they would talk to each other in civilized and tolerant fashion.

Our last research conference at WIDER was organized jointly with, and hosted by, the World Bank's Research Development in Washington D.C. on 6 February 1998. Its purpose was to discuss the constructive criticism provided by some of WIDER´s research network of the prevailing development orthodoxy being espoused by the World Bank's namely "market-friendly" policies, and it is on the issues in this debate that We would like to focus today. What is meant by "market – friendly" policies is a framework in which governments support rather than supplant markets-which in other words is friendly to, rather than hostile to, markets. This has been well summarized by World Bank economists as follows:

"Governments have done too much of the things that they cannot do well-regulating markets and producing goods and too little of the things they must do well-maintaining macro economic stability and making necessary public investments. Governments need to do less and do it better."

In other words, in the "market-friendly" policy framework, government intervention is to be confined, by and large, to the areas where markets typically fail i.e. in human development,-education, health, and social welfare, in essential public infrastructure, and recently after the Earth Summit in Rio, environmental protection. This would leave the bulk of the task of resource allocation to the private sector responding to market forces.

Now of itself this framework is not necessarily a bad thing, and under certain circumstances, it can produce spectacular growth results, as happened in Sri Lanka in the period immediately after 1977. I was privileged to be professionally involved in the design of that framework from my position in the Treasury at the time. Its major rationale then was that it was leaning against the prevailing dirigiste wind that had been blowing for some 3 decades. The problem with "market-friendly" policies and now speaking quite generally and not of Sri Lanka is not so much with the underlying conceptual framework, as with the manner of its implementation. The vehicle for implementation has been described as the Washington consensus on stabilization and

adjustment, a consensus common not only to the Bretton Woods institutions, the International Monetary Fund and World Bank, but to the various prestigious "think-tanks" strung along the Potomac river in Washington, hence the name. The Washington consensus involves five basic principles.

1. Budget balancing.
2. Relative prices correction; this involves getting major prices right, such as the exchange rate, typically a devaluation, and interest rates-typically an increase.
3. Trade and foreign investments liberalization; this involves the abolition of import controls, and progressive tariff reductions alongside an open door policy to foreign investment.
4. Privatization; this involves the elimination of state ownership of productive enterprises.
5. Domestic market deregulation.

Indeed, "market-friendly" policies may be defined as equivalent to implementing the Washington consensus, supplemented by government intervention in the areas of market failure already enumerated. This framework encounters two problems. In the first place, budget balancing within the Washington consensus can conflict with essential expenditure in areas where markets fail-on human development and public infrastructure etc., unless these activities are explicitly supported by foreign financing on an adequate scale, The second problem is that it appears to conflict in crucial respects with the implementation of the alternative policy framework that has underpinned the spectacular success of the East Asian Newly Industrializing Countries (NICS), following the pioneering example of Japan. We are referring, of course, to Korea and Taiwan, and the city states of Hong Kong and Singapore, whose example is in turn being followed by a second generation of aspirant NICS- Malaysia, Thailand and Indonesia.

"Market-friendly" policies and Budget Balancing

We propose to consider each of these problems in turn. To begin with the first problem, Dr. Gamani Corea at a recent paper, recalling Lenin's recipe for socialism-socialism equals electrification plus Soviets-presented his own equation for development which we found very attractive. Development, he said, equals skills plus infrastructure. Now both these are areas where markets typically fail, and they therefore require public investment. While the "market-friendly" framework, at the conceptual level, provides for the necessary public intervention, in practice the necessary expenditures have often had to be sacrificed in the interests of budget balancing, in the absence of supporting foreign finance. In the 1980s and 1990s, for example, conventional adjustment programmes called not for a single bout of budget balancing but for repeated bouts in the face of a continually deteriorating external environment. The typical sequence facing a developing country experiencing an external shock such as a fall in price of its staple export commodity, e.g. coffee or cocoa was, first, a sharp reduction in its export revenues; next, a vain attempt to maintain budgetary expenditures which are inflexible in the short-run, by printing the money; third, as reserves run out, a tightening of import controls with its attendant distortions, which if prolonged would lead to rapid inflation until sooner or later the country became compelled to negotiate a stabilization and adjustment programme with the Bretton Woods institutions. Given the stringencies

affecting external resources availability, the readiest way of restoring fiscal balance in such a programme was to sacrifice human development expenditure, and the adverse consequences of the policy have been explored by studies in UNCTAD, UNDP, UNICEF and UNU/WIDER. WIDER´s country study of Tanzania provides a good example of the difficulty. Under its adjustment program "expansion of education, health, and water facilities stopped despite increasing needs, as development expenditure was drastically cut."

In the joint WIDER symposium with the World Bank, Dr. Michael Bruno, former Governor of the Bank of Israel, and a distinguished member of the WIDER research network, made the point that public infrastructure investment was similarly vulnerable.

"*In the absence of a tax alternative, the pressure to balance the budget usually leads to expenditure cuts where the political opposition is least but the long-term economic cost is highest, namely investment in infrastructure (roads, communications). This is the one area in which government intervention is usually essential and the positive enterprise sector may be highest. There may be differences in the urgency of the problem in different countries, but there is a minimum requirement in each of the countries".*

It is not without significance from the stand-point of future reform that Dr. Bruno has recently been appointed as the Chief Economist of the World Bank, and Vice President in charge of the Research Department of the World Bank. For one result of the recognition of the need within the Bretton Woods institutions to address the social dimensions of adjustment, (though not yet of the sacrifice of essential infrastructure); but this has so far been in the nature of an add on to the extent permitted by available resources, rather than an integral part of the design of an adjustment programme.

In addressing the human development and essential infrastructure gap, the dilemma facing the donor community needs to be squarely faced. Once a country gets into economic difficulty, as a result of an external shock, the turn around would require major decisions on key parameters such as the exchange rate and the interest rate, coupled with a determination to restore fiscal balance. In the absence of adequate corrective actions in these areas, external support by donors can be viewed as pouring money into a "black hole" without result. It is this fear, which explains the reluctance of the G-7 countries to support the former Soviet Union, for example, in the absence of credible attack macro-economic problems.

A Sustainable Development Compact

On the other hand, once a developing country having got into difficulty as a result of an unexpected external shock, decides firmly to put its economic house in order by taking the basic macro-economic decisions needed to chart an irreversible course for economic recovery and growth, there is a prima facie case for addressing the country's needs for human development and essential infrastructure as a matter of urgency. The solution that needs to be put in place for dealing with this problem is for budget balancing to take place gradually, and for the donor community to provide in recognition of progress in other relevant areas of the Washington consensus-eg. Getting key prices right, foreign financing support for human development, essential public infrastructure, and environmental protection. The suggestion that the reciprocal obligations between a country and its donors involved in such a solution should be

embodied in an "Environmental Compact for Sustainable Development" between the parties, was first elaborated in my Dr. N.M. Perera Memorial Lecture in August 1999.The idea was adapted with acknowledgment by the UNCED Secretariat, and presented to the Rio Earth Summit as their principal proposal on financing, under the caption "A Partnership in Additionality: Contracts for Accelerated and Sustainable Development." The idea as presented by the UNCED Secretariat is that:

" It might facilitate the provision of aid if developing countries were to put forward ambitions, accelerated and sustainable development programme, and if willing donors responded with additional funding."

A partnership in additionality would be based on a developing country's clear articulation of policies and strategies and a programme of action for their implementation. The strategies would be designed to enable full use of economic opportunities in a drive for fast growth in production levels, while at the same time re-ordering internal priorities toward a broad-based attack on poverty, concentrating, for example, on basic education, and rural infrastructure. Such strategies would be the basic for a commitment to increased funding from international and bilateral donor sources. A sustained commitment would be needed by both developing countries and by the donors. It would be essential for such programmes also to enjoy broad popular support since the donor-recipient relationship would be unlikely to endure nay charge of unwanted conditionality.

Such a process could be co-ordinated through existing consultative group and roundtable processes. However, in view of the broad nature of the funding required, a special process could be considered where periodically the contracting parties could meet to discuss progress and agree on the solution of any emerging problems and on future plans.

In the final decision of Earth Summit, a somewhat weak formulation of this compact was adopted in Chapter 33 of Agenda 21: Financial Resources and Mechanisms:

"For an evolving partnership among all countries of the world, including, in particular, between developed and developing countries, sustainable development strategies and enhanced and predictable levels of funding in support of longer term objectives are required. For that purpose, developing countries should articulate their own priority actions and needs for support and developed countries should commit themselves to addressing these priorities. In this respect, consultative groups and roundtable and other nationally based mechanisms can play a facilitative role."

What is crucial to the notion of a compact between developing countries and their donor implicit in this Earth Summit decision, is that a country's development strategy is cast over a sufficiently long period of time. There is an opportunity for doing this by extending the 3 year time horizon of the Policy Framework Paper (PFP) a country has to prepare as part of any IMF package, to a minimum of 5 years, and fleshing it out to encompass expenditure on its sustainable human development and infrastructure goals. This process can make use of the country strategy notes being prepared under United Nations auspices in some 40 countries. There is an opportunity available at the forthcoming Social Development Summit of the UN for ideas along these lines to gain political endorsement.

20-20 Vision

Subsequently, a parallel initiative has been developed by UNICEF, based upon UNDP work, which isolates a subset of priority areas of human development which are in the nature of basic human rights that should never be sacrificed on the altar of an adjustment programme. This can readily be incorporated in such a country level compact, once the concept gains the necessary political endorsement, again possibly at the forthcoming UN Summit on Social Development.

What UNICEF envisages is a global compact termed "20-20 Vision". What this means at the aggregative level is that donors (both bilateral and multilateral) undertake to provide 20 percent of their aid for priority human development needs, as the *quid pro quo* for developing countries deciding to allocate 20 percent of their budgetary expenditure towards these same purposes. This contrasts with the current global averages, where under ten percent of aid, and barely ten percent of developing countries budgetary expenditure go towards meeting priority human development needs. For "20-20 Vision" purposes, priority human development expenditure can be defined as a sub-set of allocations for the social sector, and would comprise the following activities:

1. Primary health care (including basic curative care)
2. Basic education (including per-school, primary, literacy and life skills)
3. Low cost rural and peri-urban water supply and sanitation.
4. Nutrition support (including community based approaches, and the provision of micro nutrients)

"20-20 Vision" as defined above is in the nature of a global compact between donors and recipients. What would be required to incorporate it into a compact at the individual developing country level of the kind envisaged by the Earth Summit, would be to link foreign saving support for basic human development priorities (with 20 percent of all aid to that country and 20 percent of its budget being devoted to these priorities), with irreversible movement in the direction of economic reform. The simplest formula that needs to be specified as regards a country's commitment to economic reform is that it is engaged in an economic reform programme acceptable to the Bretton Wooda institutions, or is in otherwise good standing with one or other of these institutions.

It is instructive to see how Sri Lanka could benefit from "20-20 Vision". The UNDP analysed the data for some 25 developing countries covering 74% of the developing would for the year 1998. Countries were first ranked in accordance with the percentage of their GNP allocated to priority human development expenditure for which data was available-primary health care, and basic education. A ratio of above 5% was considered to mean high human expenditure, of between 3% and 5% medium human expenditure, and under 3% low human expenditure. Twelve of the 25% countries, including Sri Lanka were in the low human expenditure category. Four countries-Zimbabwe, South Korea, Morocco, and Malaysia met the 20% target for priority human development expenditure in their budgets. A mixed bag countries-some low income, some middle income-had ratios below 10%. They are listed in descending order with the ratios given

in parenthesis-Bangladesh (10.1) Chile (9.5) Tanzania (8.3) Sri Lanka (7.7) Nigeria (7.6) India (6.8), Argentina (5.6) Pakistan (2.9) and Indonesia (2.3). In the latter group, the proportion of aid allocated to priority human development expenditure was for the most part below 10%, with Bangladesh and Sri Lanka being above 10% and heading the list. These aid ratios are given in parenthesis against each country: Bangladesh (12.2) Chile (9.5) Tanzania (10.2) Sri Lanka (11.3), Nigeria (0.6) India (4.6) Argentina (1.4) Pakistan (8.5) Indonesia (2.69. The acceptance of "20-20 Vision" will involve an increase in both ratios in all these cases.

For the donor community as a whole, there are limits to how far their obligations can be reached by a re-allocation of existing aid along. This is because only Norway has reached the 20% target for donors, with only the smaller donors within reasonable distance of it, and the large donors performing at under 10% and in important cases under 4%. Indeed UNICEF has estimated that the donor obligation would cost an additional $ 25 billion per year in the remaining years of the century-a less than 50% increase in today's ODA of $ 60 billion.

For the developing countries however, implementing "20-20 Vision" will require a major reassessment of expenditure priorities. In Sri Lanka, budgetary expenditure for human development priority areas will have to rise by 12 percentage points from the present 8% to elicit an increase in aid devoted to these same purposes by 8.5 percentage points from the present 11.5%. For Sri Lanka, the readiest way of proceeding, and possibly the only way, would be shift a major share of military expenditure now running at Rs. 30 billion a year, or 19% of budgetary expenditure, to human development priority purposes. Indeed if military expenditure were reallocated in this way, virtually the entire expenditure on human development priorities in Sri Lanka will in effect be financed by the donor community as part of their obligation under 20-20 Vision".

"Market-Friendly" Policies and the East Asian Development Model

The discussion has so far been concerned with ways of providing adequately for public investment in the areas of market failure that are threatened by the Washington consensus principle of budget balancing, and with protecting, as of right, expenditure on defined human development priority areas. The second problem with the Washington consensus is that some of its other principles could conflict with the successful policy framework introduced by the East Asian economies. What is distinctive about the policies of these economies can be summarized under 4 heads. Under each head, the East Asian strategies differ from "market-friendly" policies, in some cases markedly, in others in more nuanced fashion.

1. Industrial strategy and support
2. Exchange rate policy
3. Foreign investment
4. Price liberalization and subsidies

Conclusion

The WIDER-World Bank symposium is of an ongoing international debate on what constitutes the best recipe for successful development. There is a major research project

under way within the Bank, as a result of the views urged by Japan in the Bank's Executive Board. Meanwhile how should we appraise "market-friendly" policies? Sri Lanka's experience suggests that they constitute a powerful necessary condition for rapid growth, removing important price distortions that had accumulated during 3 decades of dirigiste policies. However, the rapid output and export expansion that followed after 1977 could not, in all endowment that Sri Lanka had also built up in its dirigiste phase. Indeed, in one of the best know of WIDER's books, Hunger and Public Action by professors Jean Dreze of London University and Amertya Sen of Hharvard University, Sri Lanka's development experience constitutes an important case of one of the two valid development strategies analyzed by the authors, "support-led security", the other being "growth-mediated security".

An important element in Sri Lanka being able to afford the necessary investment in human development, with social expenditure being consistently in the range 9%-12% of GNP from the mid 1960's to 1979, was her extremely low level of military expenditure throughout that period. This rarely exceeded 1% of GDP, at a time when the rest of the developing world was spending nearly 5% of GDP on arms, Sri Lanka's level today. Sri Lanka is also unique in having had a consistently high level of unemployment of 13% to 16% for nearly two decades, on the evidence of various surveys spanning the period 1961998. High human development and high unemployment is a uniquely Sri Lankan recipe for endemic violence, generating expectations, which cannot in the circumstances be fulfilled. This, in turn, risks a further reduction in social expenditure from recent levels of around 6%-7%. Thus eroding Sri Lanka's human development base further.

It is therefore all the more important to recognise that the requirements for minimum levels of social protection are not overridden by the "market-friendly" framework, at least in its budget balancing aspect. The move towards a solution of this problem is bound to require international action through negotiation within the United Nations of an appropriate global compact as described above, involving both 20-20 Vision" and sustainable development compacts at the country level. It is also necessary that we evolve ways of expanding employment opportunities rapidly by boosting our growth rates, and by looking to regional cooperation for expanding markets at a time of global recession. This could take the from of a fast track within SAARC by accelerating Indo-Sri Lankan economic cooperation through a reciprocal preference scheme as envisaged in the 9th WIDER Study Group Report which we understand has been adopted as part of government policy.

We would also need to work out our own adaptation of the East Asian model, by strengthening our educational policies in the tertiary sector, by adopting selective strategies for "picking winners" including interest rate subsidies, and creating viable self-employment opportunities in small to medium scale activity. We would also need the kind of detailed framework for consultations between government and the private sector that was pioneered by Japan and adopted by all the aspiring NICS. In a word, "market-friendly" policies are in Sri Lanka's case at best no more than necessary conditions for transition to NIC status. They are far from being sufficient conditions as well, and require to be supported by the kinds of interventionist and full-employment strategies, which the East Asian NICS have successfully pioneered.

Above all, we need to end the war in the North and its drain on our finances. War is, however, not only an economic drain. Its costs in human terms are incalculable; it can leave behind a brutalized society that glorifies violence. For a secure future, we have to transcend the ethnicities within which we are imprisoned and resolve the conflict in a way that will reunify our fragmented society.

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