Chapter 5

MAJOR DEBATES IN ECONOMIC DEVELOPMENT

The Role of the State and the Role of Trade

1. INDUSTRIAL POLICY FOR A DEVELOPMENT STATE

So far we have focused on our own theme. This chapter covers some alternative points of view, and the associated policy implications.

Much of the study of economics today traces its roots to Adam Smith’s *The Wealth of Nations* (1776). Smith’s doctrine of *laissez faire* limits the role of the government to providing for law and order, national defense, public works and so forth. Trade, both domestic and foreign, is not to be restricted by either the government or a monopolist. Recent debates in development policy cluster around three issues:

(a) *How* active should the government be in a developing economy?
(b) *Whether* giant firms are essential to development, and thus deserving of support?

(c) What role has trade played in East Asian growth?
Related to (c), there are further controversies concerning:
(d) *Why* should or should not one draw particular conclusions from the statistics on total factor productivity?
Dynamism, Decentralization, and Selective Pressure as Sources of Market Efficiency

We start with the case for *laissé faire*. Unlike Smith and his immediate followers, most discussions in the literature are presented in analytical terms, under simplified assumptions.

The *case against monopoly* (or cartel), and hence against giant firms, has been made both in partial equilibrium terms with deadweight loss, and in general equilibrium terms with the Fundamental Theorems of Welfare Economics. Such proofs are established under highly abstract assumptions such as fully rational individuals, no increasing returns, and a timeless world. Yet to many observers, the efficiency of the institution of market competition also has a *dynamic* and more basic source: by *Arrow’s Law*, freer entry (and less support of giant firms) allows for more innovations.

The *case against state intervention* requires more discussion. If we conduct our analytical discourse within the usual models, then, in principle, a wise and selfless social planner can duplicate whatever the market can do; the market system cannot be shown to be superior to a planning system that imitates the market.

In fact, the real world is far *too complex and dynamic*. In the former Soviet economy (which was far simpler than the economy of the West), there were 24 million types of different goods, where many pairs of different types lack mutual interchangeability (Ericson, 1991). In the PRC before the reform, to formulate the annual state economic plan, the center and the subordinate units could exchange messages at most 3 or 4 times (see Wan, 1992). For resource allocation, no economic planner can ever match the information efficiency of the market, where decision-making is decentralized by price. There is little hope that central planning can ever be efficient even in any approximate sense.

Moreover, shortcomings of central planning arise not only from ‘the theory of teams,’ where individuals have fully shared goals though not fully shared information, but also ‘the theory of games’ where bureaucrats operate under their personal agendas. Attempting to contain the malaise of corruption by *bureaucrats*, one ushers in a system of suffocating *bureaucracy*: an imperfect cure often worse than the ailment. Before the Indian reform, to complete a single transaction, it often takes hundreds of forms and the approval by dozens of officious officials (Roy, 1998). As proposed by Alchian (1950), and underlying the evolutionary games today: market efficiency is self-enforced by Darwinian selection. The inefficient does not survive. Thus, the case for market competition can also be made on the incentive ground of *market discipline*. 