

Clapham, Ronald

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Intereconomics

*Suggested Citation:* Clapham, Ronald (1974) : A design for a market economy, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 09, Iss. 8, pp. 242-246, <https://doi.org/10.1007/BF02929106>

This Version is available at:

<https://hdl.handle.net/10419/139059>

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## Economic Order

# A Design for a Market Economy

by Dr Ronald Clapham, Cologne \*

**In most LDCs, the public sector and dirigisme have been allotted a vast, if not dominating, influence over the national economy. As a viable alternative to this widespread trend, the author seeks to develop an economic pattern of development policy based on the principles of market economy.**

For a long time already, a controversy has been raging over the question whether it is at all possible to base LDCs' economies on a market economy design, in order to bring forth economic and social progress. A majority of experts seems to incline to the view that the special social and economic conditions in such countries would stultify permanent economic growth along the lines of a strategy for market economy. The effect is that *dirigisme* has been conceded a vast, if not overpowering, degree of influence. In practice, this means overall economic planning by government, control over, and guidance for, the remnants of permitted private investment activities, government-owned industrial and trading agencies, price fixing and physical production and turnover quotas being imposed, and government control of foreign trade.

This kind of economic policy is widespread, but the attempt will be made here to oppose it by a viable design for development policies based on a market economy. Due to theoretical deliberations and empirical experiences it must again be discussed. One of the major reasons for this attempt is the fact that, during the last twenty years or so, a number of LDCs have succeeded in attaining a high rate of economic growth whilst basing their economic policies on the principles of market economy (e.g. Taiwan, South Korea, Thailand, Mexico, the Ivory Coast, etc.). Moreover, recent empirical studies of the sociology of economic institutions and patterns of acting in traditional societies have come to the conclusion that a great lot of the views uncritically embodied in the fashionable theories of development have absorbed a high degree of "economic folklore". Such observations

may lead to encouraging attempts to join up isolated attempts to create a design for market-oriented proposals into a grand overall development concept, based on actual experience<sup>1</sup>.

### Minimum Conditions

The first basic question that has to be answered in this context is whether it is at all possible to impose a market economy design on LDCs. In order to settle this it is possible to define clearly the minimum conditions for setting up a "modern market economy", which will be very different from the, historically predominating, "traditional semi-monetary market economy", and to compare them with actual conditions prevailing in the least-developed of LDCs. There is some agreement on the following conditions being sufficient:

□ A framework of rules, institutions, and laws, created by government, that is suitable to the purpose. This includes, as major elements, a stable rule of law, institutions that are able to work, and efficient government departments and agencies. Empirically, such foundations for viable and modern market operations have been found to exist only in part in LDCs. Problems and obstacles are often the lack of uniform and nationwide legislation, the scant social understanding of modern law, the uncertainty of legal rules and customs about landed property, the big gaps in specifically economic and trade legislation, and the weakness of general protection of the inhabitants and their just claims by rules of law. Moreover, public administration and the civil service are frequently

<sup>1</sup> cf. R. Clapham, *Marktwirtschaft in Entwicklungsländern. Zur Anwendung und Leistungsfähigkeit des marktwirtschaftlichen Konzeptes.* (Market Economy in LDCs. About Practising a Market-oriented Design and its Feasibility.) Freiburg, 1973.

\* University of Cologne.

inefficient. In many cases, even limited duties to be performed by the public power, which are indispensable for the survival of an organised commonwealth, and which will grow in the course of economic development, cannot be tackled satisfactorily by government authorities, since they are woefully understaffed and undertrained.

□ Markets for goods and factors must be able to operate. Market forces will enforce optimal effects of pricing as a steering, incentive and distribution mechanism only on condition that the easiest possible and unhindered access to the market, a free price formation, and effective competition exist. The fact is, however, that in LDCs the markets for capital, goods, and labour are of a low and weak profile and only partly integrated in the national economy. This is caused mainly by economic dualism and by government-operated and private manipulation of the markets. Subsistence farming, through the irreversible spread of a monetary economy, is being drawn into a monetary market economy with painful slowness.

Where such conditions prevail, prices in the local markets are different from those which would arise if and when these markets were fully integrated in the national economy and in equilibrium. This means that also price relations in the "modern" sector of a given LDC do not indicate the overall economic scarcity of actually marketed goods and services. Therefore, it is very doubtful whether scarce resources will be allocated exclusively through the market price mechanism.

#### Hostility to the Business Community

□ In a genuine market economy, industrial entrepreneurs have a key function as innovators and imitators. Generally, it is frequently pointed out that LDCs are swarming with extremely capable traders, gifted craftsmen, and moneylenders, but it is being regretted that there is an extreme scarcity or even complete absence of native entrepreneurs (manufacturers). That factor of production which, according to Schumpeter, establishes technological and commercial innovations, is always and everywhere relatively scarce. Economic history, however, demonstrates that the degree of its scarcity may, obviously, differ greatly over different periods and in different regions of the world. Potential entrepreneurs, moreover, may be very effectively suppressed and stunted by the traditional moral and ethical codes operating in a given society. The admirable entrepreneurial record of national minorities, originating from emigration from their former homelands and social pressures and conventions, e.g. the Pakistanis in East Africa, have proved clearly what it

may mean to be unfettered from the shackles of traditional societies.

However, it is far too little known what a powerful influence, at the same time, is brought to bear by the equipment with additional resources (capital, technology, etc.) and, above all, by the government's economic policies on the supply of entrepreneurial talent and activities. In order to make a successful trader willing and able to change himself into an industrial manufacturer, the decisive need is for him to know what are the chances for him to earn a profit, and how great the risks will be, that arise from such an entirely novel activity. Provided there are ironclad guarantees for the security of private property and for the unfettered right of the owner-producer to buy and sell his production implements freely, both formally and actually, this alone will favour the emergence of enterprising manufacturers who develop long-term investment programmes. Seen from this aspect, it is clear that an actual scarcity of entrepreneurial talent and initiatives is often due to the anti-entrepreneurial attitudes and creeds of both the government and its civil service.

□ Widespread reactions to economic incentives: Any active evolution from the basis of economic plans that have been designed for operating in a decentralised fashion, and which will actually operate in this way, presupposes that the society within which they are to be practised contains a sufficient number of members who will react, and repeatedly react, to economic incentives. It is often drawn into doubt that such conditions exist at all in LDCs. In order to explore the actual reactions of people under the same social circumstances, it might be advisable to study the behaviour of peasant farmers — who, in most cases of LDCs, are the most numerous social group — towards production and supplies offered to them. Empirical studies under different geographical and historical conditions have shown that price elasticity of farm production (measured by the size of the areas farmed) appears, indeed, to exist and to be significant.<sup>2</sup> In numerous cases, the results of such studies are equivalent to those culled from industrialised countries; where there are divergences they can be explained by structural and/or institutional obstacles (e.g. the traditional system of leasing land, and/or the government's price policies enforced by state-operated purchasing agencies). Yet, on the whole, it has been observed that peasant farmers in LDCs do react to price incentives and relative price shifts by vary-

<sup>2</sup> cf. R. Krishna, *Agricultural Price Policy and Economic Development*. In: H. M. Southworth and B. F. Johnston (eds.), *Agricultural Development and Economic Growth*, Second Edition, Ithaca, N.Y., USA, 1968, p. 506.

ing the areas under the plough and the structure of their production.

The analysis shows that the factual background in LDCs, on the whole, is not fundamentally averse to development via the market and free enterprise, although it is often hindered by partial difficulties. If that is so, which would be the strategic basis for economic development through free enterprise and the market, and which would be the methods of economic policy enabling LDCs to march along this route? Here, it will only be possible to sketch the basic guidelines for such a strategy because its practical details and applications can only be based on the given situation in different LDCs, including the prevalent attitude to the facts of economic life, the political atmosphere and forces, the relative availability of economic factors, as well as the degree of integration and level of economic activities. This naturally means that different approaches towards further development through the market are conceivable, though all of them will have a common basis.

#### The Principle of Complementarity

The constitutive structure of the strategy is the joint cooperation between the formally and materially free market forces and pricing mechanisms and the development policies of the government. This cannot be a pragmatically-found mixture between the decentralised allocation of resources and *dirigiste* state interference but only a specified form of applying the complementarity principle: The basis of the whole system must be co-ordination through pricing, free markets, and actually alive competition. "Coordination from the outside", which means planned interference with economic structures and circulation-parameters, will be the task of agencies and instruments used by the government's regulating and animating policies. This foundation is the one upon which the two main pillars may be built for any market-oriented development policy:

Government must lay the foundations upon which market-directed economic growth will be possible;

The use of available resources must be guided by market forces and a suitable economic policy.

#### Infrastructural Tasks

Under the first heading, there will be at least three complicated tasks to be mastered: The first of them is the planned creation of an infrastructure that will be favourable for growth — materially, institutionally, and individually. These three spheres of infrastructural sectors are highly interdependent and complementary with each other. In analogy with the thesis of balanced growth it may be stated that only a fair equilibrium between the arrival in time, the quality, and the quantity of the three different components of a viable infrastructure will set up favourable conditions for economic growth.

The grand design of a market-oriented economic development must allot to institutional infrastructure (the rule of law, the accepted standards, the modes of operation, and the institutions safeguarding all of this) the same weight of priority as to its material and staffing problems, because any improvement in the overall, infrastructural equipment of a given country has far-reaching external effects which, hitherto, have been vastly underrated. They include, for example, the strengthening of security under the law, an increased efficiency of the civil service, a quicker dissemination of technological and organisational knowledge and of market information, as well as the reduction of the risks for private investments. Such improvements will not only favour private capital accumulation but also improve the whole economy's capital productivity. In all the three fields of infrastructural improvements, the capacities, in terms of volume and of structure, will have to be planned for the longer term, and this will be an important part of development planning according to the principles of market economy.

The second task will be to strengthen and evolve further the market forces and the pricing mechanism, in order to increase the pressure on individuals engaged in economic activities, so as to

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impel them to observe rational economic rules in order to increase the benefits flowing to them from such activities. In order to achieve this, government will have to improve the institutional preconditions which means: public power must build a viable organisation of the markets for goods and factors. In this context, the markets for real estate and for farm products must not be neglected.<sup>3</sup> Since the two markets have a strong influence on the growing and the distribution of agricultural incomes, they are absolutely essential for speeding up the domestic economic circulation. Moreover, government economic policy has to press for ever growing perfection of education of the agricultural and industrial managers in the fields of general knowledge and available information about the variables and processes of a live market – which means, generally, to foster the growth of economic thought in terms of market. Such processes may be initiated, e.g., by development companies specialising in farm produce (this was done in the Ivory Coast), or by public-sector or semi-public sector trading agencies (this was the case in Taiwan).

#### **Improvements of Market Mechanism**

Finally, setting up the conditions for competition to be functioning is of top priority. It remains also true for LDCs that a determined policy fostering competition will induce faster economic growth, because competition is instrumental in rapidly spreading technological and organisational innovations, in improving the allocation of factors, and in compelling entrepreneurs to remain steadily on the run in adapting to changing structures of demand. Competitive pressures can be deliberately increased by successive steps of import liberalisation (this was done in Mexico), and by government subsidisation of newcomers, *inter alia*, by favouring the formation of joint ventures. It is possible, through improving and strengthening market forces and the pricing mechanism, to reduce substantially the gap between private and social costs and yields. Dismantling market imperfections and doing away with government-imposed price regulations will have the effect that price relations evolving in the market will more and more approximate the social scarcity relations. In spite of this, there will be numerous deviations from this desirable norm in the cases of private and social yields of investments, which means that compensating interference will remain necessary as an instrument of correction.

The third principal task is to keep official economic policies on a steady and even keel. Risks run by private investors – which are relatively high

because of the shortage of capital, the dearth of technological and organisational skill, and the insecurities of the markets – must on no account be artificially increased by an economic policy which is characterised by vague or swiftly changing objectives. On the contrary, it must be impressed on LDCs that their legislative, their executive, and their political parties must remain consistent in settling, once for all, the problem of the economic order that is to prevail in their country, and which importance the private sector will have within this framework. If they adopt a market economy, this must mean that the private sector predominates in their national economy. Thus, it is indispensable for them to cling to a long-term grand economic design of objectives and principles for their economic policies – which will be an additional task for planning development on the basis of a free market.

#### **Self-Financing – a Bone of Contention**

How the forces of the market and a government's economic policies (which, in themselves, are bearing upon macro-economic variables) may cooperate cannot be described here in detail; it must suffice to sketch the outlines of their major characteristics, as they might operate in three exemplary cases.

One of the crucial problems will always be how to mobilise the savings potential of an entire economy, and how to channel such savings as investments into the right places. Capital accumulation by the government may be increased by fully enforcing statutory taxation, by reducing tax evasion and the costs of tax collection, and by raising the rates of direct taxation and the taxes to be borne by farmers. However, the thresholds up to which such efforts will have a real effect are low, because going beyond these limits would create powerful incentives for the flight of capital and prevent private capital accumulation. Moreover, the use of rising government revenues for investments will come up against formidable obstacles, because political pressure for financing higher consumption will be exceedingly strong.

The strong encouragement of self-financing of private industry through taxation and trade policies is – apart from distribution problems – heavily disputed from the point of view of growth policy. Whilst industrialisation is beginning, it is a highly typical development that native industries operate in nascent markets as oligopolies, in the absence of competition by potential substitutes and of an efficient system of accountancy within

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<sup>3</sup> cf. the contributions of P. T. Bauer and B. S. Yamey, *Markets, Market Control and Marketing Reform*, Selected Papers, London, 1968.

individual businesses. Such structural deformations frequently persuade companies to making (from the point of view of the overall national economy) misguided investments. Besides, it is possible that rising profit rates in industry may alter the terms of trade to the detriment of farming. Should such shifts change the distribution of incomes to the disadvantage of the farmers, this sets up disincentives against making structural changes and increases in output required by economic growth. Furthermore the accumulation of capital in the agricultural sector and the transfer of capital to the secondary and tertiary sectors are impaired.

### Market Integration of Farming

A strategic guideline, which has been proposed to replace the possibilities just described, would be: to modify and steer the rate of self-financing via taxation policies, and to reduce it by making it easier to mobilise funds for investments by drawing on the capital market. To feed this market, it is possible to mobilise, in a much stronger way than in the past, the savings potential of private householders, which has been done successfully in Taiwan, South Korea and the Ivory Coast.<sup>4</sup> Yet, before this becomes possible, it will be imperative to set up possibilities of investing safely and under an umbrella of protection against inflation, with an attractive real rate of interest, and highly diversified finance institutions.

Another point is the transformation of the traditional forms of farming. To educate peasant farmers to serve the market, by showing private initiative and the willingness to take risks, will be a crucial step towards speeding up the integration of farming in the market. Studies that have been made about the supply elasticity of farmers have shown that there are obvious and relatively high reserves of production growth in native farming. Such potential reserves can be made to become actual ones by the government's agricultural policy leading to improvements in the institutional foundations of production and in production itself. Following Hirschman, it might be possible to describe such situations as those of incentive and pressure, which, in their combination, have to be optimised. One of the crucial influences for mobilising economic potentials, in this context, will be brought to bear by sufficiently strong incentives given by prices and potential incomes. Such incentives can be set up by reorganising the legal basis of farming (especially the leasing

system), the production structure of farms, and their sales channels in such a way that tenant farmers and small landowners will reap direct benefits from additional efforts.

### International Division of Labour

A third field of gearing an LDC economy to the market consists of industrialisation. Any market-oriented design is based on the effects of an international division of labour that make for increased productivity and economic growth. To make a stagnant economy dynamic, some of the most important effects of foreign trade are the indirect ones, because they enforce changes in the production functions, increase a national economy's production facilities, and bring with them new information and the chances for modified training. Any progressive economic policy is bound to lead steadily to a form of expert-oriented industrialisation. In this context, it is useful to practise an economic policy of selective and temporary import substitution, because this will be connected with new incentives and educational effects. Such an approach will evade the losses of growth which will occur if and when import substitution is exaggerated.<sup>5</sup> As has been found by trial and error in Latin America, exaggerated import substitution deprives farming and existing export industries of resources, too many of which would be channelled into those industries which are designed to replace former imports, and at the same time, it would strongly increase the demand for foreign currency to pay for raw materials, semi-finished goods, and capital equipment.

Designing a market-oriented strategy, however, will result in a limited substitution of imports, combined with the simultaneous creation of export industries (parallel strategy). It would be possible, for example, to foster such import substituting industries which, according to all the information available, will offer comparative advantages in the future. Through orientation towards market prices and towards realistic rates of exchange, it will always be possible to find out which industries will be viable for this purpose, according to the individual LDC's factor equipment. All this means an expectation that limited import substitution, which costs consumers something through protectionist trade barriers, will later on be more than compensated for by the profits of an industry manufacturing export goods that are geared to comparative advantages of local production. Finally, it must be emphasised that the market-oriented design for LDCs which was sketched here, is not only generally feasible but has already proved its value in a number of countries.

<sup>4</sup> cf. UN, *World Economic Survey 1960-70*, New York, 1971, pp. 208-210.

<sup>5</sup> cf. I. Little, T. Scitovsky, and M. Scott, *Industry and Trade in Some Developing Countries. A Comparative Study* (Published for the Development Centre of the OECD, Paris), London-New York-Toronto, 1970, chap. 5.