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The Market Economy: No Panacea for Developing Countries

by Dieter Schumacher, Berlin*

The controversy about the pros and cons of state interference in the economy has become much more heated in recent years. In the industrialised countries this can be gauged from the debate about deregulation and privatisation. The proposition that the more market-oriented the economy the more successful it will be is also relevant to policy in developing countries.¹ The following article shows, however, that there is no simple, universally valid link between a country's economic system and its achievements in the development field.

In the development policy debate in the Federal Republic of Germany the proposition that the market economy is more successful in the Third World than central planning is founded mainly on empirical studies of the link between the type of economic system and development performance, based on data for a large number of developing countries with the aim of obtaining average results for groups of countries.² Success is measured in terms of a whole series of socio-economic indicators grouped into three categories relating to domestic economic development (national product, sectoral structure of the economy, etc.), the external sector (the development and structure of exports and imports, indebtedness, etc.) and the social field (nutrition, education, medical care, etc.).

Average Results

One analysis divided the developing countries into four groups according to their economic system, namely "strongly market-oriented", "market-oriented", "socialist" and "strongly socialist". Arithmetic means of the individual indicators were then calculated for these four country groups. The results indicated that on average the countries classified as market-oriented achieved higher economic growth, a higher economic return on capital and a more dynamic manufacturing industry and services sector than the more centrally planned economies. The market economies also tended to be more closely integrated into the world economy and their integration was structurally sounder. In the social field, on the other hand, there were no substantial differences between the various groups on most of the measures of comparison.

A second study divided the developing countries simply into "more market-oriented" and "more non-

market-oriented" but at the same time broke these groups down further according to the countries' endowment with natural resources, level of development, size and regional location. Overall, this study also concluded that developing countries classified as market economies generally achieved greater economic success, both in international comparison and over time in the case of countries that had undergone political change. In the social domain, it found that structures and development successes differed noticeably only in the field of education, with the planned economies having the edge.

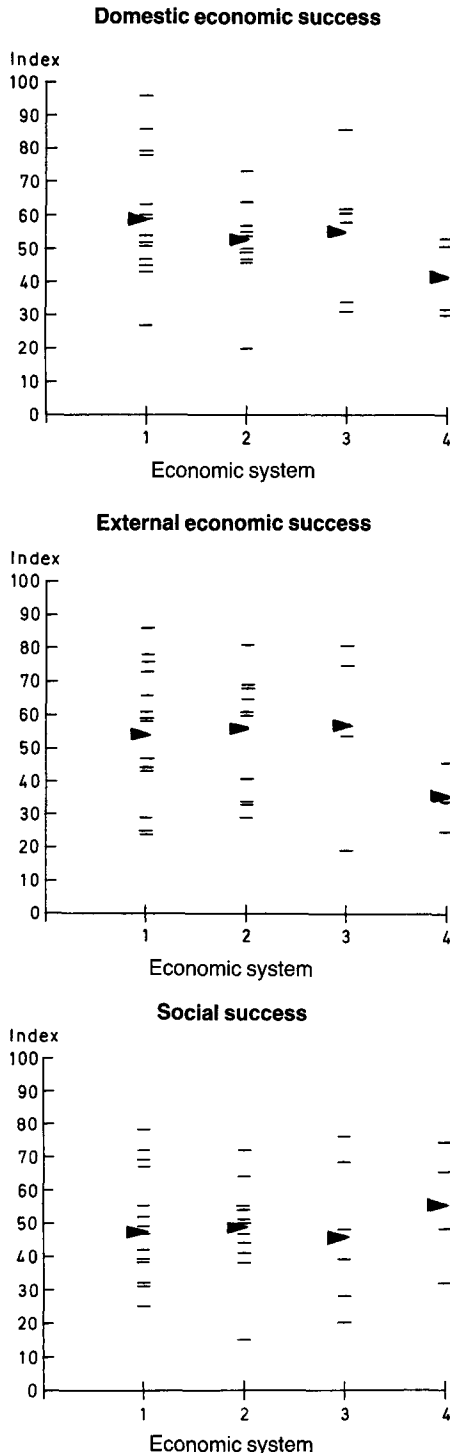
Analysis by sub-groups showed that differences in economic progress could be demonstrated to depend on the type of economic system only in the case of middle-income countries, but not the least developed low-income countries. As proof that the calculated differences are significant, the study in question carried out a significance test on the average economic growth of all the market-oriented and non-market-oriented countries under examination.³

¹ On this theme see K. Fertig, D. Kobschull: Auswirkungen von Eigenanstrengungen auf den Entwicklungsprozess; H. Wilkens, H. J. Petersen, S. Schultz and D. Schumacher: Wirtschaftliche, soziale und politische Bedingungen der Entwicklung – Ein Beitrag zur Erklärung von Entwicklungserfolgen in Ländern der Dritten Welt; Wissenschaftlicher Beirat beim Bundesminister für wirtschaftliche Zusammenarbeit: Wirtschaftsordnung und Entwicklungserfolg, and the bibliography it contains. These three studies have been published by Weltforum Verlag as volumes 70, 71 and 72 of the research reports of the Federal Ministry for Economic Co-operation.

² A. J. Halbach, R. Osterkamp, H.-G. Braun and A. Gälli: Wirtschaftsordnung, sozio-ökonomische Entwicklung und weltwirtschaftliche Integration in den Entwicklungsländern, research project commissioned by the Federal Ministry for Economic Affairs, BMWi-Studienreihe No. 36, Bonn 1982, and A. J. Halbach: Economic System and Socio-Economic Development of Developing Countries, Ifo research report No. 63 of the developing countries department, Munich 1983. A summary of the findings is contained in A. Halbach, R. Osterkamp and S. Schönherr: Mehr Markt: ein Rezept für Entwicklungsländer? Ein empirischer Beitrag zur ordnungspolitischen Diskussion, in: ifo-schnelldienst 10-11/85, pp. 14-25. The article also subjects some findings to a significance test and discusses criticisms of the Ifo approach.

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Chart 1
Indicators of Development in Selected Countries
in the Seventies, according to Type
of Economic System (Ifo Classification)



Note: \blacktriangleright indicates the arithmetic mean.
 Source: Calculations by the DIW.

A more far-reaching investigation, which involved variance analysis of the data and closer examination of the significance test, showed, however, that the individual data on which the findings were based were very widely dispersed, so that using simple averages did not produce meaningful results. This will be demonstrated below. The analysis ties in with work carried out at the DIW on the link between structural conditions and development.⁴

Widely Scattered Data

To measure development success, the DIW also uses socio-economic indicators which broadly correspond to those used in the studies mentioned above. However, the concept of development success is defined more narrowly and related solely to the change in performance data (in the seventies). To enhance comparability, the measurements are also converted to a 100-point scale and synthesised into three composite indices to describe domestic economic development, external economic development and social advances. The index figures for individual countries, arranged according to the four categories of economic system of the Ifo classification, are reproduced in Table 1. Table 2 shows the average index figures for the four country groups. In addition it lists the group of strongly socialist countries including the People's Republic of China. Here too, the average figures show that performance was highest in the countries regarded as strongly market-oriented and fell off across the scale towards the strongly socialist countries. The gradient is 59:41 in domestic economic performance and 54:35 in external achievements. In the social field, on the other hand, there was a gradient in the opposite direction (47:55).

As the figures in brackets on the range of the results show, the average figures conceal a tremendous spread within each group. For example, the index for domestic economic development within the group of strongly market-oriented countries ranges from a high of 96 (Singapore) to a low of 27 (Nicaragua⁵). In the group of strongly socialist countries the extreme values are 53 and 30. If China's index of 80 is included, the results for the various groups overlap almost completely. These findings apply to all country and indicator groups. The scatter diagrams in Chart 1 portray this vividly and demonstrate that there is no connection between the economic system and successful development. Nor

³ Cf. A. Halbach, R. Osterkamp and S. Schönherr, op. cit., Table 1.

⁴ For details on the findings and the methods used, see H. Wilkens et al., op. cit., chapters 1 and 2.

⁵ The period under examination preceded the revolution.

does regression analysis reveal a significant relationship.⁶

To underpin this finding, similar calculations were carried out at the DIW on the basis of a classification by Gastil⁷ that differs from the one used above and covers a larger number of countries. These are arranged in five categories: "capitalist" with a capitalistic modern sector and a traditionalistic agricultural sector, "capitalist-statist" with very large state-owned industrial enterprises and state interventions that are not aimed primarily at distribution objectives, "mixed capitalist" with an extensive state services sector and marked distribution objectives on the basis of private property, "mixed socialist" with major parts of the economy in private ownership and "socialist" with a nationalised modern sector and state control over agriculture.

The results are summarised in Table 3. The averages and the degrees of scatter are very similar to those derived from the four-group classification, although the average differential in economic performance between capitalist and socialist countries is less pronounced here. This serves to show how unreliable averages are if individual values are widely scattered. A significant correlation between the indicators of success and the economic system cannot be demonstrated for the classification used by Gastil.⁸

Little Significance

An assessment purely in terms of averages is misleading if the component data are widely scattered. It can certainly be shown that the difference in economic growth between market-oriented and non-market-oriented developing countries is significant, but only if all the countries in question are included regardless of their level of development and the periods examined.

More differentiated analysis produces other findings. First, the lower average growth rate in "non-market economies" can be explained partly by the fact that this group includes a high proportion of the least developed countries; low-income countries in both the market-oriented and the non-market-oriented groups recorded

lower average growth than those at a higher level of development. Secondly, countries that underwent political change should be examined more closely. According to the average figures, countries that moved away from the market economy had to accept a slowdown in growth, while those that switched to free market principles achieved higher growth than they had during their non-market-oriented phase.⁹ However, it is doubtful that changes in development progress in the countries under consideration can be attributed to changes in the intensity of state intervention. All but one of the seven countries that moved away from the market

Table 1
Indicators of Development Success in Selected Countries in the Seventies, according to Type of Economic System (Ifo Classification)

	Domestic economic success	External economic success	Social success	Population in 1980, in millions
1 Strongly market-oriented countries				
Argentina	54	76	32	28
Brazil	59	58	42	119
Greece	52	73	49	9
Hong Kong	63	47	67	5
Ivory Coast	51	29	31	9
Kenya	43	24	38	16
Republic of Korea	78	78	47	38
Malawi	51	43	25	6
Malaysia	79	61	31	13
Morocco	51	44	55	20
Nicaragua	27	-	39	3
Philippines	60	66	69	48
Senegal	45	44	31	6
Singapore	96	86	72	2
Taiwan	86	59	78	18
Togo	47	25	52	2
2 Market-oriented countries				
Bolivia	49	41	47	6
Cameroon	57	34	38	8
Colombia	64	68	51	27
Dominican Republic	50	60	55	5
India	47	69	50	673
Mexico	54	81	44	67
Nigeria	55	61	64	85
Paraguay	73	65	54	3
Sierra Leone	20	33	15	3
Thailand	63	61	72	46
Venezuela	46	29	41	15
3 Socialist countries				
Iraq	62	-	68	13
Mali	31	81	28	7
Sri Lanka	57	57	20	15
Syria	86	54	76	9
Yugoslavia	61	75	48	22
Zambia	34	19	39	6
4 Strongly socialist countries				
Algeria	53	34	74	20
Burma	51	46	48	33
Guinea	30	-	32	5
Tanzania	32	25	65	18
China ¹	80	-	100	994

⁶ The coefficients of determination (r^2) are 0.08 for domestic economic success, 0.03 for external economic success and 0.00 for social success. Hence well over 90 % of the variance in the results is due to factors not examined here; the economic system can explain 8 % at most.

⁷ R. D. Gastil: *Freedom in the World - Political Rights and Civil Liberties 1982*, Westport 1983.

⁸ The coefficients of determination are only 0.01 for domestic economic success, 0.04 for external economic success and 0.02 for social success.

⁹ Cf. A. Halbach, R. Osterkamp and S. Schönherr, *op. cit.*, p. 21.

¹ Not included in the Ifo classification.
Source: Calculations by the DIW.

Table 2
Indicators of Average Development Success in the
Seventies, according to Type of Economic System
(Ifo Classification)

	Domestic economic success	External economic success	Social success	Population in 1980, in millions
1 Strongly market-oriented countries	59 (69)	54 (61)	47 (53)	342
2 Market-oriented countries	53 (53)	55 (52)	48 (57)	939
3 Socialist countries	55 (55)	57 (81)	46 (57)	72
4 Strongly socialist countries	41 (23)	35 (21)	55 (42)	77
Strongly socialist countries including China	49 (49)	—	64 (68)	1 071

Figures in brackets show the range between the highest and lowest values.

Source: Calculations by the DIW.

Table 3
Indicators of Average Development Success in the
Seventies, according to Type of Economic System (Gastil's Classification)

	Domestic economic success	External economic success	Social success	Population in 1980, in millions
1 Capitalist	53 (59)	52 (100)	48 (69)	299
2 Capitalist-statist	48 (86)	52 (81)	48 (88)	1,599
3 Mixed capitalist	54 (69)	63 (86)	54 (55)	38
4 Mixed socialist	54 (57)	43 (81)	53 (49)	159
5 Socialist	42 (59)	33 (49)	53 (86)	1,177

Figures in brackets show the range between the highest and lowest values.

Source: Calculations by the DIW.

economy belong to the particularly poor countries. In general, these achieved slower growth in the more adverse conditions of the seventies than they had before (contrary to this trend, in two of the countries in this group, Somalia and Benin, growth actually increased after the changeover to a non-market system).¹⁰ In the second group of five countries, petroleum was probably largely responsible for the improvement in the situation of Indonesia and Egypt, while in Tunisia the main factor was the country's world market orientation in emulation of certain developing countries in South-East Asia. Egypt also enjoyed special support from the USA on account of its geopolitical importance.

If the low-income countries and countries that underwent political change are excluded from the

significance test, the difference in average growth between centrally planned economies and market economies is not significant,¹¹ in other words the significance demonstrated for the totality of cases depends on the level of development and general conditions in the world economy, not on the nature of the country's economic system.

Hence it cannot be inferred from the available empirical studies that the nature of the economic system explains successful development.¹² This finding may be due partly to the inadequacy of the underlying classification according to economic system. A major problem with such an exercise is that economic systems differ in many respects from one country to another. If the normal criteria are applied, that is to say the nature of economic management and the type of property ownership, it will be seen that there are only mixed systems in the developing countries, as elsewhere. No country foregoes elements of state control or elements of regulation by market forces. Nowhere does the state leave capital formation entirely to private enterprise and nowhere does it monopolise it completely. Furthermore, state control is exercised not only through direct intervention but also in the form of taxes and subsidies, laws and regulations.

Irrespective of the problem of classification, theoretical considerations alone suggest that a connection between the economic system and successful development just does not exist in the simple form postulated here.¹³ As the optimum mix between private and state activity differs from one country to another and over time – depending on progress in the development process, for example – international comparisons cannot be expected to show a steady improvement in performance as the role of the state

¹⁰ The World Bank shows GDP growth in the group of low-income countries to have been about 1 % lower between 1970 and 1980 than in the preceding decade (excluding China and India, an annual average of 3.5 % compared with 4.4 %). In contrast, the group of middle-income countries achieved more or less the same rate of growth in both decades (5.6 % compared with 5.9 %).

¹¹ The test statistic used, z , which must be greater than 1.96 for the difference to be significant with a 5 % probability of error, falls to 0.8. The same result is obtained using the alternative test statistic t .

¹² The same conclusion is reached by a study concerned solely with success in meeting basic needs; cf. H. Sangmeister, P. Abel: Statistische Aspekte grundbedürfnisorientierter Ländergruppierungen. Discussion paper No. 4 of the Institut für international vergleichende Wirtschafts- und Sozialstatistik of the University of Heidelberg, September 1982. All three of the country groups defined by means of cluster analysis according to the extent to which basic needs are met "include states committed to the capitalist economic model and socialist states with more centrally controlled mechanisms for regulating the economy" (p. 24).

¹³ See also the remarks in chapter 2 of the above-mentioned paper by the Economic Advisory Council to the Federal Minister for Economic Cooperation (Wissenschaftlicher Beirat beim Bundesminister für wirtschaftliche Zusammenarbeit).

diminishes. It is much more a question of the way in which the economic system is organised in practice, the individual objectives pursued and how effectively resources are directed towards those aims.

Hence the question of which economic system is better cannot be answered simply by recommending a free market system. The performance of the least developed countries is consistently poor, irrespective of their economic system. The available resources are simply not sufficient; this applies to infrastructure, competitive markets and entrepreneurial knowhow just as much as to a capable administration. It is true that among the more advanced developing countries those with market-oriented economies on average showed better economic results than non-market economies, but the scatter of data is very wide and both groups include countries with good and bad overall results. The studies assessed do not enable the causes of performance differences to be clearly identified. They should therefore not serve as a basis for a carrot-and-stick system of development aid in the sense that countries deemed to have a market economy are "rewarded" with more aid while those regarded as centrally planned are "punished" by the withdrawal of assistance. In other words, formal classification according to the type of economic system cannot be a criterion for development aid grants geared towards efficiency.

Conclusion: Need for Economic Rationality

Simply classifying countries according to their economic system is clearly too crude and does not adequately reflect the complexities of the real world. The formal configuration of the economy is probably less important for successful development than having an efficient system of resource allocation. This means knowing and taking account of the actual scarcities against the background of individual and social aims, technical knowhow and the available resources. Undoubtedly it matters less that the state intervenes as little as possible than that it sets clear priorities. Each country must find its own path in the interaction of state planning and private decision-making. This depends on the country's culture and mentality, its history, the relationships within society, the level of development, the availability and standard of indigenous entrepreneurial talent as well as the technical competence and probity of the state administration. There is no recipe valid for all countries and all times.

On the assumption that humans act primarily out of self-interest, a market-oriented system with its decentralised regulatory mechanism is an efficient

system of allocation that is economically superior to central direction in a complex world involving an untold number of economic processes. However, the more control is left to the market, the more care must be taken that the preconditions are met. These include reducing extreme inequality in the distribution of wealth, basic education for all and the control of power. These essentials are much less likely to be found in the Third World than in presentday industrialised market economies, so that the creation of these conditions is a priority for many developing countries. Given the significance of agriculture, more equitable distribution of the rights to exploit usable farmland is particularly important. In a great many countries this means carrying out land reform.¹⁴

Regulation of the economy via market prices is a mechanism that in itself entails no value judgement. The true value decisions, such as the assessment of social costs and benefits or the redistribution of income and wealth from the point of view of social justice, must be reached as part of a socio-political decision-making process (elections, administration, organised trade-off of interests). In other words, if the economic outcome is to be socially acceptable, there must be workable institutional arrangements for settling conflicts peaceably and arriving at a social consensus. The respect of fundamental human and political rights plays a particularly important role in this context.

Finally, mention should be made of the responsibility of donor countries. It is right that demands are made for greater efficiency in the use of development aid and that developing countries are called upon to improve the underlying conditions. However, the donor countries themselves can contribute a great deal towards increasing the effectiveness of their aid by gearing their economic relations with developing countries more strongly towards the very market principles they recommend to the Third World. They should thus cease to tie aid, even in the field of consultancy, for example. The real value of aid could be increased considerably if, for example, advisers from countries such as Israel, India, South Korea, China or Brazil were employed on technical co-operation programmes. Above all, a more liberal policy towards imports of goods from developing countries can greatly increase the efficiency of aid. Here the actual behaviour of the Western industrialised countries contrasts with their repeated professions of commitment to free trade and market forces.

¹⁴ It should be pointed out in this connection that an essential precondition for the rapid and even development of South Korea and Taiwan, two frequently quoted examples of good performance, was a thorough redistribution of wealth (especially land reform) in the late forties and early fifties.