A RAND NOTE

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September 1988

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The Dramatic Effects of Gradual Change

Major changes in the international environment can come about through two different processes: the gradual accumulation of small changes or abrupt and sharply discontinuous events. The gradualism of the first process often belies the depth and breadth of the accumulated changes. The rise of market forces around the world in the past decade has illustrated this phenomenon. We might more accurately describe the phenomenon as the rediscovery of the power and value of market forces, because market forces held sway in the industrialized world from the end of the eighteenth century until the growth of Marxism, Fabian socialism, and social democracy in the mid-twentieth century. The gradual revival of interest in and recognition of market forces has made the international economic landscape of the 1990s fundamentally different from that of prior decades.

Markets and Governments in the Allocation of Resources

Before reviewing the altered role of market forces, considering their future prospects, and reflecting on what U.S. policies toward them should be, we should dispel certain myths and acknowledge certain truths about market forces and the relative roles of markets and nonmarkets (or governments) in influencing the allocation of economic resources.

The cardinal policy issue facing modern economic systems concerns the
appropriate roles and relative scale of government and markets. The choice is not clear-cut between perfect governments and imperfect or inadequate markets, or between perfect markets and imperfect or inadequate governments. The real choice is among imperfect markets, imperfect governments, and various combinations of the two. Thus the cardinal economic choice concerns the degree to which markets or governments—with their respective flaws—should determine the allocation, use, and distribution of resources.¹

This issue pervades the U.S. political and economic scene. Disagreement about how to resolve it is one of the two principal differences between the Republican and Democratic parties. (The other is in their views of the Soviet Union—its objectives, the goals of its leadership, its prospects for fundamental systemic reform—and how the United States should conduct relations with it.) The market-versus-government issue also divides the business and financial communities (generally pro-market) from the media and academic communities (generally pro-government). To be sure, these divisions are often blurred by the willingness of protagonists on both sides to adjust their principles to more immediate and practical considerations of self-interest.

Thus the U.S. business and financial communities, which typically extol the virtues of the market and contribute to the Republican party, are often in the forefront of lobbying activities favoring the protection of domestic markets against foreign competition. Similarly the academic and media communities, which typically extol the virtues of government intervention and contribute to the Democratic party, complain if the government intervention and assistance they generally favor is tied to standards or criteria pertaining to their own activities. For example, these latter groups plump for government aid to education but oppose having it conditioned on standards of performance established and evaluated by the government.

Milton Friedman has aptly commented on this familiar subservience of principle to self-interest by observing that pro-market advocates in industry seem to favor the market’s free operation with regard to other industries while seeking government help for their own. In contrast, pro-government advocates in academia favor freedom from government restraint for their own activities while advocating government intervention to regulate the activities of others.

The real world has neither perfect markets nor perfect governments. Both are abstractions, useful for analytic purposes but dubious, if not dangerous, if extended too far or applied too rigidly. In the real world the markets-versus-government issue relates to the preferred degree of reliance on one or the other mode in allocating resources for the economy as a whole as well as for particular sectors. If the preferred choice favors the market, a
significant role for the nonmarket will and, because of the pervasiveness and inevitability of market failure, should remain. This role relates especially to the production of so-called public goods such as defense and national security, to establishing and maintaining the legal and other environmental conditions for the effective functioning of markets, and to the provision of appropriate redistributive services and programs constituting an acceptable safety net for society and reflecting the standards of "distributive justice" with which that society is, as Jacob Viner put it, "tolerably content."  

But if the preferred choice favors allocative decision making by nonmarket means, a significant role for the market may and, because of the extent and inevitability of nonmarket failure, should also remain. This role relates especially to the production of private goods in amounts that comport with demand for them and to production methods that reflect the relative scarcity and productivity of production factors.

The genuinely striking change in the international economic landscape and in the agenda of economic policy discussion around the world in the past decade has been the sharp tilt toward greater reliance on market mechanisms and away from nonmarket mechanisms in the allocation, use, and distribution of resources.

### Market-Oriented Policies in the Three Worlds

Although the trend toward greater reliance on markets has been global, its manifestation in the so-called First World (the industrialized and capitalist democracies of North America, Western Europe, and Japan) represents a resuscitation and renewal, whereas in the so-called Second World (the communist countries) and the even less aptly named Third World (the developing countries) the trend is, for the most part, a genuine innovation that is largely unprecedented.

In the First World the expanded attention to market forces marks a midcourse adjustment, or at least a slowing down, in the rate of government expansion into market domains in the three or four preceding decades, when the welfare state and the programs of social democratic parties were growing. In contrast, among communist and developing countries the rise of market forces is largely a first-time reconsideration and restructuring of the centralized statist premises on which their economic policies have generally been based.

In the First World the reorientation toward market forces has been led by Ronald Reagan's administration in the United States and Margaret Thatcher's Conservative government in the United Kingdom. From its inception in the 1980 campaign, the Reagan administration has stressed
incentive-oriented tax reductions and reform, the deregulation of business (notably in airlines, other transportation, and banking), a reduced role for the federal government in housing, transportation, and welfare, and a moderate commitment to privatizing government assets (for example, in the sale of Conrail and of certain small parts of the government's loan portfolio).

It is significant as well as sobering that, despite the strong commitment of the Reagan administration to greater reliance on market forces, the share represented by federal government spending in the U.S. gross national product (GNP) is slightly larger (about 25 percent) in 1988, the last year of the Reagan administration, than it was at the end of the preceding administration in 1980. Although this change is in part due to a slight increase in the percentage of GNP devoted to defense, it also reflects that outlays for social and other programs, representing resource allocations through nonmarket processes, have grown apace with GNP. The rise of market forces in the United States should not be misconstrued: federal government programs and the additional 11 percent of GNP represented by the expenditures of the 50 state governments remain large and vigorous.

In Britain the rekindling of market forces has been the central tenet of three successive Thatcher governments, preceding the Reagan administration in the start of their market-oriented policies by two years. Since 1979 Thatcher has privatized thirteen major companies in the telecommunications, airline, aerospace, automotive, and transportation industries, representing more than $11 billion in state assets returned to the private market sector. With Thatcher's renewed mandate in 1987, she will certainly pursue plans to transfer other government-owned companies and several public services in the next few years. In particular the British Steel Corporation, newly returned to profitability, is a prime candidate for privatization. In Britain privatization has been the focus of market-oriented policies, whereas tax reduction as a stimulus to the market sector has played a secondary role.

French market-oriented policies under a mixed socialist-conservative government have included the denationalization of several large firms in electricity, glassworks, banking, and other industries that had been nationalized by the previous socialist administration. These policies also include ambitious plans to denationalize 65 companies representing $30-50 billion in state-owned assets, although the implementation of these plans was delayed by the October 1987 stock market crash. Besides privatization, the turnaround in French economic policies has accorded an enhanced role to market forces in other areas by invoking market standards for determining industrial wage rates and opening the state-owned television industry to competition by private television stations.

Market-oriented policies have also waxed, though to a lesser extent, in
Germany, Japan, and Italy. In Japan these policies are reflected in the privatization of the huge Nippon Telegraph and Telephone Corporation and in the loosening of restrictive regulation in banking and finance. Of course, one reason for the more limited extent of new market-oriented policies in Japan in recent years is the predominance of such policies all along. In West Germany denationalization measures have been an important adjunct of efforts to reduce the government’s budget deficit and cushion the initial revenue effects of tax reform. Italy’s market-oriented policies have included privatization by the large state-owned industrial reconstruction holding company (IRI) of 26 enterprises, including Alfa Romeo, between 1983 and 1987.

Within the First World one contrast between the United States and the others is worth noting. In the United States, where labor markets are freer and more competitive, employment increased by more than 13 million between 1981 and the start of 1988, and the unemployment rate fell from 7.5 to 5.8 percent. In Western Europe, where labor markets are much more tightly regulated by government and labor union restrictions, total employment remained nearly unchanged, whereas average unemployment rates rose to 10 or 11 percent, about twice what they had been a dozen years ago.

Although the First World has accorded market forces an enhanced and pervasive role, the point should not be carried too far. In the United States, Western Europe, and especially Japan, the agricultural sector remains protected from market forces by far-reaching, complex antimarket subsidies, tariffs, and import restrictions. Moreover, in the 1980s the average government-spending share of gross domestic product for the European countries in the Organization for Economic Cooperation and Development (OECD) continued at about 47 percent. If so-called off-budget expenditures are added, the resulting share is over 50 percent (compared with 36–37 percent in the United States).

In the Second World the pace-setting, innovating country with respect to market-oriented policies has clearly been China under the leadership of Deng Xiaoping, beginning in the late 1970s. Following the turmoil of the Cultural Revolution, Deng’s aim has been to advance China’s Four Modernizations—of agriculture, industry, technology, and defense—at least in part through market-oriented reforms. These reforms involve the decentralization of economic decision making partly guided by market prices in agriculture, in the small-scale production of consumer goods, and more extensively in China’s special economic zones, while maintaining centralized resource allocation in large-scale industrial and infrastructure sectors. Although there may be a fundamental conflict between these two directions—partial market orientation in agriculture (which remains heavily influenced by large government subsidies as well as price controls) and
small-scale industry, on the one hand, and centralized resource allocation in heavy industry, on the other—in the past decade China has achieved impressive rates of real economic growth, averaging better than 6 percent per annum, largely attributable to the working of market forces.

Following in China's path with a lag of seven or eight years, the Soviet Union, under Mikhail Gorbachev's leadership, has embarked on a much-publicized program of economic restructuring (perestroika) that purports to accord a more active role for market forces in this planned socialist economy. Gorbachev has described the reasons for perestroika—stagnation in the Soviet economy from the late 1970s through at least the mid-1980s, resulting in constant or perhaps even declining rates of growth in per capita Soviet GNP—with disarming candor:

In the latter half of the 1970s... the country began to lose momentum. Economic failures became more frequent... Elements of stagnation began to appear in the life of society... The gap in the efficiency of production, quality of products, scientific and technological development began to widen... thus a sizeable portion of the national wealth became idle capital... There are glaring shortcomings in our health services... and there were difficulties in the supply of foodstuffs, housing, consumer goods and services.*

*perestroika involves a series of reforms that include an enhanced role for market forces: legalizing service enterprises, extending permission and encouragement to agricultural collectives to produce for the market, full-cost accounting to be applied in agricultural and industrial enterprises, and promulgating the rule that "profits will be directly proportionate to efficiency." These reforms, embodied in formal decrees and legislation by the Central Committee and by government regulations, represent a surprising recognition by a communist state of the need to rely more on market forces.

Nevertheless, the results of perestroika should not be exaggerated. Thus far, nearly three years after Gorbachev assumed leadership, an enormous gap remains between the rhetoric of marketization and decentralization, on the one hand, and actual movement in these directions, on the other. Moreover, even the rhetoric of perestroika abounds in ambiguities and inconsistencies, as in Gorbachev's statement that "we do not want to weaken the role of the center, because otherwise we would lose the advantages of the planned economy." Gorbachev's reiterated intention to strengthen and revitalize the role of the party and the center, while relying more on market forces and decentralized incentives, smacks of the dialectical contradiction that Marxism-Leninism attributes to political and social systems other than its own.
In fact the contradictions inherent in efforts to reconcile centrally planned socialism with a considerably expanded role for market forces are serious. For example, if market-determined outcomes are allowed in some sectors (such as agriculture, consumer goods, and services), while central planning is maintained in others (such as heavy industry and high technology), grey or black markets will construct a bridge between them. As a result, capital and labor will gravitate away from the controlled and toward the market-oriented sectors. If central allocation is maintained in these input markets, then grey or black markets will arise again, and the economy will return to the unsatisfactory situation Gorbachev so candidly described. Nevertheless, over the past decade market-oriented reforms have become more important in most communist countries, either antedating the Soviet restructuring (in Hungary and Poland) or following upon it (perhaps even in Vietnam and North Korea).

The rise of market forces in the multiple other worlds that we conveniently, if inaccurately, refer to as the Third World has been hardly less surprising. Economic development theory since the 1940s was never particularly sophisticated, realistic, or practicable in part because until a dozen years ago the field was dominated by the economic ideas associated with Raoul Prebisch, Rosenstein-Rodan, and the Cambridge economists. Their ideas focused on the predominant developmental role of government, central planning, foreign aid, and other nonmarket processes. At least until the mid-1970s the economic development field had a distinctly antimarket orientation in which prices, competition, and incentives played second fiddle to centrally planned government investment, planning, and control for industry, agriculture, and infrastructure.

This orientation was reflected in the policies not only of most Third World governments but also of the national and international agencies concerned with economic development—namely, the World Bank, U.S. and other developed countries' foreign aid agencies, and the Overseas Development Council. As a result, most developing countries have resolved the cardinal choice in favor of government, rather than market, determination of major allocation decisions.

The exceptions to this generalization are a small number of Third World members, including South Korea, Taiwan, Hong Kong, Malaysia, and Singapore. Despite occasional setbacks, these newly industrialized countries (NICs) were the only successful instances of sustained economic growth in the Third World during the 1970s and early 1980s. Their success was marked by a more prominent role for market forces and competition, especially competition in international export markets, in resolving the cardinal economic policy choice. Generally government policies in these countries encouraged rather than hindered the market's role. That their policy makers
were disposed and able to depart from the usual statist pattern followed by most Third World countries in the 1960s and 1970s is not easy to explain. In South Korea the influence of Japan's market orientation surely was part of the explanation. In Taiwan the Kuomintang leadership evidently learned what not to do from its unhappy mainland experience, and Taiwanese entrepreneurship responded remarkably to the new environment. In the other three instances, the explanation probably lies in some combination of the legacy of a market-oriented, British-trained civil service together with the entrepreneurial zeal of expatriate Chinese.

Until recently these countries were exceptions to the prevalence of anti-market forces and limited growth in most of the Third World. In the mid- and late 1980s, however, the prominence of market forces increased markedly. Price competition, competitive exports as a leading growth sector, the privatization of state enterprises, and incentive-oriented tax reform have become prominent, though not necessarily dominant, items on the policy agendas of many Third World countries. Significant policy changes along these lines have begun in Brazil, Chile, and Turkey, and to a lesser extent in Mexico, Argentina, the Philippines, Indonesia, Nigeria, Kenya, Senegal, and Tanzania.

These policy changes in Third World countries have been associated with corresponding changes in the concerns of the international and national agencies involved in economic development and technical assistance programs, notably the World Bank, the U.S. Agency for International Development (AID), and the development agencies of the West European countries and Japan. For example, in 1986 AID convened an international conference on privatization attended by participants from 40 countries. At the meeting AID officials stressed that "privatization is a major priority of the Reagan administration, and certainly of AID," and Secretary of State George Shultz observed: "Privatization is not just a device to cut back the size of government; rather, it is a policy to improve the delivery of services people are now getting—energy, housing, transportation ... and it is central to the solution of a lot of the problems we see around the world." Although such pronouncements are hardly synonymous with the implementation of market-oriented policies, the changes they imply should not be underestimated. Such statements were beyond the bounds of the Third World's economic development dialogue a decade ago.

The Rise of Market Forces: Reasons and Prospects

In sum, the past decade has witnessed a remarkable global recognition of the importance of market forces in contributing to sustained economic
growth, and this recognition has been conspicuously manifest in all of the three so-called worlds in which the globe is sometimes divided. Although the trend has been pervasive, its strength and durability are less certain.

Pointing toward its continuance are the basic reasons underlying the trend itself: the aspiration toward greater efficiency associated with the operation of market forces and the disenchantment with nonmarket mechanisms to govern the use of resources. There is substantial evidence that market forces—competitive prices, free and open markets, the mobility of capital and labor, and the wide accessibility of information about products, factors, and technology—are associated with allocative efficiency (the efficiency with which inputs are used to produce outputs of goods and services at a given time) and dynamic efficiency (sustained growth of output and productivity over time), although the evidence is controversial.10

With respect to allocative efficiency, one international survey of comparisons between private and public output in the United States, West Germany, Switzerland, Australia, and Canada found that in 40 of the 50 case studies reviewed, private (market) production was more efficient than public (nonmarket) production. In three of the studies (relating to electric utilities, veterans' hospitals, and garbage collection) nonmarket provision seemed less costly than market delivery. In five studies (dealing with Canadian railroads, refuse collection in the United States, electric utilities in various parts of the United States, and insurance sales and servicing in West Germany) the results showed no difference between public and private production efficiency, whereas in two of the studies the results were ambiguous.11 A recent study by E. S. Savas of the record of privatization in the past decade and its prospects for the future further supports the greater efficiency associated with market-based operations.12

With respect to dynamic efficiency, the examples of Korea, Taiwan, Hong Kong, Singapore, and Malaysia indicate the growth-promoting effects of market forces. Other evidence is provided by empirical work done at the World Bank and at the Rand Corporation dealing with the economic growth of various countries in the 1970s and 1980s. Subject to a number of qualifications about the underlying data and other factors, this work strongly suggests that, in general and on the average, a larger and growing market sector is associated with higher economic growth, whereas a larger and growing nonmarket sector is associated with slower growth.13

To be sure, other factors have contributed to the rise of market forces; for example, the desire to reduce the role of government in areas that can be privatized so that government resources can be diverted to those that cannot, such as defense.14 But the principal cause of the dramatic rise of market forces has been the desire to achieve greater efficiency and more rapid growth and to escape from the stagnating effect of nonmarket forces,
regulations, and bureaucracies. These influences have contributed to the trend of the past decade and seem likely to sustain it.

Another major factor supporting this trend is the explosion of telecommunications technology, which has increasingly linked financial and commodity markets worldwide. The unprecedentedly rapid transmission of information about prices, costs, changes in tax policies and legislation, and investment opportunities has strengthened market forces throughout the world, partly by assuring that the financial markets are accessible 24 hours a day and partly by facilitating market-related responses to such information. Although the accelerated transmission of economic information can also be a source of instability—witness the speed with which the October 19, 1987, stock market crash in New York reverberated in the Tokyo and London exchanges—rapid and extensive information dissemination is generally a powerful contributor to the improved functioning of markets.

In the past decade the increased globalization of financial and commodity markets has both transcended and reinforced the separate factors contributing to the rise of market forces in each of the three worlds. This trend is likely to accelerate in the 1990s, providing momentum for the wider influence of market forces. International trade in the 1980s has been governed by flexible market-determined exchange rates, sometimes abetted and sometimes impeded by the monetary and fiscal policies of the major trading countries. In the future, exchange rates may be less flexible, but they are still likely to result primarily from the play of market forces.

Although there are strong reasons to expect market forces to continue to rise, some influences point to a slowing down or even a reversal of the pro-market trend. Two such influences are the rising tide of protectionism in the United States and Western Europe and the failure of Japan to open its markets fully to competition in imports of services and goods from other developed countries as well as the NICs. In addition, agricultural markets in the United States, Western Europe, and Japan are immured by a larger, more complex, and more expensive set of subsidies, quotas, and tariffs than ever before. These antimarket forces are as likely to remain or grow as to recede.

Another cause of a possible reversal of pro-market forces lies in a rising concern for equity, fairness, and social justice and criticism of the inequities and hardships accompanying market outcomes. Viner's comment of nearly 30 years ago still holds: "No modern people will have zeal for the free market unless it operates in a setting of 'distributive justice' with which they are tolerably content." Efforts in majoritarian democracies to remedy the distributive injustices of the marketplace may, if not devised and managed with care, erode the mainsprings of investment, innovation, and growth, thereby curtailing if not reversing the rise of market forces. It is also true
that these efforts, even when motivated by genuine concerns for distributive justice, may impair rather than contribute to it.

Whether the rapid growth, innovation, change, and flexibility associated with markets are viewed as desirable goals or as unsettling risks depends on the eyes, heart, and mind of the beholder. If less-rapid growth is preferred to more-rapid growth, restriction of the market sector may be preferred to its expansion. (In this respect, China's development plan for 1986-1990 deliberately opts for restrained growth rather than rapid growth). Also, in the communist world the surprising rise of market forces over the past decade—within the bureaucracy and among the leadership—will encounter stiff resistance as one of the inherent contradictions of such reform efforts becomes starkly evident; namely, the contradiction between decentralized decision making through markets and the central political control of the Communist Party and its ruling elite. In the Third World it is also possible that political and bureaucratic elites may curtail the growth of market forces to acquire and expand political power.

Policies and Implications

How the cardinal choice between markets and governments in the allocation of economic resources will evolve in the 1990s is as important as it is uncertain. In my view, the rise of market forces is likely to continue at a diminished rate in the Western democracies, especially in Western Europe but also in the United States; it is likely to continue at a sustained or even an increased rate in the Third World (despite the dangers of protectionism and the restrictive effects on the flow of private capital to the developing countries caused by the international debt overhang); and it will run into serious obstacles in the communist world, with a continued rise of market forces more likely in China than in the Soviet Union.

In U.S. public policy at home, the choice between markets and governments should not be posed so starkly that it obscures the crucial issue of identifying opportunities by which government and markets can each improve the operations of the other. For example, government efforts could improve the functioning of markets by revising and reducing regulations of labor markets, health care, pension funds, and anti-trust legislation. By the same token, market forces could greatly improve the functioning of government in, for example, dual-sourcing defense procurements, providing educational vouchers for the public school system, taxing emissions of chemical or other pollutants rather than specifying precise levels of permissible emissions, and using "beneficiary charges" as a partial substitute for taxes to finance some public services.
U.S. policy has limited leverage on the emergence and expansion of market forces in the rest of the world. Nevertheless, we should not underestimate the influence of precedent, advocacy, and negotiation, given the global repercussions of Reagan's and Thatcher's policy redirections.

Among the objectives U.S. policy should seek to advance within the First World is the gradual elimination, or at least reduction, of the network of complex and costly impediments to free trade in agricultural products in Western Europe, Japan, and the United States itself.

U.S. policy toward the communist world should encourage, pragmatically and without meddling, the further development of market forces for political as well as economic reasons. If communist countries genuinely move in the direction of decentralized market-oriented decision making, international trade can prosper, to mutual advantage. Moreover, market-oriented reform in the communist countries will contribute to economic pluralism and diversity, which are likely (though not certain) to promote political pluralism and perhaps a gradual transformation of communist systems. The pragmatic encouragement of market forces in the communist world should involve reducing barriers to free trade and developing joint ventures governed by commercial considerations of costs, prices, profits, and risks. However, U.S. policy should eschew all subsidies—whether in the form of subsidized credits, loan or investment guarantees, trade preferences, or any other measures—of economic reform in Marxist-Leninist systems, first, because providing subsidies would relieve or reduce pressures for genuine economic reform arising from economic stagnation and the inherent contradiction between command economies and efficiency; and second, because providing subsidies would reduce the operation of market forces and thereby encourage the very misallocation of resources that the operation of market forces is intended to remedy.

These arguments against unwarranted subsidies apply also to U.S. policies toward the Third World, with several qualifications. First, extending economic and technical assistance to these countries is justified by basic humanitarian considerations and by the formidable difficulty of escaping from the poverty trap. Second, many Third World countries face additional resource burdens because they need to maintain or enhance their security capabilities, thus straining the resources they can mobilize through market forces alone. Nevertheless, when the United States extends economic and technical assistance, it should arrange a clear but tactful discussion with recipients of the market-oriented policies such assistance envisages. External assistance should complement and reinforce market forces rather than work against them.
Notes

1. For an extended treatment of these and other ideas, see Charles Wolf, Jr., Markets or Governments: Choosing Between Imperfect Alternatives (Cambridge, Mass.: MIT Press, 1988).


3. On nonmarket failure, see Wolf, Markets or Governments.

4. "Less aptly named" because this "world" is really not a single entity but rather multiple and heterogeneous ones whose diversity is much greater than that within the other two worlds.

5. See Wolf, Markets or Governments, p. 8; and Peter Saunders and Friedrich Klaw, The Role of the Public Sector (Paris: OECD, 1985).


7. Ibid., p. 72.

8. Ibid., p. 77.


12. See Savas, Privatization.

13. See Wolf, Markets or Governments, pp. 139-48.

14. This motive is most relevant to the United States and other First World countries.


17. See ibid., p. 71.