

Chapter VI

MARKETS

1. Opinion regarding the appropriate role of markets and the degree to which Governments should intervene to regulate or override market processes has fluctuated over the past 200 years. The doctrine of *laissez-faire*, or non-intervention, dominated economic thinking for most of the nineteenth century. Towards the end of the nineteenth century, however, free market theories and policies came under attack both from socialists and from advocates of a nationalist approach to economic policy. By the end of the Great Depression of the 1930s, it was widely agreed that market processes were inherently unstable, that market outcomes were inherently unjust and that a large degree of government intervention in markets was a crucial requirement for an efficient economy and an equitable society.

2. In the period after the Second World War, this consensus was reflected in the emergence of a “mixed economy” in which a large share of economic activity, including the provision of most basic services and economic infrastructure, was undertaken by Governments. For several decades, the only serious challenge to the mixed economy came from Communist advocates of the complete abolition of private business and a minimal role for markets, with an economy based on central planning.

3. From the 1970s onwards, there was a resurgence in the role of markets. Systems of economic planning were gradually dismantled in some formerly socialist States and collapsed abruptly in others. The policies of developing countries switched from encouraging state-led autonomous development to attracting foreign investment in export-oriented industries. In the developed countries, many Governments adopted policies of deregulation and privatization, and sought to reduce the growth of government expenditure and taxation. This trend was particularly noticeable in such countries as the United Kingdom, the United States, Australia and New Zealand. In several of these countries, there have been recent signs of a reaction against radical free-market policies, but the future outlook remains to be determined.

The competitive market ideal versus market imperfections

4. The fundamental logic of the competitive market was first set out by Adam Smith¹ and refined by the neoclassical economists of the nineteenth and twentieth centuries. Under an idealized set of

assumptions, it can be shown that the allocation of resources generated by competitive markets is optimal.² Broadly speaking, if the ideal conditions are satisfied and the initial distribution of resources is equitable, the competitive market equilibrium will be the best allocation of resources available to society. These conditions are stringent, however. Complete markets must exist and function perfectly for a vast range of commodities specified by time and place of delivery and allowing for a whole range of uncertain contingencies.³

5. The ideal conditions for a perfect competitive market equilibrium are never satisfied in reality. The central controversies in economics relate to how markets that are not perfectly competitive should be analysed and how public policy should deal with such markets. For some socialist and other critics of the market economy, the conditions under which competitive markets can be shown to produce an optimal outcome are so far removed from reality as to render the assumptions presented above totally irrelevant. Although such views have been influential in the past, few participants in the economic policy debates of today, in any country, base their position on a complete reliance on markets alone.

6. Mainstream analysis of economic policy begins with the observation that the conditions for competitive optimality are rarely fulfilled exactly. In particular, economies of scale and barriers to market entry may give rise to problems of monopoly and oligopoly. Further, the actions of producers and consumers may give rise to “externality”⁴ effects, such as pollution. Or the existence of public goods defined as commodities or services that are jointly consumed and whose existence creates “free-riding”⁵ can create severe restrictions when the market is unable to determine an equilibrium level of production and an equilibrium price. In addition, the lack of adequate or correct information for market participants may produce unsatisfactory outcomes or even render impossible the emergence of markets for particular goods or services. These problems are collectively referred to as “market failures” or “imperfections”.

7. A separate difficulty is that there is no way of reallocating initial endowments without intervening in market transactions. Hence, it is not possible to treat the determination of prices through markets as an issue separate from that of the distribution of income. Policies designed to redistribute income affect market prices and quantities. Conversely, the adoption or removal of policies of intervention in markets affects the distribution

of income.

8. Finally, there is also the issue of whether markets are impersonal mechanisms for the valuation of production on the assumption that the “invisible hand” leads them toward equilibrium. The argument in favour of this position is that markets, defined by supply and demand conditions, are the most efficient mechanisms in the determination of equilibrium prices and production levels. They reflect the coincidence of interest of both producers and consumers. The counter-argument to this position is that since industrial organizations are not always very competitive the neutrality of markets is affected. In less competitive industrial organizations, markets may not be politically neutral forces akin to the forces of nature. For example, it has been argued that stock markets thrive on the weakness of labour, organized or otherwise: they reward companies that drastically downsize, they rally on news of stagnant wages and they insist that the gains of productivity be turned over to shareholders rather than wage earners. Markets are indeed not neutral.⁶

Public interest and private interest approaches

9. Within the mainstream approach to economic policy, two competing approaches to the problem of imperfectly competitive markets may be distinguished. The “market failure” approach takes as its starting point the competitive equilibrium that would arise under an equitable distribution of income. Government intervention in the economy is considered desirable if it moves the actual market outcome closer to this ideal outcome (in a sense that can be made precise using a social welfare function).

10. A typical example may be seen in the standard economic analysis of pollution externalities. In the absence of restrictions on pollution, a factory, which dumps its waste in a river, imposes costs on other members of society. Since the factory owners do not bear these costs they will dump waste in the river as long as this is the cheapest method of disposal. An appropriately designed tax can eliminate the divergence between the private costs faced by the factory owner and the costs borne by society as a whole. When such a tax is imposed, the factory owner will have an incentive to reduce pollution to the point where the marginal social benefits of further reductions would be outweighed by the costs of achieving such reductions.

11. Because this approach begins with a presumption that government policies are designed with the objective of improving social welfare, it is commonly referred to as the “public interest” approach. The underlying rationale of the public interest model is that the democratic system ensures that politicians wishing to be re-elected must introduce policies in line with the desires of the electorate, and hence must promote the

perceived interests of the majority of the community.

12. The alternative approach, which may be referred to as the neoliberal or “private interest” approach, takes as its starting point the actual market outcome. The central assumption in this approach is that the actual market outcome represents the closest possible approximation to the theoretical ideal, and that government intervention generally makes matters worse.

13. Advocates of neoliberalism used the failure of many programmes of government intervention to argue for the development of a category of “government failure” as a counterpoint to market failure. In addition to criticism of the actual performance of particular interventions, a number of counter-arguments to the theoretical basis of proposals for intervention were developed. Perhaps the most theoretically significant was the critique of the case for Pigovian taxes developed by Coase⁷, which developed into the theory of property rights⁸. Property rights theory played an important role in the case for privatization of government business enterprises.

14. The most fundamental critique of regulation is that of public choice theory. Developing out of earlier models of regulation⁹ and bureaucracy¹⁰ and attempts at economic modeling of political processes¹¹, public choice theory became the basis of a comprehensive critique of all forms of government activity. The central methodological tenet of public choice theory is the claim that the actions of voters and Governments could be understood in terms of the individual self-interest of participants in the political system. The constraints imposed by democratic accountability are implicitly or explicitly assumed to be irrelevant.

The welfare state and the resurgence of markets

15. From the second World War until the 1970s, most developed countries (with the exception of the formerly centrally planned economies) sought to promote a “mixed economy” in which public interest models of market failure were used to justify extensive government intervention. In particular, sectors of the economy that were seen as displaying the characteristics of “natural monopoly” were normally subject to public ownership. A range of externality and income distributional arguments justified public provision of health, education, social insurance and other services. Finally, concerns about economic stability led to tight regulation of domestic and international financial transactions.

16. The mixed economy was associated with the rise of the welfare state and with the use of Keynesian macroeconomic policies to stabilize the economy. The welfare state developed differently in different countries. Northern European countries adopted more comprehensive social systems based on universal entitlements, while other developed market economies,

notably the United States, relied more on “residual” or “safety net” systems of benefits targeted at the poor.¹² The United States also avoided public ownership whenever possible, relying instead on an intrusive regulatory regime that duplicated many of the outcomes of public ownership while maintaining the formal private status of utilities and other infrastructure enterprises.¹³

17. Government intervention was even more extensive in less developed countries, most of which were influenced to some degree by, among other factors, the apparent success of the former Soviet Union as a development model. However, despite the vast material and administrative resources required for comprehensive economic planning, the most common outcome was an extensive but unsystematic set of interventions, including public enterprises, import restrictions, licensing rules and systems of rationing.

The crisis of the 1970s

18. The mixed economy model performed well during the post-war “long boom” from 1945 to the early 1970s. Incidentally, this was the only sustained period of full employment in the history of the developed market economies. At the same time, other developing countries, such as Argentina, Brazil and Mexico, attempted to implement import-substitution industrialization policies based on the premises of inward-looking development strategies.¹⁴

19. The prosperity of the post-war boom gradually spread beyond the already-rich countries, such as northern European countries and the United States. Japan exhibited the most spectacular growth in Asia, but southern European countries, such as Italy and to some extent Spain, also caught up with the previous leaders. Towards the end of the period, the East Asian “Four Tigers” (Hong Kong, China; Singapore; Taiwan, Province of China; the Republic of Korea) began the rapid growth that would propel them into the ranks of the developed in subsequent decades.

20. Economic performance was not so satisfactory for most developing countries as a whole. Despite considerable promise and periods of rapid growth, the economies of Latin America fell further behind those of the more developed market economies. Hopes that decolonization in Africa and Asia would lead to rapid and broad-based economic development were not fulfilled. There was, therefore, growing disillusionment with existing development policies, in particular with the role of the state.

Developments since the 1970s

21. The problems of the mixed economy first became evident in the international sphere with the breakdown of the Bretton Woods system of fixed

exchange rates and the associated restrictions on international capital markets. Exchange rate instability followed. An emergence of surplus capital flows, in part due to the recycling of dollars that both the first (1974) and second (1979) oil shocks generated, depreciated the United States dollar. This trend reversed after implementation of strict monetary policies in the United States to stabilize inflation in the late 1970s. In fact, in almost all developed market economies attention rapidly turned to national policy responses to the upsurge in inflation and unemployment.

22. In most countries, this response took the form of a shift away from Keynesian policies of demand management in favour of monetarist policies based on control of the money supply. Strict monetarism implied that monetary authorities should adopt a rule of money creation that was perfectly consistent with a pre-established expected economic growth goal. In general, this stabilization policy was contractionary and unemployment remained above an acceptable level. Thus, monetarism fell out of favour by the early 1980s and was replaced by an eclectic policy based on a mixture of Keynesian and monetarist ideas. The longer-lasting impact of the rise of the monetarist approach to macroeconomic policy was the renewed respect given to the market-oriented views on microeconomic policy, espoused most notably by the Chicago School.¹⁵

23. As a policy cause, neoliberalism is derived from the classical free-market liberalism of the nineteenth century. However, dogmatic advocacy of a minimalist state is replaced by a more sophisticated critique of the mixed economy and a case for more market-oriented policy.

24. The mainstream of the neoliberal approach has been an attempt to raise efficiency and thereby create employment and an increase in income while at the same time reducing the discretionary intervention of the state as far as possible. Public ownership of infrastructure has been replaced with a combination of privatization and regulatory frameworks designed to satisfy social objectives and prevent the exploitation of monopoly power. In some cases, direct public provision of services, such as health and education, has been replaced with the purchase of services from private suppliers selected through competitive bidding (or tendering). Vast deregulation of the private sector took place and has been replaced by reliance on market forces.

25. In the United Kingdom, the United States and some other countries, notably Chile, neoliberal policies were pursued vigorously in the 1980s and early 1990s. The most notable cases were in the United Kingdom and New Zealand. Similar policies were pursued less enthusiastically, less systematically and with a considerable time lag in western Europe and in the newly industrializing countries and areas of East Asia.

26. The move towards more market-oriented

policies was reinforced by the political changes in eastern Europe and the demise of the centrally planned economy paradigm. A number of the post-socialist Governments imposed radical free-market policies, which have so far generally had extraordinarily high transitional costs. But even where the objective was to construct a western European-style mixed economy, the role of the market was greatly enhanced. At an ideological level, the apparent inability of centrally planned economies to achieve satisfactory economic performance, compared to economies based on market rule, undermined the belief that any fundamental alternative to a market economy was feasible.

27. Economic policy in many developing countries has been affected by worldwide changes in thinking about the appropriate roles of Governments and markets, and more directly by the influence of international organizations, such as the World Bank and the International Monetary Fund. The role of the International Monetary Fund in providing emergency credit had always encouraged its advocacy of policies of fiscal stringency, which typically included limits on government activity. This did not change in the 1980s and 1990s. By contrast, the World Bank recommended market-oriented reforms with much greater vigour in the 1980s and 1990s than previously. The so-called “Washington Consensus” was strengthened.¹⁶ In particular, policies of privatization were strongly encouraged.

28. All of these developments took place at different rates in different countries. From the early 1990s onwards, attention shifted back to the international dimension of the free-market resurgence. This shift in attention was commonly associated with discussion of globalization, which was gaining pace. While the term globalization was used in publications and public discourses in many different ways, central propositions in most discussions of the topic were the claims that globalization was an inevitable result of technological innovations, such as the Internet. Further, it was claimed that globalization necessitated the adoption of free-market policies, whether Governments and their domestic electorates liked it or not.

29. In the subsequent debate, it has been demonstrated that the first of these claims was incorrect. On most measures of economic integration, the world economy was considerably more integrated before the First World War than in the 1950s and 1960s, despite dramatic improvements in communications and transport technology. The ratio of the stock of capital derived from foreign direct investment to world output fell from 9.0 per cent in 1913 to 4.4 per cent in 1960, before rising to 10.1 per cent in 1995.¹⁷

30. The second point raises more complex issues. On the one hand, there is no clear evidence that the taxation and welfare policies of developed countries have converged since the 1970s. Data on the ratio of public

expenditure to GDP shows that the gap between high-expenditure northern European countries and such low-expenditure countries as the United States has remained broadly unchanged since the 1980s.¹⁸

31. Moreover, attempts at radical retrenchment of the welfare state and of the role of government have generally failed to roll back public expenditure. In numerous cases, neoliberal Governments that held power for many years achieved only modest cuts in the ratio of public expenditure to GDP, and these cuts have been partially reversed by their successors.¹⁹

32. On the other hand, it is clear that concerns about international competition and global financial markets have played a role in encouraging the adoption of market-oriented domestic policies. Conversely, the deregulation of domestic markets has frequently necessitated the abandonment of restrictions on international markets.

33. In summary, the links between globalization of the international economy and market-oriented reforms of national economies are complex and not unidirectional. Accounts of globalization as an irresistible exogenous force are debatable since profound globalization trends at the beginning of the twentieth century were eventually reversed in the mid-twentieth century. In fact, market-oriented policies in the domestic and international spheres have reinforced each other and undermined both domestic and international policy frameworks based on discretionary intervention.

State and market interactions – the East Asian paradigm

34. A rather different form of mixed economy developed in a number of East Asian countries or areas. Whereas the theory underlying the mixed economy in Europe and the English-speaking countries was based on the need for Governments to intervene in cases of market failure, the East Asian model was based on government intervention in support of the development of a strong private business sector.²⁰

35. Japan was the first of the East Asian economies to experience rapid economic growth. However, debate over the merits of the East Asian model as a replicable policy framework was stimulated most strongly by the successful take-off of the Four Tigers. The East Asian approach, based on “business-friendly” strategic intervention and exemplified by Japan’s Ministry of International Trade and Industry (MITI), was widely seen as an alternative to the neoliberal policies being advocated by many economists and others in the developed world.²¹

36. The alternative view, that the exceptionally strong economic performance of the East Asian economies was due to the adoption of market-oriented policies and sound “fundamentals,” and that strategic

interventions, such as those of MITI were at best harmless diversions, was put most strongly by the World Bank.²² A third view, that there was nothing exceptional about East Asian economic performance that could not be explained by the rapid growth in inputs of labour and capital, was vigorously debated in the late 1990s.

37. The stagnation of the Japanese economy during the 1990s and the Asian financial crisis, which began in 1997, have widely been seen as vindicating critics of the East Asian model. However, the crisis was exacerbated by policies of financial deregulation advocated by supporters of neoliberal reforms. In retrospect, these policies were often poorly implemented, but with the wisdom of hindsight, the implementation of reform policies is rarely perfect. Despite the weaknesses that have become evident, the East Asian economies delivered rapid economic growth and higher living standards for many years, and most of these gains have been sustained through the recent crisis.

Financial markets

38. The growth in the volume of financial transactions and the influence of financial markets has been one of the most spectacular developments in the world economy since the 1970s. It has been observed that cross-border transactions in bonds and equities for the United States rose from 9.0 per cent in 1980 to 135.5 per cent in 1995.²³ Similar though not quite as rapid growth has been evident in the volume of domestic financial market transactions.

39. It is necessary to view the role of financial markets in historical context. The breakdown of the Bretton Woods system of fixed exchange rates in 1971 and the subsequent upsurge in rates of inflation enhanced the status and power of financial markets. Faced with conflicting concerns about unemployment, economic growth and price stability, Governments appeared unwilling or unable to bring inflation under control. By contrast, the real return to investments in currencies and bonds depends on rates of inflation. Hence, financial market participants were unwilling to hold bonds and other financial instruments denominated in currencies subject to high inflation except at high interest rates or low exchange rates. Markets therefore demanded depreciating exchange rates and rising nominal interest rates from countries with relatively high levels of inflation. In retrospect, the general consensus of many economists is that the anti-inflationary discipline imposed by financial markets was beneficial, though there is still vigorous dispute over whether reductions in inflation could have been achieved with a lower cost in terms of unemployment and lost output.

40. Developments since the middle of the 1990s have led to qualifications of claims about the power of financial markets and the extent to which financial markets are accurate and impartial judges of the merits of

economic policy. With inflation rates at low levels in most developed countries, the role of financial markets as a source of monetary discipline has become less important relative to the potential disruption associated with financial crises. Moreover, as the example of New Zealand has shown, excessively zealous pursuit of low inflation and the approval of financial markets can produce economic stagnation.²⁴

41. The most important factor in the development of a more balanced view of financial markets has been the series of international financial crises, of which the East Asian crisis beginning in 1997 was the most important. The Asian crisis undermined the view of financial markets as judges of policy. The countries that were hit hardest were precisely those that had previously been regarded most favourably by financial markets. If the demands of financial markets are unpredictable, the idea that Governments can prosper by complying with those demands is logically incoherent.

42. The imposition of exchange controls by the Malaysian Government in 1998 was a pivotal event. Many advocates of globalization argued that any such policy was grossly mistaken and that, in any case, the financial markets would not allow such a policy to be implemented. In the event, the policy was successful in achieving at least some of its short-term goals and Malaysia was able to re-enter global financial markets without any apparent retribution.

43. Financial markets, particularly those for equity and corporate debt, also play a major role in the allocation of investment. As with currency markets, opinions as to the effectiveness of capital markets in achieving appropriate investment outcomes have fluctuated. During the post-war boom, the dominant view was summarized by Keynes' view of the stock market as a casino. Belief in the value of the financial discipline exerted by stock markets grew after the 1970s, particularly in the United States. The massive stock market boom of the 1990s reflected growing popular belief in the value of stock markets and the associated assumption that stocks were the best possible long-term investment.

44. The boom and bust in the NASDAQ index in the United States (which doubled in value between March 1999 and March 2000 then lost all its gains in the following year) has cast some doubt on this view. Although all well informed analysts and many previously influential financiers viewed the increase in the value of technology stocks as an unjustified "bubble" their views were powerless against the popular belief in an ever-rising market and the spurious "new economy" theories invented to justify and bolster that belief. Many investors lost large sums as a result of short selling based on the (valid) view that NASDAQ shares were grossly overpriced. Meanwhile, tens of billions of dollars were invested in essentially spurious "dotcom" companies created with the primary objective of delivering an initial

public offering (IPO) that would generate profits for inside investors.

45. The challenge for the future is to construct a system of domestic and international regulation (sometimes referred to as a “global financial architecture”). It would be expected to promote the beneficial effects of financial market transactions while reducing the instability and misallocation of resources associated with large-scale speculative movements of funds between currencies and financial instruments. One possible instrument is the proposal for a small tax on international financial transactions, commonly referred to as a “Tobin tax”. More generally, it seems that the counterpart to a more rapid pace of financial innovation is the need for more rigorous and transparent prudential regulation to ensure that financial institutions, which benefit from the protection of a publicly guaranteed financial architecture, do not misuse this protection by taking inappropriate risks.

Markets and infrastructure

46. Another area where private sector involvement has grown rapidly since the 1970s has been that of infrastructure construction, operation and ownership. Two main concerns led to government dominance of this area in the post-war period. The first was the belief that private investors adopted an excessively short-term focus that was inappropriate in the case of long-lived infrastructure projects. The second was concern about the natural monopoly characteristics of many infrastructure services, especially such networks as road systems, electricity grids and water supply systems.

47. The transfer of responsibility for infrastructure services from Governments to markets has taken place through privatization of existing publicly owned assets and through arrangements under which the private sector takes responsibility for the construction of new infrastructure, frequently with some form of explicit or implicit public guarantee. Prominent examples of the latter approach include the Private Finance Initiative in the United Kingdom and Build, Own, Operate and Transfer (BOOT) schemes, popular as a method of financing toll roads and other infrastructure projects in Australia and a number of Asian countries since the 1980s.

48. Privatization of government business enterprises has had a mixed record. The most favourable case is that where a money-losing government business enterprise is sold to a private buyer who can restore the enterprise to profitability. A number of cases of this kind have been reported in formerly centrally planned economies, especially former East Germany, and in some developing countries.²⁵

49. Less favourable cases arise when public assets are acquired by private buyers for less than their true

value, as measured by the present value of future earnings that could be anticipated under continued public ownership, with appropriate restructuring and management changes. The most notorious examples of this kind have taken place in some countries of Eastern Europe and the former Soviet Union. For example, in the Russian Federation and some other CIS countries, the mechanism of privatization was oriented towards the quickest possible abolition of state ownership and the promotion of all conceivable owners and public revenue rather than improving production efficiency.²⁶ It can also be argued that most privatization in developed countries have resulted in reductions in the net worth of the public sector. Inappropriate privatization has been encouraged by obsolete budget conventions that allow Governments to treat the proceeds of asset sales as current income.²⁷

50. Use of the present value of earnings as a test of the social desirability of privatization is complicated in the case of infrastructure by the existence of monopoly power. In some cases of privatization, sale prices have been artificially boosted by the allocation of monopoly privileges to private buyers. In other cases, where competitive markets are opened up at the same time as government business enterprises are privatized, it is difficult to assess the likely earnings of the enterprises if public ownership were to be maintained.

51. The main problems with private sector construction of infrastructure have been problems of risk allocation and problems of natural monopoly. Some evaluations of the Australian experience of BOOT road projects have illustrated the problems of risk allocation that arise when the returns to a private road developer depend primarily on the decisions made by Governments.²⁸ Similar problems have emerged in the developing world.²⁹

52. There have been numerous attempts to develop alternatives to public ownership as a response to the problem that many infrastructure services are natural monopolies, for which the most efficient outcome is to have the entire service provided by a single enterprise. Prices and rates of returns have been regulated, technically inefficient duplication of facilities has been encouraged to promote competition and rules have been imposed to require third-party access to monopoly infrastructure.³⁰ All of these approaches have costs and benefits, and none has been shown to be uniformly superior to the others or to public ownership.

Market creation as a policy instrument

53. The resurgence of faith in market processes has been accompanied by the development of a range of policy instruments designed to achieve “market-like” allocations of resources in areas where the final decision on resource allocation is still made by government. Two examples are the use of auctions to allocate rights to use parts of the electromagnetic spectrum for

telecommunications, and the use of internal markets and outsourcing in the provision of public services.

54. The worldwide swing to the use of auctions rather than administrative procedures to allocate valuable rights, such as the use of the electromagnetic spectrum for telecommunications, has been driven by a number of factors. First, the basic logic of the market solution is clear. Auctions allocate resources to the bidder who values them most highly and, in general, this bidder will put the resource to its most valuable use. Moreover, whereas in the past rights of this kind were commonly allocated to publicly owned telecommunications agencies or to media companies owned by nationals of the country concerned, the processes of privatization and globalization and the requirement to open national markets to competition means that rights are now frequently allocated to foreign-owned corporations. Hence, a government that gives such rights away is simply transferring national wealth overseas. Finally, the “fiscal crisis of the State” means that Governments cannot afford to overlook any potential source of revenue.

55. The experience of the recent auctions in this field provides some insights into the benefits and potential weaknesses of the auction approach. Numerous Governments auctioned rights to segments of the electromagnetic spectrum to be used for advanced wireless telephony services, commonly referred to as “third-generation” or “G3”. Outcomes differed greatly between countries, and auctions in May and August 2000 yielded approximately 20 billion pounds sterling (\$US 33 billion) and 100 billion deutsche mark (\$US 46 billion). In both cases, this amounted to about \$US 600 per potential customer. The Netherlands auction, held between the British and German auctions, yielded significantly lower returns, possibly because of collusion between bidders. After the German auction, the willingness of bidders to pay for G3 spectrum rights fell dramatically. The Australian auction, originally expected to yield more than 2.6 billion Australian dollars (\$US 1.3 billion), now looks to generate about one billion Australian dollars or \$US 500 million, amounting to about \$US 25 per potential customer. A number of factors contributed to this divergence. First, quite modest differences in the organizational arrangements for the auctions turned out to have large effects on the intensity of competition between bidders. Second, some Governments focused primarily on maximizing revenue, subject to constraints designed to avoid monopoly pricing, while others placed more weight on non-monetary factors, such as employment creation. Finally and perhaps most significantly, there were radical changes in market sentiment, partly associated with the current boom and bust in the share prices of technology stocks.

56. In using an auction approach, then, it is necessary to adopt a design that avoids both the danger of

allocating valuable rights at unacceptably low prices and the danger of generating socially undesirable outcomes in an attempt to maximize revenue. More theoretical and empirical work is required in this area.

57. The use of competitive bidding or tendering for publicly provided services has been seen as a way of introducing market forces into areas which were previously subject only to political control. The basic idea is to prevent workers and managers in the public sector from using the absence of direct markets for their outputs to perpetuate inefficient and costly work practices.

58. Initial accounts of the benefits of competitive tendering, particularly in the United Kingdom, were glowing, with claims of cost reductions as large as 50 per cent. Subsequent evaluations have been more restrained. Although competitive tendering has, on average, reduced the cost of publicly provided services, it has not always done so, and the average reduction after management costs have been taken into account has been less than 10 per cent in most jurisdictions. Moreover, much of the apparent saving has taken the form of reductions in wages or uncompensated increases in the hours and intensity of work, rather than genuine improvements in efficiency.

59. Equally importantly, it has become apparent that the benefits of market discipline often come at the expense of democratic political accountability. This is not an accidental outcome. The cost savings arising from competitive tendering are feasible precisely because private contractors may not be accountable, on a day-to-day basis, to ministers and parliaments.

60. Some similar concerns have emerged in relation to private sector “outsourcing” of information technology, property management, human resources and other services. In some cases, outsourcing has worked well, allowing businesses to focus on their core activities. In other cases, resolution of the inevitable difficulties associated with, for example, information technology, has been complicated by contractual disputes between firms and the suppliers of outsourced services.

Markets for health, education and social insurance

61. A central element of the welfare state was the idea that society as a whole was responsible for the provision of a range of basic services, including health, education and social insurance. Since the share of total expenditure allocated to these services tends to increase as income rises, policies of public provision implied the need for a steady increase in the share of GDP allocated to public expenditure, and therefore in the ratio of taxes to total income. The combination of growing demand for publicly provided services with resistance to increases in taxation has been the most important contributor to the “fiscal crisis of the state”. Concerns have also been

expressed about the quality of publicly provided services, the “paternalism” involved in universal systems of education and health care, and the adverse effects of dependence on welfare. Chapters IX, XI, XIII and XIV in the present report document the complexities of these fundamental social areas.

62. One response to the budgetary imbalances associated with the fiscal crisis of the state has been an attempt to replace public expenditure on health, education and social insurance with private expenditure. In addition, the ideas behind competitive tendering have been extended to the social services sector with the idea of the “purchaser–provider split”. Even where services are financed from government revenue, it is argued, the provision of those services should, where possible, be left to the private sector.

63. In the case of health, attempts to increase private expenditure fall into two main classes. First, there have been attempts to make patients, at least those not classed as “needy”, bear some health costs (for example, the costs of doctors’ visits and medicines) directly. Second, there have been attempts, for example through tax subsidies, to encourage the purchase of private health insurance. Both initiatives are being tried in national system reforms in countries at all levels of development.³¹ On the whole, such attempts have not yielded large benefits. For example, the performance of the United States, the only jurisdiction to rely primarily on subsidized private provision, is controversial. Health costs in the United States remain high in international terms,³² while many Americans are excluded from health insurance. Partly as a result, the United States performs relatively poorly as compared to other developed countries on measures of mortality and morbidity.

64. Attempts have been made to implement a purchaser-provider split in health, frequently in conjunction with a “case-mix funding” model, in which hospitals and other providers are paid on the basis of the cases actually dealt with in a given period, classified into diagnostic groups on a basis of estimated costs. This approach may be contrasted with funding based on historical expenditure or on the estimated needs of a service area.

65. Even the systematic attempt to implement a purchaser-provider split turned out to be unsuccessful and was partially revoked. More limited steps appear to have had some success in reducing budgetary costs, though the impact on quality of service remains a matter of some dispute.³³

66. In education, one of the most popular proposals for market provision is based on a “voucher scheme”. Under this scheme, free public provision of education would be replaced by a payment to students or their parents, which could be applied to the purchase of education services from any provider, public or private. Voucher schemes have been debated more vigorously

than they have been applied. However, some countries provide public assistance to private schools comparable to that received by public schools.

67. Both theoretical analysis and practical experience have raised concerns about voucher systems. The main problem is that of competition between schools for the most desirable students, commonly referred to as “creaming”. Given equal funding per student, schools will be unwilling to accept students who are costly to teach because of learning disabilities or behavioural problems. Often, the public system bears a disproportionate share of the responsibility for teaching children with special needs and disabilities. Moreover, whereas private schools can easily expel students for misbehaviour, or refuse admission to students considered undesirable, the public system is forced to accept all applicants.

68. One of the commonly referred cases of privatization of social insurance is that of Chile. Pensions were fully privatized, but the Chilean health-care system was not.³⁴ Established in 1981, the reform of pensions replaced a bankrupt “pay-as-you-go” public scheme. Under the new scheme, affiliated workers contribute 10 per cent of their salaries as net personal savings and pay administration costs and life insurance for an additional of approximately 3 per cent (that varies among a dozen private pension fund managers). Savings are privately managed under the funding method of individual capitalization accounts. For low-income workers, it is hoped that the return will be twice that obtainable under the older public scheme. The health-care reform has generated a creaming of patients that for its most part is also related to income level. All workers contribute 7 per cent toward health insurance, and they chose either public health care or private insurance. Patients at greater risk, generally relatively less-off, have concentrated on public health provision, while the more affluent and patients less at risk are serviced by health insurance companies that charge an extra fee for additional services.

69. Lessons can be derived by an examination of Chilean social insurance. The reform introduced a novel model and, in combination with other social policies has improved living standards.³⁵ At the same time, Chilean pension privatization commenced when the stock market was at a historically low level and was followed by an unprecedented boom that levelled off after 12 years of uninterrupted strength. It therefore led to important capitalization gains in individual saving accounts for retirement. In general, it cannot be expected that privatization elsewhere will take place under such favourable conditions. Moreover, the transactions costs associated with competition between fund managers are very large. In a period when share prices are rising rapidly, such expenses are sustainable. Such an expensive scheme would perform poorly in the event of a prolonged market downturn. In addition, the fiscal cost of pension

reform was initially very high. The private pension system needs to correct for lack of competition and high administrative costs as well as principal agency problems in the management of funds.

Market-state interactions

70. A common theme in many of the policy areas discussed above has been the interaction between the market and the state. The mixed economy of the post-war period was characterized by a fairly sharp division between the public and private sectors. Public sector agencies, even when engaged in the provision of goods and services, were characterized by employment conditions, financial procedures and accountability rules modelled on those of the civil service. On the other hand, regulation of private firms was relatively limited.

71. Since the 1970s, these sharp distinctions have become blurred. Through such processes as outsourcing, commercialization and corporatization, public sector agencies have become more like private companies, and have entered into extensive contractual relationships with private firms. On the other hand, privatization and increased reliance on private firms has necessitated more extensive and formal systems of regulation regarding pricing rules, service conditions and third-party access.

72. As a result, the scope of market-state interactions is more extensive and the range of options available to meet social needs is much broader than in the past. Increasingly, ideological debates about the relative merits of the public and private sector are being replaced by a more sophisticated and nuanced discussion of the optimal combination of market and state institutions required to meet particular needs.

Outlook for the future

73. Like markets themselves, policy settings are subject to waves of fashion and episodes of overshooting. Periods of excessive distrust of markets are followed by periods of excessive optimism about the rationality and self-correcting properties of unregulated markets. An extreme example of such excessive optimism is the wave of “pyramid” financial schemes that emerged in many post-socialist countries where financial markets had long been suppressed. However, the same pattern has been evident throughout the world since the 1970s, as the failure of state socialism and the difficulties of Keynesian social democracy reduced the appeal of interventionist policies.

74. Among the developed countries, the swing towards market-oriented policies was most marked in such countries as the United Kingdom, Australia and the United States. In all three countries, the period of

extreme optimism about the benefits of market-oriented reform has passed, and policy makers are seeking a more balanced approach to the relationship between Governments and markets. The most programmatic version of this search is the “Third Way” project of the British Government. The Labour Government of New Zealand, elected in 1999, has also sought to roll back the most extreme free-market reforms and adopt a more mainstream policy position. Similar developments are taking place in Australia, particularly at the state (provincial) level, where advocates of more radical free-market reforms have been replaced by advocates of a more consensus-based and balanced approach in policy.

75. In Europe and South-East Asia, the view that the unfettered free-market is not the most appropriate guide to the allocation of resources has been strengthened by financial market crises and the end of the stock market boom in the United States. Although countries in these regions are undertaking market-oriented reforms in some areas of the economy, they have generally tried to avoid the social destabilization associated with radical reforms. In particular, the reform process in the European Union has been aimed at modernizing and refurbishing the social-democratic welfare state rather than, as with radical free-market reforms in the English-speaking countries, aiming at “the end of welfare as we know it”.

76. What really proved crucial for the success of many market-based economies in the twentieth century was not only private property but also an ability to sustain competition among market agents. A competitive environment turned out to be indispensable for the organization of efficient production and was a decisive factor for the consolidation and development of the market economy, as we know it today. It has propelled technological advancement and the attainment of some major development goals, notwithstanding the emergence of different types of economic and social costs that need to be addressed – inequity and pollution, among many others. In most countries, a competitive economy proved to be dynamically efficient and has much better chances to produce equitable outcomes. On the contrary, non-competitive behaviour generates inefficiencies and monopolies, inequitable outcomes and eventually, lack of technological progress and advance. Privatization of formerly state-owned enterprises or institutions in the name of liberalization alone may lead to more rather than less inefficiencies. The latter may become an undesirable reality if the transfer of monopoly power from government to the corporate sector is not appropriately addressed as a market failure. Effective regulation and government supervisory oversight should be introduced as crucial policy goals to increase market discipline and greater transparency. They are a necessary condition for preserving competitive behaviour and supporting the continuous development of the market.

NOTES

¹ Smith, Adam (1776, 1976), *The Wealth of Nations* (1976 ed.). Oxford: Clarendon.

² Contemporary economic theory usually defines the optimum allocation of resources in the context of the so-called Pareto-optimum, named after Italian economist and sociologist Vilfredo Pareto (1848-1923) who laid the foundations of modern welfare economics. In a Pareto optimum, it is impossible to make anyone in the economy better off without making anyone else worse off. Also, it may be shown that any Pareto-optimal allocation can be generated as a competitive equilibrium if the initial distribution of resources is chosen appropriately.

³ For example, economies of scale and externality effects such as pollution are ruled out. Firms must be able to enter and leave markets without incurring sunk costs. The markets are assumed to have at least roughly accurate and symmetric information about the market. Most importantly, there must exist a costless method of redistributing assets to ensure that the initial distribution is equitable.

⁴ "Externalities" are unintended effects (positive or negative) of some activities (such as production processes, for instance); in economic theory they are considered in the context of differing private and social values. Externalities (or spillovers), may impact society as a whole, for example affecting persons who do not belong to the buyer or seller side of the market of the goods and services in question. Negative externalities are of a particular concern to society. The reasons for "externalities" to exist may be technological or of a pure economic nature. In the second case, the technological solution to prevent negative spillovers may be available in principle but economic motives (the profit maximisation factor) make it cheaper for the company to disregard the social cost of negative externality unless Government regulation forces the company to behave differently, making it internalize the externality.

⁵ "Free-riding" is abusive consumer behaviour that implies misuse of entitlements or rights. If left unattended, it leads to consumption without proper payment.

⁶ Frank, Thomas, "When markets rule politics" in *Financial Times* (London), April 6, 2001

⁷ Coase, R. (1960), 'The problem of social cost', *Journal of Law and Economics* 3(1), 1-44.

⁸ Furubotn, E. and Pejovich, S. (1974), *The Economics of Property Rights*, Ballinger, Cambridge, Mass.

⁹ See Stigler, G. J. (1971), 'The theory of economic regulation', *The Bell Journal of Economics and Management Science* 2(1), 3-21.

¹⁰ See Niskanen, W. (1968), 'The peculiar economics of bureaucracy', *American Economic Review* 58(2), 293-305.

¹¹ Downs, A. (1957), *An Economic Theory of Democracy*, Harper and Row, New York.

¹² See, for example, Gosta Esping-Andersen, *The Three Worlds of Welfare Capitalism*. Princeton: Princeton University Press (1993).

¹³ Thomas K. McCraw (ed.) *America versus Japan*. Harvard Business School Press, Boston, Mass. (1986)

¹⁴ See, for example, Sunkel, Osvaldo, 1975, *El subdesarrollo latinoamericano y la teoría del desarrollo*. México, D.F. : Siglo XXI Editores; Cardoso, Fernando Henrique and Enzo Faletto, 1969. *Dependencia y desarrollo en América Latina : ensayo de interpretación*: Siglo XXI Editores; Furtado, Celso, 1976. *Economic development of Latin America : historical background and contemporary problems*. Cambridge; New York : Cambridge University Press.

¹⁵ See, Friedman, Milton, 1962, *Capitalism and Freedom*. Chicago: University of Chicago Press.

¹⁶ See Stiglitz, Joseph E. "More Instruments and Broader Goals: Moving toward the Post-Washington Consensus" WIDER Annual Lecture 2, UNU World Institute for Development Economics Research (UNU/WIDER), Helsinki, January 1998.

¹⁷ Baker, D., Epstein, G. and Pollin, R. (eds.) (1998), *Globalisation and Progressive Economic Policy*, Cambridge University Press, Cambridge; table 5, p9.

¹⁸ Baker, D., Epstein, G. and Pollin, R. (eds.) (1998), *Globalisation and Progressive Economic Policy*, Cambridge University Press, Cambridge; table 11, p16.

¹⁹ See, for example, IMF International Financial Statistics (various years).

²⁰ See, for example, Robert Wade, *Governing the Market. Economic Theory and the Role of Government in East Asian Industrialization*. Princeton: Princeton University Press.(1990)

²¹ See Amsden, Alice, "Asia's Next Giant: South Korea and Late Industrialization", New York, Oxford University Press (1989); Johnson, Chalmers "MITI and the Japanese Miracle. The Growth of Industrial Policy, 1925-1975" Stanford University Press, Stanford California, 1982.

²² Leipziger, Danny M, Thomas, Vinod, *Lessons of East Asia*. The World Bank, Washington, D.C. 1993

²³ Baker, D., Epstein, G. and Pollin, R. (eds.) (1998), *Globalisation and Progressive Economic Policy*, Cambridge University Press, Cambridge; p. 10.

²⁴ Bean, C. 1999, 'Australasian monetary policy: a comparative perspective', *The Australian Economic Review* 32(1), 64-73.

²⁵ Kikeri, S.; Nellis, J.; Shirley, M., (1992), *privatization: The lessons of experience*, Washington, DC, The World Bank.

²⁶ Egor S. Stroeve, Leonid S. Bliakhman, Mikhail I. Krotov, 1999. *Russia and Eurasia at the Crossroads. Experience and problems of Economic Reforms in the Commonwealth of Independent States*. Berlin, Heidelberg: Springer-Verlag; p. 100.

²⁷ See Quiggin, John (1995), 'Does privatization pay?', *Australian Economic Review* (2nd quarter), 23-42.

²⁸ Harris, A. C. (1996), 'Financing infrastructure: private profits from public losses', New South Wales Auditor-General, Public Accounts Committee, Parliament of New South Wales Conference, 'Public/Private Infrastructure: Still Feasible?', Sydney, 31 July.

²⁹ Estache, A. and Strong, J. (2000) *The Rise, the Fall, and ... the Emerging Recovery of Project Finance in Transport*, World Bank Institute Working Paper. Please complete reference. Also see, for example, J. A. Gomez-Ibanez and J. R. Meyer, *Going Private: The International Experience with Transport Privatization*, (Washington: Brookings, 1993); A. Estache, "Privatization and Regulation of Transport Infrastructure in the 1990s," World Bank Policy Research Paper 2248, (Washington: World Bank, November 1999).

³⁰ King, S. and Maddock, R. (1996), *Unlocking the Infrastructure*, Allen and Unwin, Sydney.

³¹ See, for example, World Health Organisation, 2000. *The World Health Organisation Report. Health Systems: Improving Performance*. Geneva: WHO.

³² World Health Organisation, 2000. *The World Health Organisation Report. Health Systems: Improving Performance*. Geneva: WHO; annex table 1, p.155.

³³ See also chapter 11, the section on health.

³⁴ See, for example, Cruz Saco Maria Amparo and Carmelo Mesa Lago, eds., 2000. *Do Options Exist? The Reform of Pensions and Health Care Systems in Latin America*. Pittsburgh: Pittsburgh University Press.

³⁵ See Castaneda, Tarsicio, 1992. *Combating Poverty. Innovative social reforms in Chile during the 1980s*. San Francisco: ICS Press.