Public Policy in a Market Economy

(Lecture Note by Jonathan Pincus, 2012)

If there is a single question that dominates public policy in the 21st century it is this: what are the appropriate roles and functions of the market and the state? What activities should be left to individuals to carry out on their own without interference from government, and which activities properly belong in the public sector?

There are many different answers to this question, and every country must work out a dividing line between market and state that people view as acceptable and that delivers the social, economic and political outcomes they desire. It is certainly not possible to borrow solutions from other places without adapting them to the specific conditions of one's own country.

The appropriate role of the market and state is not just a question for developing countries. High income countries like the United States are still debating this issue. In fact, one could argue that the 2012 presidential election in the US is mostly about this single issue. President Obama's Democrats generally see a larger role for the state in social policy issues such as health care, education and inequality, and also in promoting growth through subsidies to emerging industries. Mitt Romney's Republicans want to rely more heavily on markets and to reduce the size and role of government.

It is important to remember that in historical terms this is a relatively new debate. In Europe before the 17th century, we cannot really speak of markets in the sense that we use the word today. Economic activity was for the most part governed by tradition and authority rather than markets. The land was controlled by the aristocracy and worked by peasants who surrendered their output to the lords in exchange for protection. Land was not bought and sold, but granted by the king or taken in war. Manufacturing was controlled by guilds that set prices and regulated quality. Crafts producers did not compete with other and only the guilds had the the right to produce specific goods—a right that was granted to them by the king or other sovereign authority. Labor did not move around looking for the highest wages. Peasants were tied to the land and apprentices to their guild masters. The idea that production would be "left to the market" would be incomprehensible to 16th century Europeans.

Nor did the nation-state exist as we know it today. People were not citizens of centralized states but instead subjects of their local lords or other traditional authorities. Monarchs were mostly concerned with raising money to finance armies to defend against other monarchs and to ensure the loyalty of the aristocracy, which relied on the king for its protection.

This began to change in the 17th century. The absolutist monarchs centralized power to compete with other monarchs. They used their power to promote exports to earn the money they needed to raise armies and fight wars. In doing so they took power from the nobility, which until then had controlled the local economy. A stronger central state gave rise to national economies for the first time. The organizing principle of these national economies was mercentalism, which was a system designed to increase state power through exports. Under mercantilism, trade was conducted through state monopolies that sold the output of local producers abroad and imported foreign products, for example tea, coffee, spices and other luxuries from Asia. The central state also promoted new agricultural technologies and public works like roads and drainage to obtain more export goods. Big farmers were encouraged to intensify production. In England, the big farmers were allowed to enclose common lands to raise more sheep to produce more wool. Barriers to trade between regions were reduced. National currencies were created.

Eventually the creation of a national economy led to the rise new groups who were not part of the traditional elite. These people did not rely on state power to make their fortunes, and they wanted to operate in markets that were controlled by state monopolies and the nobility. In England, the Glorious Revolution of 1688, when King James II was overthrown by parliament, represented the rise of these new classes of merchants, farmers and industrialists.

Adam Smith's the *Wealth of Nations*, published in 1776, defended the rise of these independent groups against the dominant mercantilist system. The title of the book reveals the author's main idea: that the wealth of the nation cannot be defined in terms of how much gold it has, or even how much it exports, but rather in the productivity of the people. The nation would be richer if the government allowed the market to flourish than if the state creates monopolies and restricts competition. It is the greed of individuals that drives the system forward, not the wisdom of rulers.

Smith's big idea was not the invention of markets (they already existed, even if they were constrained by government), nor the celebration of private property (John Locke had done this one hundred years before). The remarkable conclusion of the *Wealth of Nations* was something quite different. He argued that allowing people to operate according to their own self-interest would not result in chaos as was feared by traditional rulers. Order would emerge spontaneously out of the free choices of individuals. This was a radical idea at the time. Since people were sufficiently rational—and reliably self-interested—their individual choices lead to an automatically balanced economy and not the total anarchy feared by the traditional elites.

Not only balanced, but also efficient and just. It would be efficient because competition would eliminate waste and poorly performing producers. But it would also

be fair, since people would earn exactly what their skills entitled them to earn. The market was objective and automatic.

From this Smith concluded that the role of government should be limited to three things: security, a fair enforcement of the law and public goods. Removing constraints on trade would increase the wealth of the nation and the people. Although Smith wrote more than two centuries ago, he still has his adherents in the 21st century: people who believe that "the state that governs least governs best."

But the story does not end there. Markets were unleashed in the 18th and 19th centuries in Europe, and industrial revolution changed the nature of production and consumption in ways that could not have been imagined just a few decades before. But free markets also gave rise to terrible abuses. Young children worked in horrendous conditions in the mills of Manchester and Birmingham and in the mines in the north of England. Workers could not be said to be "freely contracting" with their employers if they had no alternative means of surviving. The outcome of free market transactions were also far from fair: the rich accumulated vast amounts of wealth while the poor lived in appalling conditions with no hope of escape.

Governments responded with regulations on businesses such as the Factory Acts in England that regulated child labor and conditions of work. Eventually, in the 20th century, workers formed unions to increase their bargaining power. Governments also took action to create more opportunities for the poor, for example progressive taxation and free education. Laws were passed to control pollution, regulate the quality of food, and correct for many other market failures.

Nowadays we focus on five ways in which markets fail to achieve the perfect and just outcome expected by Adam Smith:

1. **Monopoly and monopsony**: When there is only one buyer or seller then coercion is inevitable. The free entry of producers (and consumers) does not always prevent monopolies. Sometimes they are given by technology, but what is considered a "natural monopoly" has changed over time. Monopolies are also created by market power. For example, there are only two major producers of commercial aircraft left in the world.
2. **Exploitation**: If power relationships are unequal, the strong can exploit the rich. Does labor enter into contracts with employers freely, or is the bargaining relationship unequal?
3. **Inequality**: Does the free market lead to extreme differences in income that undermine society? Should society try to achieve equality of opportunities or equality of outcomes?
4. **Externalities**: When the costs and benefits of economic activity are not shouldered by or received by parties to a contract. Pollution is the most obvious example.

5. **Public goods**: The market will not provide some kinds of goods if no profits can be made in producing them. The classic example is a national park. Since it is difficult to charge for entry, and the cost of the land is high relative to the price people are willing to pay to visit parks, no individual investor will buy large areas of forest or other nature preserves to maintain them for public use. The government must do this if it values nature conservation and public access to places of natural beauty. But what we consider to be a public good varies from country to country. Is medical care a public good or a service to be bought and sold? What about university education? Fire departments?

The debate over the proper roles of the state and market still continues in Vietnam. In fact, it will probably always continue. An interesting recent contribution to the discussion was published last year by the World Bank and VCCI. The report, entitled "Vietnam in Transition: Changing Attitudes towards the Market and State," included some surprising findings. Although there may have been a few methodological problems with the survey, the report suggests that Vietnamese people have some inconsistent and even contradictory ideas about the role of the market and the state. They believe that the state should control prices but think that price controls did not reduce inflation. They support a large role for state industry but feel that large SOEs in Vietnam have not make a large contribution to the national economy.

We should not read too much into one survey. But it appears that the debate about the proper role of the state and market in Vietnam still suffers from a lack of analytical clarity. Perhaps opinion leaders like academics, journalists and government officials have not done a good job of explaining the issues at stake in an unambiguous and understandable manner.