Idols of the Market-Place

Sumanasiri Liyanage

A well-known philosophy of Francis Bacon is his enumeration of what he calls "idols" by which is meant bad habits of the mind that cause people to err. One of these is the "idols of the market-place". Though I use it in a different sense, some respondents to my article have demonstrated that they have difficulty escaping from what is generally called TINA (there is no alternative) mindset. I am not surprised by the nature of the response to my article from young economics graduates, as nothing other than neo-liberal economics is taught in the classrooms. I will confine myself here to substantial arguments and have no intention to deal with specific criticisms though they are valid within limits. It will suffice to say that 'distant' does not mean that I have been out of the discipline.

Let me begin with the opening two paragraphs of a recently published book by a Harvard University professor.

"On a visit to a small Latin American country a few years back, my colleagues and I paid a courtesy visit to the minister of finance. The minister had prepared a detailed PowerPoint presentation on his economy's recent progress and listed all the reforms that they had undertaken. Trade barriers had been removed, price controls had been lifted, and all public enterprises had been privatized. Fiscal policy was tight, public debt levels low, and inflation non-existent. Labor markets were as flexible as they come. There were no exchange or capital controls, and the economy was open to foreign investments of all kind. 'We have done all the first generation reforms, all the second generation reforms, and are now embarking on third generation reforms' he said proudly.

Indeed the country and its finance minister had been excellent students of the teaching on development policy emanating from international financial institutions and North American academics. And if there were justice in the world in matters of this kind, the country in question would have been handsomely rewarded with rapid growth, poverty reduction. Alas not so! The economy was scarcely growing, private investment remained depressed, and largely as a consequence, poverty and inequality were on the rise. What had gone wrong?" (Dani Rodrik, One Economics Many Recipes: Globalization, Institutions and Economic Growth, Princeton University Press, 2007, p. 1)

Many students of economics were forced to accept free and unprotected trade, minimum state intervention, and uncontrolled foreign investment as fundamental conditions of economic development. They were also made to believe that today's developed countries had achieved their success in economic development through free and unprotected trade, and minimum state intervention. If we consider history as the laboratory of economics, it gives ample evidence that these economic nostrums are absolutely incorrect. In this article, I will deal with the argument of free trade leaving other issues like government intervention and foreign investment for a separate article. Let me cite examples from Great Britain and the USA.

Great Britain: At the beginning of the 19th century, the average tariff rate on manufactures was 50 per cent—high by almost any comparative standard. It reduced its tariff on manufactures after it reached world economic pre-eminence.

USA: According to the World Bank estimates, the average US tariff on manufactures was 40 per cent in 1820. It was around 30 per cent for most of the 1870 to 1910 period.

Though it was normally believed that trade protection was higher in Germany and France than it was in Britain and the US, facts dispute it. Responding to my article, **AJ writes:** “People who oppose free trade automatically support inefficient domestic producers (local entrepreneurs who get fat on the poor consumers).” Let me narrate a story.

“Once upon a time, the leading car maker of a developing country exported its first passenger car to the US. Up to that day, the little company had only shoddy products. The car was nothing too sophisticated. But it was a big moment for the country and its exporters felt proud.

Unfortunately, the product failed. The car had to be withdrawn from the US market. This disaster led to a major debate among the country’s citizens.

Many argued that the company should have stuck to its original business of making simple textile machinery. If the company could not make good cars after 25 years of trying, there was no future for it. The government had given the car maker every opportunity to succeed. It had ensured high profits for it at home through high tariffs and draconian controls on foreign investment in the car industry. Fewer than ten years ago, it even gave public money to save the company from imminent bankruptcy. So the critic argued, foreign cars should now be let in freely and foreign car makers, who had been kicked out 20 years before, allowed to set up shop again.

Others disagreed. They argued that no country had got anywhere without developing ‘serious’ industries like automobile production. They just needed more time to make cars that appealed to everyone.

The year was 1958 and the country was, in fact, Japan. The company was Toyota.” (Ha-Joon Chang, Bad Samaritans: The Myth of Free Trade and the Secret of Capitalism, Bloomsbury Press, 2008, p. 19)

Ricardo-HOS Model

Not only does the neo-classical orthodoxy not sit very well with historical experience in developed countries, it is theoretically flawed. The Ricardian principle and its later modifications are essentially wrong as they are based on static assumption in explaining potentially dynamic situations. I will prove this point by using a simple example. Figure 1 presents a simple comparative advantage model by using Ricardian two-country trade relations.

Figure 1

	Tea	Cloth	Domestic Barter Rate
Sri Lanka	80	90	1 tea = 0.8 cloth
England	120	100	1 tea = 1.2 cloth

In this example, Sri Lanka has an absolute advantage in producing both tea and cloth over England. According to the Ricardian principle, this does not prevent the two countries from entering into trading transactions because Sri Lanka has a comparative advantage in producing tea while England possesses comparative advantage in producing cloth. So, both countries will be benefited if Sri Lanka specializes in production of tea while England specializes in production of cloth. But the story does not end there. Since production of cloth is characterized by increasing returns, technological growth and synergy and production of tea is subject to decreasing returns, in the process, England will become rich and developed and Sri Lanka will remain poor and underdeveloped.

Neo-liberal orthodoxy suggests that a country should specialize in production in which it has comparative advantage determined by its factor endowment. Hence, when the South Korean government planned POSCO (Pohang Iron and Steel Company) in the late 1960s, the World Bank refused to finance it on the grounds that the project was not viable. Since South Korea's traditional exports consisted of fish, cheap apparel, wigs and plywood and it did not possess iron ore and coking coal, the decision appeared insensible. But, dynamic changes can transform comparative disadvantage into comparative advantage. Today, POSCO (now privatized) has become one of the most efficient steel makers in the world and the third largest. What would have happened had South Korea allowed the so-called market logic to operate? Paul Krugman has observed that in the US a very few actually follow the standard neo-liberal trade theory model. He writes: "[T]he view of trade as a quasi-military competition is the conventional wisdom among policy makers, business leaders, and influential intellectuals… It is not just that economics has lost control of the discourse; the kinds of ideas that are offered in a standard economics textbook do not enter into that discourse at all" (except in the global south).

This brings us to an issue of great importance: Is the state inherently inefficient, bad and wasteful? Should the role of the state be limited to maintenance of law and order, provision of legal and property rights, and provision of security for its citizens? As suggested earlier, I leave this issue for a separate article.

We may specify four developmental models, namely, (1) free market neo-liberal orthodox model; (2) development state model under authoritarian rule; (3) social-democratic model; and (4) state command centrally planned model. These are broad categories. In the real world many combinations and hybridities exist. In my view, the development experience in the last 250 years shows that model 1 (except in case of Hong Kong and Chile under Pinochet) and Model 4 (whatever the initial successes) failed to make development sustainable in the under-developed countries' context. What Sri Lanka tried in the last three decades (1977-2008) has been much closer to the Chilean model but with limited and formal democracy and without complete reversal of the pre-1977 welfare policies. Model 2 cannot work in countries like India and Sri Lanka with their long democratic tradition (whatever the democratic deficit and limitations). If we operate within broad categories, there is an alternative, and the alternative is some form of social democracy, and that alternative can be legitimized not only by pure economic reasoning but by other reasoning as well.

The writer teaches political economy at the University of Peradeniya.

E-mail: mailto:sumane_l@yahoo.com