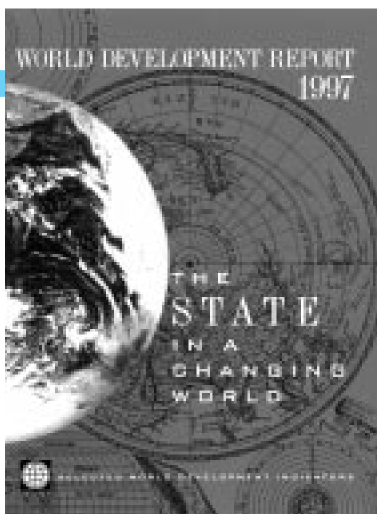

How Can States Foster Markets?

BRIAN LEVY

Governments can encourage market development by clearly defining property rights, ensuring a sound regulatory framework, and pursuing industrial policies. But what they do in these areas should be determined by their institutional capability.

GOVERNMENTS throughout history have experimented with different approaches to economic activity, assuming roles that called for varying degrees of state intervention—from laissez-faire to command and control. Some of these approaches have proven more successful than others in fostering economic development, but experience has shown that no one approach is suitable for all countries at all times. Although it is generally agreed that the state and markets play complementary roles and that the state is responsible for laying the foundation for market development—for example, defining and protecting property rights—there is more controversy about what the state should do—and how it should do it—in areas such as regulation and industrial policy.

Property rights

Markets cannot develop unless property rights—including the right to use an asset, to permit or exclude its use by others, to collect the income generated by the asset, and to sell the asset—are adequately defined. Property rights, in turn, rest on social arrangements, which include reasonable restraints on lawlessness (protection from theft, violence, and other acts of predation); protection from arbitrary government actions that disrupt business activity; and fair and predictable mechanisms for resolving disputes. But many countries lack even these basic social arrangements. In a survey of private firms in 69 countries that was conducted for the *World Development Report 1997 (WDR)*, firms in 27 countries said that the triple curse of corruption, crime, and an unpredictable judiciary was a powerful deterrent to investment.

Once there is a modicum of order, development can begin, even in the absence of formal, state-sponsored institutions. In the early Middle Ages, European merchants devised their own sophisticated legal code to govern commercial transactions. A twentieth-century example of informal social enforcement mechanisms is provided by the extensive business networks of Chinese clans.

Informal arrangements are usually inadequate, however, when business transactions become more complex. Consider the example of nineteenth century mining investments in the "Wild West" state of Nevada in the United States. Initially, Nevada's few hundred miners were able to operate on the basis of unwritten, informal ownership agreements. But the discovery of rich lodes of gold and silver precipitated a flood of prospectors, making it necessary for miners to establish formal rules. As surface ore was exhausted and mining became a more expensive, capital-intensive undertaking, the miners pressed for full recourse to the US judicial system, and Nevada became a state. Once formal mechanisms have been put in place, economic development may accelerate.

The number of ways different aspects of the legal system can buttress property rights is vast—ranging from land titling and the collateralization of movable property to laws governing securities markets, the protection of intellectual property, and anti-monopoly legislation. However, sophisticated reforms in this area will not bear fruit in countries that lack strong institutional capabilities.

Information and coordination

Even in countries with well-defined property rights, information and coordination problems can impede market and private sector development. Information problems occur because the "rules of the game" may not be spelled out clearly, and because knowledge and understanding are inevitably limited. For example, businesses or individuals may lack knowledge about the probity of potential partners or be unaware of potentially profitable opportunities. Coordination is difficult because self-interested people and firms generally are willing to share information only when they do not lose by doing so. The risk that other parties might renege on agreements makes it difficult for firms to take advantage of opportunities for mutual gain. However, states can alleviate information and coordination problems through regulation and industrial policy.

Brian Levy,
a South African national, was a principal author of the World Bank's World Development Report 1997.

How much the state does in these areas should reflect its institutional capabilities in two regards: first, the ability of government officials and agencies to manage technical complexity; and, second, the extent to which the checks and balances in force in the country can restrain agencies, officials, and politicians from departing from their stated commitments and lapsing into arbitrary and unpredictable enforcement. In countries where institutional capabilities are strong, restraints can be accompanied by some flexibility, allowing officials to respond to unexpected events. Countries with weaker capabilities may need to do less and to proceed in ways that limit the risks of arbitrary behavior.

Box 1

Telecommunications regulation in Jamaica

During much of the colonial period and in the years immediately following independence, the terms under which Jamaica's largest telecommunications utility operated were set out in a legally binding, precisely specified license contract. The ultimate court of appeal for Jamaica's independent, well-functioning judiciary was the United Kingdom's Privy Council. This system was adequate to ensure steady growth of telecommunications services. Yet a newly independent Jamaica chafed under the apparent restrictiveness of a concession arrangement that afforded virtually no opportunity for democratic participation. Consequently, in 1966 the country established the Jamaica Public Utility Commission, modeled on the US system. But the United States has a variety of constraints on regulatory discretion (including well-developed rules of administrative process and constitutional protections on property), while Jamaica had virtually no checks on Commission decisions. The result was that price controls became progressively more punitive and led to government takeover. In 1987, after a decade of underinvestment, Jamaica reprivatized its telecommunications utility, this time using a precisely specified legally binding license contract, similar to those used prior to 1965. Investment has surged.

Regulation

Regulation, if well designed and implemented with care, makes it possible for societies to influence market outcomes for public purposes. It can be used to conserve the environment as well as to protect consumers and workers from some of the consequences of information asymmetries. It can also foster competition and innovation, and prevent the abuse of monopoly power. More broadly, it can help win social acceptance of market outcomes by establishing their legitimacy and ensuring their fairness. If badly designed, however, regulation can result in large costs for firms and society. It can undermine property rights, fuel corruption, and inhibit market entry. As countries proceed with economic liberalization, many areas of regulation are recognized as counterproductive and abandoned. But certain types of regulation serve a valuable purpose and should be preserved.

Utilities. Regulation in the utilities sector remains crucial, even in the wake of revolutionary technological changes. In telecommunications today, for example, signals traverse multiple network systems owned by different operators; power generators supply customers through common-carrier transmission lines. Real competition can occur only if regulatory rules mandate easy interconnection and specify how interconnection prices will be determined.

Regulation is also a vital tool in protecting private investors from the risk of expropriation. If a government has a change of heart, utilities are particularly vulnerable because their assets cannot be redeployed for other uses. Thus, in the absence of a clear regulatory framework, investors run the risk that governments may initially offer them attractive terms only to impose costly demands later. A well-designed mechanism that commits the regulator to a clearly defined course of action can offer the reassurance needed by potential investors.

A cross-country comparison of telecommunications reform illustrates the options available to countries with different levels of institutional capability with respect to how much flexibility they give their regulatory agencies. At one extreme are industrial countries such as New Zealand and the United Kingdom, where institutional checks and balances are strong enough to permit experimentation with highly flexible regulatory approaches without scaring off private investment. The United Kingdom, for example, imposes an overall ceiling on utility prices based on the annual rate of inflation minus an adjustment factor set by the regulator. Price-cap regulation gives the utility an incentive to be efficient and can encourage innovation, but it also gives the regulator substantial discretionary power. A better option for countries with weaker checks and balances might be to combine price-cap regulation in which the adjustment factor is fixed with an agreement to share unexpectedly high profits on the basis of a prespecified formula. Between these two extremes, we find Jamaica, which has given its regulatory agency limited flexibility (Box 1).

The long-term goal for countries with weak background institutions must be to strengthen them. In the short term, one option is to substitute an international mechanism for the missing national foundation. The Philippines has attracted independent private generators of electric power by agreeing on very rigid "take-or-pay" contracts that are enforceable offshore. The World Bank Group offers guarantees for infrastructure projects to protect private investors and lenders against noncommercial risks, including the risk of administrative expropriation.

Banking. The case for regulation in the financial sector is also compelling. The goal should be not to channel credit in certain predetermined directions but to safeguard the health of the financial system through prudential mechanisms. In the absence of regulatory incentives to provide reliable information, banks can easily disguise the extent of nonperforming loans in their portfolio—and their own lack of solvency. Information asymmetries in the banking sector can be destabilizing. Without reliable information, depositors might rush to withdraw their funds when there are rumors about troubled banks. When banks go under, nervous depositors can start runs on other banks, with potentially severe macroeconomic consequences.

To reduce the risks and costs of bank failures, countries with strong administrative capabilities and well-functioning legal systems generally promulgate detailed regulations and assign a central role to bank supervisors. Key elements of such banking systems include capital adequacy and entry criteria; restraints on insider lending; rules for banks to classify the quality and risks of their loan portfolio; and regulations that banks must meet minimum auditing standards and disclosure requirements. But these types of measures will be difficult to implement unless reasonably reliable accounting and auditing information is available on the financial health of a bank's borrowers and unless there are a sufficient number of supervisors who are not only skilled enough to do the job but politically independent enough to do it impartially.

Especially if institutional capabilities are weak, more emphasis can be put on making the incentives and interests of bank owners, managers, and depositors compatible with prudent banking. Recently, for example, the World Bank and the European Bank for

Box 2

Japan's postwar push in the metal industry

In the late 1940s, Japan's machinery companies had difficulty penetrating export markets. They identified the high cost of steel as a major impediment. The steel companies, in turn, attributed the high cost of steel to the high cost of coal, which was either mined in Japan or imported—both at great expense. Building on institutional arrangements developed during wartime, in 1949 Japan's Ministry of International Trade and Industry (MITI) put in place a joint public-private deliberative structure, the Council for Industrial Rationalization, composed of representatives of industrial associations, leading enterprises from each industry, and public officials. Together, key representatives agreed on the following commitments:

- The steel and coordination branches identified the price of coal that would make it possible to produce steel for export at competitive prices.
- The coal industry committed itself to investing ¥40 billion to rationalize production from domestic mines, as long as steel firms agreed to purchase coal from them afterward at the new prices, which were 18 percent below prevailing levels.
- The steel and coal industries agreed on an overall target purchase price for coal by steel firms. The price was achievable by mixing domestic purchases and imports.
- The steel industry made a commitment to invest ¥42 billion to upgrade its facilities. With this investment, and lower coal prices, it would be able to export steel competitively.
- In return for commitments of lower steel prices, the machinery and shipbuilding industries were in a position to embark on major export-oriented investment programs.

Reconstruction and Development (EBRD) collaborated in Russia to onlend funds through participating banks that agreed to submit to annual audits by international accounting firms and to adhere to prudential norms.

Industrial policy

In cases where externalities, a lack of competition, and other market imperfections drive a wedge between private and social goals, there is general agreement that states can enhance welfare by regulating markets. There is much more controversy about whether states should try to accelerate market development through activist industrial policies. The rationale for industrial policy in developing and transition economies is that their information and coordination problems are especially acute and pervasive. This is because, in countries where the number of market participants is small, information is a source of power and therefore tightly guarded, and because the institutional arrangements that evolve as markets develop to facilitate economically beneficial coordination remain weak. With appropriate institutional capability, governments can support industrial development by acting as brokers of information and facilitators of mutual learning and collaboration.

A key distinction needs to be made between initiatives that require only a light touch from government and those that require more intense government involvement. The latter should be approached cautiously or avoided, except by countries that have unusually strong institutional capabilities.

Postwar Japan's development of the steel, coal, machinery, and shipbuilding industries offers a rare example of successful government activism (Box 2). In contrast, the Philippines' experience with industrial policies in the 1970s and 1980s shows what can happen when large ambitions are not matched by institutional strengths and government is swayed by powerful private interests. In 1979, the Philippine government announced a new $5 billion program of "major industrial projects," all in heavy, capital-intensive industries. By late 1987—but only after intense pressure by critics and a change of government—5 of the 11 initial projects, accounting for almost $4 billion, had been shelved.

Industrial initiatives that require a light touch from government—inexpensive public-private partnerships intended to foster the provision of intra-industry public goods—offer more flexibility. In mature market systems, networks of private firms flourish. Domestic, regional, and international networks create sources of learning and open up opportunities for firms; specialized buyers open up new market niches and offer information on product standards; equipment providers transfer technological know-how; input suppliers help with product and process innovations; and competitors are a rich source of new ideas. Often, clusters of firms, buyers, equipment suppliers, input and service providers, industry associations, and other specialized organizations come together in the same region. But in countries with underdeveloped markets, a catalyst (public or private) may be needed to set this process in motion.

Catalytic initiatives can be directed either at individual firms or at groups of firms. Some successful initiatives have focused on events, such as joint participation in trade fairs. Others (in Chile and Denmark, for example) have aimed at achieving a broader shift in the business culture to favor cooperative efforts that can lead to increases in productivity. A promising approach involves giving matching grants to firms, typically on a 50:50 cost-sharing basis, to help them penetrate markets and upgrade technologies.

Focusing on the possible

In fostering markets, there is no "one-size-fits-all" formula. If institutions are strong, far-reaching state actions can contribute to economic well-being. Without strong institutional foundations, such actions are likely to prove ineffective—or even an invitation to capture by powerful private interests or for predatory behavior by the state.

How, then, should countries with limited institutional capabilities proceed? In the short term, until institutions can be strengthened, the first challenge is to focus on the essentials—establishing a lawful state and setting sound economic policy, for example—while setting a lighter agenda for state action. The second challenge is to find tools for state action that are better aligned with country capabilities. Two approaches appear to be particularly promising:

- specifying the content of policy in precise rules, and then locking in the rules using mechanisms that make it costly to reverse course; and
- working in partnership with firms and citizens, sometimes shifting the bur–den of implementation entirely outside government.

The results may not be first-best in a textbook sense. But as state capability grows, it will become possible to switch to more flexible tools that are capable of increasing efficiency gains. Throughout, states must maintain the confidence of firms and citizens that flexibility will not be accompanied by arbitrariness or else the foundation for development will crumble.

F&D

This article is based on the World Bank's World Development Report 1997: The State in a Changing World *(New York: Oxford University Press for the World Bank).*