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Political Economy of Adjustment in Developing Countries and their Labour Markets

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It is with great sadness that we have to report the death of Shiv Nath, shortly after this paper was completed and presented. Shiv was a valued colleague and he will be greatly missed in the Department.

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Political Economy of Adjustment in Developing Countries, and their Labour Markets

Adjustment policies, like all public economic policies, belong to normative applied economics. The analysis and recommendation of such policies are grounded on welfare economics; they share the strengths and the weaknesses of that part of economics. Yet it is not uncommon to see in the relevant literature rather cavalier use of such concepts as 'Pareto improvement' and 'increase in social welfare', etc. In section 1 of this paper, we review these concepts and the normative foundations of economic policies generally. We emphasize the interdependence of the economic and non-economic determinants of social welfare, particularly in a developing country.

The political systems of developing countries, which are discussed in section 2, are vulnerable with poorly developed consciousness of a nationhood, fragile social cohesion, and the lack of long and established record of civic order. These factors make the social justice aspect of economic policies much more important in developing countries than in developed countries. Economic policies do not only have to be socially just, they also have to be seen to be so by the different and poorly integrated linguistic, religious and tribal groups comprising the society in a developing country. Moreover, unlike developed countries, most developing countries do not possess stable political parties competing for

power only through the ballot box at regular intervals. These features of their political systems make the ready application of the Pareto criterion even more problematic in devising economic policies for developing countries.

In section 3 we select a few characteristics of the labour markets in developing countries, which are of a kind that vitiate some of the assumptions of the economics of labour markets of developed countries. There may be good reason to doubt that the hypothesis of real wage resistence applies to large sections of unorganized labour which work in the informal sectors - some of which produce notable amounts of treadeables. For the informal rural and urban sectors, food subsidies may be an important corrective to the disadvantages they suffer regarding other inputs when compared to the formal sectdor. Again the 'economy of high wage rates' which perhaps is no longer of such importance in developed countries may well be an important, vibrant and growth-inducing phenomenon in developing countries.

1. Theory of Improvements in Social Welfare

In theory a distinction can be made between stabilization and adjustment policies. The former deal with the kind of problems which are often thought of as short-run: such as an unsustainable balance of payments deficit or government deficit, and high rates of price inflation. Needless to say, these three problems are often found together. (In a developed country a stabilization programme may also be designed to deal with the problem of an unusually high rate of unemployment, but in developing countries unemployment of various kinds is a long-term problem.) Structural adjustment policies, on the other hand, consist of measures which are expected to improve the allocative efficiency, strengthen incentives through removing distortions, and thus also raise the rate of growth of GNP per capita. Thus they are medium-to long-term policies. However, the two kinds of policies are closely linked in practice: usually it is when a country faces an acute stabilization problem that it is then also advised (and sometimes required) by the international agencies to undertake certain adjustment policies. Indeed in an acute crisis, all proposed policies are sometimes lumped together under the heading of "adjustment". Typical examples of some of the adjustment policies which have been advocated are: elimination of price and wage controls, of food subsidies, of tariffs and other barriers to international trade; and, sometimes, improvements in infra-structure. The essence of adjustment policies, as distinguished from stabilization policies, may be claimed to be that of improving "economic efficiency" (a concept which we shall

evaluate below), strengthening economic incentives, and promoting economic growth.

Any adjustment policy like any other economic policy can only be advocated on the basis of some explicit or implicit normative premise of what the goals of economic policy are. We shall first outline what appears to be the implicit normative framework of the adjustment policies usually advocated. We shall then go on to develop a critique of this framework, and also offer an alternative normative framework for the design of adjustment policies.

Adjustment policies advocated by the international agencies are clearly grounded on the traditional welfare economics. Social welfare is thought of as social happiness or utility (or, occasionally, whatever increases the number of choices of individuals). Any concept of a personified Society or State, etc. is eschewed. The concept of a social welfare function (SWF) was first explicitly introduced into economics by Bergson (1938). According to him, SWF is a real-valued function (i.e. it can be represented numerically). To begin with he defined the SWF as a very general function - depending on economic variables and non-economic variables, the latter to include such variables as the political system, political freedoms, being at war or at peace, etc.

(1) $W^* = W^*(E_i, A_j)$; $i = 1,\ldots,n$; $j = 1,\ldots,m$.

Here E_i are the economic variables and A_j the non-economic ones. Bergson then put two restrictions on this function. The second of which is innocuous, indeed essential if economic policy is to be based on liberal values (see below): but the first restriction, though apparently also innocuous - and indeed even apparently also necessary to make the analysis of economic policies manageable - is, nevertheless momentous, and, it will be argued, a possible source of irrationality when the usual framework of welfare economics is applied to the problems of the developing countries.

It is worth pointing out that - special economic schools like the Marxian and other kinds of radical economics apart - all welfare and policy economics is based on iberal values. The single most distinguishing feature of these values has always been recognized to be the respect for the individual. And indeed the second restriction on social welfare functions to be mentioned below is that social welfare is to be thought of as a function of individual welfares. The most lucid and persuasive restatement of liberal values is that provided by Dworkin (1978); according to whom the basic ethical principle of those values is that the state should treat every individual with equal concern and respect.

We turn now to the first restriction imposed on the SWF. It is the assumption that during any economic policy analysis A_j (the non-economic determinants of social welfare) are assumed to stay

constant. The justification for this assumption that is usually advanced is that though the non-economic determinants do obviously affect the economic variables, they are not, in their turn, affected by the economic variables. Regarding climate of a region this assumption is obviously reasonable; though in an age of rapid deforestation, even that may be a bit doubtful. Again, regarding countries with mature and stable political systems, it is reasonable to assume that while the political variables do affect the economic determinants of social welfare, in the analysis of almost all policy problems those political variables can be assumed not to be affected by developments on the economic front.

However, for developing countries with their recent histories of nationhood, regional rivalries, unstable governments, frequent agitations, riots, violent strikes and where a military coup d'etat is an ever-present possibility, it is highly question-begging to assume that changes in the economic variables cannot easily bring about any important changes in the non-economic determinants of social welfare. Thus economic policy analysis for developing countries, if it is to be rational especially in the context of an acute economic crisis, has got to consider the inter-linkages between economic and non-economic determinants of social welfare. Some of the discussions of adjustment policies have been seriously marred by this implicit assumption that economic variables have no effect on the non-economic determinants of social welfare.

The second restriction which Bergson imposed on the SWF was to define social welfare as a function of individual utilities, which - in their turn, because of the first restriction - are taken to depend only on economic variables such as consumption, leisure and wealth, etc.

(2) $W = W[U^1,...,U^S]$

$= W[U^i(x^i_1,...,x^i_n)]$

where the $x_1,...,x_n$ are various economic determinants of individual utility. The functions U_i are taken to be based on the individuals' own evaluations; this is the value judgement of consumer sovereignty.

A further restriction, and again one which will be of crucial relevance in our critique of the usual recommendations regarding adjustment policies, is nearly always placed on the SWF; the function is taken to be of Pareto type. A basic value judgement is adopted that $\partial W/\partial U^i > 0$; i.e., that if at least one individual's utility level rises, other levels remaining the same, then social welfare is to be judged to have increased. From this restriction, the definition of a Pareto optimal allocation of resources directly follows: it is that allocation of resources which, if altered, would make any individual better off only at the expense of making some others worse off. With reasonably divisible goods and

inputs, there is a great number (in principle, an infinite number) of such Paretian optima. Each such optimum is distinguished from another by having a different distribution of goods and hence of utilities among individuals. Each Pareto optimal allocation of resources has come to be commonly designated as "economically efficient". And the necessary conditions for such an economically efficient allocation are that, ignoring externalities, there should be no wedge between the price paid for any good or service and the price received for it; that like goods and services should have like prices; that the price of every good should equal its marginal cost; and that - in the open economy context - domestic price ratios for tradeable goods should equal world price ratios. When such conditions are not satisfied, prices are said to be distorted; or it is said that there are market distortions.

A normative criterion is used by economists in policy analysis so nonchalently that many have come to think of it as being as objective as perhaps the law of diminishing marginal product; it is the Pareto principle (or criterion). In its strong form, it states that if at least one individual's utility level rises, those of others staying the same, then there is an improvement in the economic conditions of the society; that the social welfare can be taken to have risen. The Pareto principle in this conditional normative form, is constantly used in discussions of adjustment policies. It will be argued below that that use in itself is normatively, and, therefore, politically controversial. However, what is unforgivable, because it is pure sophism, is the occasional implicit use of

the Pareto principle as a biconditional normative criterion, implying that an economic change can be recommended by economists if and only if it will pass the Pareto criterion. No such proposition follows even if there were universal agreement that the social welfare functions must be Pareto-type (i.e. satisfying the condition that $\partial W/\partial U^i > 0$). Once feasibility considerations are brought into the analysis - such as the recognition that "the lump-sum transfers [for redistribution] necessary to achieve an optimum are scarcely ever feasible" (Mirrlees, 1986) - it is quite obvious that the point of maximum social welfare (the socially optimal allocation of resources and distribution of incomes) may well be where the necessary conditions for Pareto optimality are not satisfied. For social welfare to be at a maximum according even to a Pareto-type social welfare function, it is not essential that the economy be at a Pareto optimum. Thus the use of the Pareto principle as a biconditional normative proposition needs to be justified by some peculiar normative arguments.

Even the use of the Pareto principle as a conditional normative propisition is controversial on a number of grounds. Used thus, the principle gives approval to all consensual arrangements among economic agents; it sanctifies freedom of contract. Thus the Pareto principle was violated when in Britain a ban was put on the employment of women and children in the coal mines by the Coal Mines Act of 1824,or when, later, acts were passed setting minimum standards of working conditions. See Checkland (1964). And the Pareto principle is violated whenever the legislature interferes to protect a group of workers who are so vulnerable

that without the legislative protection they would find themselves entering into contracts which are unfair and therefore unconscionable, or even agreeing to terms which are not consistent with human dignity. Indeed, while the Pareto principle as a biconditional normative proposition is often made to trade on liberal values, in a number of circumstances liberal values cannot permit the use of the Pareto principle even as a conditional normative criterion. See Nath (1988). It may be that there are many instances of legislative interferences in markets, and particularly labour markets, in the developing countries which cannot be justified on liberal grounds. But what is being argued here is that just because some legislation interferes with the market (i.e., introduces a so-called 'distortion'), it does not necessarily follow that social welfare will be greater when that legislation is removed. If the Pareto principle is to be used as a conditional normative criterion, then we must first make sure that the economic agents participate in trade and negotiation as fundamentally equal partners. The noble-sounding principle of "free to choose" is, at best, a smoke-screen for "benign" neglect, and, at worst, a hypocritical facade for exploitation in situations when some of the individuals are faced with no real choices, but only a need to survive at any cost. In such situations, individuals would appear to "choose" terms and conditions of employment which - if they had any real choice - they would never accept. This was true in the early decades of industrialization in the West, and it is true today of large sections (not necessarily of all sections) of the labour force in the developing world.

It may be that in a given situation no objections arise on grounds of unconscionability of a contract, or on grounds of any inalienable individual rights being violated, such as the right not to be sold into permanent servitude. It still does not follow that when the economic conditions are created for a Pareto optimal allocation, the new situation would necessarily be actually better than the previous one according to the Pareto criterion. Consider Figure 1. Say there are just two individuals i and j in the society. FF' is the utility possibility frontier of this economy; every point on FF' is a Pareto optimum. When a distortion exists, the economy is at Point A, a non-Pareto optimum. Points on the BC segment of the frontier are Pareto superior to point A. But when the distortion is removed, there is no guarantee that the economy will shift to a point on the BC segment of the frontier. It is quite possible that the economy moves to a point like D on the frontier. But D cannot be said to be superior to A on the Pareto principle. Thus the recommendation to remove a distortion - even when second-best problems are ignored - cannot necessarily be deduced from the Pareto principle, unless we ensure that though the activity levels of some will rise, those of others will not fall.

It may be argued that, assuming lump-sum transfers, surely the gainers from the elimination of the distortion could more than adequately compensate the losers. But it is a well established result in welfare economics, see for example Nath (1969, p.101), that a Pareto-optimal point,

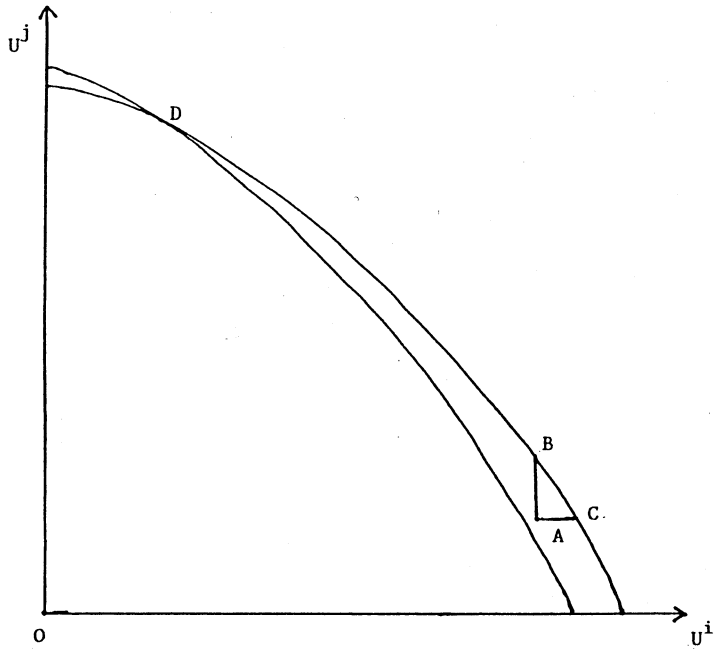

Figure 1

in comparison with a non-Pareto optimal point, may or may not pass such a compensation test. Thus we cannot be sure a priori that such theoretical compensation will be possible. (In Figure 1, the utility possibility curve resulting from lump-sum redistributions from point D has been drawn to pass to the south-west of point A.) Moreover, the compensation is in any case theoretical; since no such compensation ever takes place in practice, the Pareto principle cannot legitimately be used to recommend the elimination of a distortion, unless the analysist is sure tht no individual's or group's utility levels will be lowered as a result. What this discussion

shows is that policy recommendations which are apparently neutral on matters of distributive justice are often in fact not so.

There is a second reason for caution in the ready use of the Pareto principle as a conditional normative criterion. In theory an economic policy is approved by the strong Pareto principle only when the utility levels of some individuals would have risen, and those of all others have at least stayed the same. In practice, there is no reliable method available for directly observing and assessing the utility levels, or the changes in them, of large numbers of individuals. Thus in practice the policy analyst applies the Pareto criterion by observing and predicting the changes in incomes of individuals, or, rather, groups of individuals - such as urban workers, rural landless workers, farmers or business owners, etc. Thus when real incomes of some groups are likely to rise, those of others remaining the same, the policy analyst concludes that the economic change would pass the Pareto criterion. However, in theory it is possible that the utility levels actually drop of those individuals or groups whose real incomes have remained the same. This would be if there is a noticeable change in the relative living standards, and if some notion of what are fair relative living standards is a variable in the utility (or welfare) functions of at least some individuals. If these drops in the utility levels of those whose real incomes remain constant while those of others' increase could be observed, then of course in theory the economic change would not be recommended on the basis of the Pareto principle. But that is so only in theory. In practice, the use of the Pareto criterion on observed

or predicted changes in income levels ignores what is happening to at least some individuals' welfare because their sense of what is just and fair is being damaged if not outraged. In other words, the changes in economic variables would be bringing about a change in one of the non-economic determinants of social welfare. If the sense of social justice of a large number of individuals is sufficiently outraged, then there would be political repercussions, with further adverse consequences on social welfare. Even if one or two minor economic policies, over a year or two, adopted on the basis of the Pareto principle interpreted in terms of incomes do not seriously threaten social cohesion and social welfare, a series of them over a number of years do run the serious risk of doing so. Paradoxically, this risk may be greater in those developing countries where in a recent decade or two there has been some economic growth accompanied by some improvement in the living standards of the poor classes. This is because history suggests that social unrest and political revolutions are more likely when people who hitherto had no hope at last see that technological and economic possibilities exist for their living conditions to be better than the ruling groups are permitting or arranging them to be. Thus once again changes in economic variables will have important effects on the non-economic determinants of social welfare.

Since Lipsey and Lancaster's (1956) work on the second-best theorem was published, it has been known that the removal of a distortion does not

necessarily increase economic efficiency or take the economy nearer to a Pareto optimal allocation. Indeed, the removal of one or several distortions - unless their interactions with the rest of the economy are carefully ensured to be of the right kind - is quite likely to take the economy further from a Pareto optimum. It can be argued that the insights provided by the second-best theorem are more frequently overlooked in the policy recommendations of neo-conservative economics for the developing countries than perhaps in any other area of economics. This or that distortion, or a specific group of distortions, is highlighted by an analyst, then a ready conclusion drawn that social welfare in the country concerned will necessarily be higher if that distortion, or that group of distortions, is removed. It has almost become a game: spot a distortion, recomend its removal because social welfare is bound to rise. All such recommendations are suspect without further analysis. Is the distortion in an isolated sector of the economy with no important substitution or complementary links with other sectors (which have their own distortions) through either production or consumption? Policy analysts sometimes sidetrack this problem by assuming that while they are recommending the removal of a distortion in one sector, the government would be also simultaneously - as a result of the other recommendations (possibly by other analysts) - removing all other distortions in any other sectors. (cf. Sen's 1972 discussion of the Little-Mirrlees approach.) This is clearly an unrealistic assumption. In any case, in any policy analysis where such as an assumption cannot be justified, there is a need for cautiously examining the second-best repercussions of removing any

particular distortion or a group of distortions. And as we noted above, even if we are sure that there are no second best problems, so that the removal of the pinpointed distortion can indeed be relied upon to bring about a Pareto optimum, it does not follow that the recommendation is neutral from the distributive point of view.

It is also worth mentioning that though a great deal of the discussion of adjustment policy concentrates on 'distortions' induced by governments, yet because of the existence of externalities and of public-goods phenomena, markets often fail to bring about the necessary conditions for Pareto optimality. Information and transactions costs for internalizing externalities are likely to be greater in developing countries where markets are often fragmented and poorly developed even where they exist. Thus if Pareto optimality is desired, then some government intervention in markets is likely to be required. Once again, it can never be a sensible aim to attain just any Pareto optimum; distributive considerations will come in here too. For recent analyses exploring the distributive effects, and the impact on the poor, of adjustment policies, see Demery and Addison (1987), Kanbur (1987), and Helleiner (1987). For a discussion of the larger policy issues, see Streeten (1987).

2. The Realities of Politics and Economic Policies in Developing Countries

We have already touched upon the special sensitivity, in developing countries, to changes in economic conditions, of the non-economic determinants of social welfare. But in this section we would like to discuss further some special features of the political systems and conditions of developing countries - features which have important implications for economic policy analysis.

Unlike the developed countries of the West, most developing countries do not have stable political parties competing for office through the ballot box at elections which are generally believed to be fair by the population. In a developed country, a government in power usually feels reasonably secure between one election and the next, four or five years removed. There is no similar sense of security for governments in developing countries. Even where a government is formed by a political party which won an election, there is often a risk of defections by party members. Party loyalties have not yet developed to the levels they have in most developed countries. But where the government is not a properly elected government, it is in constant danger of being outsted from office by means similar to those which brought it into office.

Even in a developed country, a government is often a coalition of interests all of which do not always pull together in the same direction. But such a lack of cohesion is much more marked in developed countries.

There are various reasons for this. A number of these countries are not homogeneous nations; instead they often consist of different linguistic, religious and tribal groups. cf. Killick (1976). Where the history of nationhood is recent, such groups often feel relatively little inter-group solidarity. It is easy for a group to get seriously antagonized. With low levels of literacy, poorly developed media, few channels for public debate over political and economic issues, freqently with no prospect of registering disapproval of government policies at the ballot box, and, most importantly, with large numbers living so close to subsistence that they can easily feel seriously threatened, discontent in large sections of the public easily boils over into violence not only against the government but against other citizens - usually those from another region or linguistic group etc. Thus both civic peace and the nationhood can come under threat with such frequency and speed as cannot be imagined to be possible in the developed countries of the West. It is obvious that social welfare depends crucially on civic peace and national integrity; the problem is that civic peace, political stability and law and order can quickly and easily come under serious threat by economic changes in a developing country. This problem is made worse because the linguistic, religious and tribal divisions exist not only in the population at large, but also in the civil service, police force, and the armed forces. There is in many developed countries no established tradition of unquestioning loyalty to the civil government on the part of the armed forces; indeed the armed forces - or, rather, many military officers - play an active part in the politics of the country.

It has often been argued, even in connection with developed countries, that the economists' scenario of the public policy-making process is unrealistic. (See, for example, Grant and Nath, 1984); that governments often do not possess a clear social objectives function with well-defined rates of trade-off between different objectives, and that a satisficing model of government economic policy seems more appropriate. See (Mosley (1976). These observations are probably even more applicable to governments in developing countries. But we want to emphasize a different point here: namely, that it is unrealistic to expect governments in developing countries to want to embrace every policy recommendation which takes the economy to a point on the frontier of Paretian optima, or at any rate to a point nearer that frontier, i.e. a second-best Pareto optimum. Even if no group's incomes decrease while those of some others increase from such a policy (so that an actual Pareto improvement is in prospect), the groups who gain may be the ones who have already benefited from a series of policies recently adopted, or they might be the groups who arouse serious social envy with its threat to civic peace.

When the policy recommended can only promise a theoretical Pareto improvement - i.e., that though there would be gainers as well as losers, the former could in theory adequately compensatre the losers - then the reasons for a government's resistance to such a recommendation are even more understandable. If among the losers would be those who are just about subsisting, then the promise of their also one day benefiting from

other Pareto improvements is just not good enough. It is not good enough on ethical ground, because the poor are entitled to have a very high rate of time discount; and it is not good enough on political grounds if at all the government is other than a military dictatorship which can afford to be impervious to public disapproval and can also effectively quell any civil unrest. It is worth recalling that in most developing countries there are no unemplyment benefits, free medical care or even rudiments of a welfare state. In a developed country, if a worker is thrown out of a job and if he then faces the prospect of long-term unemployment, he will still be able to survive, though with much damage to his self-respect. In a developing country a worker in a similar situation would find his family's very survival under threat. The more democratic or liberal or sensitive to public opinion a government in a developing country is, the more likely it is to want to balance the claims of one section of the population against another, not over several years, but each year.

It does not follow from these considerations that optimality of some specific kind in the allocation of resources is irrelevant in developing countries. What does follow is that to aim for just <u>any</u> Pareto optimal allocation, or just <u>any</u> point near the Pareto utility frontier, is irrational for a government in developing countries. Efficiency and distributive considerations which arguably cannot or should not be separated even in developing countries, definitely cannot and should not be separated in developing countries. The relevant normative theoretical concept for the developing countries is that of the social optimum, in theory at a point in

time, but in practice during any relatively short period of time - an optimum which is the result of taking Pareto efficiency, social justice and political feasibility considerations all into account. (This is the concept of feasible social optimum where social welfare is at a maximum subject to all the relevant constraints; see, for example, Nath (1969, ch.3). Such a feasible socially optimal set of policies and allocations is likely to be characterized by the violation of some of the necessary conditions for Pareto optimality - the so-called "distortions". But such "distortions" would be necessary if the feasible social optimum is to be attained. Indeed the so-called "distortions" are best called "Pareto-distortions" in order to puncture the disapprobation which has come to be automatically attached to that term in economic policy analysis.

The fragile nature of civic order and social cohesion in developing countries has another important implication for policy analysis of their economic problems. Economics does not consist of well-tested theories; the consequences of applying a theory to the economic problems cannot be predicted with any certainty. There is uncertainty at each of the following crucial stages: (i) how well tested and colloborated any economic theory is; (ii) the empirical estimates of the parameters of the model based on that theory; (iii) the predictions based on those estimated parameters; and (iv) the lengths of the relevant time-lags. Thus there is an inevitable subjective element in an analyst's choice of the economic theory which he uses to make policy recommendations. (cf. Blaug, 1980, especially ch.1). This subjective element has an important consequence.

As Ruduer (1961) has argued:

> Since no scientific hypothesis is ever completely verified, in accepting a hypothesis on the basis of evidence, the scientist must make the decision that the evidence is sufficiently strong or that the probability is sufficiently high to warrant the acceptance of the hypothesis. Obviously our decision with regard to the evidence and how strong is 'strong enough' is going to be a function of the importance, in the typically ethical sense, of making a mistake in accepting or rejecting a hypothesis. How sure we must be before we accept a hypothesis depends on how serious [we consider] a mistake would be. (p.33, original italics.)

I would like to submit that the consequences of a mistake are likely to be much more serious in a developing country than a developed one, for the reasons already given. For example, it has been argued that the length of the recession and the extent of the increase in unemployment in Britain following the adoption of the monetarist experiment in the U.K. in 1979 surprised the government. There were some inner city riots in the earlier stages, but, by and large, the social cohesion and political stability were not seriously threatened. Can it be argued that similar unexpected consequences of a similar experiment would have been accommodated with as little political difficulty in a developing country?

These arguments concerning the risks and uncertainties of economic policy are not meant to provide support for a programme of no-reform, of doing nothing. Instead, what they imply is that it is irresponsible if not unethical to use a developing country as a field of

experiment for every novel economic idea. There is a need for moving much more cautiously in developing countries. Short, sharp and total shocks should be out; as should be root-and-branch "reforms". No matter how comprehensive the adoption of economic policies of a particular school of economics, when things go seriously wrong, it is only too easy to claim that the reforms were not comprehensive enough. Witness the experience of the Southern Cone with financial and trade liberalization policies. See Carbo, de Melo and Tybout (1986), and also Foxley (1983).

Or again, note the apparent plausibility of the Harris-Todaro model of rural-urban migration. The early doubts were only about how a would-be migrant would estimate the probability of getting a job in the uran sector. But later field research (see Mazumdar, 1987) has seriously brought into question a number of the assumptions of the model, and hence the policy conclusions which were deduced from it. The kinds of uncertainty we have been discussing suggest a need for caution, for proceeding slowly and by trial and error, and argue against bold one-stroke experiments of economic policy in developing countries.

In negotiations with international agencies, since the government of a developing country is often in the position of a supplicant, and since it is possible that there is an unconscious lack of regard for the wisdom of the local economists and politicians, international agencies and their representatives run the risk of attaching end values to what are only policy instruments the use of which may or may not be appropriate given

the end values which must be pursued at a particular juncture in a particular developing country. There are some remarks by Fleming (1968, p.390) which he was applying to governments; but ironically they are equally appropriate today when applied to the international agencies:

> "... they are very apt to assign end value to variables that have no direct connection with ultimate human needs but are believed, on the strength of some dubious but probably quite complex economic theory, to exercise an influence on economic welfare. For this reason, variables such as exchange rates, interest rates, or budget balances, that ought to be treated as primarily instrumental ... will be regarded as targets and thereby removed from the category of instruments, or irrational limitations will be put on their use".

3. Adjustment Policies and Labour Markets in Developing Countries

Excellent surveys of the characteristics of rural and urban labour markets have recently become available. See Mazumdar (1987), Squire (1981), and Binswanger and Rosenweig (1981). I shall only select some of the more important features of these labour markets, which are relevant to our discussion. An important characteristic of large sections of the labour force in developing countries is that they are not organized into trade unions; indeed they work in sectors where conditions of employment are ill-defined, wages are paid irregularly, and dismissal is quick and uncomplicated. This is true of all casually employed labour in agriculture and in urban-areas - the daily hired porters and carriers and pullers and pushers of loads, the domestic servants, the assistants in little tea and snack establishments in the city, and even in small scale construction, transport and manufacturing enterprises. About the only sectors in which terms and conditions of employment and dismissal approach those in the developed countries are multinational companies, really large ones of the indigenous companies, government and nationalized industry. These comprise the formal sector of employment. Though government employees may typically constitute a large percentage of the formal sector employment, that sector itself typically constitutes only a small percentage of the total employment. It is also worth pointing out that the formal sector employment does not coincide with the employment in the tradeable sector. The latter clearly excludes government employees; but some other parts of the formal sector also produce non-tradeables. Nor is

the informal sector unemployment irrelevant to the production of tradeables: clearly agriculture (even other than the "plantations" sector) produces tradeables, and indeed so do many of the small and medium scale manufacturing enterprises - particularly 'craft' products.

For this large portion of the employed, some of the contemporary generalizations about the labour markets of the developed countries just do not apply. This is something which does not always seem to be appreciated in the literature. It is possible that both nominal and real wage rates are flexible to some extent in this sector of employment. It is extremely doubtful that the nominal wage rates in this sector adjust with any appreciable speed to the rise in the wage rates.

These characteristics of large parts of the labour markets in developing countries have an important implication regarding the policies of subsidies on staple items of food. Subsidized food of this kind protects the vulnerable groups against starvation, or at least going hungry, in a world which is inflationary; sometimes the price inflation is due to reasons beyond the local government's control, e.g., the oil price shocks. In a recent article Braverman and Kanbur (1987) argue that if food subsidies are abolished in a developing country as a result of an adjustment programme, then it is possible, if not likely, that the "urban bias" in the country will result in the urban sector being able to maintain its standard of living through the channel of increased government expenditure. They construct a model in which the proportionate

expansion of government expenditure leaves the real value of the government deficit unchanged. As they point out, "in the process, however, of attaining this new equilibrium, an inflationary spiral might be generated with its own adverse consequences". (p.1183).

I would like to submit that the government of a developing country would have good reasons, based on considerations of social justice, to resist the abolition of the food subsidies in the first place. Such subsidies do not represent an urban bias so much as the aim of protecting the vulnerable groups of the labour force who have no guarantee that their nominal wage rates will increase in proportion with the cost of food, let alone the cost of living. Food subsidies are in the same class of policies in strait economic circumstances as was the food rationing introduced in the U.K. during World War II. It must not be forgotten that large sections of landless agricultural workers, and marginal farmers, are also helped by the food subsidies. Therefore, food subsidies cannot be considered an example of pure urban bias, which may well exist, and may have other manifestations. It is worth recalling that the rioters who sparked off the French Revolution in 1789 were, in the first place, demanding bread.

There are other arguments in favour of subsidizing the simpler, basic items of diet. As Mazumdar (1987) points out, the large-scale sector enjoys a number of advantages compared to the small scale sector. "The economics of bulk buying of raw materials and the operations of the organized credit market favour large firms, who are also in a better

position to market their products, particularly abroad". (p.122). As he also points out, since the large-scale sector makes greater use of imported intermediate goods and also obtains licenses for key imports more freely, the overvalued exchange rates of the developing countries further strengthen the hidden official subsidization of the large-scale sector. Food subsidies indirectly subsidize the employment of labour; and since small-scale firms tend to be much more labour-intensive than the large-scale firms, food subsidies to some extent reverse the rest of the official bias in favour of the large-scale firms in developing countries. Moreover, the customers of the small-scale firms are mostly the poorer classes. To the extent that the food subsidies keep their costs of production lower than they would otherwise be, they also perform an indirect equity function - quite apart from their direct egalitarian impact. Of course it is true that some of the help given by the food subsidies leaks to the not-so-poor classes. But if only the simplest items of food are subsidized, this leakage can be minimized. See Besley and Kanbur (1987).

There is no doubt that when food subsidies are combined with such prices for the local agricultural producers as are below world prices, there is a strong disincentive effect on the producers. But there is a way of combining the restoration of price incentives for agricultural producers with cheap food policies. Till the U.K. joined the Common Market, it practised such a policy successfully for years. Of course, government expenditure has to fill the gap between prices for staple food items received by farmers and those paid by the consumers. But as Braverman

and Kanbur (1987) point out, even with a policy of just abolishing food subsidies, there is the possibility that the real government deficit would soon be back to where it was.

The neo-Keynesian worries of downard rigidity of real wage rates (and salaries), and quick and ready proportionate increases in nominal wage rates and salaries following an increase in the price-index, only apply in developing countries to the employees in the public sector and the very large firms. These employees are usually organized into trade unions, and otherwise too are quite powerful lobbyists in developing countries. Often their wage rates and salaries are index-linked. The thrust of the policies to introduce greater flexibility and to reduce government expenditure needs to be directed here. These groups of the labour force are often not the most deserving in terms of social justice, though often they may be more deserving than the owners of capital. As part of a devaluation policy, or a programme of reducing government deficit, there can be a lot to be said for squeezing the real incomes of this sector, while protecting the food intake of the informal sector employees. As for the owners of capital, we run into the usual arguments of keeping the incentives keen, allowing the ratio of profits in GNP to increase in the hope of raising the ratio of domestic saving and investment. But capital owners in developing countries are often profligate in their consumption expendure. Thus for the sake of encouraging saving and investment, of following the demands of social justice and of the need to keep social peace, there is a lot to be said for adjustment policies always to include a

programme of much higher taxes on luxury items of expenditure. Instead of the food subsidy, it is the conspicuous consumption of some classes which needs to be squeezed in a programme of adjustment. There is no reason why the policy of price support for the farmers should not put the economy on its efficient production frontier, and indeed, over time, help to push that frontier outwards. Similarly, none of our arguments weaken the case for rooting out x-inefficiency wherever possible. What is being argued is that these aims can be achieved without consumers having to face the world price ratio between staple items of diet and other goods, though the producers should be allowed to face the world price ratio.

The perspective we are advocating also has implications regarding minimum wage legislation. Because of the extreme difficulty, indeed almost impossibility, of enforcing minimum wage laws in the small-scale rural farming and industry and the informal urban sector, such laws usually affect only the formal sector of employment. But contrary to the view sometimes advanced, it does not seem likely that the differential between the urban formal and informal wage rates is due mainly to the minimum wage laws, trade unions or other institutional interferences. As Mazumdar (1987) points out such differentials existed in several countries in the early years of industrialization when trade unions had not been formed, and wage regulation was minimal. There is also evidence that shows that wage-rates are positively correlated with the size of firm. Mazumdar advances plausible arguments to explain this correlation. Larger firms prefer a stable labour force because their costs of training a

worker are high, and with their more intricate production processes (as compared to the small firms), it takes time to train a worker. Labour stability and labour productivity are closely related in large firms. The labour force in an urban area of a developing country consists of two broad categories: temporary migrants who come and go between urban and rural areas, and who tend to be single males; and permanent migrants who usually bring their families with them either straightaway or mean to do so on finding a job. Larger firms prefer the permanent migrants, and both the demand price for them and their supply price tend to be higher. Smaller and simpler firms employ proportionately many more of the temporary migrants. Mezzera (1981) advances a similar argument: because of the imperfections of the credit markets, larger firms can raise large loans more cheaply and thus choose more capital-intensive techniques; with such techniques labour stability and productivity are closely related, therefore, the larger firms pay higher wage rates than the market-clearing wage rate.

As Mazumdar explains, the possible effect of minimum wage laws can be analysed in two contexts. The first concerns unskilled homogeneous labour. The traditional view is that such laws, by raising the wage rate above what it would otherwise be, tend to encourage substitution of capital for labour, and thus prevent industrial employment from griowing as fast as it might have done. Reynolds and Gregory (1965) undertook a detailed study of the experience of Puerto Rico over 1954-61. They broke down the rise in capital-labour ratio into two components: the rise due to a change

in the overall composition of the industrial sector; and the rise due to the increase in the capital-labour ratio within individual industries. They found that a large part of the increase in the capital-labour ratio was due to the second component; firms within industries were getting larger, and the number of large firms in industries was increasing. They concluded that this shift in the structure of individual industries could not be attributed mainly to the sharp rise in wage levels; for one thing, the evidence did not suggest that the profit margins of the smaller firms were squeezed because of rising wage rates. They thought that a primary cause of the change in capital-labour ratios was technical change of a labour-saving kind, because there was very little change in the capital/output ratios. Studies of individual plants in fact revealed that a rise in wagerates was primary the trigger for finding ways of reducing X-ineficiency.

Before we leave the assumption of homogeneous labour, it is worth considering the social welfare effects of minimum wage laws on the assumption that they do result in lower employment. Assume that the minimum wage law is abolished. Assume also that the result is an increase in employment at the lower wage rate. Those who were unemployed and have now gained employment are now better off. Those who were already in employment, but now receive a lower wage rate are worse off. If the new wage rate is at least at subsistence level in some meaningful sense, so that perhaps no objection arises on grounds of unconscionability, the comparative social welfare evaluation of the new situation would depend

on how the gain in employment of the new workers is weighted against the reduction in the real wage rate of those who were already in employment. Probably the employers would also be better off with minimum wage law abolished. If so, that fact will also have to enter into the calculations of net gain of social welfare. If the minimum wage law was the only Pareto distortion in the economy, then the abolition of that law should take the economy on to a point on its Paretian utility possibility frontier. But, clearly, it is not a move which is bound to be approved of by the Pareto principle; though some people gain others lose from the move.

However, it is perhaps more relevant to analyse the possible effects of minimum wage laws on employment in a context where labour is not homogeneous - as it never is. This is the more realistic case. The unrealistic assumption of the homogeneity of labour prevented us from introducing it into the analysis the interesting and momentous possibility that the introduction of a legal minimum wage rate may actually lower labour costs per unit of output for an employer, because the higher wage rate results in a rise in labour productivity which is proportionately greater than the rise in the wage rate. The outcome is a clear, actual Pareto improvement. This is the phenomenon which often came into operation in nineteenth century England, and which came to be known as "the economy of higher wage rates". The reasons for the rise in labour productivity could be several, such as these: the higher wage rate encourages greater stability in employment and thus enables the firm to train a worker more effectively and to benefit for a longer period from his

training; also if the earlier lower wage rate just about enabled the worker to survive, the higher legal wage rate minimum is likely to improve the worker's diet and health and hence attendance record and physical productivity.

It may be asked: if a higher wage rate can have such beneficial effects which in fact lower unit labour costs, why is a law required to raise the wage rate? Why don't the employers on their own offer the higher wage rate? The answer to this question is obvious, but not one which is likely to be acceptable to an analyst who is totally committed to the assumption of fully-informed, rational, maximizing economic agents inter-acting with one another in perfect labour markets. Whatever the validity of this assumption in developed countries, in areas of nascent industrialization, and where there are large cultural barriers of empathy between the employers and the employees (because the gap in their living standards is so huge, or for other reasons), in such underdeveloped labour markets it can easily be the case that the employers' perceptions of the likely consequences of a somewhat higher wage rate are wrong. This was often the case in nineteenth century England, and it is now often the case in parts of the labour markets in developing countries. Mazumdar (1987) cites the example of employers in Africa during the colonial era who had convinced themselves that any increase in wage rates would merely cause workers to spend a shorter period in towns to earn their target income before returning to country areas. The actual experience after the introduction of the minimum wage laws was to prove them wrong: these

laws actually encouraged a more stable labour force, raised productivity, and also employment levels. There was an actual Pareto improvement.

Minimum wage laws are often included in the list of government-induced Pareto distortions which an adjustment programme should abolish. The above analysis suggests that their inclusion in such a list may not always be rational. The irony of course is that because of the problems of implementation, which were alluded to above, such laws often end up applying to those sectors of the labour markets where the workers are perfectly capable of looking after themselves because they are sufficiently organized. It is even possible that in such sectors these laws on balance do more harm than good. But in those sectors of labour markets where such laws could result in actual Pareto improvements, such laws are difficult to apply. This is an interesting, but not an isolated example of the paradox that in order to attain a given economy-wide technological production frontier, and, even more importantly, in order to push it outwards, there is often a greater need for government regulation in developing countries, but the administrative capability in developing countries is usually more limited, and the tasks required of it are often more difficult than is the case in developed countries.

Conclusion

We have argued that the normative theory of economic policy based on the Pareto system needs to be handled with greater care and sensitivity for its limitations and qualifications than appears to be the case always, when applied to the analysis of adjustment policies which are to be recommended to a developing country. We pointed out that even an actual Pareto improvement is never distributionally neutral, and that an improvement which is only a "potential" Pareto improvement - in the sense of taking the economy to some point on its Paretian utility possibility frontier - may not necessarily pass the theoretical compensation test. Even when it passes such a test, since the lump-sum compensation is never forthcoming, the distributional effects are even less neutral than in the case of the actual Pareto improvements.

We have also highlighted some specific features of the political systems of the developing countries; features which make the economic and non-economic, particularly political, detrerminants of social welfare interdependent in a much more serious way than is the case in developed countries. This must bring the aims of encouraging social cohesion and maintaining civic order into the set of objectives which guide economic policies in general, and stabilization and adjustment policies in particular, for the developing countries. Finally, we discussed a few of the peculiar characteristics of labour markets in developing countries, which vitiate the policy conclusions of the economics of the developed economy labour

markets. All in all, our message is the need to proceed with greater caution and sensitivity, than has apparently always been the case, when devising adjustment policies for developing countries.

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