MARKETS IN DEVELOPING COUNTRIES

PARALLEL, FRAGMENTED, AND BLACK

Edited by

Michael Roemer

& Christine Jones

International Center for Economic Growth

Harvard Institute for International Development

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PREFACE

In developing countries, where government intervention is often used as a tool to achieve economic and political goals, parallel markets arise as producers and consumers seek to evade official regulations. By lessening the effectiveness of controls, parallel markets can also diminish the benefits realized when controls are removed. Understanding how these markets work is therefore necessary for predicting the outcome of deregulation. Only recently, however, have parallel markets become direct objects of research.

This volume is a copublication of the International Center for Economic Growth and the Harvard Institute for International Development. It is based on papers presented at a workshop sponsored by HIID to address issues relating to the dynamics of parallel markets. The authors investigate the realities of parallel markets—including fragmented and black markets—for consumer and producer goods, labor, currency, and credit in sub-Saharan Africa, the Philippines, and Taiwan. Several chapters delineate the economic and social contribution that parallel markets make in addressing needs not met by formal markets. Other subjects explored in the book include the interaction between government policy and the behavior of parallel markets, the influence of cultural preferences on parallel markets, and the capacity of parallel markets to increase economic efficiency and equity.

This book provides insights into an important area of economic behavior. Although little studied or understood, it is an important issue—one that must be considered in designing effective policy reforms in developing countries.

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Panama City, Panama
April 1991

Editors' Preface

Government controls over prices and quantities, as well as taxes, are universally evaded by agents who deal in "parallel" or "black" markets. Development economists have been concerned for decades about the effects of government intervention on efficiency, equity, and growth. Indeed, liberalization or deregulation of developing economies was a dominant theme in the literature and an overriding concern of policy analysts during the 1970s and 1980s. Much less attention has been paid to the effects of parallel markets that spring up to evade controls. If parallel markets can counteract some of the impact of government interventions, their existence also qualifies the case for economic reform.

In November 1988, the Harvard Institute for International Development (HIID) sponsored a workshop in Cambridge, Massachusetts, on parallel markets. We had two aims. First, by gathering together some of the major contributors to the literature, we hoped to move toward a common understanding of the principles underlying the analysis of parallel markets. Second, we hoped to alert officials of developing countries and the major aid agencies to the implications of parallel markets for policy reform and implementation.

Twenty papers were submitted to the workshop. Nine of these were assembled into a special issue of *World Development* (volume 17, number 12 [December 1989]). The lessons of those investigations have been summarized in our paper "Modeling and Measuring Parallel Markets in Developing Countries," which has been revised and included in this volume as Chapter 2, "The Behavior of Parallel Markets in Developing Countries."

During the workshop, it became apparent that the concept of parallel markets, which arise as a consequence of government intervention, cannot explain all of the markets in developing countries that are divided into segments in which differing prices prevail for the same goods, services, or factors. At least one other market type, a *fragmented market*, is important. Fragmented markets are broken up, not (or not only) by government interventions, but by natural divisions that would prevent prices from being unified even if government did not intervene. Furthermore, terms such as *black market* and *informal sector* are widely used although less precisely defined.

The idea for this volume arose from attempts at the HIID workshop to sort out these terms and their meanings. Here we assemble papers dealing with three of these concepts. After an introductory essay on parallel, fragmented, and black markets, the next six chapters deal with parallel markets, including those for grain, currency, consumer goods, and labor.[1] A second set of three chapters covers the most important example of fragmented markets in developing countries: fragmented credit markets, both rural and urban. A final chapter describes how tax evasion—the major source of the black economy—works in India.

We had strong support in preparing both the HIID workshop and this volume. Dwight Perkins, director of HIID, encouraged us to undertake this project and was generous with financial support. Deena Khatkhate, then honorary managing editor of *World Development*, committed himself to a special issue early in our planning, an incentive both to the organizers and to potential workshop participants. Planning for this volume began at the same time: Nicolás Ardito-Barletta, general director of the International Center for Economic Growth, and Lawrence Chickering, associate director of the Center, promoted the concept of a second volume and agreed to fund travel expenses for workshop participants coming from outside the United States. Willing administrators and assistants at HIID made important contributions to the management of the workshop and compilation of the volumes,

1. Two of these chapters are based on papers that appeared in *World Development* 17, no. 12 (December 1989): Trien T. Nguyen, "The Parallel Market of Illegal Aliens: A Computational Approach"; and David Bevan, Paul Collier, and Jan Willem Gunning, "Black Markets: Illegality, Information, and Rents." The latter has been substantially revised for this volume. We are grateful for permission to use these articles.

especially Phyllis Glass, Alison McPhail, Laura Reichenbach, and Karen Seal. The authors of papers and other contributors to the HIID workshop guaranteed the success of this venture with their time, creativity, constructive discussions, and confidence in the outcome. We are grateful to all of them.

Michael Roemer
Christine Jones

Cambridge, Mass.
Washington, D.C.
April 1991

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Christine Jones
David L. Lindauer
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Chapter 1

Parallel, Fragmented, and Black: A Taxonomy

A broad consensus among economists favors the liberalization of markets as a strategy to achieve both greater efficiency and more rapid economic growth in developing countries. Policy makers in developing countries increasingly accept that prescription and are reforming their economies, particularly by deregulating markets.

Economists' recommendations for deregulation generally follow from an analysis resting on two assumptions. First, government controls over market prices or quantities are effective. Second, in the absence of controls, markets would approach the competitive ideal: all participants could buy or sell at identical prices. Economists have, however, identified many different markets in which one, or both, of these conditions is not met. Government controls are almost always evaded to some extent, and in the absence of controls many markets are not as unified as competitive models assume.

Policy makers in developing countries should be concerned about both these deviations from theory. If government interventions are not totally effective in controlling prices or quantities, liberalization of markets will yield some but not all of the benefits claimed for deregulation. It is even possible that liberalization will create net welfare losses if a market is not fully unified when controls are removed.[1]