Test your understanding 19.1

Explain the possible consequences of economic growth on **(a)** living standards, **(b)** unemployment, **(c)** inflation, **(d)** income distribution, **(e)** the current account, and **(f)** sustainability.

19.2 Balance between markets and intervention

Most countries in the world today are *mixed market economies*, meaning economies strongly based on markets, but with a degree of government intervention. However, countries differ enormously with respect to the degree and types of government intervention. This raises the questions: how much should governments intervene in developing countries, and what are the appropriate roles of markets and intervention? This topic directly addresses one of the four central themes of this course (page 14).

This section brings together many topics examined in previous chapters. You will therefore frequently be referred to the relevant pages for a review of the important issues.

Strengths and weaknesses of market-oriented policies

Market-oriented policies, as the term suggests, are based on the market mechanism introduced in Chapter 2. Market-oriented policies we have studied include:

- market-based supply-side policies, including:
  - policies encouraging competition (deregulation, privatisation and anti-monopoly regulation (page 340)
  - labour market reforms (page 341)
  - incentive-related policies (page 342)
- trade liberalisation (free or freer trade; page 485)
- freely floating exchange rates (page 382)
- liberalised capital flows, or the absence of exchange controls which limit the amount of foreign exchange that can be purchased with the domestic currency (page 495).

Strengths

- Discuss the positive outcomes of market-oriented policies (such as liberalised trade and capital flows, privatisation and deregulation), including a more efficient allocation of resources and economic growth.

Market-oriented policies are based on the idea that free markets, working under competitive conditions, offer a method to answer the *what to produce* and *how to produce* questions of resource allocation in the best possible way. With market-determined prices working as signals and incentives, markets co-ordinate the countless independent decisions of consumers, firms and resource owners, allowing social surplus to be maximised, thus achieving allocative efficiency (see page 43).

At the same time, the pursuit of self-interest by all economic decision-makers (consumers, firms and resource-owners) gives rise to incentives for hard work, risk-taking, innovation and investment, which lead to higher levels of output (economic growth) and possibly higher standards of living. The operation of markets therefore also promotes general welfare by achieving economic growth.

It thus follows that policies encouraging competition, such as deregulation, privatisation and anti-monopoly regulation, which work by freeing market forces and making markets more competitive, are intended to result in greater efficiency in production, lower prices and improved quality, and a better allocation of resources, as well as increased levels of output, or economic growth.

Labour market reforms similarly promote free market forces in labour markets, allowing the allocation of resources to improve. Incentive-related policies, involving adjustments to various types of taxes, are intended to work by improving the incentives to work, innovate and invest, thus making the signalling and incentive functions of the price mechanism more effective, again improving the allocation of resources and also allowing for economic growth.

Trade liberalisation is based on the same ideas, and has the same intended benefits. The elimination of trade barriers and the opening up of countries to free trade has the effect of making markets much larger than they would be with trade barriers. The result of larger free markets is to increase competition, increase efficiency in production, lower prices and improve quality, increase consumer choice, improve the allocation of resources, and allow for greater economic growth.

Freely floating exchange rates are simply another aspect of the price mechanism of free markets. A market-determined exchange rate is one that reflects the forces of supply and demand for a currency, and therefore can effectively carry out the signalling and incentive function of prices (here applied to the 'price' of a currency) for those carrying out international transactions of all kinds. Just as a market-determined price of a good 'clears' the market, so too a freely floating exchange rate automatically adjusts to excess

demand or supply of a currency, bringing about a balance in the balance of payments and offering greater flexibility to policy-makers to pursue policies needed domestically (see page 403).

Liberalised capital flows (or absence of exchange controls) allow domestic residents to purchase any amount of foreign exchange without restrictions, whether for imports, or for travel or investment abroad, etc. This is important for attracting multinational corporations (MNCs) because it means the MNC is free to repatriate profits or to purchase inputs from abroad (import them). In addition, free capital flows mean a more efficient global allocation of savings, since savers are free to make financial investments anywhere in the world without restrictions, in accordance with the expected profitability of their investments.

Weaknesses

- **Discuss the negative outcomes of market-oriented strategies, including market failure, the development of a dual economy and income inequalities.**

Market failure

One of the most important weaknesses of market-oriented strategies is that they cannot deal with the issue of market failures, discussed in Chapter 5. While this issue is important for any country, it is of special importance in many developing countries where market failures of all kinds are far more widespread.

Market failures we have studied include:

- negative environmental externalities (of production and consumption) and the problems of common access resources
- insufficient provision of merit goods (goods with positive consumption externalities) including education, health care and infrastructure, such as sanitation, clean water supplies, road and transport systems, irrigation, power supplies, etc.
- failure to provide public goods
- abuse of monopoly power
- information asymmetries

There are two additional failures of concern to developing countries: co-ordination failures and weak or missing market institutions.

Co-ordination failures Co-ordination failures provide a possible explanation for the failure of firms to be set up and to contribute to growth. Suppose that firms would be able to increase their output if they began producing in a market requiring skilled labour. However, they will not enter this market if the skilled labour is not available; at the same time, workers will not acquire the skills if the firms that could hire them do not exist. As a result, the firms do not enter this market, and the workers do not acquire the skills. Both the firms and the workers get stuck in a position where they are worse off than they would have been if they could co-ordinate their activities and simultaneously enter the new market and acquire the necessary skills.

In another example, farmers could increase their production of agricultural goods for sale in the market, but to do this they need intermediaries, or 'middlemen', who will effectively represent them in distant markets. As long as the middlemen are not available, the farmers will not begin producing for the market; and as long as the agricultural output for the market is not produced, the middlemen will not become available.[8] The farmers get stuck in a position where they are producing less output than they could, and potential middlemen that could have benefited themselves and the economy do not emerge. Everyone is worse off, and the possibilities for expanding output remain unrealised.

Co-ordination failures arise when two or more activities that must begin simultaneously fail to do so, even though decision-makers make economic decisions that are in their best self-interest. The inability of decision-makers to co-ordinate their behaviours results in an outcome where everyone is worse off than they would have been had co-ordination been possible. These failures lead to *underdevelopment traps*, where people are trapped in a situation from which they cannot escape without outside help.

Weak or missing market institutions To be able to function effectively, markets need an institutional and legal environment that is often missing in less developed countries (and some transition economies). This environment must include enforcement of property rights, enforcement of legal contracts, effective legal recourse, a stable currency, a well-developed banking and insurance system, an effective road and utility infrastructure system, and readily available information on prices, quantities and quality of goods, services and resources to consumers, firms and resource owners. In the absence of these conditions, markets are highly imperfect in their functions and fail to function effectively.

[8] See Michael P. Todaro and Stephen C. Smith (2006) *Economic Development*, Pearson Education, where these ideas are explored more fully.

Development of dual economies

A dual economy (or dualism) was explained in Chapter 16, page 444. Dual economies may persist even as a country grows and develops. They are the outcome of market forces that do not work to the benefit of all or most people in a country because of the presence of market failures such as weak market institutions or co-ordination failures, because of the geographical isolation of many groups of people, the persistence or growth of great income inequalities and extreme poverty, or government policies that support one sector of the economy at the expense of another. Like all kinds of market failures that require some government intervention for their correction, so dual economies also require government policies that attempt to eliminate the dualism. The appropriate policy depends on the nature of the dual economy, i.e. whether it involves an advanced agricultural sector together with traditional, subsistence agriculture, or an advanced capital-intensive industrial sector together with a traditional labour-intensive urban informal sector.

Income inequalities

We have studied the effects of market-oriented policies on income distribution in Chapter 12, in connection with market-based supply-side policies, and in Chapter 17 in connection with the effects of trade and market liberalisation. The loss of protection of workers resulting from labour-market reforms, and increases in unemployment resulting from some policies to increase competition, including trade liberalisation which often involves the closure of firms, often result in increases in income inequalities. In addition, the inability of certain groups of people to take advantage of opportunities opened by trade and market liberalisation can also lead to increasing income inequalities (page 486).

Insufficient credit for poor people

As discussed in Chapter 17, page 467, poor people do not have access to credit, as the market working on its own does not allow poor people with no collateral and seeking very small loans to acquire the credit they need. This results in lower investment possibilities, greater poverty and poorer income distribution, as well as the inability to escape the poverty cycle.

Questionable effects on economic growth and development

Contrary to expectations, trade and market liberalisation may not lead to improved export performance and greater economic growth and development in some countries. Experiences have shown performance to be highly variable, with some countries faring better than others. According to the evidence, the countries that are better able to take advantage of opportunities offered by trade and market liberalisation are those that have already developed an industrial base, and are therefore better able to withstand the competition arising from the elimination or reduction of trade barriers. Low-income countries tend to perform the worst, because they can least withstand the competition with larger, more 'mature' foreign firms, and this sometimes leads to a weakening of their industry together with increased unemployment, poverty and growth of the urban informal sector (see page 485).

Capital liberalisation, if undertaken before countries have developed the necessary institutions, may lead to capital flight, reduced ability to conduct monetary policy in accordance with domestic priorities, and even financial crisis (see page 496).

The withdrawal of government from provision of merit goods that often comes with market liberalisation has negative effects on economic and human development.

These processes have the effect of increasing inequalities between rich and poor countries, as well as between higher income and lower income groups within countries.

Strengths and weaknesses of interventionist policies

Strengths

- **Discuss the strengths of interventionist policies, including the provision of infrastructure, investment in human capital, the provision of a stable macroeconomic economy and the provision of a social safety net.**

Interventionist policies are based on government intervention in markets intended to correct market deficiencies and create an environment in which markets can work more effectively. The strengths of interventionist policies include their potential to contribute to the following.

Correcting market failures

Governments have a major role to play in the correction of market failures. This includes policies that try to:

- correct negative environmental externalities of production and consumption and overuse of common access resources (Chapter 5)
- provide public goods as well as merit goods that are underprovided by the market due to positive

consumption externalities – as we know this involves investments in human capital (health and education) and investments in infrastructure (Chapter 5)

- assist in the correction of co-ordination failures (see page 532 above) – government intervention is needed to help people escape underdevelopment traps by allowing the simultaneous occurrence of necessary activities
- contribute to the development of market institutions that enable markets to operate more effectively (see page 532 above).

Investment in human capital

Investment in human capital (education and health) was noted above in connection with government policies to correct market failures. Education and health have significant external benefits, thus calling for government intervention (such as direct provision) that increases the consumption of both. Education and health are major factors behind increases in productivity that contribute to economic growth, and they also directly lead to greater economic and human development. Investment in human capital also forms a part of industrial policies, discussed below. (See also page 463.)

Provision of infrastructure

The provision of infrastructure also forms part of policies to correct market failures (noted above). Infrastructure includes a broad range of goods and services, also with significant positive externalities. As a type of physical capital, it includes water supplies, sanitation and sewerage, power, communication, transportation, roads, irrigation, and many others. All of these play a very important role in encouraging economic growth, as well as making possible economic and human development (see page 475). They increase productivity, and make a direct contribution to improved standards of living. Therefore, there is a strong role for governments in order to ensure the provision of the appropriate kinds of infrastructure, with the appropriate access by the population.

Provision of a stable macroeconomic environment

A stable macroeconomic environment includes price stability (the general price level should rise only gradually); full employment (people willing and able to work should be able to find a job); a reasonable budget deficit; and a reasonable balance of trade (avoidance of large trade or current account deficits). The market mechanism cannot accomplish these tasks on its own, and requires government intervention through the use of appropriate policies in pursuit of these objectives. We studied these policies in Chapters 12 and 14. A stable macroeconomic environment is important for ensuring that economic decision-makers (consumers, firms and resource owners) can plan their future economic activities (such as consumption investment, imports, exports, etc.). It is a key condition for investment, in particular, leading to the formation of physical and human capital, which are fundamental prerequisites for economic growth.

Provision of a social safety net

In Chapter 11, we saw that the market cannot ensure that everyone in a society can secure enough income to satisfy basic needs (food, shelter, etc.). The government must therefore step in with the provision of a social safety net to ensure that people falling below a minimum income level will be able to secure their basic needs. A **social safety net** is a system of government transfers of cash or goods to vulnerable groups, undertaken to ensure that these groups do not fall below a socially acceptable minimum standard of living (see page 309 on transfer payments). The provision of a social safety net by the government is very important in a market-based economy, where there are risks of becoming unemployed or falling into poverty.

Redistributing income

Another method to deal with the market's inability to secure everyone a minimum income involves government's policy of income redistribution, discussed in Chapter 11.

Industrial policies

Industrial policies are interventionist supply-side policies that include support for small and medium-sized businesses as well as protection of infant industries (such as through tariffs or subsidies) in order to help developing countries in the early stages of their industrialisation (page 339).

In addition, industrial policies include government support of appropriate technology transfer from developed countries and the establishment of a research and development capability, as well as the investments in human capital.

Industrial policies were a key factor behind the success of the Asian Tigers (page 484). Whereas these policies were discouraged by the Washington Consensus, according to New Development Consensus they can play an important role in helping developing countries develop their industries and higher value-added activities (page 487).

Weaknesses

> Discuss the limitations of interventionist policies, including excessive bureaucracy, poor planning and corruption.

Government activities are subject to several weaknesses that limit the effectiveness of their interventions in the market.

Excessive bureaucracy

A bureaucracy is an administrative structure of an organisation involving rules that determine how the organisation functions and carries out its tasks. Governments often run into the problem of excessive bureaucracy, meaning there are too many rules governing procedures, red-tape, unproductive workers, high administrative costs and inefficiency. This is a key argument often used in favour of reducing the size of the government sector through privatisation of government-owned enterprises, contracting-out of government activities, and private financing of public sector projects (see page 340) to reduce bureaucratic procedures and improve efficiency.

Poor planning

Government planning involves making decisions on what and how much of certain goods and services it will produce, how these will be produced (by use of what resources), how much they will cost and what revenues they might be expected to provide. Planning plays a major role in government provision of merit goods and public goods, as well as numerous government policies such as taxes, subsidies, transfer payments as well as virtually all of its economic activities.

Planning may run into difficulties because it requires technical knowledge and expertise on the part of planners, which they may not possess, as well as a tremendous amount of detailed information, much of which is often not available. The result is that planning can become highly bureaucratic and inefficient, resulting in a waste of resources.

Corruption

Corruption is defined by the World Bank as 'the abuse of public office for private gain'. It can take many forms including bribery, construction kickbacks, procurement fraud, extortion, false certification, nepotism, embezzlement, and more. It occurs everywhere in the world, but tends to be more important in countries where the legal system, mass media and the system of public administration are weak. It should be noted that multinational corporations in their dealings with governments play an important role with respect to bribes.

Corruption is often associated with lower growth and poorer development prospects. When it takes the form of a payment for something, it works like a tax that makes private investments more costly, reducing the overall level of investment. If it involves bribes to receive basic services like education or health care it works like a regressive tax, because the bribe is a higher fraction of the income of lower income earners. Unlike taxes paid to the government that become available for use in socially desirable activities, bribes go into the pockets of public servants and politicians, depriving society of resources that could have been used to pay for the provision of important merit goods. Bribes for tax evasion result in further reducing government revenues. Corruption can also result in a misallocation of resources as government officials accept bribes to pursue uneconomic projects (such as dams and power plants) instead of socially necessary services like education, health care, sanitation, etc. Corruption can also weaken sustainable development as government officials may accept bribes to bypass environmental regulations. Finally, corruption damages the people's trust in the state and encourages contempt for the rule of law.

Market with government intervention

Why good governance is important

> Explain the importance of good governance in the development process.

According to the World Bank, **governance** is 'the manner in which power is exercised in the management of a country's economic and social resources for development. Good governance ... is synonymous with sound development management.'[9]

Governance is not about *what* is done for economic growth and development, but rather *how* it is done. It is about the effectiveness of government, but also it involves the relations between government and society, and how they interact to make decisions. According to researchers on this topic, *good* governance consists of six principles:[10]

- **Participation** – the extent to which the stakeholders affected by policies are involved in making decisions and in the implementation of decisions.

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[9] The World Bank (1992) *Governance and Development*.
[10] Goran Hyden, Julius Court and Kenneth Mease (2004) 'Making sense of governance: empirical evidence from 16 developing countries', Overseas Development Institute.

- **Fairness** – the extent to which rules apply to everyone in society equally.
- **Decency** – the extent to which the formation and implementation of rules does not harm or humiliate anyone.
- **Accountability** – the extent to which political figures and decision-makers are responsible to society for the actions and their statements.
- **Transparency** – the extent to which decisions made by government are clear and open.
- **Efficiency** – the extent to which scarce resources are used without waste, delays or corruption.

Good governance is important because according to studies making cross-country comparisons, better governance is related to more investment and greater economic growth. The effectiveness of government, the efficiency of bureaucracy and rule of law are positively related to economic performance and adult literacy, and negatively related to infant mortality.[11]

Achieving a balance between markets and intervention

- Discuss the view that economic development may best be achieved through a complementary approach, involving a balance of market-oriented policies and government intervention.

During much of the 20th century, many countries around the world saw significant increases in government intervention. In developing countries, intervention took the form of import-substituting industrialisation during the 1950s and 1960s, followed later by export promotion (pages 482–84). In communist countries there was a very strong government presence that largely replaced the market system and took the form of central planning (government planning of most economic activities).

From the 1980s, there was a shift in most countries in the direction of less government intervention and a stronger emphasis on markets. This shift was influenced by the weaknesses of import-substituting industrialisation policies, as well as by market-based supply-side thinking that emerged in the United Kingdom and the United States at that time. It was also strongly encouraged by the Washington Consensus (page 485), part of which involved World Bank lending (structural adjustment loans) and lending by the International Monetary Fund (and its stabilisation policies). At the same time, there was a growing recognition of the limitations of central planning in communist states. In China and former communist countries, a deliberate choice was made to move toward a stronger market orientation; these economies are called 'economies in transition'.[12]

By the early 2000s, it had become apparent that neither the extreme of very strong government intervention, nor the extreme of a highly free market orientation, is appropriate for the conditions of developing countries (page 487). Attention of policy-makers therefore turned toward finding an appropriate mix of market-based and interventionist policies.

Based on the experiences of developing countries accumulated over a 60-year period and the evolution of economists' thinking on this subject, we can arrive at the following broad conclusions:

- **Very strong government intervention in the market, such as that pursued during the 1950s and 1960s, has been mostly discredited as a strategy for economic growth and development, and international trade.** It is now well understood that very strong government intervention leads to misallocation of resources and inefficiencies in production, and may result in lower rates of growth. As of the early 2000s, there tends to be a convergence on the idea that market forces should be allowed to play an important role, and that trade, growth and development strategies should be for the most part market-led, though with varying degrees and forms of government intervention.
- **A market-led economic development strategy with a minimum amount of government intervention, such as is represented by the Washington Consensus, does not take into account the special set of circumstances faced by developing countries.** If such a policy is pursued over an extended period, it is likely to lead to only limited progress in economic growth and economic and human development, as a result of persisting and possibly increasing poverty, a likely increase in unemployment and underemployment, persisting and probably increasing inequalities in income distribution, insufficient investments in education and health (human capital) as well as

[11] Julius Court (2006) 'Governance, development and aid effectiveness: a quick guide to complex relationships', Overseas Development Institute.

[12] Most economies in transition appeared after the collapse of communist regimes in eastern Europe and the former Soviet Union in 1989–90. The countries in this group include the ones that emerged after the break-up of the Soviet Union (15) and Yugoslavia (7), plus the countries of eastern Europe that experienced a transition to democratic regimes. China, also a transition economy, has taken a different route by choosing to introduce market reforms gradually under the direction of its Communist Party.

in infrastructure, unsustainable development, the continued use of inappropriate technologies, and limited opportunities to expand exports.

The New Development Consensus outlines a number of areas in which governments of developing countries should intervene in order to promote growth and development. As of the early 2000s, there is broad agreement among development economists that there should be government intervention in areas including: poverty alleviation; reductions in income inequalities and inequalities in economic opportunities; investments in health, education, infrastructure, technology transfer and the establishment of a research and development capability; some support for small and medium-sized businesses; protection of the environment and sustainable development. In addition, many economists support the idea that developing countries, especially the very poor ones, may require some protection for their domestic industries in the initial phases of their industrialisation in the form of industrial policies, including protection of infant industries.

It would be a mistake to take a blanket (or uniform) approach to all developing (or any other) countries with regard to proposals for market-led or interventionist strategies (or any other type of strategies for that matter). Each country is unique, and should be able to tailor its strategies to its own particular needs and conditions, in consultation with aid and development assistance agencies.

It is likely that countries at lower levels of economic development can benefit from strategies that are more strongly interventionist; government can gradually withdraw and give greater reign to market forces as the country grows and develops. Countries at lower levels of development are more likely to be lacking in the necessary institutions and regulatory and legal mechanisms required for markets to work well, thus needing a relatively greater degree of government intervention. With growth and development, and the gradual establishment of more effective institutions, the government can increasingly withdraw, allowing market forces to take a stronger hold.

1 Explain some of the main strengths and weaknesses of market-oriented policies.

2 Explain some of the main strengths and weaknesses of interventionist policies.

3 **(a)** Explain the meaning of good governance. **(b)** Why is good governance important in economic development?

4 Why would it be inappropriate to take a uniform approach to making policy recommendations on the roles of the market and government intervention in developing countries?

5 Explain whether you agree with the propositions that **(a)** markets and government intervention should complement each other in developing countries, and **(b)** governments should intervene more strongly in countries that are at a relatively lower level of economic development, and less strongly as countries grow and develop.

Economic growth and development in Peru

During the 1990s, Peru reoriented its economy toward the market to achieve economic growth and development. This involved abandoning its policies of import substitution, including elimination of price controls, lowering trade protection barriers, lowering restrictions on foreign direct investment, and reducing state ownership of firms. Since 2002, it has experienced high rates of growth, and has been the fastest growing economy in Latin America.

Peru's economic performance was not always so favourable. In the late 1970s the economy had suffered a serious collapse, and remained mostly depressed for about two decades. By 2005–6, real GDP *per capita* just managed to reach the same levels of the 1970s.

An important factor behind the collapse involved massive declines in export revenues, due to excessive specialisation in the export of only a few primary commodities: minerals (mining of copper, gold and zinc) and agriculture (coffee, sugar, potatoes). Terms of trade shocks caused by declines in global commodity prices reduced the value of exports by more than 80% in 1979–93, resulting in declining incomes, increasing unemployment and poverty, a balance