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The Role of Government in Economic Development*

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It has been almost three decades since I began working on issues of economic development. During that time the world has changed markedly and so has the intellectual framework we use to approach development. Thirty years ago we felt both hope and concern. We believed that developing countries could close the substantial gap separating them from industrial countries, though we worried about why so few countries had actually done so. Standard textbooks discussed the leaps the Soviet Union had made between the mid-1920s and the onset of World War II. That supposed success—which now looks more virtual than real—influenced developing countries, many of which set up planning commissions to guide their economies. In many instances the state went well beyond guidance and into actual production and ownership of enterprises.

What a difference thirty years makes. The Republic of Korea—whose per capita income in 1960 was roughly the same as India's (less than $500 in 1995 dollars)—is now a member of the Organization for Economic Cooperation and Development (OECD). The successes of Korea and other East Asian economies demonstrate the effectiveness of a more market-based development strategy. In most instances East Asian governments abandoned the rigid planning model early on. But they did not err by going to the other extreme. Their governments helped to guide and create markets rather than completely supplanting or surrendering to them.

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Meanwhile, the economies that stuck with the planning model experienced slow growth, stagnation, or worse; the collapse of the socialist economies was but the final nail in the planning coffin. By the 1980s countries around the world were actively engaged in privatizing state enterprises.

The dramatic failure of the grand socialist experiment had an unanticipated consequence: it lent support to extremists of the opposite ideological persuasion, according to whom government should play almost no economic role. But the rejection of one extreme is not the affirmation of the other. The real issue that both the success of East Asia and the failure of the socialist experiment raise is: *what is the appropriate role of government in economic development*? There is a third way—or, I should say, many third ways—between the extremes of total government control of the economy and complete laissez-faire. At different stages of development or in different situations countries will and should choose different points along this spectrum.

I cannot possibly touch here on every aspect of the appropriate role of government. Instead I want to draw selectively on advances in economic theory, interpretations of the East Asian miracle, and my experiences within the US government to highlight aspects that have not received sufficient attention in recent discussions. Certain topics (such as the role and design of industrial policies and the role of government in the financial sector) are omitted or treated only briefly because they have already been discussed widely elsewhere.

Before developing this framework, I want to make two preliminary remarks. The first relates to developments in economic theory. The perspective that I argue for here places markets at the centre of the economy. The theoretical foundations for this market-oriented perspective rest on Adam Smith's notion of the invisible hand and especially its modern rendition, the fundamental theorems of welfare economics. To be sure, economists have long recognized the need for selective interventions in the marketplace to remedy well-identified problems such as externalities.[1] But developments over the past fifteen years have shown that well-designed government actions can improve living standards whenever there are imperfections of information or competition or incomplete

[1] Although some economists have suggested that even those difficulties could be handled privately through Coasian bargaining, most economists believe that market interventions, in the form of Pigouvian taxes, are the appropriate remedy.

markets—problems that arise in all economies, but especially in developing ones. The use of the word *can* here is crucial. Not every market 'problem' calls for government action. In order to raise living standards, government actions must meet two criteria: they must address some serious imperfection in the marketplace, and they must be designed efficiently enough that their benefits outweigh their costs.

My second prefatory comment is that the key arguments in favour of a tightly circumscribed role for government have generally been shown to have only limited validity. Critics have asserted that government is unnecessary, ineffective, and to the extent that it actually affects anything, counterproductive. They argue that anything government can do the private sector can do better; that anything the government does will be offset by actions of the private sector; and that rather than improving resource allocations, government interventions actually make matters worse, especially because of rent seeking. The first proposition is simply false, while the second is true only under highly restrictive conditions. As for the third, the historical evidence shows that government actions can and have made a difference for the better; and both theory and evidence show that concerns about rent seeking, while real, are typically exaggerated. For rent seeking to completely dissipate the profits generated assumes perfect competition in rent seeking. The major thrust of these criticisms, however, is one that I have already noted and with which I fully agree: the fact that markets are not constrained Pareto-efficient does not imply that any arbitrary intervention will necessarily improve matters. The full consequences of any proposed action must be carefully assessed.

What Should Government Do?

Theory can provide valuable guidance on the appropriate role of government. In this context I believe that the East Asian experience and the experiences of the industrial countries are instructive. To be sure, there is the ever-present problem of the counter-factual: would these economies have grown even more quickly if government had not taken the actions it did? Although we may never know for sure, a wealth of evidence suggests the contrary. And I am convinced that while the United States also relied primarily on markets, its success was in part attributable to selective government actions. In both the United States and the rapidly growing economies of East Asia, government has played six important roles that have spurred development.

Six Important Roles

In a sense, much of the role of government can be viewed as establishing infrastructure in its broadest sense—the educational, technological, financial, physical, environmental, and social infrastructure of the economy. Since markets cannot operate in a vacuum, this infrastructure is necessary if markets are to fulfil their central role in increasing wealth and living standards. Because constructing the broad infrastructure is beyond the capacity or interest of any single firm, it must be primarily the responsibility of government.

Promoting Education

The first role of government that the United States and the East Asian economies have in common is in *promoting education*. Even before the adoption of the US Constitution, the federal government of the United States, in the Northwest Ordinances of 1785 and 1787, recognized its responsibility for promoting public education by setting aside land in the newly formed states for that purpose. Later, in 1863, the federal government helped establish the public university system.

The East Asian economies also emphasized the role of government in providing universal education, which was a necessary part of their transformation from agrarian to rapidly industrializing economies. Universal education also created a more egalitarian society in East Asia, facilitating the political stability that is a precondition for successful long-term economic development. In pursuing such egalitarian policies, the economies of East Asia laid to rest the trickle-down theories of development. Simon Kuznets had argued that economic growth was associated with an increase in inequality; Arthur Lewis had suggested that such inequality was necessary because capital accumulation lay at the heart of growth. Since rich individuals were assumed to save more at the margin than poor ones, higher levels of inequality would increase savings and hence growth. The East Asian economies showed that high levels of savings could be attained in an egalitarian setting and that human capital accumulation was every bit as important as—if not more important than—increases in physical capital.

Promoting Technology

The second role of government is in *promoting technology*. In 1789, the US Constitution recognized the importance of science and technology by giving Congress the right to grant patents to promote the progress of science. Even in the early part of the nineteenth century, support for research went well beyond the establishment of a system of intellectual property. Just as the modern telecommunications system—including the Internet—was fostered by government, so too were earlier advances. In 1842, for example, the federal government financed the world's first telegraph line, between Baltimore and Washington. Over the more than 150 years during which it has supported research, the US government has had an impressive record of successes. In the nineteenth century, agriculture was the mainstay of the economy, accounting for more than 35 per cent of GDP in the 1870s. The remarkable growth in productivity in the agriculture sector is largely attributable to the federal government's support for research and dissemination of its results. East Asian governments have also played a central role in the promotion and transfer of technology.

Supporting the Financial Sector

The third role of government is in *supporting the financial sector*. Sometimes depicted as the 'brain' of the economy, the financial sector is responsible for deploying scarce capital resources in the most efficient way. It is concerned with gathering, processing, and disseminating information—precisely the areas in which market failures are often most marked. In 1863, in the midst of the Civil War, the United States recognized the need to create a national financial system and passed the National Banking Act, establishing the world's first supervisory banking agency. Although we now know that far more is needed to create financial stability, this legislation did much to reduce the financial instability that had characterized the economy up to that time. In later years the government created the Federal Reserve system as well as a series of financial intermediaries to spur markets that had been thin or non-existent. Similarly, East Asian governments took an active role in ensuring the safety and soundness of financial institutions and in creating new institutions and markets to fill gaps in the private sector.

Investing in Infrastructure

The fourth role of government is in *investing in infrastructure*, including institutions as well as roads and communications systems. In both the United States and the successful East Asian economies, governments created institutional infrastructures within which competitive markets could thrive. Only recently, as the formerly socialist economies have struggled to establish market economies, have we become fully aware of the importance of institutional infrastructure, which includes property rights, contract and bankruptcy laws, and policies to promote competition where it is viable and to regulate markets where it is not.

Preventing Environmental Degradation

The fifth role of government is in *preventing environmental degradation*. Although economists have discussed the need for government action to correct market failures at least since Edgeworth, the concept has become widely accepted only during the past quarter-century. Good environmental policies should not be viewed as luxuries, to be enjoyed only by the well off. We should not confuse increases in GDP with increases in standards of living, or increases in measured GDP today with increases in long-term wealth. Recent attempts at building 'green' GDP accounts recognize these points. They highlight the enormous challenges faced by countries that have not prevented environmental degradation: it will take generations to undo the environmental damage that has been wrought in many developing and transition economies.[2]

Creating and Maintaining a Social Safety Net

The sixth role of government is in *creating and maintaining a social safety net* including access to basic health services. In some cases these activities can be justified in utilitarian terms: they increase the productivity of the labour force and foster political stability by reducing opposition to change. But they may also be justified in terms of basic values. As I noted above, standards of living embrace more than the variables captured in GDP statistics. There is a fundamental sense in which, for instance, improved health conditions represent an improvement in living standards, even if such an improvement is not reflected in GDP.

Virtually all societies have provided social safety nets, albeit not always through the government. For at least two reasons governments today may have to assume a larger role in providing safety nets than either the US or East Asian governments did at comparable stages in their countries' development. First, the pressures of urbanization call for a stronger government role. In 1975, just over a third of the world's population lived in cities; the United Nations and the World Bank

[2] In many cases even the short-run costs of unsound environmental policies (such as health-care costs) can be high.

estimate that by 2025 that proportion will double. Urbanization—and the migration from traditional communities with which it is associated—is likely to result in less effective community-based social safety nets. Second, in transition economies large firms traditionally provided much of the social safety net (such as pensions and health care). The transformation of these economies is being accompanied by the shedding of these social responsibilities by corporations facing new competitive pressures. The government is the only backstop.

Special Role of Government in Developing Economies

Government needs to function in the six capacities I have delineated in all types of economies. But I want to take note of the special problems facing developing and transition economies. In such economies markets are either lacking or the ones that do exist may function less effectively, and information problems are more severe than in industrial countries simply because of the rapid change in the economic environment.[3]

While market failures loom larger in developing and transition economies, the capacity of the government to correct these market failures is often weaker.[4] Assessing the appropriate role of government requires recognition of both the need for and the limitations of government action. Successful governments have helped create markets (such as bond and stock markets and long-term credit institutions). They have established and enforced laws and regulations that have made financial markets more stable and increased competition in all sectors. In many cases governments have acted as surrogate entrepreneurs, encouraging the establishment of firms to enter certain markets. Especially in export markets, governments have provided firms

[3] Recent literature has emphasized the importance of reputation mechanisms and implicit contracts in governing economic relations. The effectiveness of these mechanisms depends on the long-term nature of the relationship. In developing countries rapid transition threatens the long-term viability of many such relationships, the weakening of social ties reduces the role of social sanctions as an enforcement mechanism, and high interest rates encourage short-run self-interested behaviour at the expense of long-run cooperative behaviour.

[4] I noted earlier the importance of establishing the appropriate institutional infrastructure for a market economy in transition economies. But it may take a strong government to establish the institutional infrastructure that facilitates the viability of a strong market.

with strong incentives. (Some econometric evidence suggests that many of these interventions were quite effective. For example, an analysis of the mild financial restraint evidenced in most East Asian economies suggests that it did lead to more rapid economic growth.)

The Conservative Reply

Most economists today accept the proposition that markets alone may not succeed in ensuring economic efficiency and may fail to protect some segments of society from abject poverty. While most economists also agree that such shortcomings might provide a rationale for government action in principle, some argue that government interventions all too often have been counterproductive in practice. Any balanced account of the role of government must acknowledge that this has often been the case, a topic I touch on below. But that in itself proves nothing. The question is: can responsible democratic governments put in place policies that raise living standards? Based on the experiences of East Asia and the United States, I believe the answer is a resounding yes.

Some critics of the role of government argue for a different perspective on the East Asian experience. They contend that all—or almost all—of the growth of the East Asian economies can be accounted for by factor accumulation. Thus, they argue, there is no miracle but simply the inexorable working out of standard fundamental increased inputs leads to increased outputs. Total factor productivity growth has been negligible.

There are several technical problems associated with the studies reporting these results. (Does anyone who has studied wage setting in Singapore, for example, really believe that wages are set in a competitive process, so that the real wage equals the marginal product of labour, as most of the studies assume?) But even if we take at face value the findings of low total factor productivity growth, these studies do not really address the question of whether government policies made a difference. They neither ask nor answer questions such as these:

1. Why were savings rates in East Asia so high? Elsewhere, comparable savings rates had been attained only under the compulsion of strong government force, as in the communist countries. Although econometric studies suggest that East Asia's savings rates may be

partly explained by traditional economic factors, government actions also played a constructive role.

2. Why were the East Asian economies able to invest efficiently at such a rapid pace? Other countries (the former Soviet Union is the classic example) have invested heavily but ended up with high incremental capital–output ratios rather than rapid growth. Government efforts to create effective financial institutions combined with the practice of providing funds to firms that proved their mettle in the competitive export markets surely contributed to the efficiency with which East Asia's capital was allocated.
3. How were the East Asian economies able to reduce the technological gap between themselves and the most economically advanced countries so quickly? The East Asian economies demonstrated an enormous capacity to absorb both capital and technology. The speed with which they closed that gap entailed more than just buying technology. Governments played a major role in investing in human capital, allowing foreign investment (with some exceptions), and creating an economic atmosphere conducive to foreign investment.
4. How did the East Asian economies ensure that the benefits of rapid growth were shared broadly across the population? As already noted, the increases in inequality that inevitably accompany development, as suggested by earlier experiences, simply did not occur in East Asia. To the contrary, there are reasons to believe that greater egalitarianism—a result of deliberate government policies—actually contributed to the remarkable growth in these economies.

Improving Government Performance and Responding to Change

I have argued above that people who advocate a tightly circumscribed role for the government—providing only for national defence, for example—go too far. But I want to stress again that government is not infallible. Even in the successful East Asian economies, governments have made mistakes. (The Japanese government, for example, initially attempted to prevent Honda from entering the automobile industry.) Government cannot fix every problem. Government definitely has a place, but it must know its place.

The pragmatic framework that I set forth earlier for assessing the role of government entails a balancing of the strengths and limitations of markets and government, and the determination of how they can best complement each other. It does not begin with two columns labelled 'activities to be carried out by government' and 'activities to be carried out by the private sector'. This careful balancing puts greater emphasis on how the government does what it does and how it interacts with the private sector. To that effect, I want to outline a few general principles, motivated by both theoretical analyses and historical experience.

Incentives and Change

In assessing the proper role of government, we must take into account two fundamental points. The first is the importance of incentives. The second is the dynamic nature of government's role; as the economy changes, so must the government.

The government is a large organization, but unlike large market organizations it is not subject to the pressures of market competition. In democracies, political competition exercises some discipline: incompetence is punished and performance is rewarded. To be sure, political competition is a far cry from the textbook ideal of perfect competition. But so too is actual market competition. It is sometimes suggested that bureaucrats lack incentives, but incentives can also be distorted in large corporations. It has also been suggested that bureaucrats are not responsive to the wishes of voters. But both theory and evidence suggest that managers of many large corporations are not always responsive to the wishes of the shareholders to whom they are in principle accountable.

In short, the distinctions between the public and private sectors are often overblown. But we must be careful not to go to the other extreme: incentives do play a somewhat more important role in the private than in the public sector. Provided adequate competition policies are put in place, market competition is more effective in providing incentives than is ersatz public competition. The question is whether, and how, the public sector can put in place an effective set of incentives.

We must also recognize that the role of government is not static. Changes in the economic environment fundamentally alter what the government can and should do. In a world with limited international trade, for example, it might have made sense for countries to worry about material balances, and there might have been some rationale for the kinds of planning exercises that once dominated development thinking.

But with the expansion in international trade and the fall in transportation costs, countries can now specialize in that part of the production process in which they have a comparative advantage; they are not limited to domestic markets on either the demand or the supply side. Consider automobile production. Assembly is only one part of a car's cost, representing only about a fourth of the value added at the factory. Different parts can be constructed in different countries and then shipped to the assembly point. Modern telecommunications systems ensure that orders for parts can be transmitted quickly from the assembly plant to the parts plant, wherever it is located.

In the past ten years this pattern has spread from large multinationals to much smaller companies. As a result of improved transportation and telecommunications a small or medium-size firm in the United States or Europe can develop relationships with suppliers in East or South Asia, sending them precise product specifications. While the long-run implications are not yet clear, these developments have been a boon for developing economies. The globalization of entrepreneurship has loosened the constraint on growth imposed by one of the scarcest of factors in the developing world.

Globalization is just one example of a change in the economic structure that necessitates a change in government policies. Below, I discuss other examples, including how changes in technology have enhanced the scope for competition in areas that were once considered natural monopolies (telecommunications and electricity).

Recognizing the importance of incentives and the continually changing role of government, we can now consider ways in which government performance can be improved: increasing consumer orientation, monitoring and rewarding performance, extending the scope for competition, corporatizing and privatizing, and improving regulatory policy.

Increasing Consumer Orientation

One of the problems arising from a lack of competition is a lack of choice. Consumers do not get to choose the providers that issue their driver's licence or passport. When there is a choice, as in buying airline tickets, some consumers will choose to go to airlines with shorter lines, even if they have to pay a slightly higher price; the market reflects the diversity of consumer preferences. One way to address the problem of choice within the public sector is to create more competition; short of that, government can create a culture of customer orientation. Performance measures may be effective in drawing organizational attention to relevant variables and perhaps in motivating the behaviour of individual bureaucrats. Changes in attitude towards users of government services—thinking and referring to service users as customers, for example—may also help.

In some instances performance can be measured and monitored. The length of time it takes a service representative to respond to a customer is an example. Standard survey techniques can evaluate customer satisfaction with, for example, telephone interactions. Indeed, at the individual level the motivational and monitoring problems facing, say, the Social Security Administration are little different from those facing a private insurance company. In the United States, where government agencies have worked hard over the past three years to improve customer orientation, we have shown that government can in fact succeed in improving service: ratings of the Social Security Administration's services are highly competitive with the best comparable service providers in the private sector.

Monitoring and Rewarding Performance

Private firms have simple bottom-line performance measures—profits and market value. Although government as a whole has no comparable summary statistic for capturing performance, performance at particular activities (typing letters, issuing visas, processing driver's licences) can be identified and measured. It is important that output, not process or input, measures be used: too often rewards are based on how well a worker complies with standard operating procedures.

In many cases activities performed by the public sector are similar enough to activities performed by the private sector so that private sector performance can provide a yardstick. For instance, while every firm has slightly different travel needs, it is possible to obtain a range of estimates of the administrative costs associated with travel. These costs can then be used to determine how government agencies compare and to use performance relative to private sector norms as a basis for rewards.

But many public sector activities are different from activities conducted within the private sector. Public sector activities are disproportionately administrative in nature, making measurement of individual performance particularly difficult. We do not know how to measure the quality of many administrative decisions made collectively, let alone the contributions of individuals. In many other activities there is no single metric of performance. Consider education. Rewarding performance only in terms of basic skills (which can be measured more easily than other skills) will divert resources away from developing higher-order and cognitive skills. It may, however, be possible to redesign the production process to mitigate these effects (for example, by assigning different teachers different tasks). Whether this is desirable depends on the magnitude of the incentive distortions relative to the economies of scope. If economies of scope are weak (for example, between teaching basic skills and teaching higher-order cognitive skills), it may be desirable to redesign the production process so that individual performance can more easily be monitored.

Extending the Scope for Competition

One way to provide more effective incentives, including enhanced consumer orientation, is to extend the scope for competition. Creating effective competition among vendors, for example, is an essential step in ensuring that the government procures goods and services at the lowest possible price. But the task of competitive procurement is more difficult than is often realized. It used to be thought that competitive bidding was the simplest way to ensure that government does not pay too much for a good or service. Competitive bidding, however, typically requires the government to draft precise specifications for the item being purchased—describing a simple t-shirt could take thirty small-print pages. Since most firms do not normally produce to those precise specifications, they may find it unattractive to bid even if their products have similar performance characteristics. Thus the number of bidders is often relatively small. As a result the government may have to pay higher prices than the public at large.

In a sense the problem arises because of the difficulty of developing and clearly articulating performance measures. Government uses competitive bidding to ensure that taxpayers do not overpay and to mute criticism that the government has wasted taxpayers' money. Yet these cumbersome procurement policies—a form of micromanagement of contractor production—have often contributed to higher average costs. Where a competitive marketplace exists, the discipline of competition in the marketplace may suffice. In the United States, for example, procurement reforms based on this principle enacted under the Clinton administration will save US taxpayers $12.3 billion over the next five years.

Corporatizing and Privatizing

Even when competition is not a viable option, it may be desirable to incorporate features of a private firm. This objective goes beyond introducing performance pay, extending to broader issues of personnel, procurement, and budgeting. When competition is not viable, however, the danger of abuse of monopoly power is real. To constrain the abuse of power, policymakers need to ask three key questions:

(a) Is there a dedicated source of revenue related to the benefits conferred?
(b) Is there a governance structure that can ensure efficiency and a regulatory structure that can protect against abuses of monopoly power?
(c) Can production issues be separated from other public policy issues, including those related to externalities and safety, for example?

Privatization represents only one point along a spectrum of organizational forms that includes a variety of corporatization structures within the public sector. Sappington and Stiglitz's (1987) Fundamental Theorem on Privatization established that the conditions under which privatization could fully achieve the public objectives of equity and efficiency were extremely restrictive—and similar to the conditions under which competitive markets attain Pareto-efficient outcomes. Because of differences in risk aversion and time discounting, the state may receive less—possibly far less—than the expected present discounted value of the profits of the enterprise. Moreover, even with a complicated set of Pigouvian taxes the state may not be able to induce the privatized industry to act in the way it would like, especially when there are complicated social objectives.[5]

The theorem's main thrust is that privatization has to be justified on a case-by-case basis: the increase in economic efficiency must be sufficient to outweigh the disadvantages of privatization. In many cases (as in telecommunications) that case clearly has been established.

When privatization has been determined to be desirable, it must be implemented correctly, with appropriate built-in protections—including

[5] A Pigouvian tax, levied on producers of externalities, raises the producer's perceived private costs to the level of the social costs of the activity.

protections against abuse of any monopoly power. Appropriately designed competitive auctions typically are the most effective way of ensuring that the public obtains full value for publicly owned resources. The carefully structured spectrum auctions in the United States illustrate how to raise public revenues while promoting competitive markets and innovation.

Corporatization, privatization, and the other reforms discussed earlier help to focus attention on performance—on outputs rather than on inputs and process. This focus is necessary if the efficiency of the public sector is to be enhanced. In areas where privatization may be inappropriate (such as the granting of patents), government functions can be organized to focus on performance, as the United States has done in establishing performance-based organizations that establish organizational and individual incentives to enhance performance.

Improving Regulatory Policy

A focus on performance is also critical to ensure that regulations achieve their objectives at minimum cost. In many countries the environmental regulations of the past two decades have brought about enormous improvements in air and water quality. In some cases, however, the objectives could have been obtained at lower cost. Rather than focusing on performance criteria, policymakers imposed design standards. In some cases such standards were imposed because there was no effective way to monitor performance. But appropriately designed regulations could have provided incentives for the development of monitoring technology.

Nowhere is the changing role of government and the increasing reliance on market-based regulatory policies more evident than in the telecommunications and electricity industries. We used to think of these industries as natural monopolies, where governments faced a choice between nationalization and regulation, with most governments choosing nationalization. But as the inefficiencies of state-owned enterprises became apparent, more and more countries privatized their telecommunications systems, creating a monopoly that was often subject only to weak regulation.

Few governments took the next step of asking how competition could be ensured. They did not do so because economists told them that competition was not a viable option, that these industries were natural monopolies. But on closer observation, we have realized that competition is indeed viable in many, if not most, parts of these industries. We are therefore left with a subtle question: how do we ensure that monopolies in those segments in which competition is not a viable option do not destroy competition in other segments (for example, through discriminatory access or pricing)?

In the case of the US telecommunications industry, it became clear that regulation alone could not effectively prevent discrimination; structural separation of the 'list mile' (a natural monopoly) and other parts of the telecommunications system was thus required. With the appropriate institutional infrastructure, competition could be made viable in large segments of this vast market, allowing government regulators to focus on a much narrower set of issues.

The same process is now taking place within the electricity industry, another sector traditionally regarded as a natural monopoly. We now recognize that this industry has at least three major components: generation, transmission, and marketing. Already, changes in technology have made possible a competitive market in generation. And in the United States, where an effective pro-competition regulatory structure is being put in place, a competitive market in electricity generation is rapidly emerging. Tele-communications and electricity represent two areas for which the role of government in most countries has changed dramatically, from protection or detailed regulation of the entire industry to regulation only to ensure that the parts of industry where competition is not viable do not abuse their market power.

Conclusion

It has become almost a cliché to refer to the vast changes in our world and the need to adapt to those changes. Yet the fact remains that extraordinary changes have taken place and that societies that adapt better to those changes will do better, in terms of raising living standards, than those that do not. Government can help societies embrace change.

Both the constants and the changes in development practice and theory are remarkable. So too is the similarity of arenas of activity between countries that developed successfully in the nineteenth century and the East Asian economies that developed largely in the second half of the twentieth century. (One difference is that the earlier development experience lacked the benefit of insights from modern economies!) Among the constants are putting competitive markets at the centre of an economy, with governments acting to assist, use, and supplement those markets; providing public investment in education and technology; and constructing appropriate institutional infrastructures, including those that support dynamic and competitive telecommunications and financial sectors. Governments must also provide a basic safety net and protect the environment. Among the changes is the recognition that government can make use of many of the mechanisms that have helped make markets work so effectively and that the scope for competition is broader than had previously been thought.

Making government perform better is an important concern everywhere. Good policies on education, health, and the environment are not luxuries to be postponed to a later date. Making government focus more on customer orientation, performance, and competition is also essential. Indeed, the scarcity of resources and the tightness of fiscal constraints facing developing countries today make it imperative that resources be spent efficiently.

Too often discussions of what the government should do present false dichotomies. Good environmental and educational policies can actually enhance economic growth. Yet it is also true that only if developing countries grow more rapidly will they be able to provide their citizens with a decent standard of living. Development and improved living standards have many dimensions, but both ultimately depend on increased production of goods and services. It is right that we redress an imbalance that saw this increased production as an end in itself. But having refocused our attention on the right set of objectives, we should not lose sight of the means by which those objectives must be attained.

The theories and historical experience to which I have alluded here may guide us in shaping the role of government. Leadership can help articulate visions of that role. But in the end it is the desires—real and perceived—of the people whom government is supposed to serve that will determine both the scope of government and its ability to be a positive and creative force.

Annexure: Floor Discussion on 'The Role of Government in Economic Development,' by Joseph E. Stigiltz[1]

Michael Bruno (chair), noting Joseph Stiglitz's comment that his view of the government's role in the economy had not changed since he had joined the government, asked whether Stiglitz would have said the same thing had he started working for a government in a developing country. On a spectrum ranging from the government doing everything to the private sector doing everything, Bruno wondered whether the quality of the people staffing the public and private sectors would alter Stiglitz's views (assuming that the United States represents the far edge in terms of quality).

Stiglitz acknowledged that market failures—absent or ineffective markets—are more prevalent in developing countries than in industrial countries, adding that the public sector is also less effective in most developing countries. Thus a balance must be struck. East Asian economies provide a good example of how governments can play a positive role and make a difference. Thirty years ago, for example, per capita incomes in the Republic of Korea were comparable to those in India. Although it is important not to generalize, many East Asian economies engaged in practices that increased the likelihood of effective government and decreased the likelihood of corruption and other abuses. Competitive procurement practices are one way a government can use market mechanisms to allocate resources competitively and improve performance in the public sector.

A participant from the World Bank's International Trade Division asked about competition between the public and private sectors and about how the two should compete with and complement one another. Stiglitz had suggested that replacing a state marketing board with a private marketing monopoly might not be an improvement if the private operation exploited farmers even more than the state operation had. Why not let the private sector compete with the state marketing board, asked the participant. Over time, even if the state board is efficient, the private sector could replace it. The participant also wondered about the relationship between government action and market failures. There were stories, for example, of pan-territorial pricing in some sub-Saharan African countries. No private sector transport or storage

[1] This session was chaired by Michael Bruno, senior vice-president and chief economist, Development Economics, at the World Bank.

capabilities developed because, with prices fixed, there was no incentive to develop such facilities. Given the government's limited capacity, might it not be better to focus on creating the institutions that allow the private sector to flourish?

A good question, said Stiglitz. There is now scope for competition where previously none was thought to exist. But it is not so much a question of whether such competition is viable. There is no natural monopoly in marketing grain, for example, so there is no compelling argument for a government monopoly. If the concern is that private firms will exploit farmers, the appropriate mechanism is policies to ensure that competition thrives. That a market does not exist does not mean that it cannot develop. But governments must provide the institutional infrastructure that makes competitive markets work. In many areas the government has demonstrated a role for markets and markets have followed, although in some cases the government continued to play a dominant role. In the United States for example, the government-established Fannie Mae (Federal National Mortgage Association) has played a national role in providing a market for securitized mortgages, which has lowered the cost of mortgages for millions of homeowners. Although markets could have done this, they did not, so the government created Fannie Mae, which is now a viable enterprise. Interestingly, the government had tried to create more than one agency to engage in this process, but Fannie Mae remained the dominant player in the market.

A participant from India asked Stiglitz if he thought that the private sector must take over the duties of the public sector in developing countries or if there is scope for making public sectors more efficient in terms of professionalism, continuity in management, technology, and so on. Stiglitz said he would have rephrased the question to ask which is more important: making the public sector more efficient or redefining its role? Both are important. They are not alternatives, and countries should not have to choose one or the other. In fact, the appropriate scope of government depends on how effectively it increases efficiency in the public sector. There are a number of ways that can be done, and many of them involve emulating practices in the private sector. In fact, in many essentially public activities, there is a continuum that runs from fully private to fully public. In developing new strategies it is important to avoid pigeonholing activities in either of the two extremes. Many countries have chosen to privatize air traffic control, for example, but some have chosen to corporatize it. The parent system is another example. The United States and the United Kingdom are both redefining their patent systems using performance-based organizations.

A small business owner who had recently struggled with a maze of government bidding procedures asked Stiglitz if he had any recommendations for how governments could improve their functions, considering the shortage of bidders from the private sector. Stiglitz agreed that governments tend to produce too many bureaucratic forms. The United States recently has made efforts to simplify procedures. People are increasingly aware that bureaucratic procedures disproportionately harm small businesses, which cannot afford a full-time employee to handle paperwork the way large corporations can. The US Small Business Administration, for example, used to require so much paperwork that it was difficult for small businesses to apply for loans. But things have changed in the past few years: the agency's new, much shorter application form asks only for essential information. Pension procedures for small US businesses have similarly been simplified. Now small businesses with pension plans have to file only a brief form, and it costs less than $10 a year per pension recipient to operate the system.

Another participant from the World Bank asked if the state could play any role in addressing the social and economic problems associated with ethnicity, with which countries in Africa, Eastern Europe, and Central Asia have been struggling. Stiglitz said he believes that the government has an important role to play in ensuring that all groups have access to opportunity and a particular responsibility to ensure it for groups that have been denied such access in the past. Some countries, he noted, have done well in this role.

Reference

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