Chapter 8

Development Policymaking and the Roles of Market, State, and Civil Society

Problems and Policies: Domestic
1 A Question of Balance

• We examines the balance of states and markets in the process of economic development.  

• Empirically, some governments help but some stifle development. Achieving the proper balance between markets and public policy is a challenge  
  - Corruption and poor governance in many countries has made policy weak  
  - But China, Vietnam, and some countries have shown that the government can play a constructive role in development

• 3 important trends in governance and reform: fighting corruption, implementing decentralization, and encouraging broad-based development participation.  

• Civil society and NGOs also have important role in economic development
• The Planning Mystique
  - In the past, few doubted the importance and usefulness of national economic plans
  - Recently, however, disillusionment has set in
• The planning record, unfortunately, didn't live up to its advance billing.
However a comprehensive development policy can play an important role in accelerating growth

• The nature of development planning
  – Economic policy is a written strategy designed to control economic activity due to social objectives formulated by government

• Planning in mixed developing economies (mixed ownership of private and public sectors)

• Composition of private sectors
  – The subsistence sector
  – Small scale businesses
  – Medium size enterprises
  – Larger domestic firms
  – Large joint or foreign owned enterprises
• The Rationale for Development Planning
  – Market failure
  – Resource mobilization and allocation
  – Attitudinal or psychological impact
  – Requirement to receive foreign aid

• 3 general forms of market failure
  
  1. MKT cannot function properly/ or no market exists
  
  2. MKT exists but implies inefficient resource allocation
  
  3. MKT produces undesirable social outcomes
     - Items such as more equal income distribution, and “merit goods” such as health, are treated as separate rationales for policy, outside of economic efficiency
• Elements of market failures
  – Market failures can occur when social costs or benefits differ from private costs or benefits of firms or consumers
  – Market power (monopoly, monopsony)
  – Public goods: free riders cannot be excluded except possibly at high cost
  – Externalities: (-) agents do not pay all costs of their activities, (+) or are unable to receive all the benefits
  – Coordination failures can occur when coordination is costly; e.g. with big push problems
  – Capital MKTs are particularly prone to failure

• Government Failure: broader arguments
  - Government failure: occurs when politicians and bureaucrats are utility maximizers, not public interest maximizers
  - So in practice, a good economic policy cannot be guaranteed the success
  - Analysis of incentives for government failure guides reform, e.g. civil service reform, constitution design
  - Developing countries tend to have both high market failure and high government failures
3. The planning process: some basic models

- **Planning process** is the procedure for drawing up and carrying out a formal economic plan.

- Planning in 3 stages
  - Aggregate growth
  - Multisector input-output, social accounting, and CGE
  - Selecting investment project

- Aggregate Growth Models:
  Projecting Macro Variables

\[ K(t) = cY(t) \]  \hspace{1cm} (1) \hspace{1cm} \text{Where}
\[ K(t) \] is capital stock at time \( t \)
\[ Y(t) \] is output at time \( t \)
\[ c \] is the capital-output ratio (average and marginal)

\[ I(t) = K(t + 1) - K(t) + \delta K(t) = sY = S(t) \]  \hspace{1cm} (2) \hspace{1cm} \text{Where}
\[ I(t) \] - gross investment at time \( t \); \( s \) - savings rate; \( S \) - national savings;
\[ \delta \] is the depreciation rate
If $g$ is the targeted rate of output growth, then

$$g = \frac{Y(t+1) - Y(t)}{Y(t)} = \frac{\Delta Y(t)}{Y(t)} \quad (3)$$

$$\frac{\Delta K}{K} = \frac{c\Delta K}{K} = \frac{(K/Y)\Delta Y}{K} = \frac{\Delta Y}{Y} \quad (4)$$

$$S_{\pi} \pi + S_W W = I \quad (5)$$

$$n + p = \frac{S}{c} - \delta \quad (6) \text{ Where}$$

$n$ is the labor force growth rate

$p$ is the growth rate of labor productivity

$$W + \pi = Y \quad (7) \text{ Where}$$

$W$ – wage ; $\pi$ - profit

$$g = \frac{SY - \delta K}{K} = \frac{s}{c} - \delta \quad (8)$$

Where : $s_W$ - marginal propensities to save from wage

$s_{\pi}$ - MPS from profit

$$c(g + \delta) = (s_{\pi} - s_W)\left(\frac{\pi}{Y}\right) + s_W \quad (9)$$
3 The development planning process: some basic models

- Multi-sector models and sectorial projections
- Inter-industry or input-output models
  - Can be extended in 2 ways
    1. SAM models where data from national accounts, BOP, and flow-of-funds databases is supplemented with household survey data.
    2. CGE models where utility and production functions are estimated and impacts of policies are simulated.

- Project Appraisal and Social Cost-Benefit Analysis
  - Basic concepts and methodology
    ◦ Specify objective function
    ◦ Compute social measures of all project inputs and outputs: shadow prices or accounting price
    ◦ Establish decision criterion
• Computing shadow prices and social discount rates
  
  – Calculating the social rate of discount or social time preference

  Net present value, or NPV is given by

  \[ NPV = \sum_{t} \frac{B_t - C_t}{(1 + r)^t} \]  

  Where

  \( B_t \) - the expected benefit at time \( t \);
  
  \( C_t \) - the expected cost at time \( t \)

  \( r \) - the social rate of discount

• Choosing projects: some decision criteria

  – NPV rule

  – Compare the internal rate of return with an interest rate

• Conclusions: planning models and plan consistency
4 Government Failure and Preferences for Markets over Planning

- In the 1980s policy shift toward free markets
- Problems of Plan Implementation and Plan Failure
- Theory versus practice
- Deficiencies in the plans and their implementation
- Insufficient and or unreliable data
- Unanticipated economic disturbances, external and internal
- Institutional weaknesses
- Lack of political will
- Conflict, post-conflict, and fragile states
Potential problems of government intervention in developing world

- Individuals know more about their preferences, circumstances
- Government may increase risks by pointing all in same direction
- Government may be more rigid and inflexible in decision making
- Governments lack capabilities to administer detailed plans
- Bureaucratic obstacles may block private sector initiative
- Hard to replicate market incentive system within governments
- Different parts of government may be poorly coordinated
- Black markets place constraints on government
- Controls create incentives for rent seeking
- Planning may be manipulated by narrow, privileged groups
5 The Market Economy

• Well functioning market economy requires
  – Clear property rights
  – Laws and courts
  – Freedom to establish business
  – Stable currency
  – Public supervision of natural monopolies
  – Provision of adequate information
  – Autonomous tastes
  – Public management of externalities
  – Stable monetary and fiscal policy instruments
  – Safety nets
  – Encouragement of innovation

• The “Washington Consensus” on the Role of the State in Development and its Limitations
  – The consensus reflected a free market approach to development espoused by the IMF, the World bank, and key U.S. government agencies
## The Washington Consensus and East Asia

<table>
<thead>
<tr>
<th>Elements of the Washington Consensus</th>
<th>South Korea</th>
<th>Taiwan</th>
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<tbody>
<tr>
<td>1. Fiscal discipline</td>
<td>Yes, generally</td>
<td>Yes</td>
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<td>2. Redirection of public expenditure priorities toward health, education, and infrastructure</td>
<td>Yes</td>
<td>Yes</td>
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<td>3. Tax reform, including the broadening of the tax base and cutting marginal tax rates</td>
<td>Yes, generally</td>
<td>Yes</td>
</tr>
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<td>4. Unified and competitive exchange rates</td>
<td>Yes (except for limited time periods)</td>
<td>Yes</td>
</tr>
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<td>5. Secure property rights</td>
<td>President Park starts his rule in 1961 by imprisoning leading businessmen and threatening confiscation of their assets</td>
<td>Yes</td>
</tr>
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<td>6. Deregulation</td>
<td>Limited</td>
<td>Limited</td>
</tr>
<tr>
<td>7. Trade liberalization</td>
<td>Limited until the 1980s</td>
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<td>9. Elimination of barriers to direct foreign investment (DFI)</td>
<td>DFI heavily restricted</td>
<td>DFI subject to government control</td>
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<td>10. Financial liberalization</td>
<td>Limited until the 1980s</td>
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6 The Washington Consensus on the Role of the State in Development and Its Subsequent Evolution

• Toward a new consensus
  – New emphasis on government's responsibility toward poverty alleviation and inclusive growth
  – Provision of fundamental public goods
  – Importance of health and education
  – A recognition that markets can fail
  – Governments can help secure conditions for an effective market based economy
7 Development Political Economy: Theories of Policy Formulation and Reform

• Understanding voting patterns on policy reform
• Institutions and path dependency
• Democracy versus autocracy: which facilitates faster growth?
• Role of NGOs in development and the broader citizen sector
Global Trends in Governance, 1946-2008

Number of countries
(with population > 500,000 in 2008)

Year


Democracies
Anocracies
Autocracies


Note: An anocracy is a mixed, or incoherent, authority regime.
8 Development Roles of NGOs and the Broader Citizen Sector

- Potentially important roles in:
  - Common property resource management
  - Local public goods
  - Economic and productive ideas
- Possibly other activities that are either:
  - Excludable but not rival
  - Rival but not excludable
  - Partly excludable and partly rival
Typology of Goods

The shaded diagonal indicates the area of primary NGO comparative advantage in dimensions of rivalry and excludability. When, based on local conditions (such as government failure), NGOs are in a position to supply public or private goods at a lower price or higher quality, they may be found expanding into these nonshaded areas as well (Type I and Type III goods).
• Other potential comparative advantages of NGOs
  
  – Innovative design and implementation
  
  – Program flexibility
  
  – Specialized technical knowledge
  
  – Provision of targeted local public goods
  
  – Common-property resource management design and implementation
  
  – Trust and Credibility
  
  – Representation and advocacy
Other limitations: “voluntary failure” – NGOs may be...

- Insignificant, owing to small scale and reach.
- Lacking necessary local knowledge to develop and implement an appropriate mix of programs to address relevant problems
- Selective and exclusionary, elitist, and or ineffective
- Lacking adequate incentives to ensure effectiveness
- Captured by goals of funders rather than intended beneficiaries; may change priorities one year to the next
- Giving too little attention to means, preventing needed scale...
- Or, find that means—such as fundraising—can become ends in themselves
- Lacking immediate feedback (as private firms get in markets, or elected governments receive at the polls); this can let the weaknesses go on for some time before being corrected
9 Trends in Governance and Reform

- Tackling the problem of corruption
  - Abuse of public trust for private gain
- Good governance enhances capability to function
- Effects of corruption fall disproportionately on the poor
- Good governance is broader than simply an absence of corruption
- Tackling the problem of Corruption
- Decentralization
- Development participation- alternate interpretations
  - Genuine participation and role of NGOs
Corruption as a Regressive Tax: The Case of Ecuador

The Association between Rule of Law and Per Capita Income

Concepts for Review

- Accounting prices
- Aggregate growth model
- Comprehensive plan
- Corruption
- Cost-benefit analysis
- Economic infrastructure
- Economic plan
- Economic planning
- Government failure
- Input-output model
- Interindustry model
- Internal rate of return
- Market failure
- Market prices
- Net present value

- Nongovernmental organization (NGO)
- Partial plan
- Path dependency
- Planning process
- Political will
- Project appraisal
- Rent seeking
- Shadow prices
- Social profit
- Social rate of discount
- Voluntary failure