Role of government in economic development and interference of government

Chapter 9

The question of government's proper role in encouraging growth is one of the oldest in economics. It was a primary concern of Adam Smith in the wealth of nations. The proposed answers have ranged from a vision of minimal government interference (laissez-faire) to complete government ownership of the means of production.

The Case for Government Intervention in the Economy

The starting point for most analyses of government intervention in the economy is market failure, the idea that in some circumstances unfettered markets will not produce an efficient outcome. Although market failure can take many forms, we focus on four types: public goods, externalities, and monopoly and coordination failure.

The simplest form of market failure occurs when there are particular goods, called public goods, which the private market cannot supply-most commonly because there is no practical way to charge those who benefit from the use of such goods. The classic example of a public good is national defense. Other public goods that are relevant for determining economic growth include the rule of law, infrastructure such as airports and highways, the standardization of weights and measures, and a stable currency.

A second reason for government intervention in the economy is externalities: the incidental results of some economic activity that affect people who do not control the activity and are not intentionally served by it. For example, a government policy motivated by externalities: the creation of a new technology often involves large externality benefits to people other than the inventor. Because the inventor does not take these positive externalities into account – instead he only compares his private benefit from making an invention to her cost in creating it – the amount of invention is naturally lower than the socially optimal amount. Such positive externalities are the reason that governments play a role in supporting R & D through both direct spending and patent protections that raise the fraction of invention's social benefits received by the inventor. A second example of a policy that is motivated by externalities is education. When a person chooses how much education to pursue, he weighs the private costs of an education against the benefits to society beyond those that the individual receives: An educated person helps improve the quality of life of those around him. Because people ignore these external benefits, the quantity of education that individuals will decide on for themselves will be lower than the socially optimal amount, so the government has a role to play in encouraging education. Similarly, in the case of negative externalities, such as pollution, a private firm will tend to produce more than the socially optimal quantities. Government regulation is required to limit this externality.

A third form of market failure that can motivate the government economic policy is the existence of monopolies, single firms that are the sole suppliers of a particular commodity. An industry such as electricity transmission is often viewed as a natural monopoly because it would be impractical for several companies to string electric wire to every house. In such a case, there is a role for government regulation to prevent the monopolist from charging an inefficiently high price.

The private market can also potentially fail in in cases requiring the coordination of activities by many firms or many people. Some potential coordination failures – and the need for a government to correct them – are obvious. It is useful for everyone to drive on the same side of the road, and even the most diehard free marketer would have little objection to letting the government announce which side it should be. But coordination failure may also be more subtle. Consider a case where firms are reluctant to invest in a second industry – say, a bicycle factory – because they fear there will be no raw materials for them to purchase, while firms fear there will be no market for their output. It is often argued that in such cases, government planning can break the logjam and further the process of economic development.

Despite its prominence in this discussion, market failure is not the only reason that governments become involved in the economy. Another motivation for government to take a hand in economic matters concerns not the total quantity of output but rather the way that output is distributed among the citizens of a country. Governments may view income distribution – the transfer of income from rich to poor, from working – age adults to the elderly, or from the general population to members of some favored group – as one of their proper roles.

The Case against Government Intervention in the Economy

Few economists would argue that there should be no government intervention in the economy. Rather, it is a question of degree, for many economists, the reasons for government intervention are sufficient to justify the degree of intervention that we observe. As a result, they argue, government intervention, at the margin, reduces economic welfare.

The case against government intervention starts with the observation that, although proper government policy can theoretically fix any market failure, in practice it often fails to achieve its goals. When governments tries to take the place of private firms, the resulting enterprises ten to operate inefficiently because they lack the incentives (specifically profit) that motivate private firms. Similarly, in cases where industries are regulated as natural monopolies, often such regulation effectively preserves the absence of competition. In general, the success of any government intervention depends crucially on the ability and the honesty of the officials entrusted to carry it out. When these qualities are lacking, the resulting government failure can be worse than any market failure that government policy was designed to correct. Recognizing the difficulty that governments have when they try to intervene in the economy suggests that, whenever possible, the role of government should be defined as narrowly as possible.

Critics also argue that many fewer market failures exist than the proponents of activist government policy believe. In the case of public goods, the debate centers on the question whether some of the goods that governments supply could have been supplied privately if government had not taken over their provision. In much of the world, functions previously performed by the government are being privatized, that is, handed over to the private sector. In various countries, privatized activities have included the building of roads and telephone networks and the operation of jails. A parallel trend has been deregulation of industries (removing them from government supervision). In the United States, for example, the deregulation of telephones, airlines and trucking led to steep declines in the prices paid by consumers.

The issue of income redistribution presents some of the most difficult questions regarding the proper role of government. For other issues, the costs and benefits of intervention can be measured in the same terms – for example, the inefficiency of monopoly versus the inefficiency of government regulation. In the case of income redistribution, however, the benefits of such a policy (a greater degree of equality) are of a different nature than the cost of the policy (a lower degree of efficiency). This is called equity-efficiency trade off. However, critics of big government point out that much of the income that governments redistribute does not flow from rich to poor. Rather, it is redistributed among people in the same income groups, who are at different stages of their life cycles, as when taxes are taken form working-age adults and transfers are paid to the elderly. Critics argue that these redistributions have a large effect on the efficiency with which the economy operates but do little or nothing to improve quality.

Swings of the Pendulum

While there has never been a consensus about government's proper role in the economy, either among economists or among those who govern, the 20th century saw two broad swings of the pendulum in the intellectual analysis and the practice of government intervention. Beginning around World War I, the idea that the government could play a decisive, active role in further ing economic development gained ground throughout the world. The most extreme example is the Soviet Union, where a series of Five Year Plans, including government ownership of factories and forced collectivization of agriculture, sparked impressive agriculture economic growth during the 1920s and 1930s. the economic collapse of the Great

Depression, which seemed to be evidence of coordination failure on a massive scale, inspired forceful government intervention in the workings of the economy. The fascist states of Germany and Italy imposed strong controls over the market, with the apparent result that these countries were able to shake off the effects of depression more rapidly than their neighbors. Even in the United States, where politicians had long been hostile to government intervention in the economy, President Franklin Roosevelt's New Deal Program to promote economic recovery represented an unprecedented degree of government meddling in the economy, including price controls, purchases of surplus agricultural output and direct job creation through public works. The Great Depression also inspired the theories of John Maynard Keynes, which provided an intellectual foundation for activist monetary and fiscal policies designed to maintain full employment.

Following World War II, governments in Western Europe developed elaborate welfare states providing nationalized health care, public housing and generous unemployment insurance and old age pensions. In the developing world, the newly independent governments that emerged with the end of colonialism pursued a model of sate-led industrialization and economic planning.

The last two decades of the 20th century witnessed a shift from government control of the economy. This shift has been most pronounced among the communist and former communist countries, which have moved decisively toward a market system. In the industrialized world, there has been a wave of deregulation and privatization of some functions of government, along with reduction in the generosity of welfare-state benefits. In the developing world there has been a turning away from state-led industrialization. Whether this change in the direction of economic policy will produce the promised increase in growth remains to be seen.

Scope

Classification of Work

It is now universally recognized that in order to overcome the rigidities inherent in an developing economy, the state must play a positive role. It cannot act as a passive spectator. The problems of underdeveloped countries are of such a magnitude that they cannot be left to the free working of other economic forces. Private enterprise is unable to solve them because it does not exist in the modern sense of the term. State actions are, therefore, indispensable for the economic development of such countries.

There is then the need for speedy socio-economic reforms to move these countries off the dead center of stagnation. In the early phase of development, investments will have to be made in those directions which promote external economies and social overheads like power, transport, education, health, etc. private enterprise is not forthcoming to undertake these activities as the risks are large and profits are low. There is the need for balancing the growth of the different sectors of the economy so that the supply is adjusted to the demand. State regulation and control is, therefore, essential in order to attain such a balance. It necessitates control over production, distribution and consumption of commodities. For this purpose, the government has to devise physical controls, and monetary and fiscal measures. Further, such measures are inevitable for reducing economic and social inequalities that pervade the developing countries. “ Breaking social chasms and creating a psychological, ideological, social and political situation propitious to economic development becomes the paramount duty of the state in such countries.” The sphere of state actions is, therefore, very vast and all pervading, it includes, according to Professor Lewis, “ maintaining public services, influencing attitudes, distribution of income, controlling the quantity of money, controlling fluctuations, ensuring full employment and influencing the level of investment.”

Changes in Institutional Framework: One of the important measures of economic development is to bring about changes in the socio-cultural attitudes of the people in the developing countries. Such societies possess religious and cultural traditions which are not conducive to economic development. The institutional framework does not encourage rational individualistic behavior and the spirit of competition and enterprise. If economic development is to proceed social attitudes, values and institutions entrenched in the joint family, the caste or kinship and in religious beliefs mush undergo a change. These require social revolution. “ Social revolution,” however, does not imply the rapid overthrow of the existing institutions. The process of change has to be evolutionary. Otherwise, violent social changes will lead to discontentment, frustration, unrest and violence. These factors will in turn, inhibit economic growth, professor Francis Hsu points out that “ it took Europe ten centuries or more to produce an individualistic orientation of life which bore economic fruit two hundred years ago, and there does not seem to be any way in which similar orientation could be generated in a matter of years or even decades.” Any society attempting to institute it quickly will result “ either in apathy or revolt.” Thus, “ much depends upon the way in which the process of growth and change is set in motion, the speed of the process and the extent to which it permeates all sectors of the economy. Generally, a slow but steady development is likely ot create fewer political, social and economic tension; and it is likely that an attempt to force the pace too strenuously may also be economically wasteful because the social and personal changes may not take place which are necessary to enable the individual or the society to form the development necessary to enable individuals or the society to profit and sustain it.”

Economic change is not brought about by institutional changes alone. Economic change may take place due to increased capital formation or as a result of technological change which may, in turn, cause institutional changes. Contrariwise, institutional changes may be caused by factors other than economic. Non-economic factors like changes in institutions. Thus, there may be causal relationship between economic and institution changes or these changes may be independent of each other. Institutions promote economic growth to the extent that they associate effort with reward, permit increased division of labor, expansion of trade and freedom to seize economic opportunities. Once the process of change starts it becomes cumulative. If a change starts in social institutions, people will seize new opportunities which will, in turn, further change the institutions. But it is difficult to find out the fundamental cause of change in situation. For example, it is difficult to say whether it was growing economic opportunities which brought about the Reformation and the Counter-Reformation in

Western Europe or whether it was changing religious ideas that allowed people to seize larger opportunities for progress.

The new opportunities can come in many ways. “ New inventions may create new commodities or reduce the costs of producing old commodities. New roads, new shipping routes or other improvements in communications may open up new opportunities for trade. War or inflation may create new demands. Foreigners may arrive in the country, bringing new trades investing new capital or offering chances of employment.” Such new opportunities bring about changes in institutions. These changes are gradual and perceptible. They are initiated by innovators, the new men, who endeavor to break with the past, and mold the old institutional framework into a new setting.

These innovators are townsmen. They face and resist political and social forces. By providing larger and newer opportunities in the economic field, they are ultimately successful in altering old beliefs and institutions. Similarly, contact with foreigners may be instrumental in weakening the established pattern of society. In India, the building of railroads, the spread of western education and the establishment of industrial centers in the 19th century helped in loosening social and family ties. It was the new attitude of social rationality which gave rise to popular movements for the political freedom of the country. Above all, it is the government which plays a crucial role in influencing the institutional framework. The government can do a lot by introducing reforms in social customs and religious observances, in the system of land use, and in the field of education. It can also initiate economic growth by maintaining law and order, by providing improved public utility services, by fostering new industries, etc.

Organisational Changes

Organizational changes also play an important role in economic development. They include the expansion of the size of the market and the organization of the labour market. These changes can only be performed by the government in developing countries. It is the sate which can develop the means of transport and communications for expanding the size of the market because private enterprise is incapable of undertaking such schemes. Besides, the organization and development of financial institutions to help the growth of agriculture and industries can be undertaken by the state. Such financial institutions can be cooperative banks, land mortgage banks, industrial banks, financial and investment corporations, etc.

The organization of the labour market also falls under the function of the government. An organized labour market increases the productivity of labour. The government helps in organizing labour by recognizing labour unions. It fixes working hours, payment of wages, establishes machinery for the settlement of labour disputes, provides for social security measures, etc. such legislations are meant to establish cordial relations between the employers and employees. As a result, efficiency of labour increases which increases production and reduces costs.

Labour is mostly immobile in developing countries. The majorities of people live in rural areas and are engaged in agricultural operations for a limited period. So they are underemployed or disguised unemployed. Due to lack of information, they are not aware of employment opportunities in towns and industrial centers. The government can help them in getting jobs by opening information centers in rural areas and employment exchanges in towns. In this way, the government can help in the mobility of labour.

When with development labour moves from rural to urban areas, the problems of urbanization arise which are also required to be solved by the government. such problems relate to housing, drinking water supply, electricity, slums, transport, etc. the provision for such services as constructing housing colonies, schools, colleges, hospitals, parks, city transport, drinking water, electric supply, etc., falls within the purview of state functions.

Social and Economic Overheads

The provision of social and economic overhead in developing counties falls mostly under the state activities. The need for basic services like railways, road transport, telecommunications, gas, electricity, irrigation works, etc., is imperative for future development. Their development entails large investments which are beyond the capacity of private enterprise in such countries. Not only this, investments in public utilities are risky and their benefits accrue only over the long period. It therefore, devolves on the state to provide these public utilities.

The government should formulate a plan for the development of the essential services on a priority basis. If the immediate need is to provide irrigational facilities that should be met by concentrating on minor irrigational facilities instead of damming a big river. Moreover, the provision of public utility services does not necessarily imply that they should be owned and operated by the state. The state may approve the plan for a particular project, provide finance and other necessary constructional facilities to a private concern which would construct and own it. Its working might, however, be regulated by the state. In fact, the ownership and operation of an undertaking by the state or the private enterprise depend on its nature and importance. In India, the development of the means of transport and communications are government owned and operated, keeping in view their importance in a vast country like India. While the ownership of the road transport is in the hands of both the public sector and the private sector, though the entire operations are regulated by the state. Owing and plying a bus does not involve much expenditure and the returns are also quick as compared to the railways.

Education: Economic development is not possible without education. As Myrdal says, “ To start on a national development programme while leaving the population largely illiterate seems to me to be futile.” For economic development, it is the quality of labour that is more important. Unskilled workers, even working for long hours, will have a low per capita income. Illiterate and unstrained persons cannot be expected to operate and maintain complex machinery. It is by investing in them that their productivity can be increased. It is through public education that the state can increase the effective labour supply and hence the productive capacity of the nation. An educational programme has to be wide and varied. There is the need for primary education so that every child of school going age may receive compulsory education. In order to provide material for the universities and to impart larger educational facilities, more secondary schools are required to be opened. At the same time, training institutes are need for imparting instructions to mechanics, electricians, artisans, nurses, teachers, agricultural assistants, etc. in the higher educational echelon is the university education and research institutes for turning out ever increasing number of doctors, administrators, engineers, and all types of trained personnel. " Programmes of education lie at the base of the effort to forge the bonds of common citizenship, to harness the energies of the people and develop the nation and human resources of every part of the country." Investment in such a vast and diverse field as education is only possible through the aegis of the state in underdeveloped countries.

Investment in human capital is highly productive. An underdeveloped country needs agricultural industrial technicians, doctors, engineers, teachers, administrators, etc., who would lead to a greater increase of the flow of goods and services, thereby accelerating the tempo of development. But the problem of providing educational facilities to a multitude of people is not within the capacity of an underdeveloped country due to the paucity of funds. Whatever funds are available they have to be apportioned on the basis of priorities. And economists differ on the question of priorities. Education is both a consumer and an investment service. To the extent education is an investment, it directly increases productivity.

Money spent on education and training of doctors, teachers, engineers, administrators is as much a capital investment as money spent on building a dam. But when money is spent on literacy drives to educate peasantry, it is not regarded directly productive by lewis. He maintains that " such part of education as is not a profitable investment is on par with other consumer goods, like clothes, houses or gramophones" for it helps the peasants, barbers or domestic servants " to enjoy something more (books, newspapers) or to understand something better." Professor Galbraith, however, regards investment in educating the masses equally productive. He argues that, " to rescue farmers and workers from illiteracy may certainly be a goal in itself. But it is also a first indispensable step to any form of agricultural progress. Nowhere, in the world is there an illiterate peasantry that is progressive. Nowhere, is there a literate peasantry that is not. Education so viewed, becomes a highly productive form of investment." Galbraith concludes: " That something is both a consumer service and a source of productive capital for the society does not detract all form its importance as an investment. Rather it enhances that importance." It therefore, devolves on the state to initiate a long-term programme of educational expansion and reform on a broad front stretching from a literary drive to the university level, so that in all branches o national life education becomes the focal point of country's development.

Public Health and Family Planning: Another sphere in which the state can undertake positive measures is public health. To increase the efficiency and productivity of labour, the health of the people must be progressively improved. Public health measures include the improvement of environmental sanitation both in rural and urban areas, removal of stagnant and polluted water, slum clearance, better housing, clean water supply, better sewage facilities, control of communicable diseases, provision for medical and health services especially in maternal and child welfare and health education and family planning and above all training of health and medical personnel. All this necessitates planned efforts on the part of the public authorities.

Public health measures assume great importance in underdeveloped countries mainly for two reasons:

They help in the development process by augmenting labour productivity and efficiency

By reducing the mortality rate they tend to increase the rate of population growth, thus making it imperative for the state to adopt family planning and speedy development programmes.

But all development efforts will be futile if the growth in numbers is not checked. Since the death rate is already on the decline in the underdeveloped countries the remedy is to bring down the birth rates. No doubt there is greater need for accelerating development, but to increase per capita income and improve the standard of living, the rate of population increase must be checked and family planning programmes but given top priority.

Family planning is the deliberate reduction of birth rate. India is among the first underdeveloped countries to adopt family planning programme on a governmental level. The first five year plan state: “ It is apparent that population control can be achieved only by the reduction of the birth rate on the extent necessary to stabilize population at a level consistent with the requirements of national economy. This can be secured only by the realization of the need for family planning on a wide scale by the people and next, on providing the necessary advice and service based on acceptable, efficient, harmless and economic methods. Family limitation or spacing of the children is necessary and desirable in order to secure better health of the mother and better and upbringing of children. Measures directed towards this end should, therefore, form part of public health programme.

Family planning programme should consist of:

Education of the people in family planning, which should includes sex education, marriage counseling and child guidance. The media for this may be social organizations, films, the radio, and literature.

Family planning services should be made on much larger scale. Family planning services can be integrated with the normal health and medical services. Family planning clinics should be opened in rural areas, in industrial and other establishments. There should be mobile units to educate the masses in the art of family planning. The help of voluntary organizations can also be taken. The family planning centers should tender free advice, distribute contraceptives, and undertake vasectomy free of charge. They may be subsidized by the government.

Establishment and maintenance of a large network of centers for the training of workers.

An expanded research programme in biological, medical and population problems. In India, such programme includes:

Development of studies of human genetics

Studies in the physiology of reproduction

Development of more effective local contraceptives

Development of a suitable oral contraceptive

Follow-up of sterilization cases, both male and female, to investigate after effects in such cases

Contraceptives should be manufactured indigenously so that their supplies should not lag behind to implement a widespread family planning programme. Moreover, they should be simple and safe.

To sum up, in the words of Lewis, “ one needs to put all the ingredients into this pie; to convert social leaders into seeing the dangers of a high birth rate, so that taboos and religious sanctions turn against it, instead of its favour; to raise standard s of living and education rapidly, so that women find it convenient to have fewer children; and to make widespread propaganda about birth control techniques. Action is need on all fronts simultaneously.”

agricultural development

Agriculture is the predominant occupation in underdeveloped countries and contributes more than half the share of the national income. Despite this, agriculture remains in a state of stagnation. The share of the national income is disproportionately small in relation to the number of persons engaged in it. The fundamental cause is the low agricultural productivity per acre. the reasons for the low yield are uneconomic size of the holdings, the fragmentation of land holdings, the defective land tenure system characterized by high rents, and insecurity of tenure, the lack of adequate credit facilities, indebtedness, the absence of irrigational facilities and dependence on rainfall, the use of obsolete methods of production and the excessive pressure of population on land.

In underdeveloped countries the peasants are poor, illiterate and ignorant. They lack organization. They do not possess sufficient motivation for making improvements in land. The way of living is regulated by customs and traditions. It therefore, falls within the purview of the state activities to introduce land reforms and prepare plans for agricultural development. The success of a plan will ultimately depend on the extent to which agricultural productivity is increased. Increases in agricultural production are essential so as to meet raw material requirements of industry, to attain self-sufficiency in food-grains, to hold the proce line, to raise larger resources for purpose of development and to utilize in an effective manner the unutilized and the under utilized manpower resources of the economy.

Industrial Development

Another important function of the state is to develop the economy industrially. In underdeveloped countries, natural resources are underdeveloped or less developed. These countries which remained under the colonial rule their natural resources were mercilessly exploited for the foreigners who ruled over them. Therefore, it is not in the national interest to leave the development of natural resources in the hands of foreign dominated private enterprises in such countries after their independence. It d