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Role of the state and the market in economic growth and development

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1. Introduction

We have studied some economic growth models as well as several issues of development. We concluded that investments in physical and human capital as well as in research and technology development are necessary to enhance the pace of economic growth and overall economic development. We also learnt that countries must tackle issues of inequality, poverty and unemployment in order to grow and develop.

The question thus arises as to who will undertake the responsibility of investment, research, health and education. Will markets be able to perform these activities efficiently or will states be able to do so more efficiently? How can markets and state complement each other in the process of economic growth and development? In this session we shall seek answers to such questions.

Objectives

1. To review role of markets in achieving economic efficiency.

2. To understand responsibility of the state in directing the process of economic growth and development.

3. To understand how state and markets can complement each other in creating the right environment for macroeconomic success,

4. To study the role of plans, policies, strategies as well as political interest in the development process.

5. To analyse the country specific cases of economic growth development.

2. Meaning and functions of a market and a state in an economy

Market is an organization which co-ordinates the activities of production and consumption through the forces of demand and supply.

From the perspective of co-ordinating economic activities, the essential aspects (features) of a market mechanism can be stated as:

- It coordinates economic activities through a voluntary process where the various economic agents like producers and consumers participate voluntarily in the economic activity.
- Its coordinating mechanism takes place through the invisible forces of demand and supply.
- It establishes a non-subjective and non-discriminating equilibrium position where all buyers and sellers or all stake holders arrive at a mutually acceptable price position. This equilibrium is invisible but it’s a position which the stakeholders would stick to until certain macroeconomic factors change.
- Stakeholders make adjustments in a market mechanism. Those producers or buyers (stakeholders) who cannot adjust their resources to fit into such an equilibrium position will leave the market voluntarily to join another market.

  For example, buyers who cannot afford to buy a mobile phone instrument whose equilibrium price is fixed at ₹ 35,000 will not demand it and will enter the market of an instrument whose equilibrium price is lower.

  Similarly a producer who cannot adjust the cost of production within the price which the market for a particular product offers will leave the market to invest resources in some other product.

- Market cannot make value judgements or normative decisions in fixing a price or in making allocation of resources and distribution of goods. It functions by the rule of rational behaviour explained in positive economics.

The proponents of market advocated that market mechanism is the most efficient way of allocation and distribution.

Adam Smith advocated removal of restrictions on trade in the mercantilist system as an important means of maximising wealth of nations. According to him, free trade has static as well as dynamic gains over time.

David Ricardo and neo-classical advocates of trade championed in explaining the static gains from trade. That is, they were concerned with the efficiency in allocation of resources in the given time while overlooking the wealth accumulation over time because of trade.

The neo-classical theorists relied upon the demand and supply intersection to explain market efficiency. Alfred Marshal proposed the equilibrium consumption at equality of marginal utility and price rather than cost and demand-supply equilibrium. This is because; supply is determined by marginal cost which increases after a certain point and demand is determined by marginal utility which diminishes continuously. Therefore, more efficient equilibrium consumption is determined by equality of marginal utility and demand and not the one determined by cost of production.

State is an organization which has legitimate powers to direct economic activities by forcible rule. In this sense, the co-ordination process of a state is modelled on these features:

- Legitimate coercion.

- It’s coordination process is conducted through policies and plans.
- It plans after making normative judgements. Provisions are made after making value judgements about development of all people and all sectors.
- If some people are deprived of resources to become part of a market, the state plans to include them in the process by deliberate action.

  For example, if some people cannot afford to get education or buy health facilities, the state will make provisions to include them for free or by offering subsidies.
- Rational decision making is complemented by value judgements. For example, though every government understands that trade is a benefitting activity in development, they balance international trade activity by imposing trade restrictions in certain areas where subjective decisions are required in national interest or where protection of domestic industry from foreign competition is required.

Though Adam Smith was a propagator of minimal government activity, he advocated role of government in raising income for supporting the political and administrative functions and for maintaining the sovereignty, for maintaining highly efficient public institutions to support people and their activities and to prevent exploitation of one person by another. He advocated that the state must perform these functions and indulge in certain public works besides performing the law and order function of a police state.

J. S. Mill argued that governments will have to provide for goods which the private sector does not provide, not because the private sector cannot provide those but because it will not.

Hence, Mill said the state will have to provide public works like roads, dams, irrigation, schools, hospitals etc.

With J. M. Keynes, attention of economic thinking shifted significantly from role of markets to role of government in maintaining economic stability. Keynes propagated that government actions are necessary to establish equilibrium and markets by themselves are not the most efficient way of allocating resources.

3. Reasons for market failure

Market is known to be the most efficient mechanism for allocation and distribution. However, markets are known to fail definitely in making just allocation and distribution under certain situations.

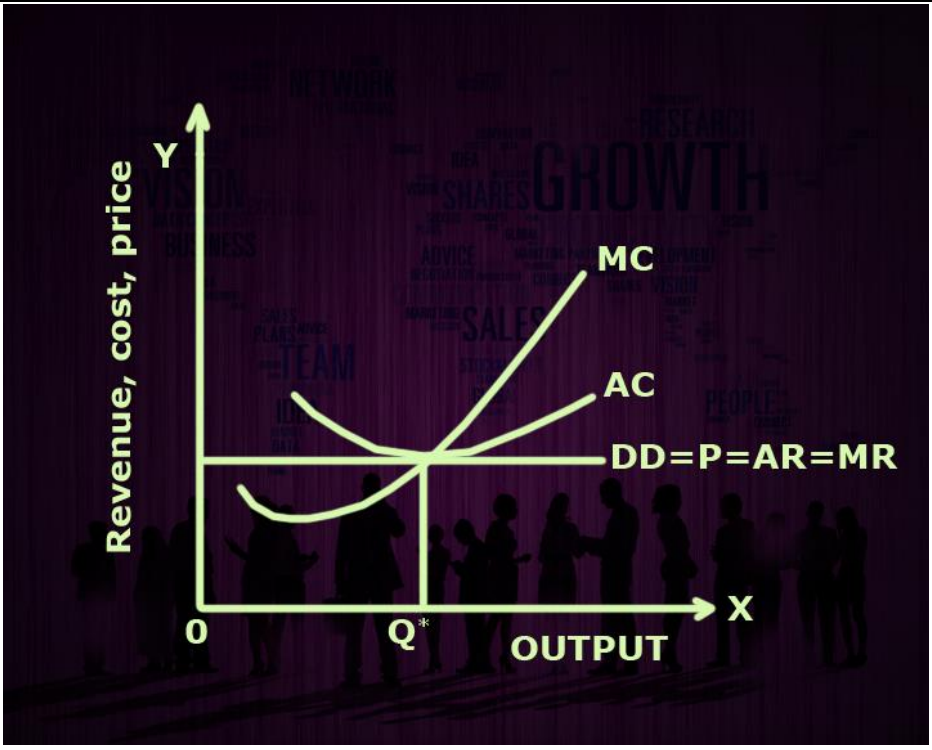
1. Market failure in producing socially desirable output under imperfect competition.

In the theory of price determination under different market structures, the output for maximum profits is determined where, MR=MC (marginal revenue = marginal cost)

A socially desirable output is considered to be one which is produced at minimum point of average cost. In other words, equilibrium output is determined where,

AR (or price)= minimum AC so that consumers pay the lowest possible price which is equal to the lowest possible average cost of production. (Let us recollect that, AR = average revenue which is also the price. AC is the average cost).

Now let us look at this figure which depicts price-output equilibrium under perfect competition.



Under a perfectly competitive market, the demand curve, the price curve, the AR curve and the MR curve are all depicted by one single horizontal line parallel to the x-axis.

The marginal cost and the average cost curves are 'u' shaped. (We may recollect here the relationship between AC and MC).

The profit maximizing equilibrium output of the producer OQ* is attained at,

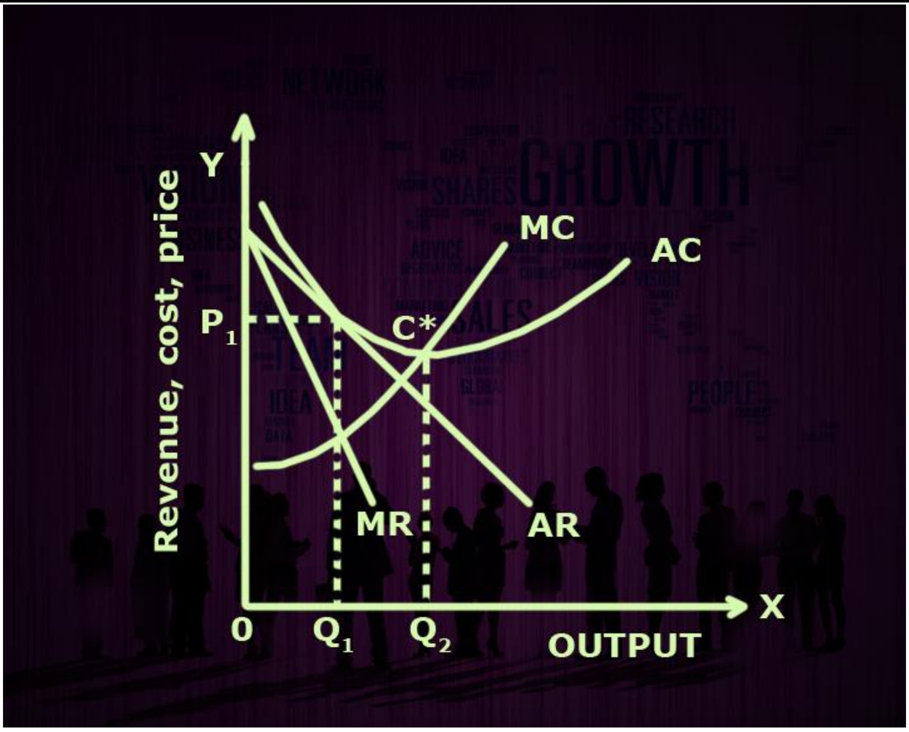
MR=MC is also the socially desirable equilibrium output OQ* which is derived at,

AR (or price)=minimum AC.

In other words, the profit maximizing output is also the socially desirable output.

Now under imperfect competition, the AR and MR curves are downward sloping and do not coincide with each other.

Look at the figure here,



Now the profit maximizing equilibrium of the firm that is, MR=MC is attained at output Q_1. At this level of output price is at p_1.

But this profit maximizing output is lesser and price p_1 is higher than the socially desirable level of output and price.

The socially desirable level of output is Q_2 which is determined at minimum level of average cost which is c*. However, under imperfect competition, the producer will not produce output till Q_2 as it is not the profit maximizing output.

Hence, in such markets, supply of output is lesser and price higher and hence consumer welfare is lower.

2. Markets will not provide goods with zero marginal cost:

There are goods for which the supplier faces zero marginal cost once they are produced.

Now, a profit maximizing producer in a market will want a price from every additional buyer as she must meet the marginal cost of production. But if the marginal cost is zero then the producer may not be able to charge any price by the free market rationale. Hence a private producer may not be interested to produce such goods under a market regime and state will have to produce such goods.

Francis Bator explained this phenomenon.

For example, if a radio or television transmission centre is set up in a region there will be no additional cost of supplying the transmission from one viewer to the second to the third and so on. Till the signals can be received in the region, the owners of new television sets will be able to view programmes. It will be difficult for the supplier to charge an exclusive price from the viewers. Hence such centres will be set up by the state.

3. Markets fail in providing for goods of collective consumption with non-exclusion:

There are certain goods which are demanded jointly or collectively by many people. An exclusive demand schedule for a single individual does not exist and hence a private producer cannot charge an exclusive price and the individual buyer will not be willing to pay an exclusive price.

For example, the demand for a concrete road in a particular locality will be a collective demand from the residents of that locality. However, a new person who comes to reside in the locality or a person not residing in this cannot be excluded from using this road.

Hence it is difficult to charge an exclusive price or exclude anybody from its use once such a good is provided.

These are called goods of collective consumption and have to be provided by the state and so are called public goods.

4. Goods with externalities:

Production can have negative and positive externalities. Producers produce goods for profit maximization. But it may be in the interest of the society to produce more of goods which have more positive externalities and lesser of goods which have negative externalities. Private producers produce goods for their own profits and do not consider the externalities.

Hence the state must intervene to regulate the production of such goods considering the externalities. In other words, the amount of goods produced by efficiency of markets may not be a socially efficient production.

For example research may have a very high positive externality but may have low private benefits and hence a private company may not spend high amount on research activity. Hence, the state will have to invest in promoting research activities.

We can quote several examples of polluting industries whose production must be regulated by the state to reduce the negative externality.

5. Market failure in case of pure private goods:

Markets can fail in efficiently providing even pure private goods because in reality information is never perfect. Markets achieve efficiency in allocation and distribution only when complete and perfect information is available to buyers and sellers. When the demand schedule of a buyer and the supply schedule of the seller are determined by incomplete market information, their intersection does not result in the most efficient equilibrium. For example, common people may not know the quality of technical goods like medical services or products and those of professional services like those of lawyers. Hence, they end up paying higher prices than what they should actually pay. On the other hand an illiterate farm labourer may not be aware of minimum wage regulations and may end up accepting much lower wages than what the wage regulation directs. Hence, such labourers get exploited.

4. State failure

Just as markets fail, the state systems fail too.

When the state provides goods, the allocation, production and distribution may not necessarily be the most desirable ones.

1. Political ideologies determine economic activities and political ideologies may not be correct.
2. The state provides goods by collecting taxes. If high expenditures are incurred to provide certain goods for the poor or for development, the state collects undue taxes from the rich which mars the interest of the rich to work more and earn more and contribute more to GDP.
3. Bureaucratic delays and inefficient decision making result in wastage of resources and inadequate supply of goods and services.
4. Allocation of resources is not made in best interest of the citizens when there is lack of transparency, accountability and participation in governance.
5. Decisions may be made for power and vested interest by bureaucrats and political parties and not for justice in allocation or distribution.
6. Government monopoly replaces the private monopoly profit by collection of ‘institutional rent’ from people by the state. ‘Institutional rent’ may be termed as the undue or exploitative charges collected by the government or state institutions for certain services. For example, undue tolls, fees, ticket charges and so on.

Since both market and the state are indispensible in economic activity, an intense debate is conducted on what is an appropriate mix of roles of both in economic growth and development.

There are many countries where growth miracles can be observed because of success of the market system and also where the state has remarkably succeeded in achieving high growth rates. While there are countries where the models adopted by some governments failed.

5. Models adopted by some governments

Let us see some growth and development models (strategies) adopted by certain countries:

1. Developmental Model in Germany

2. Model of Populism in Argentina

3. Strategy of Central Planning

4. New Development Market Economy Model of Japan, Korea and Taiwan:

5. The Policy of Structural Adjustment introduced by IMF and the World Bank for developing Countries

Developmental Model of Germany

Some models of development emerged from the experience of countries of the world.

England was an 'early starter' in the process of industrialization and by the middle of the nineteenth century had developed as the 'workshop of the world'. England had adopted the 'liberal market economy' model of the type proposed by Adam Smith. Accordingly, almost all activities of production and distribution were left to the private sector. Investment decisions in human capital, such as in education and research were also left to the private sector. The state looked after law and order and administration and prepared a basic framework for functioning of the economy.

Germany was as ‘late starter’ in the process of industrialization. Germany tried to catch up with England in the middle of the nineteenth century. The state invested heavily in industrial infrastructure, technical education and applied research.

Because of the institutionalization of scientific education and research, by the end of nineteenth century Germany emerged with several scientific discoveries. (In some areas scientific discoveries were stated to be 2.5 times greater than in England and in certain areas 60% of the original research took place in Germany). At the same time Germany imposed tariff barriers against imports of manufactured goods according to Friedrich List’s thesis of infant industry protection.

This development strategy of Germany resulted in accumulation of tangible and intangible capital and growth.

The model of ‘Populism’ in Argentina

Populism developed in Europe and North America to protect the skills and employment of peasants and artisans which were threatened by modern industrial development. The state developed strategies to protect them.

Between 1946 and 1955, Argentina adopted a ‘populism’ model and promoted ‘nationalistic’ policies such as protection against imports of manufactured goods, foreign exchange control, and nationalization of foreign enterprises. The labour laws and social security systems were strengthened. The result was that the number of labour union members increased from half a million to five million during that time. Civil service employment increased much faster than total employment reflecting an expansion of government sector. Under this 'populist' system the state was the last resort of employment to all common people, graduates and school graduates.

However, by the end of 1950s such models collapsed in all countries that adopted them. Trade union power along with 'populist' social security measures and too many people in state services resulted in inefficiencies.

Centrally Planned Economies: The centrally planned economies that existed in Soviet Union, China and Vietnam collapsed as they tried to minimize consumption so as to increase capital accumulation and growth.

New Development Market Economy Model of Japan, Korea and Taiwan: These economies adopted several measures for export promotion and investment in export sectors while protecting some target industries against foreign competition. Besides the foreign trade sector, state regulated domestic economic activities, including banking and credit, insurance, communication and transportation. These countries experienced remarkable growth.

The Policy of Structural Adjustment introduced by IMF and the World Bank for developing Countries: The IMF and World Bank perceived that the economic crisis faced by the developing countries in 1980s was not because of a slump in primary commodity markets but because of persistent failure of government policies.

Hence, the IMF and the World Bank insisted that the developing countries must adopt a 'structural transformation programme for their economies'.

To assist such a programme, the World Bank introduced the Structural Adjustment Lending or Non-Project Lending policy which was a programme of general policy assistance rather than lending for specific projects. IMF introduced the Structural Adjustment Facility which was an advance stand-by credit facility in the event of critical shortage of foreign exchange.

This model of 'Structural Adjustment Policy' was adopted by many countries. Chile and Thailand began the 'structural reform programme' even before it was formally launched.

Chile faced a crisis created by socialist policies. In the structural reform programme Chile adopted policy orientation towards balance budgets and market liberalization. Expenditures for education and social welfare programmes increased and the tax base was strengthened. The Structural Adjustment Policy in Chile succeeded in enhancing the growth of agricultural, small and medium scale sectors also. The economy attained a high macroeconomic growth ultimately.

6. Summary

We have studied that neither free markets not extreme state controls lead to long term growth and development. Several practical development models have been adopted by countries of the world. Their experience teach that growth is a result of right amount of state intervention in regulating markets, right kind of policies and efficient markets.

We must remember that with changing economic scenario in the world and during different phases of economic activity countries must reform their growth strategies. Political will and political processes affect economic growth and development.