

## DEVELOPMENT STRATEGIES AND ROLE OF GOVERNMENT<sup>1</sup>

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**Abstract:** This paper surveys the recent stream of thoughts in the issues of development strategies and role of government. From the generation of state-led development and very high government intervention to the generation of neo-liberalism with minimal role of government, we have witnessed the ups and downs of those generations. From those lessons, the new generation development strategies of the twenty-first century have emerged. More equitable distribution and poverty reduction, decent public institutions, and economic stabilization are the key strategies, which require a significant role of government. These key strategies aim to achieve the sustainable development of the world focusing more on the human well-being.

### 1. Introduction

Development economics emerged as a distinct branch of economics in the 1940s after the World War II. This time period is the starting point of this paper on the reviews of development strategies and the associated role of government. Since 1940, three paradigms of development strategies have been witnessed. The first paradigm lasted from 1940s to late 1970s is called “the first-generation” development strategies. This is the era of the state-led development strategy and the heavy government intervention. The second one called “the second-generation” development strategies dominated the world from the late 1970s to the mid 1990s. During this period, market and trade liberalizations are the keys; and the role of government is kept at minimal. Finally, from the mid 1990s to present, the “new generation” development strategies and optimal role of government are forming with huge debates. This paper reviews some of those recent proposals for the new generation development strategies.

### 2. Stage of Development Strategies and the Role of Government

#### 2.1 *The first-generation development strategies and strong role of government*

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Stemmed from the classical theory, the development economics emerged in 1940s. Viewing the problem of low-income countries coming from the resource misallocation, economists believed that these countries had to shift from low-productivity agricultural sectors to high-productivity manufacturing sectors that required high capitals. However, there was a problem of capital accumulations in low-income countries. On the supply side, people were too poor to save. On the demand side, firms did not need much capital because of small production, which was, in turns, due to low demand for goods. Therefore, the economy was stuck with this “vicious circle of poverty”. Moreover, there were problems with market failures such as the imperfect foresight and the missing markets, and problems with inadequate infrastructure, high social overhead capital and coordination failure. From these problems of low-income countries, there was a belief that the government could help solving them, so that the economy would move to a higher level of income. Together with the successes of active Keynesian governments and the Marshall Plan in 1930s, the economic development during this period valued strong roles of governments.

*Role of Government and Development Strategies:*

The role of government during this period that lasted from 1940s to late 1970s was very strong. The government regarded as a prime mover had to correct all of those problems obstructing the economic growth. There were huge market interventions of government such as directing and coordinating investment flow, subsidizing the investment, opening new investment opportunities by creating new industries especially those import-substitution industries. All of these are the arenas of authoritarian governments and the generation of state-led development strategies.

***2.2 The second-generation development strategies and minimal role of government***

After the glorious days of development strategies on the import-substitution industrialization and the state-led development for more than thirties years, the problems started in 1970s, particularly in the Latin American countries. They were stormed with problems of the shortage of budget, high external debt and skyrocketed inflation rate. Then, it was the economic downturn all over the world after the both oil-shocks, the high-interest rate era, the problems with commodity markets, and the slow down in world trade. Those countries that earlier had enjoyed the high growth faced economic austerity.

The problems of the first-generation development strategies waked the new stream of thought, the so-called “neo-liberalism”, “market fundamentalism”, or “marketism” in the late 1970s. Based on the neo-classical school, the fundamental idea is that the economy can be promoted by liberalizing trade instead of depending on a trivial domestic demand. Without price intervention of the government in the domestic factors and commodities markets, the markets become more competitive and efficient. This era of free market orientation dominated the world during the 1980s, which were the eras of Ronald Regan and Margaret Thatcher.

The principle of government intervention resulting in more problems (government failure) than laissez faire became prominent. As Krueger defines, the government failure is all uncorrected market failures and government intervention that causes more inefficient usage of resource than the market does (Krueger, 1990, p.11). The list of the government failure is far too long<sup>3</sup> than the market failure (once thought of as the main reason for the government intervention). Therefore, the idea that the government was the main cause of all troubles the country faced was widely accepted.

By early 1980s, the World Bank and the IMF started the new approach called “structural adjustment policy” to grant credits to developing countries under the condition that these countries had to have policy reforms towards more liberalized trade and sound macroeconomic policy. This new approach did help the Latin American countries from the debt crisis in 1982<sup>4</sup>.

In 1989, in order to help the Latin American countries to get a debt-equity swap under the Brady Plan, John Williamson<sup>5</sup> suggested the policy reform for these countries to the World Bank, the IMF and the US Treasury. Williamson argued that the reform was the “lowest common denominators” that the Latin American countries, which were for so long being fiscal-undisciplined and imprudent about borrowing, should have followed. The reform comprises three pillars: macroeconomics discipline, a

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<sup>3</sup> Stern (1989) has the thorough reviews of the market failure and the government failure; see Tables 1 and 2 in the Appendix for the lists of the reasons for the market failure and the government failure.

<sup>4</sup> See the process of the structural adjustment policies in Hayami (2003) for details.

<sup>5</sup> The paper titled “What Washington Means by Policy Reform”, presented in the conference held by the Institute for International Economics in Washington DC., 1989.

market economy, and openness to the world (Williamson, 2002). It was named “The Washington Consensus” as it was the reform that the Washington-based international institutions (World Bank and IMF) agreed upon. The original version of the consensus is the following:

The Washington Consensus (WC) by Williamson<sup>6</sup>:

1. Financial discipline
2. A redirection of public expenditure priorities towards fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education and infrastructure
3. Tax reform (to lower marginal rates and broaden the tax base)
4. Interest rate liberalization
5. A competitive exchange rate
6. Trade liberalization
7. Liberalization of inflows of foreign direct investment
8. Privatization
9. Deregulation (to abolish barriers to entry and exit)
10. Secure property rights.

The WC has caught the world interest ever since as it has been viewed as the neo-liberalism testament. So many developing countries (such as Latin America, sub-Saharan Africa and East Asia) and the countries in transition from socialist economy (such as East Europe and Russia) had adopted the neo-liberal economic policy and the WC.

In this era of neo-liberalism from the late 1970s to the mid 1990s, the role of government was kept at minimal. The idea rooted from evidences of bad economies from the previous era of heavy-handed government. Government interventions caused problems rather than correcting them. Also, the problems of the corruption and misgovernance deteriorated the government’s role. During this period of “the evil government” as called by Adelman (1999), the basic tasks of the government were to liberate the market, to provide the public goods, to supervise the macroeconomic stability, and to preserve law and order. The development strategies during this period

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<sup>6</sup> From Williamson (2000).

were trade and market liberalizations, based on the idea that international trade would lead the economy to a sustained growth.

### ***2.3 The new generation of development strategies and optimal role of government***

After more than two decades of the dominated neo-liberal development and the WC, many questions have been raised on how effective the policies are and the criticism is severe. Under the neo-liberal policy, several collapses of the economies: the crises in the Latin America (the Mexican peso crisis in 1994, the Brazilian crisis in 1999, and the crises in Argentina and Turkey in 2001), the Asian financial crisis in 1997 and the Russian ruble crisis in 1998, have raised many people's eyebrows. These economic downfalls urge the world community to scrutinize this development paradigm.

#### *Stiglitz's Criticism on the WC:*

Joseph Stiglitz is one of the strongest antagonists of the WC and the IMF. He argues that the failure of the WC is entrenched from three aspects:

- The reforms, including various forms of liberalization, increased countries exposure to risk, without increasing their capacity to cope with these risks
- The macro-economic reforms were unbalanced, putting too much weight on fighting inflation, not enough weight on fighting unemployment and promoting growth
- The reforms pushed privatization and strengthening the private sector, and too little weight in stressing improving the public sector; they got the balance between the state and the market wrong.

(Stiglitz, 2002 b, p. 22)

**The first aspect** of the risk coming along with the liberalization is the one that is widely criticized because it is thought of as the main cause of the Asian financial crisis. For the Asian countries with sound economies, the problem came from the capital account liberalization. The very volatile short-term capital can flow into a country in a very large amount and suddenly flow out of the country altogether as a

heard behavior, leaving the countries in shortage of capital. One good evidence is the case of capital liberalization of Thailand, where private sectors were allowed to engage in the offshore market with lower interest rate. Therefore, financial institutions borrowed a large sum of short-term foreign debts for domestic lending and later had problems servicing these debts when suddenly the capital flowed out as the economy was in turmoil.

For those small open economies without the appropriate and sufficient regulations, they are more vulnerable to external shock. Rodrick (2004) points out that, actually, freer markets require tighter regulations such as the case of the US, one of the freest markets in the world with the toughest enforcement. The problems of capital mismanagement, together with the inadequacy and elimination of regulations on financial market and capital flow of Asian countries induced the macroeconomic instability. Unlike others, China, Vietnam and India did not eliminate the capital regulation<sup>7</sup>, therefore they escaped from the Asian Financial crisis (Bhagwati, 2004 and Rodrik, 2002). This indicates that the WC urged the small countries to liberalize without precautions. Many studies (such as Kosaka, 2004; Haggard, 2004; Rodrik, 2004; and Bhagwati, 2004) come up with the same conclusion that the reasons behind the collapse of the opened economies came from their inability to manage the macroeconomic instability, which is in turns due to from premature and too rapid financial and capital market liberalizations.

**The second aspect** is a source of the failure based on emphasizing too much on fighting inflation and too little on fighting unemployment and promoting growth. Stiglitz argues that by focusing too much on inflation, growth can be adversely affected. The extreme focus on inflation and fiscal discipline can imply the inadequate resource utilization and under investment, which affect the current and future growths.

He also points out that trade liberalization destroys jobs and moves labors from low productivity jobs to unemployment. Being forced to open up the markets, those small industries in developing countries have to compete with large corporations; and jobs

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<sup>7</sup> Under the pressure from the IMF on the financial market deregulation in developing countries (Bhagwati, 2004)

cuts are the results. For farmers in developing countries, they are hit hard because the prices of their produces cannot compete with those of the agricultural products under heavily subsidized from developed countries.

On the element of growth promoting, Stiglitz (2002 a) mentions that the WC misses out on the agenda that may promote growth as well as greater equality such as the land reform. With the land reform, the sharecropping problem can be resolved. Moreover, if the land reform is done “properly, peacefully, and legally” together with the farmer’s credit accessibility and planting knowledge, the output can be increased substantially. The successful evidences of land reforms are those of Korea and Taiwan.

Elaborating the lack of growth promoting agenda of the WC lay the evidences on unimpressive growth rates of the countries during this neo-liberal era. Palley (2002) shows the world growth rate of three periods: 1965-1980, 1980-1989 and 1990-1996. The world growth rate is smallest during the last period at 1.8% and biggest in the first period at 4.1%<sup>8</sup>. Rodrik (2002) also shows that most of the countries under the WC performed poorly, such as most of the Latin American countries grew slower in the 1990s than in the period of 1950-1980. In addition, the poverty rates of many countries, especially the sub-Saharan Africa, do not improve or even become worse.

**The last aspect** of the failure of the WC is the aspect of the minimal role of government. Stiglitz argues that the WC posts too limited role of government by reducing the government expenditure. The role of government is so important not only in alleviating the market failure but also in ensuring the social justice (Stiglitz, 2002 a, p. 218), such as providing good-quality education and institutional infrastructure. Moreover, it is impossible for the market to automatically stabilize the economic. Only Market liberalization does not guarantee that. He also states that the records from the advanced industrial countries show that the government intervention helps stabilizing the economy.

Regarding the related issue, there is an argument that behind the success of the Asia miracle stands the important role of government in these East Asian countries.

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<sup>8</sup> See Table 3 in Appendix.

Kohsaka (2004) argues that the role of government of East Asian countries was not kept at minimal. Their roles were not just preserving law and order, providing the public goods, or managing the macroeconomic stability as those in the neo-liberalism. These governments had much to do with the international trade and domestic capital market interventions. However, such interventions did not deviate too far from the market. Ohno (2004) illustrates the importance of government policies on the economic growth as seen in the case of Korea. During the 1960s to 1970s, Korea adopted the dual industrial policy; the export promotion in labor-intensive and the import substitution. Ohno argues that this is not the example of free trade and limited role of government. There is no such example of successful economic development that is driven only by the market force but not by the government policies.

### ***Other Criticisms on the WC:***

There have been enormous amounts of literatures criticizing the WC. The two elements of the criticisms are the performances of the WC and the flaws in the reform itself. On the first element, as noted earlier, the world growth rate and the poverty rate were very disappointing during the period implementing the WC. Moreover, the world has witnessed the current of crises from around the world. The recurrent of the crises in Latin American countries, especially the recent crisis of Argentina<sup>9</sup>, has confirmed the failure of the WC.

On the element of the criticism on the flaws in the WC, the deficiency or narrowness and the homogeneity of the reform are the two main points. The WC misses out on many aspects that are very important for sustainable development. Such important aspects left out of the WC are the aspects of poverty reduction and distribution, the public institutions, and the pro-active roles of government. The homogeneity problem is also widely thought of as one of the failure of the WC. Many economists point out that the IMF has treated different patients with the same remedies. The situation of the Asian financial crisis is very much different from those crises of the Latin American countries. Yet the IMF's approaches to the Asian crisis are the same to those applied to the Latin America, which aggravates the crisis. The heterogeneities of the crises and of the economic environments do require different policies and approaches to deal with.

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<sup>9</sup> Because Argentina was once the proof of the success of the WC. See Hayami (2003) for details.

***The Proposed Reforms:***

There have been so many efforts in recuperating the new reforms. During this time of proposing and gathering of ideas, it has been called the “Post Washington Consensus” or “After Washington Consensus” era. In this section, three most cited proposals of Stiglitz, Rodrik, and Williamson and Kuczynski are reviewed.

Stiglitz has proposed agendas on constructing a new reform, where the focus should have been on democratic, equitable and sustainable development. The role of government will be very important in this reform. The following is main points of the agendas that he argues should be in any reform from Stiglitz (2002 b).

**1. Social mobilization:**

- Increasing the education expenditure together with concentrating on the allocation of education expenditure and content.
- Embracing the local practice, e.g. the micro-credit
- Increasing attention on environment and livable urbanization
- Providing social safety net

**2. Enhancing equity and fighting poverty**

- Creating decent jobs
- Promoting education and health programs for children
- Land reform
- Promoting saving programs
- Equitable tax; relying more on indirect taxes

**3. Creating an environment that is good for business**

- Strong well regulated local banks
- Industrial policies
- Finding the right regulatory framework
- Legal framework that ensure good corporate governance
- Maintaining real stability

Stiglitz's proposal has replaced the "too narrow" side of the WC with the broader elements. However, one can see that Stiglitz's proposal is totally different from the WC. He dismisses those liberalization, privatization and deregulation issues and embraces the social and human issues, and the right economic environment.

Rodrik (2002) mentions that there is a modification on the original WC to the so-called "the Augmented Washington Consensus."<sup>10</sup> The Augmented Washington Consensus composes of the original version of the WC and another 10 items emphasizing on the institutional building. However, he argues that this reform is once again another blueprint that is impractical. He proposes that the new reform should be the one that is practical and can be adapted to any economic environment. This reform will be a universal principle and a country must have institutional arrangement that works locally. The following is what he proposes (Rodrik, 2002, pp.10-12)

- Objective - Productive efficiency

Universal Principles

- Property rights: Ensure potential and current investors can retain the returns on their investment.
- Incentives: Align producer incentives with social cost and benefits.
- Rule of law: Provide a transparent, stable and predictable set of rules.

- Objective – Macroeconomic and financial stability

Universal Principles

- Sound money: Do not generate liquidity beyond the increase in nominal money demand at reasonable inflation.
- Fiscal sustainability: Ensure public debt remains "reasonable" and stable in relation to national aggregates.

- Objectives - Distributive justice and poverty alleviation

Universal Principles

- Targeting: Redistributive programs should be targeted as closely as possible to the intended beneficiaries.

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<sup>10</sup> See Table 4 in the Appendix for details.

-Incentive compatibility: Redistributive programs should minimize incentive distortion.

The most important issue of this reform is to set the high-quality institutions that work best in each country's environment. However, the clarification of the institutional building is quite not so thorough. Rodrik (2004) clarifies the important of the role of institutions in economic development. The market-supporting institutions are the key. The market-supporting institutions compose of property right, regulatory institution, institutions for macroeconomic stabilization, institutions for social insurance and institutions for conflict management. He concludes that the successful development requires the mix of the market and public institutions and the home-grown strategy, not from the world blueprint.

After the vast debates of the WC and suggestions for the new reforms, Williamson together with Kuczynski suggested the new development strategies in 2003. Below are the four main points of their new reform (Williamson 2004).

1. Emphasizing on the macroeconomic stability and the crisis avoidance. Concentrating on both inflation and real economy stabilizations.
2. Continuing the liberalization and privatization. Complementing the original with labor market liberalization in Latin America and import liberalization in developed countries.
3. Strengthening and building good institutions.
4. Improving income distribution.

We can see that in this new reform, the original items in the WC are still there. However, they added more issues that the WC neglects that brings widely criticisms, and gave more weight on the role of government. Most of those new items are very much similar to those of Stiglitz and Rodrik's agendas, especially for the strategy on improving income distribution as they propose the land reform and micro-credit programs.

From these three proposed reforms and others not mentioned in this paper, a new kind of reforms have evolved from the neo-liberalism views of market liberalization and

limited government role to the more on the human issue, stable economic environment and sustainable development, which require a significant role of government. Also, many proposals have agreed that it is impossible to employ “the one reform” as a blueprint that can work in any economic environment. The countries must have the right public institutions to help implementing the reform with successful results.

We have witnessed the idea of the role of government swinging from the two opposite ends: the strong role of government after the World War II to the late 1970s; and the neutral role of government in the late 1970s to the mid 1990s. With these two extremes, we have also witnessed the problems that came along with them. Now, in the twenty-first century after learning so much from our past, many have agreed upon the more sophisticated and significant role of government; what we might call “the optimal role of government”. The argument of trading off between “the market failure and the government failure” or “the laissez faire and intervention” is now outdated. The optimal role of government should fulfill the market in economic development in the elements that the market cannot deliver. The complementary between the government and the market is the key.

If we have to pin down the development strategies of this century, those strategies would be:

- poverty reduction and more equitable income distribution,
- economic stabilization, and
- public institutions.

The most important development strategy would be embracing human well-being. Starvation and low standard of living are the world’s clear and present danger. The world has stressed the importance in fighting them as we have seen in the agendas of the Millennium Development Goals 1-7, as well as the UNICEF’s remark on “Development with the Human Face”. Poverty reduction and more equitable income distribution will help contributing the world community to move towards better quality of life and sustainable development.

For small open countries that have integrated their economies more to the world economy, they are more vulnerable to the external shocks. Those past collapses of many economies have taught us the importance of the macroeconomic stability management. A crisis can become deepen and prolong with the country's bad adjustment. With no interruption or a quick recovery from a crisis, the country's development process will be smoothly continued with no hardship on the people or no societal conflicts. Therefore, economic stabilization strategy is considered very crucial for the development of a country.

Good public institutions are very important for the successes of a nation in fighting poverty, improving distribution and stabilizing economy, which in turns are the keys for sustainable development. Besides, there are other institutions that will help with the process of development such as institutions for market incentives, and institutions for good governance of the public and private sectors. In building these good institutions, the government has to play a significant role.

From these three strategies, we can see that they all point to the same goal – the well-being of human. However, as many economists have agreed upon, there is no one standardized blueprint that works well for all economies. The country itself has to adopt these strategies and assimilate them into its own environment and culture.

### **3. Concluding Remarks**

From recent literatures on development strategies and the role of government, there are three generations of strategies: the first generation of state-led development, the second-generation of neo-liberal development and the new generation of human well-being development. In the first two generations, we saw the two extreme roles of government, from the strong role to the minimal one. Now, the role of government has to be optimal.

The debates on whether which development strategy is the best still carries on. However, the focus has shifted towards the well-being of humankind. This marks a good sign that we can move towards the new century with more confidence that the

world community will be a better one. The one that all countries find sustainable developments with the prosperity of their people.

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## Appendix

**Table 1: Reasons for Market Failure**

(i)	Markets may be monopolistic or oligopolistic.
(ii)	There may be externalities.
(iii)	There may be increasing return to scale.
(iv)	Some markets, particularly insurance and futures markets, cannot be perfect and, indeed, may not exist.
(v)	Markets may adjust slowly or imprecisely because information may move slowly or marketing institutions may be inflexible.
(vi)	Individuals or enterprises may adjust slowly.
(vii)	Individuals or enterprises may be badly informed about products, prices, their production possibilities, and so on.
(viii)	Individuals may not act so as to maximize anything, either implicitly or explicitly.
(ix)	Government taxation is unavoidable and will not, or cannot, take a form which allows efficiency.

Source: Stern (1989)

**Table 2: Some problems of State Intervention**

(i)	Individuals may know more about their own preferences and circumstances than the government.
(ii)	Government planning may increase risk by pointing everyone in the same direction – governments may make bigger mistakes than markets.
(iii)	Government planning may be more rigid and inflexible than private decision-making since complex decision-making machinery may be involved in government.
(iv)	Government may be incapable of administering detailed plans.
(v)	Government controls may prevent private sector individual initiative if there are many bureaucratic obstacles.
(vi)	Organisations and individuals require incentives to work, innovate,

	control costs and allocate efficiently and the discipline and rewards of the market cannot easily be replicated within public enterprises and organisations.
(vii)	Different levels and parts of government may be poorly coordinated in the absence of the equilibrating signals provided by the market, particularly where groups or regions with different interests are involved.
(viii)	Markets place constraints on what cannot be achieved by government, for example, resale of commodities on black markets and activities in the informal sector can disrupt rationing or other non-linear pricing or taxation schemes. This is the general problem of incentive compatibility.
(ix)	Controls create resource-using activities to influence those controls through lobbying and corruption – often called rent-seeking or directly unproductive activities in the literature.
(x)	Planning may be manipulated by privileged and powerful groups which act in their own interests and further, planning creates groups with a vested interest in planning, for example, bureaucrats or industrialists who obtain protected positions.
(xi)	Government may be dominated by narrow interest groups interested in their own welfare and sometimes actively hostile to large section of the population. Planning may intensify their power.

Source: Stern (1989)

**Table 3: Trends in GDP growth for developing and industrialized countries, 1965-1996**

	1965-1980	1980-1989	1990-1996
Low and middle income countries	5.9%	3.1%	1.9%
High income countries	3.8	3.2	1.7
U.S.	2.7	3.0	2.5
Japan	6.6	4.1	1.2
World	4.1	3.1	1.8

Source: Palley (2002)

**Table 4: The Washington Consensus and the Augmented Washington Consensus**

Original Washington Consensus	“Augmented” Washington Consensus
	the previous 10 items, plus:
1. Fiscal discipline	11. Corporate governance
2. Reorientation of public expenditures	12. Anti-corruption
3. Tax reform	13. Flexible labor markets
4. Financial liberalization	14. WTO agreements
5. Unified and competitive exchange rates	15. Financial codes and standards
6. Trade liberalization	16. “Prudent” capital-account opening
7. Openness to FDI	17. Non-intermediate exchange rate

	regimes
8. Privatization	18. Independent central banks/inflation targeting
9. Deregulation	19. Social safety nets
10. Secure Property Rights	20. Targeted poverty reduction

Source: Rodrik (2002)