# The State, the Market, And Development

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# Rethinking the role of the state

- Influenced by major successes and failures of the last 30 years
  - Which have also led to reshaping our understanding of development
- And by major changes in economic theory

**Major insights:**

- Government policies need to pursue even wider range of objectives, using a wider range of instruments than I envisioned in my 1998 WIDER lecture
- We now know more about how government can successfully pursue these objectives, incl. to reduce the risk of "government failure"
- We need to broaden our analysis to go beyond thinking about the role of the state vs. the role of the market
  - More complex interactions
  - More actors, more institutional arrangements

# I. Some of the major "events" and the lessons they taught

- The success of East Asia, including China
- Development/growth beyond anything that had been thought possible
  - And contrary to what others (Myrdal) had thought would occur
- Based on government assuming a major role in the economy
  - But using markets
- Major debate about what it was that the government did that led to success
  - Different countries did different things, policies changed over time

# The WC and failures in Latin America and Africa

- In Africa, structural adjustment led to a lost quarter century and deindustrialization
  - Growth recovered, partly as a result of China’s involvement (infrastructure, buying commodities and natural resources) in this century
    - Will it be sustained as China slows?
- Policies focused on limiting the role of the state, limiting the ability of the state to increase its capacities
  - The countries that achieved macro stability and “good governance” didn’t see a flow of foreign investment except in natural resources

# The transition from communism to the market economy

- Except in China and Vietnam and the countries joining the EU, that transition has been a real disappointment
- Had expected move to market economy—end of central planning, use of prices, restoration of incentives, establishment of property rights—would lead to faster growth
  - Shock therapy didn’t work
  - Reliance on WC policies arguably contributed to failures

# Events in the Rest of The World

- The 2008 crisis showed that markets on their own were neither efficient nor stable
  - Huge losses from inadequate regulation
  - Economy only saved through massive government intervention
    - Irony:  attempt to reduce role of government led to increased role
  - Major deficiencies in “governance” even in US

# Growing inequality

- In most countries around the world
  - But some countries managed even to reduce inequality
- Showed that trickle-down economics didn’t work
  - And implied that GDP was not a good measure of economic performance
- Differences among countries showed that it was not just a matter of economies, but of policies

# The Euro-crisis

- Another example of economic globalization outpacing political globalization
- A result of an attempt to share a single currency, without the necessary institutions
- And based on same flawed economic analyses that underlay the Washington Consensus
- With important lessons for developing countries
  - Monetary policies, industrial policies, austerity policies

# II. Advances in economics

Behavioral economics

- Standard model based on “wrong” view of individuals
- Psychological literature: lack of rationality, systematic biases (confirmatory bias) equilibrium “fictions”
- Sociological literature: beliefs largely determined by those around us
  - At the center of development is a societal transformation
  - Including changes in mindsets about change
- New instruments
- New questions about how to assess societal improvements
- Standard welfare analysis does not apply
  - Raising questions about prescriptions based on models assuming fixed preferences
- New interpretations of successes and failures, e.g. of micro-credit schemes

# Endogenous technology

- Most of advances in standards of living associated with learning and improvements in technology
- What separates developing from developed countries is more a gap in knowledge than a gap in resources
  - Changed viewed of World Bank:  a knowledge bank
- But markets are not efficient in promoting learning, innovation
  - Pervasive market failures associated with competition, externalities, risk, capital markets

# Endogenous technology

- And policies based on standard model (e.g. WC)  may actually retard learning, counterproductive to learning and increases in standard of living
- A new and different role of the state
  - Argument for industrial policies, exchange rate management, and carefully designed trade policies
  - Argument against excessive financial sector liberalization (excessive opening to foreign banks)
  - Argument for well-designed intellectual property regimes (*not* TRIPS)

# Game theory and the theory of imperfect competition and imperfect markets

- Now understood that perfect markets model not robust
  - Slight imperfections have large consequences
- Most markets are characterized by some degree of market imperfections, with market participants striving to increase their market power
- Limiting case of perfect competition provides poor description and poor policy guidance
- Because of theory of second best, moving toward theoretical ideal may lower welfare
  - Free trade and capital market liberalization (in absence of perfect risk markets) can lead to Pareto-inferior outcomes
  - Another reason that the WC policies failed so badly

# Macroeconomic externalities and financial market imperfections

- Greenwald-Stiglitz had shown that whenever there was imperfect/asymmetric information and imperfect risk markets (that is, always), markets are not Pareto efficient
- Reversing presumption about the efficiency of markets
- Not just a few isolated market failures (like environmental externalities)
- These imperfections often manifest themselves as pecuniary externalities that matter
- We now know they have pervasive macroeconomic consequences—and macroeconomic policy has to be designed to take them into account

# Important implications for the role of the state

- Market, on its own, will lead to excessive borrowing, especially in foreign-denominated debt
- Market on its own will lead to too big and too intertwined financial institutions
- Need for strong financial sector regulations
  - Including macro-prudential regulations
  - Including regulations on cross border flows (capital controls)

# Monetary economics

- Credit rationing pervasive
  - Problems of liquidity (access to funds) at center of crisis

- Behavioral economics: individuals' savings behavior not well described by standard utility maximizing model

- Importance of non-convexities, interlinkages, contagion
  - Excessive diversification, rather than diversifying risk, can enhance instability

# Reforming monetary policy

- Single-minded focus on inflation was worse than was realized 20 years ago—it contributed to the global financial crisis
  - Even then, inflation target should have been higher
- Single-minded focus on interest rate is wrong—many more instruments
- Simplistic rules, e.g. “monetarism” and “inflation targeting” don’t work
- Central banks need to *simultaneously use* all the instruments at their disposal
  - Both conventional instruments ***and*** regulatory instruments
  - Can’t and shouldn’t separate the two—need to be coordinated
- Capital and financial market liberalization often lead to more instability and less growth

# Institutions

- Older theories paid little attention to many things that we now know are important
  - Held that institutions don't matter:  what drives the economy are underlying economic forces (supply and demand)
- But institutions *do* matter—such as sharecropping
- Sometimes, these institutions can be *explained* (e.g. responses to imperfections of information)
- But there is no presumption that these institutional responses are efficient
- And institutions often persist when circumstances change, leaving dysfunctional institutions in place
- Many institutions exist to preserve power structures

# Institutions and Markets

- Markets are institutions
- Markets don’t exist in a vacuum
  - They are structured by norms, laws, and regulations
- The way they are structured makes a big difference for how the economy behaviors
  - Can lead to stronger or weaker economic performance
  - Can lead to more or less inequality
- The Reagan/Thatcher era and WC entailed “rewriting the rules” in ways that led to slower growth and more inequality
  - There are alternatives which can promote development and equality

# Equality and Economic Performance

- Older theories paid little attention to inequality
- Second welfare theorem said that efficiency and distribution could be separated
  - Led to view that economists should focus on efficiency, leaving issues of distribution to "politics"
  - But modern economics explained why, in general, the Second Welfare Theorem did not hold
- Now, wealth of theory and evidence that the distribution of income affects economic performance

# Equality and Economic Performance

- But *no one* ever claimed that markets generated a socially desirable distribution, let alone one that maximized, in some sense, economic performance
  - Further reinforcing the importance of the role of the state in promoting equality and equality of opportunity

- Policies that lead to more instability (like CML) can lead to more inequality, hurting economic performance *both* because of the instability (which discourages investment) and because of the impact on inequality

# Multiple equilibria

- In many of these new models, there can be multiple equilibria
- Government can play a role in moving economy from bad equilibrium to new equilibrium
- Different role than in correcting *marginal* distortions
- Intervention can be one-time
- Interactions between economic and political equilibrium
  - Noted in the move from communism to a market economy (equilibrium with and without "rule of law")
  - Since economic inequality translates into political inequality, there can be a high inequality equilibrium and a low inequality equilibrium

# III. Some Further Observations

- Central issues we have been discussion involve comparative economic *systems*
  - Cannot conduct meaningful RTC
- Interaction between state and markets is complex
  - Complementary roles
- Need to take pragmatic view—in some countries state institutions can even be more efficient that private
  - South Korea's state owned steel companies were more efficient that US private steel companies
  - US largely private health care sector most inefficient in world
  - Large scope for rent seeking
  - US social security (retirement) program much lower transactions costs than private programs

# Multiple roles

- Government has both a regulatory role, a catalytic role, and a coordinating role

- In the most successful developing countries in both East Asia and Africa, the government has assumed the role of a *development state*
  - Even in most successful advanced countries, government has played an important role in promoting technology—the *entrepreneurial state*

# A variety of institutional arrangements

- Not just for-profit institutions and government
- In US, some of the most successful institutions are not-for-profit foundations (e.g. universities)
- Many examples of successful cooperatives
- TVE's were among important institutional innovations in China

# The public good is a public good

- So there will be an undersupply of efforts to make sure that the public sector is run well (just as there is an undersupply of efforts to make sure large corporations with wide share ownership are run well)
- Government can subsidize the institutions that can strengthen monitoring and participation—media, think tanks, education
- Important role for civil society and other forms of voluntary collective action

# Other ways of preventing government failure and capture

- Systems of checks and balances
  - But if not well designed, and if society is too divided, can lead to gridlock, entrenching existing elites

- Democracy may not provide adequate check
  - Especially in societies marked by high inequality
  - Need to have more transparency, strong right-to-know laws
  - Restrictions on the influence of money in campaigns
  - Restrictions on revolving doors

# Other ways of preventing government failure and capture

- What is needed is more than checks and balances within government, but within society—and that can only be achieved if the extent of economic inequality is limited, and if there is a break in the transmission of economic advantage across generations.

# Rule of law

- Importance has rightly been emphasized in modern discussions of development
- But there has often been confusion about meaning

- What matters is what kind of “rule of law”
- The wrong kind of rule of law can be used by the powerful to take advantage of ordinary citizens and maintain and extend inequalities
  - US bankruptcy law

- What most mean by a rule of law is a legal system that protects ordinary citizens against the powerful

# IV. Concluding Comments

- Metrics have become increasingly important, but wrong too focus narrowly on GDP
- The International Commission on The Measurement of Economic Performance and Social Progress emphasized deficiencies in measure

(a) what we measure affects what we do and the design of policy: metrics are important;

(b) no single number can capture something as complex as our society;

(c) accordingly, there will have to be a “dashboard of indicators;”

(d) the dashboard which is appropriate for one country may be different from that of another;

(e) but among the metrics that should be included are those that reflect distribution and environmental sustainability;

(f) there need to be improvements in the way we measure the value of government and other services;

(g) median income adjusted for inflation almost certainly reflects a better measure of what is happening to the typical individual, and therefore it should be among the numbers

# Marked changes in our understandings in last 30 years

- Then, the neoclassical model predominated

- Now we understand its limitations, the importance of imperfections of competition, information, and markets, the lack of robustness of that model, the importance of second best
  - Now there is a focus on behavioral economics, endogenous technology, learning
  - These are all especially important for developing countries

# Marked changes in our understandings in last 30 years

- Then, there was a presumption that markets were efficient, with the exception of certain well-defined problems, like environmental pollution.

- Now, there is a presumption that markets are not efficient or stable
  - That there are not just environmental externalities, but also information and learning externalities and macroeconomic externalities
  - Giving rise to multiple needs for government intervention—not just macro-stabilization, but also industrial and trade policies, etc.

# Marked changes in our understandings in last 30 years

- Then, it was thought that one could separate issues of distribution from efficiency

- Now, we realize that the issues of distribution and efficiency cannot be separated.

# Marked changes in our understandings in last 30 years

- Then, we paid little attention to how markets are structured by the legal system.  Economists would simply refer generally to a rule of law, with strong property rights, rigorously enforced.

- Now we realize that markets don't exist in a vacuum, that they are structured by our legal frameworks, that there are many alternative legal frameworks (rules governing bankruptcy, corporate governance, etc) and the choices a society makes make a great deal of difference, for development and distribution.
  - Inevitably, these are decisions made by the political system

# Marked changes in our understandings in last 30 years

- Then, many subscribed to Tinbergen's analysis, assigning each institution a single objective and a single instrument, assuming little need for coordination

- Now we realize that there are many more instruments in the governments tool-kit than we realized 30 years ago, that even monetary authorities need to pursue multiple objectives, and that different policies need to be coordinated

# Marked changes in our understandings in last 30 years

- Then, the focus was on limiting the role of the government—getting it out of the way

- Now we realize that government is essential, and a central part of development policy is improving the performance of the public sector

- While the Washington Consensus policies and the theories on which they have been based have been widely discredited, their influence still lingers, often masqueraded using different language
- The most successful countries had a developmental state