Chapter 11
Development Policymaking and the Roles of Market, State, and Civil Society

■ Key Concepts

This chapter looks at the effects of large, locally owned domestic firms in emerging economies as part of the private sector in developing countries. In this edition, some of the discussion on the roles and limitations of markets have been removed.

This chapter discusses development planning and the role played by the state versus the market. Major topics include:

- The role and limitations of planning as practiced by less developed countries, including a discussion of different types of planning models.
- The problems of economic transition to competitive free market economies.
- A discussion of what government can do best in terms of correcting market failures.
- The "Washington Consensus" both the old and the new ("Santiago") version.
- The impact of the political process on the quality of policy decisions.
- Tackling corruption, implementing decentralization, and encouraging broad based development participation.

Economic planning is defined as an attempt by the government to coordinate economic decision making and influence economic outcomes. An economic plan is defined as a set of quantitative economic targets to be reached by a certain date. In the past, most developing countries adopted some degree of economic planning. The justification for developing planning includes the following:

5-Year-plan

- The need to correct market failures.
- The need to ensure the most productive use of scarce financial and skilled manpower resources.
- An increase in the ability to qualify for foreign aid.

Planning is introduced at various levels including aggregate, sectoral, and project (the components of the entire economic plan). The three types of planning models described are:

- applied macroeconomic growth models based on variants of the Harrod-Domar model, with reference to the two-gap model to be introduced in Chapter 15.
- input-output models.
- project appraisal, including a discussion of relevant objectives, shadow prices, social discount rates, and decision criteria.

The crisis in planning is discussed in the inability of plans to meet their objectives. Problems include: plan designs that are often over-ambitious while vague on specific policies, data often insufficient or unreliable, unanticipated shocks that can wreak havoc, a planning agency often weak and ineffective, and countries that lack the political will to carry out otherwise sound plans.

The role of markets has been gaining ground at the expense of planning since the early 1980s. Many developing countries have attempted to reduce the role of the public sector, eliminate distortions in interest rates, wages, and prices, and encourage growth in the private sector. Development problems have been increasingly viewed (especially by aid agencies) as exacerbated by planning policies. The importance of government failure as well as market failure is stressed, and Box 11.1 presents a list of drawbacks of government intervention in developing countries.

In converting to a more market based economy, the text presents a broad range of institutional and cultural requirements for the operation of effective private markets and for market-facilitating legal and economic practices.

The 10 points of the Washington Consensus are described. These 10 points defined the approach to development policy in the 1980's and 1990's. In Box 11.1, the ten points are evaluated with respect to South Korea and Taiwan. The Santiago Consensus is then described and then summarized in Box 11.2. A section explores the political economy of successful policy reform and implementation. Whether democracy or autocracy facilitates faster growth is also discussed in this section. A final section, "Trends in governance and reform," takes up the topics of corruption, decentralization, and development participation.

In sum, the text emphasizes the need for both a public and private sector and the need for these sectors to cooperate in areas where government can best play a role, and in areas the private market should be left unencumbered. South Korea and Taiwan are cited as examples of successful proactive government industrial policy.

■ Sample Questions

Short Answer

1. Explain what is meant by market failure.

   Answer: Discussed in the chapter, pages 544–545.

   S=20% C=5

2. In the Harrod-Domar model, if the savings rate is 20% and the incremental capital output ratio is five, abstracting from depreciation, what is the implied growth rate?

   Answer: 4%.

   $g = \frac{S}{C} - \delta = \frac{20\%}{5} = 4\%$

3. In the Harrod-Domar growth model, if 12.5% of income is saved, the incremental capital output ratio is 2.5 and the rate of depreciation is 4%, what is the implied rate of growth?

   Answer: 1%.

   $g = \frac{S}{C} - \delta = \frac{12.5\%}{2.5} - 4\% = 1\%$

4. Assume a closed economy. Suppose the incremental capital-output ratio is 3, and the depreciation rate is 4%. Using the Harrod-Domar growth equation, if the savings rate is 9%, what will be the rate of growth? What would the savings rate have to be to achieve 5% growth?

   Answer: –1%; 27%.

   $g = \frac{S}{C} - \delta = \frac{9\%}{3} - 4\% = -1\%$

   $5\% = \frac{S}{3} - 4\%$

   $\Rightarrow S = 9\% \times 3 = 27\%$

5. Why must projects be appraised? What do we learn from project appraisals?

   Answer: Discussed in the chapter, pages 550–554.

6. What is the role of input-output analysis in development planning? What are the strengths and weaknesses of this technique?

   Answer: Discussed in the chapter, pages 549–550.

externality

7. In what ways may social evaluations of costs and benefits differ from those implied by market prices? Explain carefully.

   free-rider

   Answer: Discussed in the chapter.

8. What are accounting, or "shadow" prices for project appraisal? In what way do they differ from market prices, and why do we need them? Additional question or part of question: How can reference to world prices help countries gauge the real opportunity costs of development projects?

   Answer: The additional question would depend on supplemental coverage of the ideas of the Little-Mirrlees method project evaluation method.

9. Name <<some number>> of the ten points of the Washington Consensus. What is missing from this list? Did the Santiago Consensus address what was missing?

   Answer: Covered in detail in the chapter.

10. How does the Washington Consensus differ from the Santiago Consensus?

    Answer: The Santiago Consensus stresses poverty alleviation and the government taking responsibility for poverty alleviation. The Washington Consensus was much more free market based. See the chapter for more details.

11. What economic benefits might a developing country gain by reducing corruption? Discuss only economic benefits and provide examples from specific developing countries.

    Answer: The student is asked to describe the *economic* benefits of reducing corruption. These include the growth enhancing effects described in the text and illustrated in Figure 11.3 for Ecuador. The text notes that the burden of corruption falls disproportionately on the poor so combating corruption could couple as a poverty reduction strategy.

12. As an agent of economic development, in what areas do NGOs have a comparative advantage, compared to governments or markets?

    Answer: The new section on NGOs describes seven such areas of comparative advantage.

13. What is the primary composition/ownership pattern of the private sector in most developing countries?

    Answer: Page 543–544 in the textbook.

14. Discuss the BRAC model and evaluate its performance in achieving the goals of economic development? Can this model be replicated in other countries?

    Answer: Detailed in the case study at the end of the chapter.

■ Multiple Choice

1. Development plans have often failed because

   (a) they have been insufficiently specific about projects.

(b) they have overlooked noneconomic considerations.
(c) they have been overambitious.
(d) all of the above.
(e) none of the above.

Answer: D

2. Sectors where the development process leads to a more rapid expansion of demand than supply in goods or factor markets are known as
(a) the crisis in planning.
(b) input-output analysis.
(c) bottlenecks.
(d) infant industries.

Answer: C

3. The price reflecting the true social opportunity costs of a resource is known as
(a) a shadow price.
(b) an equilibrium price.
(c) a world price.
(d) a price index.

Answer: A

4. Which of the following factors has led to poor plan performance?
(a) unanticipated changes, such as in terms of trade.
(b) corruption of government officials.
(c) foreign firms are less subject to the constraints of the plan than domestic ones.
(d) all of the above.
(e) none of the above.

Answer: D

5. An example of an institutional requirement for the operation of effective private markets is
(a) enforcement of contracts. — rule of law
(b) the ability of government to correctly project trends.
(c) the ability of advertisers to influence consumers.
(d) all of the above.

Answer: A

6. An example of a market-facilitating legal practice is
(a) clearly established property rights.
(b) corruption of government officials.
(c) extensive licensing requirements for starting firms.
(d) all of the above.
(e) none of the above.

Answer: A

7. A plan that sets targets to cover all major aspects of the national economy is known as a/an _____ plan:
   (a) interindustry
   (b) complete
   (c) comprehensive
   (d) economic

   Answer: C

8. Which of the following is a rationale for development planning?
   (a) government failure.
   (b) market failure.
   (c) failure of consumers to understand their preferences.
   (d) all of the above are rationales for development planning.
   (e) none of the above are rationales for development planning.

   Answer: B

9. A shadow price is:
   (a) the price in the previous period.
   (b) the price in the next period.
   (c) the social value of a good or service.
   (d) the market value of a good or service.
   (e) none of the above.

   Answer: C

10. Which of the following is a reason for the failure of development plans?
    (a) unreliable data.
    (b) unanticipated economic disturbances.
    (c) lack of political will.
    (d) all of the above.
    (e) none of the above.

    Answer: D

11. Which of the following is *not* a rationale for development planning?
    (a) capital market failures.
    (b) rent seeking behavior.
    (c) attitudinal or psychological impact.
    (d) all are rationales for development planning in developing countries.

    Answer: B

12. If the incremental capital output ratio is 3 and the ratio of saving to national income is 9%, according to the Harrod-Domar model the growth rate of income is
    (a) zero.
    (b) 3%.
    (c) 6%.
    (d) 12%.

    $g = \frac{s}{c} - \delta$

    Answer: B

$n+p = \frac{s}{c} - \delta$

$2\% + p = \frac{24\%}{3} - 5\%$

13. If the population growth rate is 2%, the incremental capital output ratio is 3, the saving ratio is 24% and the depreciation rate is 5%, the rate of growth of income per person is

$= 3\%$

(a) 1%.
(b) 2%.
(c) 3%.
(d) 5%.
(e) 8%.

Answer: A

14. If the population growth rate is 2%, the incremental capital output ratio is 3, the saving ratio is 24%, and the depreciation rate is 5%, the rate of growth of income is
(a) 1%.
(b) 2%.
(c) 3%.
(d) 5%.
(e) 8%.

Answer: C

15. In Ecuador, as a share of a firm's revenue, the cost of bribes is highest for
(a) micro enterprises.
(b) small enterprises.
(c) medium enterprises.
(d) large enterprises.

Answer: A