Ambiguous Role of the State in Development

Economies of East Asia
ECON 377

Ambiguous Role of the State in Development

+ Economics of Corruption

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Capitalist Market Economies vs. Socialist Planned Economies

- The extreme distinction between market and planned economies is often used.
- The concept of "march to markets" can refer to both the transition from socialism in centrally planned countries and the increasing liberalization in LDCs.
- The difference in efficiency between a market and planned system depends largely on how each deals with 1) information and 2) incentives

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Role of Incentives

- It is argued that the profit motive is the most reliable way to increase output, cut costs, innovate, and meet unmet wants
- In socialist economies, public-mindedness was an insufficient incentive, so promotions and raises were offered to managers who met the goals of government planning; although these might have helped managers achieve quantitative goals, they did not encourage them to cut costs, innovate, and meet unmet needs

The Case of Vietnam and China

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Market vs. Planned Economy

Market Economy		Planned Economy	
Advantages	Disadvantages	Advantages	Disadvantages
1. better provision of incentives	1. the market satisfies demand but might not meet needs	1. successful at rapid industrialization and structural change	1. enterprises tended to be oriented toward increasing quantity of output, not quality
2. better uses local information and conveys global information more cheaply (in prices)	2. public goods not automatically supplied	2. tended to have less income and wealth inequality and higher levels of literacy and basic health care	2. economies as a whole were not technologically dynamic
	3. market power – monopolies, cartels, etc.		3. despite high saving rate, growth was slowed by low productivity of capital
	4. possible negative macroeconomic outcomes		4. output mix lopsided – producer goods vs. consumer goods and agriculture
	5. structural changes might be difficult		5. political repression

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How to Implement Reforms

- **Stabilize the macroeconomy:**
  - **Stabilization policies attempt to reduce or eliminate inflation, such as by reducing government budget deficits**
  - **The International Monetary Fund (IMF) and World Bank (WB) promote stabilization packages to guide countries**
  - **There is an empirical relationship between the inflation rate and growth rate; the countries with the highest growth rates had low levels of inflation**
  - **There is also an empirical relationship between the overvaluation of currency and the growth rate;**
    - **overvalued currencies correlate with lower economic growth;**
    - **high growth countries had black market premiums equal to 0, indicating their exchange rates were at market rates**

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- **Dismantle controls:**
  - **Dismantling controls means eliminating barriers to market activity that prevent the economy from moving toward the equilibrium without the distortions**
  - **Controls include limiting the quantity of imports, instituting a ceiling on the interest rate, etc.**
  - **Eliminating controls would help prices reflect scarcity**
- **Ensure competition:**
  - **It is better to remove barriers when competition will follow, but removing controls is not enough to ensure competition because conditions favoring monopolies might exist**
  - **In order to maximize profit, a monopoly will restrict the supply of goods and services, and prices will be higher than what would be most efficient, thus it may be necessary for the government could intervene to break-up monopolies**
  - **Opening up the country to international trade could make it more competitive and efficient (???)**

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- **Move toward scarcity prices:**
  - **A theme of neoclassical economics and development economics is the importance of "getting prices right"**
  - **Resource prices determined by the competitive process in a market economy tell decision makers the value of the resources to the economy**
  - **Controls such as fixed foreign exchange rates (which make foreign exchange cheap because the exchange rates tend to be overvalued), ceilings on interest rates (which make capital cheap), etc. are not socially optimal because these distortions do not let prices reflect the cost of resources to society, so they lead to privately profitable decisions that are not socially optimal**

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- **Increase responsiveness to market signals:**
  - **To be efficient, an economy needs decision makers who respond to market signals; however, if decision makers, such as those in government enterprises, are more concerned with pleasing whoever hired them or protecting jobs, then they might not be responsive to prices (corruption)**
  - **To resolve this inefficiency, it is often suggested the privatization of government enterprises so that decision makers will respond to profit; according to neoclassical economics, profit-seeking in a decentralized economy without government controls leads to social optimality**

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Two Ways to Transform

1. **Shock therapy – this transition is rapid and was used by Poland and some other countries**
2. **Gradual transition – this was used by China and some other countries**

Is there a "correct" way?

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The Realities of Economic Change

- **Many transition economies face *infrastructure shortages.***
- **Capital shortages are also a major constraint.**
- **It is difficult for corporations to respond to demand because consumer knowledge is vague.**
- ***Allocation mentality*, or waiting for instructions from above, represent a management problem.**
- **Employee and manager commitment can be hard to find.**
- **The changes complicate managerial decision making.**

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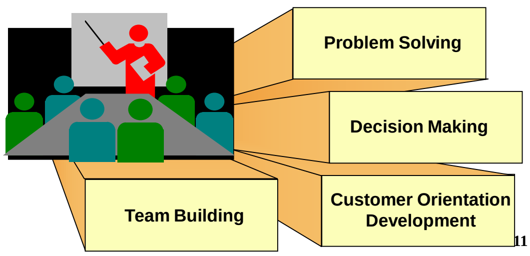
The Realities of Economic Change

Given the poor market orientation in the previous business environment, managers must adapt their behavior in these areas:



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Reasons for State-owned Enterprises

- **The reasons for the existence of state-owned enterprises in emerging market economies are:**
  - **Increased national security**
  - **Increased economic security**
  - **The investment is too large for the private sector**
  - **Governments rescue failing private enterprises by placing them in government ownership**
  - **State-owned firms are more socially-oriented than private firms which are more profit-oriented**

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Drawbacks to State-owned Enterprises

- **Competition is restrained, which results in lower quality of goods and reduced innovation.**
- **The international competitiveness of state-owned enterprises declines, resulting in the need for government subsidies.**
- **Many government-controlled corporations are losing money because the focus is on job allocation rather than business.**

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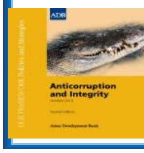
The Economics of Corruption



https://www.adb.org/documents/anticorruption-and-integrity-policies-and-strategies

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Definition of Corruption

- **"The abuse of public power for private benefit"**
  - **Or for the benefit of party, family, tribe etc**
  - **Corruption not equal to bribes**
  - **Bribes not equal gifts**
- **Corruption may be**
  - **Political ("grand") or bureaucratic ("petty")**
  - **Centralized or decentralized**
  - **Predictable or arbitrary**
  - **Etc etc**

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Rent Seeking

- **When sectors of society create quasi-rents through special interest lobbying, law suits, and other activities that seek to establish special advantages through licensing, legal awards, monopolies, etc.**
- **Resources spent on rent-seeking are generally viewed as unproductive, since they typically transfer wealth, rather than creating it.**

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Factors Causing Corruption

- Licenses, permits and authorization
  - Give monopoly power to officials
  - Single office for authorizations
  - Frequent contact, waiting time
- Taxation – invites corruption if there is …
  - Discretion
  - Lack of transparency
  - Weak control or no sanctions against offenders
- Low wages
- Government spending and investment
  - Procurement spending (many controls…)
  - Wage payments
  - Extra-budgetary accounts with lack of transparency and control
- Government supplies goods below market prices
  - Public housing, foreign exchange, water, credit, education
  - Rationing, queuing
- Party finance

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Indirect Causes of Corruption

- Quality of the bureaucracy
  - Hiring and promotion based on merit
  - Absence of patronage and nepotism
- Incentive structures
  - Salary levels and corruption – what is the link?
  - Penalty
  - The risk of getting caught
    - Free press
    - Ethics commissions
  - Quality of leadership

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The Corruption Equation

- C (corruption)= M (monopoly) + O (Opacity) + D (discretion) – A (accountability)
- Fighting corruption, thus, requires eliminating monopoly, reducing discretion and promoting transparency and the rule of law while increasing accountability standards and practices. (Robert Klitgaard)
- Opacity - Loss of clarity in something that is normally clear or transparent.

Klitgaard, R. 1998. *Controlling corruption*. Berkeley, CA: University of California 1988.

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Measuring Governance and Corruption

- The very nature of corruption (secrecy, illegality, national variations) prevents precise information on cross-country comparisons of extent and frequency
- Survey-based measures of corruption by experts and firms: Most techniques attempt to capture the degree of corruption in a country through the perception of investors, creditors, and local economic agents. The measure of corruption thus is highly subjective.
- Corruption is most often incorporated in political risk factors and its weighting differs according to each rating institution.
- We often rely on anecdotes and *perceptions* of corruption (and I have lots of anecdotes)

- Transparency International: Corruption Perception Index and Bribe Payers Index http://www.transparency.org/
- Heritage Foundation: Index of Economic Freedom http://www.heritage.org/index/Default.aspx
- You can find others

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Economic Effects of Corruption

- Positive effects (in theory):
  - Greasing the wheels arguments – speeding up things
  - Bribes promotes efficiency through bidding
  - Political glue. Politicians get necessary funds.
  - Substitute for taxes
- BUT REMEMBER: rigidities and controls are endogenous. Officials may manipulate systems and rules to maximize their rents
- Speed money is an incentive to delay things

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Negative Effects

- People are diverted from production to rent seeking
- It distorts public investment, its size, composition and quality
- Higher public deficits
- More inequality and poverty
- It distorts markets, incentives and regulations
- Obstacles for small firms (esp. many local government controls)
- Arbitrary tax with high welfare costs
- Protection of property rights and rule of law undermined
- The legitimacy of the market economy and democracy undermined. Problem in many transition economies...

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Fight Against Corruption

- No single cause of corruption, so we need a broad approach
- Donors: How do they tackle corruption?
- Anti-corruption is part of state reform
  - Civil service reform, salaries
  - Discretionary regulations
  - Eliminate tax incentives
  - Transparency
  - Leadership commitment
  - Reduce demand and Reduce supply

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Combating Corruption: A Policy Toolkit

Adapted from Center for International Private Enterprise

Supply-side Recommendations

- ✓ Independent media equipped with tools of analysis
- ✓ The role of think tanks, business associations and other NGOs
- ✓ OECD Anti-Bribery Convention
- ✓ Internationally accepted accounting standards
- ✓ Good standards of corporate governance
- ✓ Continue strengthening general OECD guidelines

Demand-side Recommendations

- ✓ Establish sound procurement codes
- ✓ Require independent audits
- ✓ Legal reform and simplification
- ✓ Inventory of legal barriers and duplicative regulations
- ✓ Reduce the “shadow” economy
- ✓ Simplify tax codes
- ✓ Salaries of the civil servants have to be competitive with private sector ones
- ✓ Transparency in the financial/banking sector

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