Case Studies on

Public Policy

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OVERVIEW

Rostow's theory of economic growth states that countries would like to modernise themselves through five stages: the traditional society stage, transitional stage, preconditions for take-off stage, drive to maturity stage and the age of high mass-consumption stage. The first stage is characterised by increase in productivity, no modern science and low literacy rate. The second stage includes growth in modern techniques in agriculture and production, infrastructural development and growth in social institutions. The stage of take-off features normal growth patterns, rapid agricultural growth and industrial modernisation. The stage of drive to maturity includes increased technological involvement and internationalisation. The last stage of this model features production and consumption of durable goods and services. In this process of modernisation, the role of government needs to be analysed at each stage. Analysts opine that the involvement of government is more pronounced in the first few stages than in the later stages. This role and involvement narrows down with every stage of economic development, although this point is debatable.

Role of the Government in Economic Development:

Phase I (1940 to 1979): During this phase, the government played a primary role in the state. Governments throughout the world tried to propel the economy from an uncoordinated, low-income, no-long-run-growth static equilibrium into a coordinated, high-income, dynamic equilibrium growth course. As a solution to the structural and coordination failures, government played an active role by subsidising investments, coordinating investment activities and undertaking direct investment from the government budget. The government was a prime mover of growth. In the late 1950s, there was a dearth of entrepreneurial abilities and no industrialists were willing to take up projects even with high rates of return. In the absence of private entrepreneurship, governments had to continue undertaking industrial projects and also foster the growth of private entrepreneurs.

Problem Phase: But this government-sponsored subsidisation led to incorrect relative factor prices. Many economies that were stuck with the planning mode experienced slow growth and stagnation during the 1970s. The government subsidisation led to underpricing of capital, relative to its true scarcity and overpricing of labour, both relative to capital and scarcity and hence, capital-intensive technology. The solution was to steady the prices by reducing direct and indirect subsidies to industries. It was felt that government intervention should be curtailed, as its effects had been counterproductive.

Phase II (1979 to 1996): Governments emphasised international trade in this phase to provide for the low domestic (aggregate) demand. It tried to remove barriers to international trade for overall economic development and sustained growth. At the culmination of this neo-classical age, the government was posing a problem rather than being a solution to underdevelopment. The governments became corrupt eventually and the intervention through tariffs, subsidies and quotas gave rise to economic inefficiencies. This period was marked with a slowdown in the world economy – recession in Japan, Europe and the US; increase in trade restrictions in the developed countries; rise in world interest rates and an effective devaluation of currencies against the dollar; second oil shock and debt crisis in developing countries; constraints in balance of payments and decline in standards of living. So, the developing countries had to depend on International Monetary Fund (IMF) and World Bank for economic stability.

The Comeback Phase: Many economists and experts realised the importance of the state role in the economy. The policy-makers of many countries realised that governments in the East and South Asian countries played a very active role in the economic development. These governments, in the midst of crisis, shifted from import-substitution to export-promotion, devalued to promote expenditure, undertook market-based policies, continued to invest in infrastructure and human capital rather than adopting deflationary expenditure and macroeconomic policies and restrictive import and wage practices. The importance of government stance led to a mix of state and market interactions in which governments played an effective role in finance, investments, human capital, technology, industrial reforms, etc. Development economists viewed that governments needed to play a strategic role in the economic development. Economists including Adam Smith suggested selective interventions in the marketplace. According to the American economist Joseph Stiglitz, "The real issue that both the success of East Asia and the failure of the socialist experiment raise is, *what is the appropriate role of government in economic development?* There is a third way – or, I should say, many third ways – between the extremes of total government control of the economy and complete laissez faire."[1]

The most important role of the government has been the promotion of education in many developed economies. In the US and East Asian economies, Federal governments realised the importance of public university system. The next important role of the government had been promotion of technology. The US Constitution had long recognised the importance of science and technology. Its government supported research, modern telecommunications system, Internet and established a framework for intellectual property rights. The third most important role of the government was to make legislations for financial stability. It created a Federal or central reserve system and financial intermediaries to activate the dormant markets yet another important role for the government was to develop infrastructure for promoting competition. Such investments included those in roads and communications system. Governments also tried to establish property rights, contract laws, bankruptcy laws and policies to promote competition.

Government's Role in Business

Governments play an important role in educational, technological, financial, physical, environmental and social infrastructure for economic development. This way, government

[1] Stiglitz Joseph E., "The Role of Government in Economic Development", http://www.economics.uci.edu/~dbell/Stiglitz_Role%20of%20Government.pdf

creates an environment, which is appropriate for the businesses to establish and flourish. Its basic role is to achieve macroeconomic and political stability by establishing government institutions, economic framework, macroeconomic policies, prudent government finances and curb inflation. Another important role is to establish overall microeconomic rules and incentives ruling competition that would encourage productivity. These include a competition policy, tax system, intellectual property rights and laws, investment laws providing consumer recourse, corporate governance rules and regulatory processes for promotion of innovation. Government policies for industry aim at sustained economic growth. Through the monetary policy, the government manages money-supply within a country to constrain inflation, maintain exchange rate, and achieve full employment and economic growth. Fiscal policy is a macroeconomic tool that ensures setting a level of expenditure. It helps the government manage the overall economy. It also includes changes in government expenditure, borrowing and taxes to control the economy.

Critics argue that government interventions in business have often been counterproductive. There had been heavy government intervention during the financial crisis that brought about financial stability; but this intervention raised issues about corporate governance and transparency. Over-borrowing and over-investment on the part of the Korean Chaebol (the Korean corporate conglomerates) followed as they became multinationals, and their activities became less transparent and more difficult to monitor.

But in emerging economies, when the markets failed, the governments intervened and stabilised the economies. The government provided incentives, subsidies and enforced laws and policies in favour of the businesses. In many cases, governments encouraged entrepreneurship, tried to eliminate destructive competition, engaged in selective protection from imports and restricted foreign investments. Statistical evidence proves that government intervention in industry had been effective in the past.

Studies reveal that the size of the government as a share of the economy has only increased substantially over the years. Exhibit I illustrates the growth of the government in the OECD (Organization for Economic Cooperation and Development) countries. From 1960 to 1996, there had been a staggering growth in government expenditure as a share of GDP (gross domestic product). But studies also reveal that large governments have retarded economic growth particularly in high-income countries. According to experts, the size of the government needs to be reduced in order to increase economic growth.

But, according to the OECD statistics, the government share of some countries has reduced to some extent after 1996 (Exhibit II). Governments across the world are trying to reduce their size for long run economic development.

Exhibit I

The Size of the Government in OECD Countries: 1960-1996

Total Government Outlays as a Percentage of GDP

Country	1960	1970	1980	1990	1996	Increase 1960-96
Australia	21.2	25.5	34.0	37.7	37.5	16.3
Austria	35.7	39.2	48.9	49.3	52.7	17.0
Belgium	34.5	36.5	50.7	54.6	54.5	20.0
Canada	28.6	35.7	40.5	47.8	46.4	17.8
Denmark	24.8	40.2	56.2	58.6	60.8	36.0
Finland	26.6	31.3	36.6	46.8	59.4	32.8
France	34.6	38.9	46.1	49.9	54.7	20.1
Germany	32.4	38.6	48.3	45.7	56.0	23.6
Greece	17.4	22.4	30.5	49.6	49.4	32.0
Iceland	28.2	29.6	32.2	39.9	37.3	9.1
Ireland	28.0	39.6	50.8	40.9	37.7	9.7
Italy	30.1	34.2	41.9	53.8	52.7	22.6
Japan	17.5	19.3	32.6	31.9	36.9	19.4
Luxembourg	30.5	33.1	54.8	45.5	49.3	18.8
Netherlands	33.7	46.0	57.5	57.5	58.1	24.4
New Zealand	27.7	34.4	47.0	50.0	42.3	14.6
Norway	29.9	41.0	48.3	51.3	46.4	16.5
Portugal	17.0	21.6	25.9	41.9	46.0	29.0
Spain	13.7	22.2	32.9	43.0	45.4	31.7
Sweden	31.0	43.7	61.6	60.8	66.1	35.1
Switzerland	17.2	21.3	29.3	30.9	36.9	19.7
United Kingdom	32.2	39.2	44.9	42.3	43.7	11.5
United States	28.4	32.5	33.7	34.8	34.6	6.2
Average	27.0	33.3	42.8	46.3	48.0	21.0

Sources: OECD Economic Outlook, Dec. 1997 (for 1996 data); OECD Historical Statistics (various issues); IMF Government Finance Statistics Yearbook, 1994 (for 1990 Luxembourg data); New Zealand Official Yearbook, various issues (for New Zealand data) and Economic Report of the President, 1997 (for U.S. data). The data for Switzerland are for current government expenditures only.

Source: Lawson Robert, et al., http://www.house.gov/jec/growth/function/function.pdf, April 1998

Exhibit II

Total Government Outlays as a Percentage of Nominal GDP

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Australia	36.3	35.5	36.2	37.9	39.7	39.8	39.4	39.2	38.0	37.0	36.9	35.8	35.7	37.5	36.4	36.1	35.9	35.7	35.5	35.5
Austria	53.2	51.7	51.5	52.4	53.0	56.0	55.6	56.0	55.5	53.0	53.5	53.2	51.4	50.8	50.7	50.6	49.9	49.5	48.6	48.2
Belgium	53.6	52.0	51.9	52.9	53.2	54.2	51.9	51.4	51.9	50.5	49.8	49.5	48.6	48.4	49.0	50.1	48.7	49.1	49.0	48.9
Canada	45.4	45.8	48.8	52.3	53.3	52.2	49.7	48.5	46.6	44.3	44.8	42.7	41.1	42.0	41.3	40.9	39.9	39.5	39.6	40.0
Czech Republic[1]	..	..	..	..	..	..	..	54.4	42.8	42.4	43.8	42.9	42.1	45.0	46.9	53.5	44.6	44.2	43.0	42.4
Denmark	55.7	56.1	55.9	56.5	57.5	60.6	60.4	59.5	59.1	57.1	56.8	55.8	53.9	54.5	55.2	55.2	55.1	54.0	53.0	52.1
Finland	46.6	44.7	48.3	57.1	62.3	63.6	62.2	59.0	59.3	56.0	52.4	51.7	48.8	48.8	49.7	50.7	50.8	50.9	50.6	50.6
France	49.9	48.8	49.3	50.5	51.7	54.3	54.2	54.4	54.5	53.7	52.6	52.6	51.6	51.5	52.6	53.6	53.5	53.9	53.6	53.0
Germany[2]	45.3	44.0	44.5	46.1	47.3	48.3	47.9	48.3	49.3	48.3	48.1	48.2	45.1	47.5	48.0	48.3	47.0	46.8	45.7	45.0
Greece	44.0	45.4	50.2	46.7	49.4	52.0	49.9	51.0	49.2	50.1	49.5	49.5	52.1	50.2	49.7	49.9	49.8	47.7	47.1	46.9
Hungary	..	..	..	57.2	60.8	60.3	63.9	56.9	53.9	51.8	51.9	49.6	47.9	48.5	52.1	49.8	49.7	50.3	48.9	48.8
Iceland	41.9	44.4	41.7	43.0	44.0	43.8	43.7	43.0	42.6	41.5	42.1	43.1	42.7	43.8	45.8	47.7	47.3	45.0	43.5	43.2
Ireland	48.5	42.7	42.9	44.5	44.9	44.7	43.9	41.2	39.3	36.8	34.4	34.1	31.5	33.2	33.4	33.5	33.7	35.8	35.2	35.2
Italy	51.5	52.8	54.4	55.5	56.7	57.7	54.5	53.4	53.2	51.1	49.9	48.9	46.9	49.2	48.5	49.3	48.7	49.2	48.5	49.0

Contd...

Japan[3]	31.9	31.1	31.8	31.6	32.6	34.3	34.9	35.9	36.4	35.1	36.2	37.8	38.3	37.8	38.3	37.6	37.5	37.4	37.6	37.8
Korea	18.1	19.2	20.0	20.9	22.0	21.6	21.0	20.8	21.7	22.4	24.7	23.9	23.9	25.0	24.8	30.9	30.9	30.9	30.9	31.1
Luxembourg	..	..	43.3	44.6	46.5	45.7	44.7	45.0	45.4	43.7	42.1	41.6	38.6	39.1	43.7	45.0	45.2	46.1	45.4	44.7
Netherlands[4]	54.3	52.3	52.5	52.6	53.5	53.7	51.4	49.3	47.6	46.3	45.3	45.0	43.4	45.4	46.2	47.1	46.6	47.7	48.1	46.6
New Zealand	52.7	52.0	53.3	51.5	49.5	46.0	43.0	41.9	41.0	41.7	41.4	40.5	39.3	7.8	37.4	36.7	36.4	37.6	38.5	39.0
Norway	52.6	52.2	54.0	54.9	56.2	55.1	54.1	51.5	49.0	47.2	49.6	48.1	42.7	44.3	47.5	48.9	46.7	46.1	46.3	46.5
Poland	..	..	..	..	..	..	..	51.3	51.2	50.2	48.5	48.1	44.9	44.7	45.6	45.8	44.7	42.8	43.0	42.4
Portugal	37.1	37.4	40.6	43.5	44.6	46.0	44.3	43.4	44.1	43.0	42.3	43.7	43.7	44.8	44.7	46.2	46.5	47.6	47.5	47.1
Slovak Republic	..	..	..	..	..	..	51.0	46.4	52.4	49.6	45.2	47.4	50.9	43.8	43.8	39.7	40.6	40.2	39.9	39.0
Spain	40.0	41.3	42.5	43.9	44.9	48.4	46.3	44.1	42.9	41.0	40.7	39.2	38.9	38.4	38.7	38.3	38.8	38.5	38.6	38.7
Sweden	60.1	62.1	61.9	63.3	71.8	73.0	70.9	67.7	65.3	63.0	60.7	60.3	57.4	57.0	58.4	58.7	57.3	57.2	57.1	56.3
Switzerland	..	..	30.0	31.7	33.8	34.7	34.7	34.6	35.2	35.6	36.1	34.6	33.9	34.8	35.7	36.7	36.7	36.9	36.5	36.1
United Kingdom	41.1	40.5	42.2	44.0	46.1	46.1	45.3	45.0	43.1	41.5	40.2	39.7	37.5	41.0	41.7	43.3	43.9	44.9	45.4	45.7
United States[5]	36.2	36.1	37.1	37.8	38.5	38.0	37.0	37.0	36.5	35.4	34.7	34.3	34.2	35.3	36.3	36.7	36.4	36.6	36.9	36.6
Euro area	47.8	47.2	48.0	49.3	50.4	52.0	50.9	50.5	50.7	49.3	48.6	48.2	46.4	47.5	47.8	48.3	47.7	47.9	47.3	46.9
Total OECD	39.6	39.3	40.2	41.3	42.4	42.9	42.1	42.1	41.8	40.6	40.2	40.0	39.1	40.1	40.7	41.3	40.8	40.9	40.9	40.7

Contd...

Note: Data refer to the general government sector, which is a consolidation of accounts for the central, state and local governments plus social security. Total outlays are defined as current outlays plus capital outlays. One-off revenues from the sale of mobile telephone licenses are recorded as negative capital outlays for countries listed in the note to Table 27. See OECD Economic Outlook Sources and Methods (http://www.oecd.org/eco/sources-and-methods).

1 In 1995, data reflect the large privatisation campaign which transferred some public enterprises to private ownership through vouchers distributed to the population, representing some 9.8 percentage points of GDP. In 2003 the activation of State guarantees, mainly for the banking sector, accounts for 6.4 per cent of total outlays.

2 The 1995 outlays are net of the debt taken from the Inherited Debt Funds.

3 The 1998 outlays would be 5.3 percentage points of GDP higher, if it included central government's assumption of the debt of the Japan Railway Settlement Corporation and the National Forest Special Account. The 2000 outlays include capital transfers to the Deposit Insurance Company.

4 The 1995 outlays would be 4.9 percentage points of GDP higher, if capital transfers to a housing agency offering rentals to low income people were taken into account.

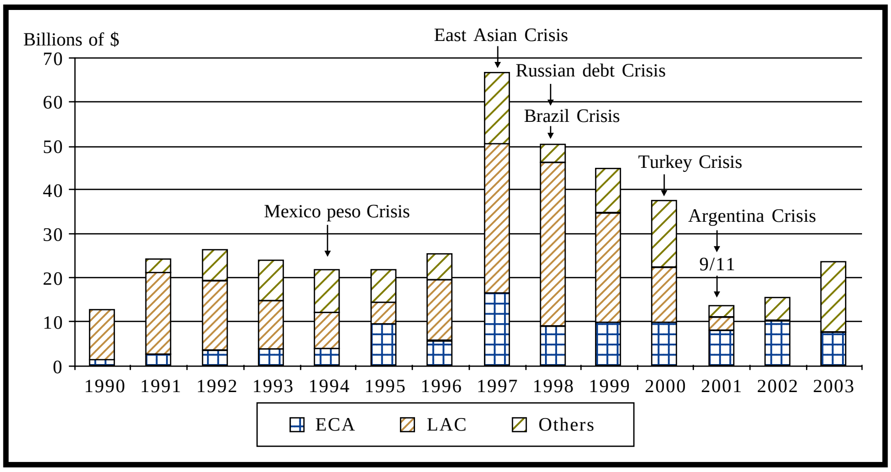
5 These data include outlays net of operating surpluses of public enterprises.

Source: "Total Outlays", http://www.oecd.org/dataoecd/5/51/2483816.xls

The privatisation of enterprises also suggests that government ownership had declined over the years. The number of transactions per country has only been growing. In the early to mid-1990s, privatisation gains in developing countries averaged between $20 billion and $30 billion annually (Exhibit III). Research also revealed that while the total FDIs slowed down from 2001, privatisation profits picked up modestly.

Exhibit III

Global Privatisation Proceeds



Source: "Privatization: Trends and Recent Developments", http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/ IB/2005/11/08/000016406_20051108153425/Rendered/PDF/wps3765.pdf, November 2005

According to research findings, government ownership is still prevalent in many developing countries. In most countries, water, electricity, telecommunications, railways, airlines and petroleum products are still state-owned and operated. In the sub-Saharan Africa, most sectors are government-owned; in the Middle East and North Africa, critical services are government-owned. In China, state plays a dominant economic role but it is slowly declining over the years. India has dominant state ownership. In Europe and Central Asia, the private sector's share has increased, whereas in Latin America, private sector's contribution to GDP is more than that of the public sector. In Mexico, the share of public enterprises in GDP declined from 15% in 1982 to less than 5% in 2001, as per OECD survey.[2] Economists including Adam Smith believed that in the course of time, private ownership would become more efficient than public ownership.

[2] "Privatization: Trends and Recent Developments", http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2005/11/08/000016406_20051108153425/Rendered/PDF/wps3765.pdf, November 2005

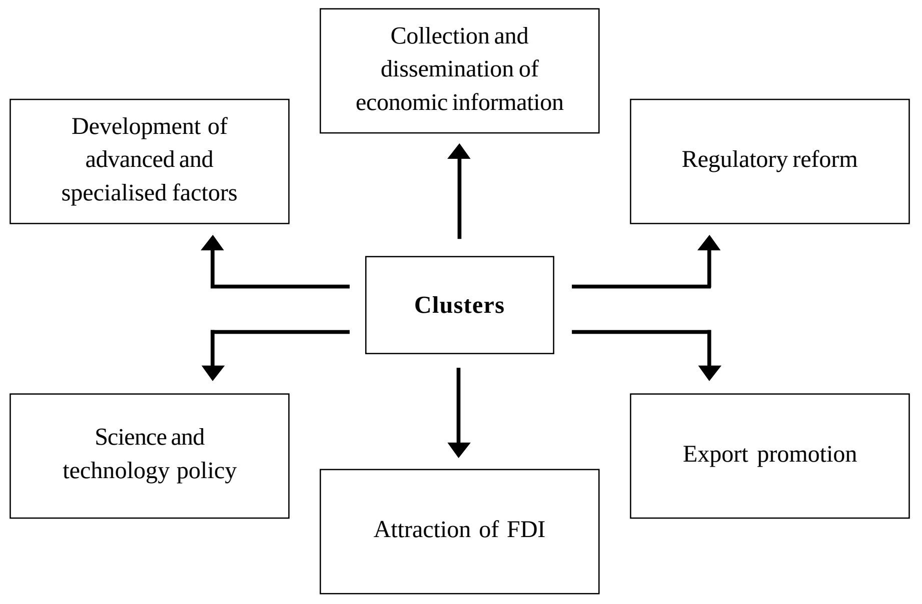
What should the Government do?

Analysts opine that governments need to play a dynamic role in the economy. They need to modify their policies and practices for the industrial development. They need to stir competition by motivating the private sector and by giving incentives to the public sector institutions. This leads to competitive business environment. Governments need to expand international trade for different economies of scale and enable changes in the economic structure. Analysts also suggest that governments need to reinvent their role continually and improve the performance through customer orientation, monitoring and rewarding performance, extend the competition and spur corporatising, privatising and improve the regulatory policies.

Governments can also play an effective role in developing and upgrading cluster (a geographically proximate group of interconnected companies and associated institutions in a particular field, linked by commonalities and complementarities). Clusters enjoy different economies of scale and the cluster-based framework can guide and influence government policies (Exhibit IV). Hence, government policies should upgrade clusters as they attract many opportunities for productivity and improve the industrial sector in the country. A successful government ensures cluster development through opening up the markets for imports, creation of new financial markets and flexible legal and regulatory framework.

Exhibit IV

Clusters and Economic Policies



Source: Porter Michael E., "Clusters and Competition: New Agendas for Companies, Governments, and Institutions", *Harvard Business School Press*, 1998 [ECCH Ref. No. 2034]

This book features case studies like *Chaebol Reforms* and *South Korea's Chaebol* that emphasise the exclusive role of the government in the overall economic development, particularly during an economic crisis. The case study *SME's in Thailand* highlights the measures adopted by the government to SME's GDP contribution. The case study, *Chinese State-Owned Enterprises: The Challenges*, discusses the importance of state-owned enterprises (SOEs) as the economic drivers dominating the capital-intensive industry.

Indian Railways – The Cost of Public Service thrashes out the challenges of the largest public sector unit of India with a debate on privatisation. The case study *Russia: Taming the Oligarch?* discusses the hurdles due to privatisation (1990s) in Russia, while the case study, *French Bailouts* delves into a debate on the free trade and the protectionist policies of the French government.