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The Role of Government: Promoting Development or Getting Out of the Way*

The state's role in society is to provide the legal framework and physical security for private economic activity.

Of all the tasks assumed by government, none is more inappropriate than that of promoting economic development. It is rare to find an American politician who doesn't act as if the state were duty-bound to generate businesses, jobs, wages, and profits. This mistake is common enough in the industrialized West. It has proved to be even more pervasive—and harmful—throughout the Third World.

For decades development economists and foreign aid officials acted as though growth came from government. Indeed, some believed that promoting development was government's most important role in society. Thus, poor countries were to undertake *dirigiste* economic programs. And rich ones were to offer foreign aid programs.

Alas, the result has been a dismal failure: Many underdeveloped states have actually been growing poorer. Economic growth will come only when governments realize that their proper role is to stay out of the way, to stop impeding the development that would naturally occur but for state intervention.

History of Development Theory

Extensive state economic intervention has long existed around the world, including the West, for political as well as philosophical reasons. Such policies have been especially evident throughout the twentieth century. In particular, the vast majority of Third World states traveled the socialist path as decolonization proceeded after World War II. Their decision was in part nationalistic; many new countries believed that true independence required indigenous control of economic resources. Statism also tended to benefit, both economically and politically, the elites that gained power after independence.

But there was also a genuine belief that the government had to guide the development process. Said Ghana's Kwame Nkrumah: "Only a socialist form of society can assure Ghana of a rapid rate of economic progress without destroying that social justice, that freedom and equality, which are a central feature of our traditional way of life."

A Western Import

This *dirigiste* philosophy was not, however, based on local tradition. Indeed, the very concept of development was an alien idea introduced by the West. Having helped ordain the goal of rapid industrialization, Western politicians and economists also played a major role in developing the statist strategies that many Third World nationalists were to call their own. Many Westerners have acted as the sirens in Homer's *Odyssey,* luring Third World economies, instead of wandering seafarers, upon the rocks. Perhaps the most important of these was Lenin. While Marx, ironically, viewed the colonial experience as a progressive force in the undeveloped world (in *The Communist Manifesto,* he lauded the potential of capitalism to transform such societies), it was Lenin, in *Imperialism: The Highest Stage of Capitalism,* who specifically applied socialist principles to underdeveloped states.

The British Fabian socialists argued for a more gradual collectivist transformation. According to Indian economist Jagdish Bhagwati, this approach exercised "a powerful impact through the large numbers of the Indian elite that were processed through the English educational institutions prior to Indian independence in 1947." Other developing countries—especially other former British colonies—looked to Fabian principles as they structured their economies.

Along with the philosophy came practical economic controls. The policies promoted by the London School of Economics eventually suffused the British Colonial Office. Many officials in London as well as colonial governors, writes P.T. Bauer, "took for granted the case for the most diverse forms of state economic intervention." Business licensing, trade restraints, agricultural marketing boards, and more were part of the administrative apparatus handed over to many new governments when countries gained independence.

Western development economists, who advised both underdeveloped states and Western aid agencies, generally leaned toward the so-called "structuralist school," which treated developing economies as inflexible and unresponsive to market forces. Leading proponents of this view included Gunnar Myrdal, Albert Hirschman, Hans Singer, Ragnar Nurkse, and Paul Rosenstein-Rodan.

Anti-Capitalist Bias

So pervasive was the anti-capitalist bias in terms of Third World development that even economists who recognized an important role for the private sector in advanced economies viewed developing states differently. Wrote Robert Heilbroner, "in the great transformation of the underdeveloped areas, the market mechanism is apt to play a much smaller role than in the comparable transformation of the West during the industrial revolution." Heilbroner saw the need for more than just active public-sector management: "Powerful, even ruthless, government may be needed."

The most fundamental principle of collectivist development dogma was the need for central planning. Development specialists like Myrdal advocated a ubiquitous public sector: "One of the most serious shortcomings of policy in the countries in which comprehensive planning has been undertaken is the failure to plan more ambitiously and on a larger scale."

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* This article, by Doug Bandow, is reprinted from the March 1997 issue of The Freeman, a monthly publication of the Foundation for Economic Education, Inc., 30 South Broadway, Irvington-on-Hudson NY 10533. Mr. Bandow, a monthly columnist for The Freeman, is a Senior Fellow at the Card Institute and the author and editor of several books, including *Perpetuating Poverty: The World Bank, the IMF, and the Developing World.*

Finally, even some Western economists who did not advocate full government economic planning nevertheless endorsed the sort of micromanagement that has been increasingly recognized as a failure in the industrialized nations. Expansive fiscal and monetary policies, for instance, were a Keynesian norm. Equally persistent was pressure on developing countries to increase taxes.

Revisionist Economic Thinking

These theories dominated international economic policy for about four decades following World War II. But reality finally intruded as it became evident that the different statist economic theories had been put to the test and found wanting. By 1989 history had clearly rendered its judgment on collectivism. The obvious lesson of this experience has received increasing acceptance: Without relatively open markets, little development will occur, irrespective of the efforts of governments in poor or rich nations.

What Causes Development?

The West's dramatic escape from poverty has always been a good place to start in attempting to understand development. The rapid economic and social progress of Europe, during which people first rose out of the dismal poverty that characterized most of human history, was largely limited to a specific kind of regime—classical liberalism. The resulting systems generally allowed markets to operate, respected the rule of law, protected private property, and permitted competition. Historian Ralph Raico explains that the "European Miracle" developed because of greater market autonomy, which was possible only through "the inhibition of the predator-state." Obviously, individual national experiences varied, but the grand sweep of history presents powerful evidence that the West's development was not accidental. Observed economist David Osterfeld in his well documented book *Prosperity Versus Planning:* "The likely relationship between the West's economic institutions and its economic growth and development cannot be ignored."

This experience has been repeated rather more quickly and notably in East Asia, where it has taken but a generation or two for desperately poor nations to develop among the world's most successful economies. (This is not to say that all these were exemplars of laissez faire. Rather, all broadly relied on market forces, despite varying degrees of government economic involvement.) What makes the East Asian experience so important is that it is more recent and reflected a conscious break with the reigning collectivist consensus, and succeeded so spectacularly.

Lessons for Developing Nations

What was true of Great Britain, the United States, Japan, and South Korea is also true of today's successful developing states. Perhaps the best broad-based study of economic policies over the last two decades is *Economic Freedom of the World: 1975-1995,* by economists James Gwartney, Robert Lawson, and Walter Block. They created an index of 17 component parts to measure economic freedom, as well as three alternative summary indexes. Ranked highest were Hong Kong, Singapore, the United States, and New Zealand. At the bottom came numerous Latin American and African countries. Most improved between 1975 and 1990 were Chile, Iceland, Jamaica, Malaysia, and Pakistan.

Although, as noted earlier, international comparisons are fraught with difficulty, two particularly important lessons emerge. First, economic policies matter. Report Gwartney, Lawson, and Block:

> The 14 countries that earned a summary rating grade of either A or B in 1993-1995, achieved an average annual growth rate in per capita real GDP of 2.4 percent during 1980-1994 and 2.6 percent during 1985-1994. In contrast, the average annual growth of per capita real GDP for the 27 countries with a summary rating of F- in 1993-1995 was *minus* 1.3 percent during 1980-1994 and *minus* 1.6 percent for the 1985-1994 period. Twenty-one of the 27 experienced *declines* in real per capita GDP during 1980-1994.

Obviously, the results for individual countries may be affected by many factors. But the overall result is compelling. Explain the authors: "No country with a persistently high economic freedom rating during the two decades failed to achieve a high level of income. In contrast, no country with a persistently low rating was able to achieve even middle income status."

Second, changes in economic policy affect national growth rates. According to the study, the 17 nations with the greatest increases in economic freedom enjoyed an average annual growth rate of 2.7 percent in per capita GDP from 1980 to 1990, and 3.1 percent from 1985 to 1994. All 17 grew, while 11 of the 16 nations with the largest drops in economic freedom suffered a decline in per capita GDP.

Similar are the results of the *1996 Index of Economic Freedom,* written by Heritage Foundation analysts Bryan Johnson and Thomas Sheehy. They explain that their analysis "demonstrates that economic freedom is the single most important factor in creating the conditions for economic growth and prosperity." Their data also demonstrate that countries which place the greatest reliance on open markets consistently have the highest growth rates.

Studies by other analysts and organizations yield the same general conclusion. Researchers at Cornell University and the Organization for Economic Cooperation and Development (OECD) have used a computable general equilibrium (CGE) economic model in an attempt to measure the impact of different policy measures. Market-oriented reforms in exchange-rate, fiscal, and monetary policies all improve economic growth rates.

A decade ago economists E. Dwight Phaup and Bradley Lewis surveyed a dozen "winners" (with average annual growth rates exceeding six percent) and a score of "losers" (average growth rates below 2.2 percent a year). The average annual growth rates were 7.7 percent and one percent, respectively. Phaup and Lewis concluded: "It would appear that whether LDCs are winners or losers is determined mainly by their domestic economic policies. Resource endowment, lucky circumstances, former colonial status, and other similar factors make little difference in the speed with which countries grow economically. The results of domestic policy choices pervade every economic area."

Phaup and Lewis found that growth rates correlated well with an index for overall economic distortion, such as price controls. Similar was the role of trade. Countries that relied on exports grew far faster than those which practiced import substitution. The two economists stated: "From this experience it can be concluded that exports cause GDP growth, rather than the reverse, even though exports are normally considered exogenous."

They found that rough indexes regarding "investment climate" yielded similar results. Government spending, in contrast, was adversely correlated with economic growth. Also apparently related to economic growth, though the data did not yield a statistically significant result, were tax revenues. Explained Phaup and Lewis: "There was a difference in the ratio of income taxes to GDP; the average for the slow growing nations was higher. Such a result is consistent with the hypothesis that high and progressive income tax rates muffle incentives and slow productivity growth."

Policy Differences

In 1996 Mancur Olson, Jr., of the Center for Institutional Reform and the Informal Sector at the University of Maryland

(College Park), came to much the same conclusion. He reported that such factors as access to knowledge and capital cannot explain the relative income differences between nations. "The only remaining plausible explanation is that the great differences in the wealth of nations are mainly due to differences in the quality of their institutions and economic policies," he explained. He found that poorer nations with the best economic policies consistently grow the fastest.

Phaup and Lewis relied in part on a detailed World Bank study, published as part of the 1983 *World Development Report.* The Bank assessed the relative economic distortions in 31 primarily developing nations and found that countries with the least interference with the marketplace had annual growth rates twice as fast as those of nations with the most inefficient policies. The more market oriented countries also enjoyed far greater domestic savings, additional output per unit of investment, and increases in both agricultural and manufacturing output. The Bank estimated that inefficient intervention—such as inflationary exchange-rate, fiscal, and monetary policies; price distortions; bad investments; and expansive regulation—could cut annual GDP growth by as much as two percent.

The Bank has focused particular attention on protectionism. In 1987 the institution devoted much of its annual *World Development Report* to trade. It concluded: "The economic performance of the outward-oriented economies has been broadly superior to that of the inward-oriented economies in almost all respects." The World Bank has similarly reported on the impact of agriculture policies. Here, too, it found that inefficient government actions, macroeconomic as well as sectoral, tended to discourage food output, while market-oriented reforms increased agricultural production.

America's Agency for International Development (U.S. AID) has reached similar conclusions. According to U.S. AID: "Recent academic and policy experience has shown a linkage between international trade policy and overall economic progress." Particularly important, in its view, were open trade policies—more outwardly oriented countries grew by upwards of four times as fast as more protectionist states. U.S. AID also pointed to the friendliness of the investment climate to domestic and foreign business alike.

Specific Experiences

These sort of general assessments are reinforced by the results of narrower studies of different regions and nations. For example, David Osterfeld reviewed the economic impact of a range of variables: corruption, food, foreign aid, migration, multinationals, population, and resources. His conclusion was that development occurred most quickly in an "enabling environment" in which the rule of law was stable, property was protected, political power was decentralized, and most of the economy was private. The primary obstacle to sustained economic development, he explained, "is an environment that penalizes individual initiative, is hostile to private ownership, discourages saving and investment, and severely restricts the operation of the free market."

Numerous international examples support this thesis. The East Asian economic powerhouses of today—Hong Kong, Japan, Singapore, South Korea, Taiwan—were much poorer than such Latin American countries as Argentina after World War II. Of the many differences between them, the most important is the economic road taken. Latin America firmly embraced the *dirigiste* model. East Asia chose various forms of capitalism. The nations of Africa, the poorest on the globe, followed Latin America over the abyss of collectivist development strategies.

The city-states of Hong Kong and Singapore possess little other than open economic markets. They have developed nonetheless. Resource-rich countries like Mexico and Zaire have, in contrast, struggled economically for decades. States as varied as Argentina, Brazil, India, and Tanzania failed to prosper so long as they emphasized state-led development plans; all four have since adjusted their policies, leading to greater economic progress.

Lessons from Africa

The World Bank has devoted particular attention to Africa. As far back as its 1981 report, *Accelerated Development in SubSaharan Africa: An Agenda for ACTION,* the Bank concluded that other "factors impeding African economic growth have been exacerbated by domestic policy inadequacies." Thirteen years later, in its *Adjustment in Africa: Reforms, Results, and the Road Ahead,* the Bank went much further. Far from being merely an additional problem, "the public sector lies at the core of the stagnation and decline in growth in Africa." In short, governments were attempting to do far too much, and were doing it badly. Similar have been the results of other research by several Bank economists.

Studies of Brazil, Chile, Pakistan, Philippines, and Turkey in the 1960s concluded that trade restrictions alone were costing these countries between four and ten percent of their GDP. Countries that improved their policies—Brazil, Colombia, and South Korea—significantly improved their employment and output. Sri Lanka changed governments, and economic policies, in 1977; the resulting liberalization had dramatic economic results. A 1993 Bank review of the adjustment experience of 18 developing countries, *Boom, Crisis, and Adjustment,* found that good policies, especially freer trade and macroeconomic stability, were important for economic success. Obviously, every country is the beneficiary or victim of unique circumstances, which makes any one pairing suspect, but the overall picture—South Korea versus North Korea, China versus Taiwan, Asia versus Africa—presents a consistent picture, and is particularly telling when it involves divided cultural groups like Germany, Korea, and China.

Conclusion

Every nation's economic environment is made up of a complex aggregation of individual laws and regulations. All governments, including those in the industrialized West, do dumb things—sometimes out of ignorance, sometimes in response to interest group pressure, and sometimes in an attempt to achieve noneconomic ends. The basic question is whether economic stupidity is the exception or the rule—whether, in essence, the government acts as if its role is to manipulate the economy.

What is needed in America and around the world is not more efficient government—reinvented by "progressive" politicians with slightly greater respect than their predecessors for markets. The real answer is less government. That is, when it comes to development, the state's role in society is to provide the legal framework and physical security for private economic activity, not to act as an agent of economic change itself.

Foreign governments that want to help poorer nations should step out of the way of private development rather than subsidize public enterprises. The history of foreign aid is one of failure—Western assistance for regimes that were simultaneously authoritarian and collectivist ended up making their people poorer rather than richer. In fact, abundant outside aid long inhibited the commitment to reform of even more responsible governments. By masking the pain of economic failure, development assistance allows borrowers to delay market reforms, worsening the underlying problem. The point is, it is necessity, brought on by collectivist and populist economics, that almost always drives the reform process.

Instead of offering new aid programs, industrialized states should reform their

own economies, encouraging faster global growth, and open their markets to Third World products. The latter step is particularly important, since poor nations need to participate in the international economy to grow. The benefit of free access to Western markets would vastly exceed the value of foreign aid now or likely to be offered.

The crisis of international poverty well illustrates the fact that restricting government to its proper role is a matter of economic as well as philosophical necessity. The people of poor nations have learned through painful experience that government cannot create growth. Perhaps U.S. politicians will eventually comprehend that lesson too. ❑

INVESTMENT FLOWS

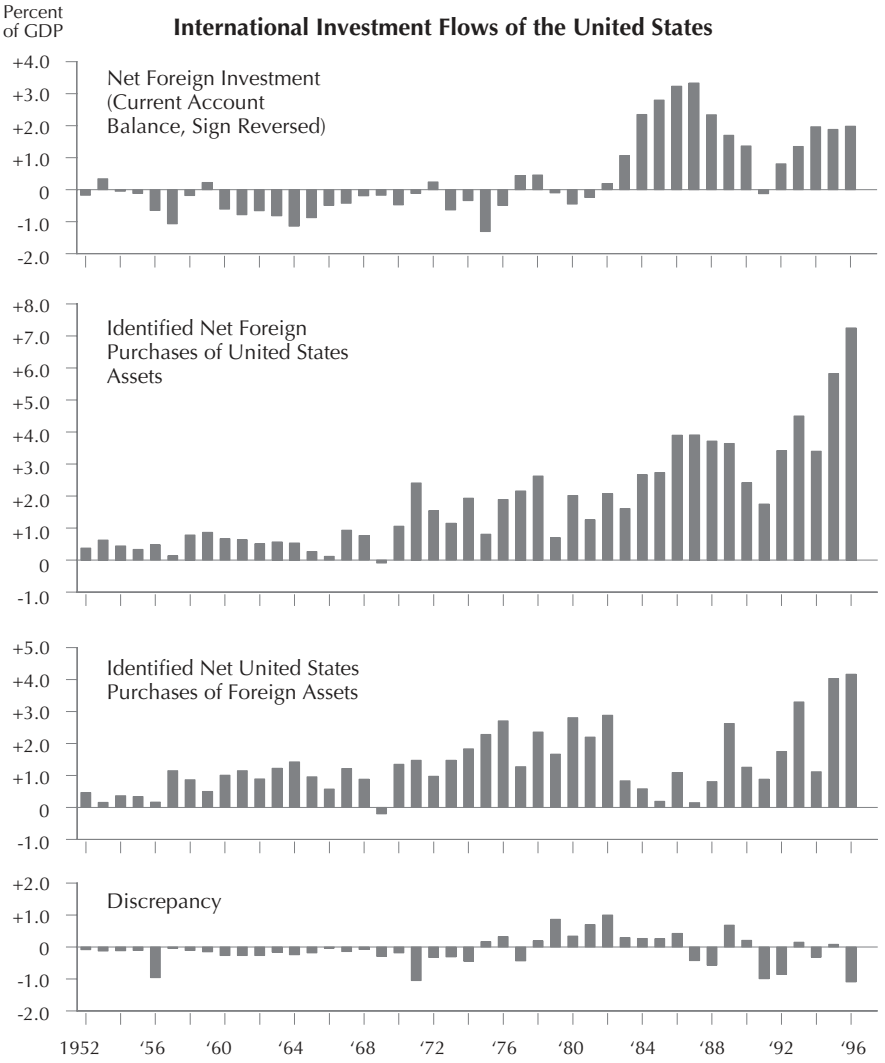
Foreigners are purchasing U.S. assets in unprecedented amounts. This indicates that foreign governments still have much to do to "get their act together."

As the preceding article makes clear, the history of government attempts to foster economic development directly is one of dismal failure. *Dirigiste* policies, in the form of state monopolies and central planning, protective tariffs for "infant industries," price controls, heavy-handed regulation, etc., have proven to be recipes for stagnation and corruption rather than economic growth.

The collapse of communism and the rejection of autarchy in favor of international markets (by all but the most dogmatically socialist regimes) have been most encouraging. But the hyperactive state is not the only barrier to economic progress. In fact, governmental failures to provide secure environments for individuals and their property probably have been a far more common cause of economic backwardness in human history.

Such stability is more significant for investment relationships than for trade in goods and services. In the latter instance, once the goods have been delivered and paid for, no further interaction between buyer and seller is required, but investors perforce expect that their transactions can be reversed (the loan repaid, the asset sold, etc.) in the future. This implies a degree of confidence and trust.

In the United States, much has been made of our international deficit on current account. In the conventional Keynesian accounting framework, this is called net foreign investment, and it is shown in the top panel of the accompanying chart. The notion seems to be that our seemingly chronic deficit reflects our poor competitive status in world markets (trade flows dominate the current account). The next two panels of the chart show the inflows of investment funds to the United States from foreigners and the outflows from U.S. investors to foreign countries. (The bottom panel shows the discrepancy in the accounts and it reflects unidentified flows, which may involve trade as well as investments.)



As this disaggregation of net foreign investment indicates, it has been foreigners' huge and growing appetite for holdings in the United States (increasing to more than 7 percent of our GDP or more than half a trillion dollars in 1996) that dominates these flows.

That foreigners choose to send their capital here, the most developed country in the world, instead of using it in their home countries or in an underdeveloped country (where virtually by definition the potential returns to capital are greatest), is a very sad commentary on the degree to which governments are trusted around the world.

The remedy for this tragic situation is not to make the United States a less attractive place to invest, however. The problem lies abroad and it is the foreigners' problem to solve. ❑

PRICE OF GOLD

	1995	*1996*	*—— 1997 ——*	
	Aug. 10	*Aug. 8*	*July 31*	*Aug. 7*
Final fixing in London	$384.05	$387.60	$326.35	$321.00

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