Chapter 12: Government

The governmental intervention in the economy affects various resorts of economic growth we have already dealt with. It influences the quality and quantity of factor accumulation, both human and physical, either through education (human~), or investment in infrastructure (physical~), but also it yields an impact on the pace of technological change through its patent system. But the most important role of the government regarding the economy is the efficiency to build a profound framework consistent of taxation, administration of laws, regulation and other tools to build a stable basis of economic activities.

In order to analyse different economic policies two perceptions are important:

- **The normative approach**: aimed at advising government on how it should act. It follows the prescriptive path, asking for the ideal behaviour, or what the government should do in order to promote economic growth.
- **The positive approach** rather focuses on the reasoning of governmental acting, why do government react as they do? Attempts to describe rather than prescribe government actions.

Defining government's proper role in the economy: the normative approach

The degree to which a government should intervene in market structures is heavily debated and the answers range from no interaction at all (laissez faire) to complete government control.

Some advocates of governmental interference state that it is necessary to interact as soon as the market cannot supply the features or efficient outcome which would be favourable for the society. Since the market fails to provide those outcomes, we are talking about **market failure**.

We will discuss four different forms of market failure; handling public goods, externalities, monopolies or coordination failures.

Public goods are failed to be supplied by the market because the profit margin is either too low or it is difficult to charge people for the usage. Examples for public goods include airports, infrastructure, education or even national defence.

A second reason for governments to interact because of market failure is the phenomenon of externalities. **Externalities** are incidental influences of an economic activity on people who are not involved in that activity. Take for example the externalities of education; that is the indirect influence of a person's education on his direct environment.

Many economists assume that the benefit of one person's education benefits the society even more than him, e.g. because he might persuade other people to follow an education or will just have a positive influence on his environment. Those externalities are not taking into account by the individual decision maker, e.g. the student who faces the decision whether to persuade more years of schooling or not.

Therefore the government needs to stimulate activities which will evoke positive externalities. Similarly, negative externalities are often a by-product of market operating firms, e.g. pollution of a plant, and need to be constraint by regulations from the government.

In addition, the existence of **monopolies** requires the interaction of governmental regulation in order to prevent the sole company of too much market power and inefficient high prices. The fourth market failure reason to intervene is potential **coordination failures**, including the coordination of flows of in the coordination of business chains. If a firm does not want to invest in a certain business because it fears that there are no appropriate suppliers for it.

Firms which want to supply think that there is no market. The government has to interact in that communication stagnancy.

Besides the reason of market failure to interact, the government has, depending on the political view, the role of redistribution of income.

The main argument of the advocates who argue for a limited or no intervention from the government is the possibility of **government failure**, i.e. that a government does not have the ability (e.g. quality of the officials) to interact in the market. If the government failure is greater than the market failure, caused e.g. by a monopolist, the overall damage will be larger than without the government interaction. That phenomenon is called **equity-efficiency trade-off**.

The implications of contra government invention are **privatization**; handing over former governmental activities to the private sector and **deregulation**; removing governmental supervision from private companies.

After World War II, Europe experienced an increasing government interaction in form of welfare states, including national health care, unemployment insurances or pensions. That trend reversed at the end of the 20th century, less government interaction more privatization and deregulation

How government affects growth

The impact of government invention can have varies roles, we will focus in particular on the three aspects: Rule of law, Taxation and efficiency, the practice of governmental planning.

1. Rule of law

One of the most important public goods that governments provide is the rule of law. By providing a legal, juridical framework for business interactions (e.g. contracts) the government creates a plan-able, stable certainty for economic activity. The result of an effective rule of law can be seen in a strong correlation between productivity and rule of law.

2. Taxation and efficiency

The prime influence of government on the economy is through taxes; the bigger the governmental expenditures the bigger the need for revenue (through mostly taxes). As the income of a country rises, the governmental spending rises more than proportionally, because a bigger and more developed economy requires more regulation. That increase of government expenditures as an economy develops is called **Wagner's law** (formulated by Adolph Wagner 1883). That law implies that developing countries should have less government expenditures, but the opposite can be observed in many developing countries. Many have higher government spending than today-developed countries at that stage.

Consider a market situation with a downward sloping demand and an upward sloping supply curve. Under free market conditions, the quantity supplied (price paid) is at its market equilibrium.

The market is working efficient. Imposing a tax on the good traded, will increase the amount paid by costumers and decrease the price received by the suppliers (See page 361). Therefore it will drive a wedge between the prices of demanders (pay) and suppliers (receive). That wedge represents the tax collected by the government per unit traded. The quantity traded (please note: less than with free market equilibrium) is called the **tax base.** After multiplying it with the tax collected per unit you get the total tax revenue.
The larger the tax collected per unit, the less the quantity is traded, and the bigger is the inefficiency on the market.

3. Governmental planning

For the reasons above a government might decide to intervene strongly in the economy and plan economic activities central. Even though economists with a free-market orientation stress the failure of central governmental planning, there are some successful examples, in which government intervention lead to high economic growth.

South Korea and Taiwan, for example succeeded with a mix of public enterprises and infant industry protection to reach a high level of growth and development. The reasons why government planning worked well are that the bureaucracy worked efficient and that public enterprises had to function after the profit seeking aspect and could be therefore easily transformed into private enterprises. But in most cases, the central planning policies did not succeed to encourage economic growth.

The strategies used to enforce governmental planning are: State enterprises, marketing boards, Trade restrictions.

- *State enterprises*: Companies, that are owned by the government are especially crucial in key sectors, like banking or raw material industries. Even though they are not privately owned they should fulfil the criteria of private owned companies, e.g. profit seeking.
- *Government-owned banks*: In no industry has government control been viewed as being more important than in banking. Government-owned banks have in theory enormous leverage to overcome market failures. Control of banking also allows the government to accomplish social objectives such as distributing resources to unprivileged population groups or regions.
- *Marketing Boards*: Those governmental owned boards have the function to buy farmers output and sell further on the international market. By centralizing the farmer's crops, the government hopes to obtain a higher price on the world market, as if the farmers would gain if they sold it individually.
- *Trade restrictions:* In order to protect the domestic industry, government might impose quotas (i.e. limited number of imports) or tariffs (i.e. taxes on imports) for foreign imports. Quotas or tariffs shall often help infant industries, e.g. new founded industries and protect them from international competition. But by imposing trade restrictions, the government might assist to build up an inefficient industry because pressure from competition is missing.

A country that is caught in a **conflict trap** may not differ in any fundamental way from a country that is peaceful and prosperous. Circumstances and luck may have been all that made the difference.

The positive approach:

Why Governments react in an unfavourable way for the economy

Until now we considered the normative approach in order to describe what governments should do. But in some case the normative and positive, i.e. what they should do and what they actually do differ; in this section we will try to assess reasons for this gap.

1. Different intentions

The government might do things in order to enhance the national interest, which might not be favourable for the economy. Therefore, the government and the economy are not always aiming for the same goal. Other examples for that gap are minimum wages (beneficial for the national interest but not for the economy) or pollution reductions by companies.

2. Corruption, Kleptocracy and the economic effect

Corruption in governmental structures hinders efficient bureaucracy and therefore the efficient development of the economy. The form of corruption that occurs in very high levels of the state is called **Kleptocracy** (i.e. "rule by thieves"). The impact of corruption on the economy can be seen in two phenomena;

- The first is that the efficiency of production is decreased due to the possibility that governmental contracts are not made with the most efficient firm, but with the firm which bids most or because of the simple reason that tax money is wasted.
- The second, more subtle impact is that policy makers will decide over new regulations with the goal to maximise their corruption's income, rather than effective market policies.

3. Self-preservation

Governments might not choose for the best policies as a tactic in order to keep in the position to wield power. For example, as a growth of the economy would only influence one part of the population, which does unfortunately not belong to the elective group of the ruling government, the government might not have interest to persuade economic growth then. A historic example of the latter is Russia, which feared in the early 19th century riots, as industrial workers would be concentrated in cities (not farmers on the countryside anymore) and industrialization would threaten the wealth of elites. Therefore Russia stayed backward in its economic development.

Developing countries and bad governance

It seems that there is a correlation between the level of development in the economy and the quality of governance. Often poor countries tend to have especially bad governments. But the question is, whether bad governments are the result of underdevelopment or the cause.

1st view: Bad governments result of underdevelopment
In favour for the phenomenon, that a bad government is not the cause of low national income, but the other way around, is the fact, that in the early developing history of today developed countries also had very corrupt and inefficient governments. A second underlying reason is that as soon as national income increases, the quality of government might increase, due to risen governmental wages paid to governmental staff (to cut off one of the main reasons of corruption).

2nd view: Bad government is the reason of underdevelopment
Regarding the influence a government can have (as discussed earlier) many economist believe that because of that influence, governments are the prime reason for the underdevelopment of the domestic economy.

The main proof for that theory is the experience with former colonies, because 22 of 30 most corrupt countries are former European colonies. The former European colonies mainly extracted profits to the "mother" countries, without building sustainable economic structures.

After the period of colonialism ended, the structures of profit seeking and extracting were kept, and the foreign colonial power was replaced by local rulers or the native elite. And

because this structures last until today, the economy is not able to develop but rather being exploited.

In addition, former colonialism influences the current development level, because foreign colonial rulers divided the land not under historical and natural aspects, but rather how it suited them best. Therefore they created “states” with different ethnical groups, which do not feel that they belong together. If you take a look at the map of Africa, you can observe unnatural straight borderlines. Those states carry a high risk of conflicts and are thus not favourable for economic growth.

On the contrary, there are former colonies which developed wealthy economies, like Australia, the USA or Canada, but the nature of those colonies was not purely extractional and the European settlers adopted European governmental systems.