Economics Honours
3rd Year
Paper VB

Role of the Government in the development process of a country

It is now widely recognised that there are many things that governments should do to promote economic development: *provide public goods*, *correct market failures*, *reduce inequalities*, *stabilize excessive economic fluctuations* etc. However, these 'actions' alone cannot make much of a dent in the problem of underdevelopment: in fact, they may be quite difficult to achieve in isolation.

Many economists nowadays feel that **the key challenge** for the governments in most developing countries is to create the basic legal and **institutional infrastructures** that protect property rights, enforce private contracts and allow individuals to freely take advantage of market opportunities. This idea is central to the concept of **institutional economics**. There is strong evidence to suggest that development of 'good institutions' (like, for example, a fair and enforceable rule of law) should be one of the main agenda on the government's table.

We should also take into account the fact that growth and development are not synonymous. Development is a more comprehensive concept that includes the overall well-being of individuals. So, while policies to promote fast growth are necessary, they are not sufficient to become developed.

Thus, we shall discuss the role of state (in the development of a nation) under three different heads – (i) macroeconomic policies (including tax and expenditure policies) to promote development, (ii) public policies aiming at reducing poverty and inequality, and (ii) public policies to **promote 'good institutions'.**

Macroeconomic policies

We know that according to the neo-classical model of growth, a country's growth is limited by its population growth rate. In such a model, macroeconomic policies will not be able to influence economic growth without (exogenous) technological progress. After the emergence of the theories of endogenous growth formulated in the mid 1980s, it has been recognised that economic policy can easily have significant effects on long run growth of income per capita. Apart from such theoretical complexities, we know that some of the key ingredients of economic success are:

(i) stable macroeconomic environment, with
(ii) low and stable inflation,
(iii) a sustainable budget balance,
(iv) a stable and competitive currency,
(v) social overheads,
(vi) a strong and inclusive financial system, and
(vii) provision of investment incentives for the private entrepreneurs.

The macro part: Maintaining low and stable inflation requires sustainable budget practices, like (i) having a low fiscal deficit, (ii) a low debt-service ratio, and (ii) spending more on infrastructure, social overheads and capacity building.

The deficit incurred by the government is also crucial for external stability. We know from the basic macroeconomic identity

$(S_P + M + T) = (G + I_p + X)$............ (1)

On the LHS of (1), we have listed all 'leakage' items – private savings, imports and tax - and on the RHS, all 'injection' items – govt expenditure (including govt investment), private investment and exports. Rearranging terms, we get,

$$(S_P - I_p) = (G - T) + (X - M) \ldots\ldots\ldots\ldots (2)$$

So, if in a simple model, private savings equal private investment in equilibrium, the sum of the two terms on the RHS of (2) must also be equal to zero. Therefore, if $G > T$ (budget deficit), it will imply $(X-M) < 0$, that is, export X is less than import M. We may take it as the current account deficit in our simple model. Therefore, running a large budget deficit year after year will definitely have an adverse impact on external balance, and hence on currency value.

Economic infrastructure, social overheads and human capital: Economic infrastructure include **public utilities** such as
(i) Power, (ii) telecommunications, (iii) water supply, (iv) sanitation and sewage etc as well as **public works** such as
(i) Roads, (ii) major dam and canal works for irrigation and drainage, and (iii) transport projects like urban and inter-urban railways, urban transport, seaports and waterways and airports.

Economic infrastructure does three things:
(1) It provides services that are part of the consumption bundle of residents;
(2) Large scale expenditures for public works increase aggregate demand and provide short-run boost to the economy; and
(3) It serves as an input for private sector production, thus augmenting output and productivity. **The government can expand the productive capacity of the economy by increasing the quantity and quality of such infrastructure.**

Social overheads and human capital: Though often the economic infrastructure mentioned above is referred to as social infrastructure or social overheads, we shall include only education and health in the class of social infrastructure.
Education and health are social goods having large positive externality. The social marginal productivity (SMP) exceeds private marginal productivity (PMP) for such goods. Therefore, private investment capital in such social infrastructure will be less than the socially optimal level. So, it is important for the state to either provide the goods itself or to provide the incentives and other resources so that such social infrastructural projects are provided by the private sector.

Having a strong and inclusive financial system: This is essential for the productivity growth of a country. **Also, the system should be inclusive to enable people to expand their opportunities and capabilities**. Thus, the financial system does not only promote growth, but also the development of a country. This is only possible with active govt intervention.

Policies to reduce poverty and inequality

We mentioned above that economic and social infrastructures are generally included in the consumption bundles of people. So, providing them at highly subsidised rates to the poor is also a poverty and inequality reducing measure. Also, modern governments directly target the poor to make them self-employed or employable. Such measures include: (i) adopting rural (or urban) employment generation programmes (like MGNREGA in India), (ii) providing housing assistance (Awas Yojana), (iii) public distribution system, (iv) providing cheap bank credit for self-employment, (v) conducting training programmes etc.

Building institutions

Strong institutions can significantly enhance countries' prospects for growth. The United Nations' Sustainable Development Goals (SDGs) have put forward not only suggestions to reduce poverty, hunger and inequality, but has also specified a number of possible targets to "build effective, accountable and inclusive institutions at all levels. They are:"

- substantially reducing corruption and bribery
- developing accountable and transparent systems at all levels, including a robust justice system
- ensuring inclusive, participatory and representative decision-making at all levels
- ensuring public access to information
- protecting fundamental freedoms.

Clearly, the government has a very major role to play if these are ever to be achieved.

Conclusion: The role of the government is omnipresent in the development process of a less developed or developing nation.