

FLEXIBILITY BETWEEN MARKET-LED AND GOVERNMENT-LED ECONOMIES

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ABSTRACT

The 1997-98 East Asia financial crisis has raised doubts over the roles of two economic-systems: market-led and government-led economies. This paper deliberates on the two opposing economic systems: the choice of which are continually debated. There is a need for governments to look at economic flexibility and determine whether the countries affected by the financial crisis could reposition themselves fast enough. More specifically, this paper evaluates the performance of government-led economies such as those in Malaysia, Singapore, Thailand, Philippines, and Indonesia when compared to market-led economies as practised in the United Kingdom, United States, and Japan. A compilation of an index method based on Angresano (1996) consisting of the quantitative performance measure for an identified country was computed over the average period 1980-2003. The findings of this study suggest that the approaches to a market-led or government-led economy is a matter of degree and are not mutually exclusive.

Keywords: *Government-led economy; market-led economy; flexibility; compilation index.*

ABSTRAK

Krisis kewangan di Asia Timur pada tahun 1997-1998 telah menimbulkan keraguan mengenai peranan dua sistem ekonomi iaitu ekonomi berpandukan pasaran dan ekonomi berpandukan kerajaan. Kajian ini membuat pertimbangan di antara dua sistem ekonomi bertentangan yang mana pilihan

di antara dua sistem ini masih lagi menjadi perdebatan. Kerajaan perlu menilai kelenturan suatu ekonomi dan menentukan kadar kemampuan sesebuah negara itu untuk mengembalikan kedudukannya semula secepat mungkin kesan daripada krisis kewangan. Secara khususnya, kajian ini menilai prestasi ekonomi berpandukan kerajaan seperti di Malaysia, Singapura, Thailand, Filipina dan Indonesia serta membuat perbandingan dengan ekonomi berpandukan pasaran di United Kingdom, Amerika Syarikat dan Jepun. Kajian ini dijalankan berdasarkan kajian terdahulu oleh Angresano (1996), iaitu satu kaedah penyusunan indeks yang meliputi pengukuran prestasi secara kuantitatif bagi negara yang dikenal pasti untuk tempoh di antara 1980-2003. Keputusan kajian mendapati pilihan pendekatan sama ada ekonomi berpandukan pasaran atau ekonomi berpandukan kerajaan adalah persoalan darjah dan bukannya pilihan saling eksklusif.

INTRODUCTION

The theory of efficient markets is only applicable to competitive markets that are in equilibrium (demand equals to supply). According to Chang (1999) when large social and economic imbalances exist in a society, free markets do not provide an adequate growth solution. Actual markets take on different forms: some cause mismanagement of resources, some make profits at the expense of the needy, and others misjudge the extent of shortages (demand greater than supply). Markets are regulated by governments primarily because they cannot function without the legal backing of contracts. Smooth operation of exchange or production requires legal action for compliance. Governments have a major role in initiating and facilitating market-reliant economic growth, in adherence to a carefully developed public policy. Government agencies are needed to initiate fair distribution of resources and services such as land, education, health-care, protection of legal rights, and outlawing monopolistic arrangements.

Economic upheaval and in turn economic crisis are brought about by market imperfections that may have a serious impact on the real and monetary sector of the economy such as unemployment, disinvestments, and recession. The longer the period of economic crisis, the greater is the inevitable economic slowdown. There is, therefore, a need for *new thinking* to respond to market failures and the necessity to formulate ideas for modern economic growth. In our view, there is a need to look at the economic flexibility of these economies; market-led vis-à-vis government-led economies. Also, economic flexibility is necessary for rapid growth to be sustained over the medium and long term.

Market-led means that the government does not seek to direct or plan the course that an economy or market should take. Under a market-led development mechanism, households and private enterprises make economic decisions based on the principles of market-based competition. Instead, we believe that investors and entrepreneurs understand markets far better. According to Hall and Lieberman (2001), an economic system comprises of two features, a mechanism for allocating resources and mode of resource ownership. A *government-led economy* means the government directs or plans the course that the economy should take and it is not left to market forces (Marsden, Adams, & Crewdson, 1984; Kohler 1989). Most of the developing countries are viewed as government-led economies.

This paper is organised as follows. Following the introduction in Section 1, the theoretical underpinning for the study is critically evaluated in Section 2. This section reviews various aspects of economic flexibility of an economy. The methodology undertaken for this study is presented in Section 3. The empirical results revealing the economic performance of various countries are tabulated and deliberated in Section 4. The final section outlines the policy implications of this study, explains the limitations of this study, and makes recommendations for future studies.

THEORETICAL FRAMEWORK

The theoretical framework for this study was drawn from a broad research tradition which links the following six aspects, namely, economic flexibility, importance of information, costs, influence of Globalisation, education and technology changes.

Economic Flexibility

Much of the theoretical discussions on economic flexibility are based on the works of Killick (1995). Killick (1995) defined flexible economy as one in which individuals, organisations, and institutions efficiently adjust their goals and resources to changing constraints and opportunities. According to the author, economic flexibility can be categorized into two divisions: (i) responsive flexibility and (ii) innovative flexibility. Responsive (or passive) flexibility refers to the reaction of economic agents to altered relative prices or other economic stimuli. For example, the positive or negative reaction of savers or borrowers to changes in interest rates or of exporters to devaluation of currency; or of governments to a natural disaster such as the *Tsunami*

incident on 26 December 2004. In contrast, innovative flexibility refers to changes initiated by the exercise of entrepreneurship. Those who exercise this quality are the leaders and the visionaries. For example, individuals may display it by investing in training that anticipates the skills which will be in short supply in the future. Businessmen may also display it through their spending on research and development (R&D) which results in products or other innovations that they introduce. Statesmen may display it through the introduction of institutions or policies which will help the economy to compete in the future, say, by the creation of advanced educational facilities or transportation infrastructure.

Both types of flexibility are looked at in conjunction with the agents involved in the adjustment process, and ease in adjusting to changes in their economic situations. At one end of the spectrum are individuals who respond with relative ease, in the middle are firms and other organizations, and at the other end of the spectrum are institutions that tend to have greater difficulty with adjustment. In short, there is a time dimension to these two classes of flexibility.

Importance of Information

According to Killick (1995), the importance of information sounds so obvious that it can be taken for granted. In many developing countries, however, availability of reliable data is sparse and often out-dated, and there is a greater reliance for a government-led economy. In such circumstances, neither private nor government decision makers can normally operate efficiently. Indeed, under imperfect competition, rising transaction costs is seen as one of the key features that distinguish developing from developed economies. In many developing countries, *information flows* often remain inadequate, but these *information flows* are rare in market-led economies where the data is transparent. A flexible economy needs adequate conditions in world trade and finance, as well as improved development within the domestic economy.

Costs

Since transaction costs would be zero in a perfectly functioning market economy and imperfect information raises transaction costs, it follows that good, low cost information flows are a necessary prerequisite for market efficiency. For example, market efficiency can be seen in price setting. In a market-led economy, price is determined by demand and supply conditions, but in a government-led economy, it is controlled by the government. According to Adam Smith, a highly reputable

economist, "if people are naturally good and kind, a market economy offers them a great deal of economic freedom to carry out their good deeds, backed up by an efficient system of production, which generates more material goods and services for them to use in doing those good works". However, but what if people are selfish, greedy, or lazy? Anyone who wants to enjoy more of the material goods and services produced in a market economy faces strong economic incentives to work hard, spend carefully, save, and invest. Most successful businesses have to produce good products, sell them at market prices, pay their employees market wages, and treat their customers courteously even if that is not their natural way of doing things (Gregory & Stuart, 1999). If markets and market systems are so efficient, why let the government interfere? Why not adopt a strict policy of what is called "*laissez-faire*" and allow private markets to operate without any government interference whatsoever?

There are several reasons that economists and other social observers have identified, which can all be illustrated with some familiar examples. In most cases, however, the role of the government is not to take the place of the marketplace, but to improve the functioning of the market economy. Furthermore, any decision to regulate or intervene in the play of market forces must carefully balance the costs of such regulations against the benefits that such intervention will bring. This can be seen in a government-led economy where transaction costs are higher compared to a market-led economy. In suggesting that a well functioning market system is conducive to economic responsiveness, however, the key word is *well-functioning*, for all economies experiencing market failures, particularly in countries still at relatively early stages of development. Among the many conditions contributing to a well-functioning market system is the freedom of entry by new firms into existing markets, thereby, encouraging the spread of successful ideas and safeguarding against industries becoming slow to take advantage of technological and other opportunities.

Influence of Globalisation

The degree of openness or globalisation of an economy also has an important influence on its flexibility. Therefore, international trade is an important medium both for the transfer of information and for the transmission of incentives that is to be adapted. Learning-by-exporting has, for example, been a crucial way in which new economic giants of East Asia have raised productivity and quality of their output.

Asean Free Trade Area (AFTA) contributes a bigger scale of production to most of the government-led countries. It assists in enlarging the

ASEAN market and provides the platform for technological transfer and development of new industries. Thus it will increase the competitive edge as a production base for the global market.

The way political power is distributed may easily act as a barrier to adaptation. Existing policies, however well chosen, often have large inertial force because those who benefit from them are powerful enough to block change (Hattori & Sato, 1997; Akama, Naro & Taha, 2003). These have often led the International Monetary Fund (IMF) and the World Bank to blame inadequate *political will* or *political commitment* for the disappointing implementation in developing-country adjustment programmes that have long-term benefits for the country.

Education and Technology Changes

A population's access to education and technology changes nominates itself as an important ingredient. According to Schultz (1975), the value of education and technological capabilities enhances the ability to adapt by improving capacities to solve problems. Those with scientific and technical education will determine the ability of a country to take advantage of modern technologies. This was earlier adopted by the market-led countries and this makes them lead ahead compared to those adopting government-led economies. For example, Malaysia promoted the implementation of a knowledge based economy in the late 1990s while most of the market-led countries already implemented this policy in the early 1990s.

METHODOLOGY

It is important for economists to evaluate and compare different types of economies as objectively as possible. Several indicators should be taken into consideration to demonstrate the superiority of each economy especially in terms of flexibility.

According to Angresano (1996), there are few criteria that need to be considered when evaluating or comparing economies. Firstly, there is a need to distinguish between theoretical models of an economy or actual economies. In reality, all economies are mixed and we should avoid labeling an actual economy according to a stereotype term such as a market economy. Secondly, the performance of an economy is influenced by goals and priorities established by authorities and by environmental factors such as technological, natural resource, political revolution, war, natural disaster, and international economic factors.

Goals and priorities are both political and economic and the two aspects are interrelated. Thirdly, an economy's performance is affected by its behaviour under *laissez-faire* policies as well as by active policies and policy instruments. Finally, evaluating and comparing economies cannot be purely objective. In evaluating and comparing an economy, it is necessary to distinguish between opposing *forces*. These *forces* explain the extent of development of principal economic institutions and those that explain the performance of an economy.

There are four steps to follow when evaluating an economy's performance and these steps are summarised in Table 1.

Table 1
Economy's Performance Evaluation Method

Steps	Method
1	Definition of performance Example: Inflation rate and percentage increase in economy's average level of prices.
2	Identification Identification of performance indicators for each chosen criteria.
3	Measurement Measurement of performance indicators such as per capita income, unemployment rate, inflation rate, infant mortality rate, and telephone usage per 100 population.
4	Compilation Compilation of an index consisting of the quantitative performance measure of each criterion weighted according to its relative importance.

Source: Adapted from Angresano (1996)

The first three steps involve selection of criteria and the final step is on compilation of index. Few performance indicators are selected and they are generally available from the Year Book of Statistics (various years); UNDP (1998), and World Bank (1998).

Choice of criteria

In this study, five criteria were chosen to evaluate the economy's performance. These criteria are:

- (i) per capita income;
- (ii) unemployment rate;
- (iii) inflation rate;
- (iv) infant mortality rate; and
- (v) telephone usage.

The first criterion mentioned is per capita income that is the dollar value of a country's final output of goods and services in a year divided by its population. It reflects the average income of a country's citizens. The per capita income shows what part of a country's total product each person would have, if this GNP were equally divided. Knowing a country's per capita income is the first step towards understanding the country's economic strength and needs, as well as the general standard of living enjoyed by the average citizen. A country's per capita income tends to be closely linked with other indicators that measure the social, economic, and environmental well-being of the country and its people. For example, generally, people living in countries with higher per capita income tend to have longer life expectancies, higher literacy rates, better access to safe water, and lower infant mortality rates. This research has been used per capita income at market price in US dollars. Per capita income helps measure the material output of a country but it does not show what kind of goods and services the country produces, whether all people share equally in the wealth of a country, or whether these people lead fulfilling lives. Going beyond per capita income helps reveal other important development issues. For example, per capita income is given in dollars, but a dollar may buy more in one country than in another. To compare the actual purchasing power of per capita income across countries, one can look at the purchasing power parity. In conjunction with these, per capita income is not the only one that will be used as an indicator, but also others such as unemployment rate, inflation rate, infant mortality rate (IMR), and telephones.

The second criterion is the use of unemployment rate. According to Gordon (2000), unemployment rate is expressed as the ratio of the number of the jobless individuals actively looking for work (or on temporary lay off) divided by the total employed and unemployed in the labour force (aged 16 to 55 years). Problems may arise as policies towards unemployment may differ between economies. Some nations like Malaysia will devote more public resources and provide employment or retraining for certain individuals temporarily out of work, while persons in the same predicament might be classified as unemployed in another economy.

The third criterion is inflation rate. According to Gordon (2000), inflation rate is the percentage rate of increase in the economy's average level of prices. This variable is the extent, duration, and regularity of fluctuations in unemployment rate and price changes in the consumer price index or value of the Gross Domestic Product (GDP) deflator. Meanwhile, the fourth criteria is infant mortality rate (IMR), which is the number of deaths under one year age in year t divided by number of live births in year t multiplied by 1,000. It is known that higher the per capita income, the lower the infant mortality rate.

The fifth performance indicator is the number of telephone usage per 100 individuals where telephone usage includes both commercial and private phones. This broad criterion can comprise numerous performances as we are in an Information, Communication and Technology (ICT) era. At the same time, the telephone line is competing with mobile phones.

Once the first three steps were ascertained, an index of overall performance was compiled. Here, we had given relative weights for each criterion. The outcomes will produce different indices depending upon the relative importance assigned to each criterion. In this study, we do not assign any weight for the indicators. To compare these performances, an overall index of performance was compiled for each economy. One easy way to construct an index is to assign a value of one (1) through nine (9) to each nation's performance in a particular area, depending how it compares to the other economies. The index is compiled by weighting each criterion equally and then adding each nation's relative performance.

EMPIRICAL RESULTS

The results from the compilation of index are presented in Tables 2 and 3. The economic performance of selected countries for the period 1980 to 2003 is presented in Table 2. The ranking order of the economic performance of selected countries is shown in Table 3.

The country that has the highest per capita income is Japan (USD25,012) and not USA (USD23,482) while Indonesia (USD633) has the lowest figure (see Table 2). The unemployment rate is a mixed bag of results, but the inflation rate is very high among poorer economies such as Indonesia (11.34) and Philippines (10.89), when compared to 0.92 for Japan.

Table 2
Economic Performance of Selected Countries 1980-2003

Criteria	Japan	US	UK	Malaysia	Indonesia	Singapore	Philippines	Thailand
Per capita GDP (USD)	25,012	23,482	16,023	2,661	633	14,543	819	1,470
Unemployment rate*	3.17	6.26	8.49	4.75	4.08	3.00	8.04	2.21
Inflation rate*	0.92	3.17	4.04	2.82	11.34	1.52	10.89	4.03
Infant mortality rate*	4.75	9.01	7.81	12.71	57.58	6.2	48.37	8.64
Number of telephones per 100 population	43.96	80.08	68.75	12.52	1.15	32.57	3.38	4.45

* Annual figures

Table 3
Economy Performance Ranking of Selected Countries 1980-2003

Criteria	Japan	US	UK	Malaysia	Indonesia	Singapore	Philippines	Thailand
Per capita GDP (US \$)	1	2	3	5	8	4	7	6
Unemployment rate	3	6	8	5	4	2	7	1
Inflation rate	1	4	6	3	8	2	7	5
Infant mortality rate	1	5	3	6	8	2	7	4
Number of telephones per 100 individuals	3	1	2	5	8	4	7	6
Index total	9	18	22	24	36	14	35	22
Ranking order	1	3	4	6	8	2	7	4

Table 3 shows the ranking order of the economic performance for some of the market-led and government-led countries. According to the findings, for the overall ranking, Japan ranked in the number one position as the best, followed by Singapore, in second, US in third, UK and Thailand both tied in the fourth position, Malaysia in sixth, Philippines seventh, and finally Indonesia in the eighth position. If we go on from criteria to criteria, market-led economy showed the best for per capita GDP, while for the unemployment rate criteria, government-led economies fared better compared to market-led countries. As for the IMR criteria, Japan ranked first followed by Singapore, UK, Thailand, US, Malaysia, Philippines, and Indonesia. As for the inflation rate criteria, both market-led and government-led countries are good enough to maintain the inflation rate. When we refer to the telephone usage per 100 individuals, data in Table 3 revealed that the US ranked first, followed by UK, Japan, Singapore, Malaysia, Thailand, Philippines, and Indonesia. For these criteria, it is proven that market-led countries are more informed and flexible to access information compared to the other countries in this study.

CONCLUSION

Failure to adjust rapidly to a changing international environment has enlightened the need for reforms. The choice of a market-led economy *vis-a-vis* government-led economy is a matter of degree, not a matter of one or the other as was previously envisaged. For example, the US, a country recognised by nearly everyone as the most representative of a market economy, still allows its Federal Reserve Board to artificially establish interest rates regardless of market forces and its Department of Justice also decides whether or not to approve mergers and acquisitions between companies.

Each of the market-led and government-led economies has their own advantages. A market-led economy gears towards a deregulated open economy to enable itself to engage in the global economy. Furthermore, a market-led economy is seen as a solution to overcome the basic problem of low growth. This would make the economic system more accountable and transparent thereby lowering incentives for corrupt practices.

A government-led economy, on the other hand, stresses the importance of the role of the government in playing a vital role in improving the technical capabilities of the industrial sector. The government plays a crucial role in directing and promoting industrial development.

Furthermore, government policies can support entrepreneurial economy by removing barriers to business start-ups and expansion, as well as opening doors to competition in every sector of the economy. In this regard, government acts in stabilising the economy and entrepreneurs do not face political uncertainties.

There is no clear-cut rule as to the extent of government intervention that is necessary to attain economic development. In other words, there is no single development model for a country. Perhaps, there will be many diverse mechanisms suggesting that it might be a market-led economy, but there would be adequate government intervention that is deemed necessary.

From the findings of this study, we can summarise that market-led economies are leading in economic performance measures such as per capita income, IMR, and telephone per 100 individuals, but in terms of the unemployment rate, government-led countries are better-off. We therefore can conclude that the standard economy approach is not a fit for every country, but each country has its own economic approach. There might be a standard framework that could be harmonised with the environment and capabilities of the country to fit into its economic system. A combination of elements in a market-led economy and a government-led economy may allow a government to perform economically well. The debate over whether a market-led or a government-led economy has constituted an important part of the general effort to figure out what level of government intervention is necessary in order to attain continuous economic development. What is good for a particular country may not be necessarily good for another, but every government has to continually monitor the viability of the economic system in an evolving environment.

There are a few limitations of the study. The first relates to data accuracy as some nations are not able to collect and generate accurate GNP and per capita income statistics. The second limitation is due to the composition of data where the statistics generated by different countries do not always include the same information. For example, many countries include estimates for home grown food in their GNP while others do not. Furthermore, there is a need to convert GNP figures to a common currency, normally in US dollars, but the conversion or exchange rate may vary from one year to another. The importance of relative prices using a standard currency such as the US dollar does not take into account the differences in relative prices from one nation to another, which effects the purchasing power of a particular level of income. Per capita data are only average figures; an average figure gives no indication of the actual distribution of income within a nation.

Average per capita income might be relatively high, but when a detailed study is carried out, a small proportion of the population might have very high incomes and the majority very low per capita income. Per capita income can only inform about money income, it does not measure how well-off people are in terms of their human development or standard of living.

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END NOTES

1. There are four basic types of economic systems: market capitalism, centrally planned capitalism, market socialism, and centrally planned socialism. For example, market capitalism is a system where resources are allocated primarily by the market and owned primarily by private individuals. According to Chang (1999), it is believed that in the early 1990s, a market economy system has prove to work best.
2. In a real situation, it is very hard to differentiate which economic system is the best. We agree that these two systems are opposing concepts and in practice they are opposite ends in the same scale. For example, in South Korea, the government responded to the banking crisis by injecting fiscal funds, equivalent to 30% of GDP including capital injections, non-performing loan purchases, and depositor protections. They are not mutually exclusive and we can find elements of each of them in every economy in the world. The difference between market economies and managed economies is a matter of degree, not a matter of one or the other.

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