# MZF Dialogues

## The Case for Democratic Developmentalism

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I have been asked to speak today about a paper I wrote a while back in which I try to make a theoretical case for what is now known as democratic developmentalism, a paper whose excerpts have found their way to cyber space, apparently generating some curiosity amongst a number of you. As an amateur speaking to professional economists, I have tried to limit to the minimum the use of economic concepts and terminology. You will agree with me, however, that it is impossible to avoid their use altogether, hence my strange choice of language—speaking in English to an Ethiopian audience.

In the interest of brevity, I will focus my remarks on the basic theoretical arguments for democratic developmentalism, which I hope will provoke a lively and substantive discussion, including on the application of these concepts in Ethiopia —a topic which my paper does not address.

The central thesis of my paper is that the neo-liberal paradigm of development, which is sometimes also called the Washington Consensus and which has become the dominant paradigm in Africa, is a dead end, and that this is so not merely for reasons of implementation difficulty or due to excesses in the articulation of the underlying theories, but rather on account of its inherent structural flaws. I also argue that democratic developmentalism provides a more hopeful alternative to the flawed neo-liberal vision.

## 1. The Two Flawed Pillars of the Neo-Liberal Paradigm

The first thing I wish to do in laying out the case for democratic developmentalism is to briefly outline the basic theoretical pillars of the neo-liberal paradigm and see how they stand up to scrutiny. There are two such basic pillars on which the theoretical case for neo-liberalism rests.

The first is the belief or faith in the efficiency of free and competitive markets. Obviously, neo-liberals admit there are in practice few, if any, truly free and competitive markets. However, they argue that the theoretical case for the efficiency, or Pareto optimality, of such markets is unassailable, and hence the closer one gets to the theoretical ideal the more efficient the outcome. The corollary is that, though there are market failures, they are neither as pervasive nor as critical to development as its critics suggest. In any case, government action to correct market failure, neo-liberals famously argue, is, as a rule, a cure that is worse than the disease.

The second theoretical pillar articulated by neo-liberal political economists has to do with the nature of the state. The argument here builds on the assumption that the participants in an economy or a market are rational, self-interested players who always look to maximize their own private benefits. Neo-liberals proceed to extend this hypothesis from the economic to the political realm so that the state, no less than the market, is conceived as being populated by such self-interest maximizers.

The conclusion that follows from this supposition is clear. If the state were to be involved in allocating resources in an economy, it would do so in the interest of the self-serving individuals who populate and control it rather than of the society at large. To avoid such a perverse outcome, its role will therefore have to be limited to that of a night watchman—to the use of its monopoly of coercive power for the purpose of enforcing the rule of law and of carrying out other limited regulatory tasks. Keep the state small and its hands off the cookie jar to prevent the wielders of state power from grabbing a disproportionate share of the cookies for themselves.

The two pillars of the neo-liberal paradigm are distinct but reinforce each other. One pillar suggests that governments should interfere in the market as little as possible because markets are, as a rule, more efficient and because government intervention would in general make a bad situation worse. The second pillar suggests that the state should be kept small because if it intervenes in the economy extensively it would do so in the interest of rent-seeking behavior by those who populate and control it.

Let us now critically assess the first pillar. The neo-liberal paradigm has since Robert Sollow rightly argued that, in the final analysis, the source of sustained growth in productivity, and hence of development, is technology. Development is not so much a process of capital accumulation as a process of technological capability accumulation, a process of technological development. A variant of the neo-liberal paradigm called the endogenous growth theory has also provided a relatively extensive assessment of the deep and pervasive market failures in technological development.

New knowledge is based on old knowledge. The more accumulated knowledge a society possesses the more new knowledge it can create. The availability of accumulated knowledge not only determines a society's capacity to generate new knowledge but also its capacity to take full advantage of such knowledge. The more knowledge there is, the greater the possibility of creating new knowledge and of fully exploiting it. This is a case of increasing returns to scale.

Where there are increasing returns to scale there always are vicious and virtuous circles. A society whose accumulated knowledge is markedly small is caught in a vicious circle of a low technological growth trap from which no market can lift it. It can neither produce nor effectively exploit new technology because its accumulated knowledge is too small. Its accumulated knowledge is lacking because it can neither create nor satisfactorily exploit new knowledge. A society with adequate knowledge, on the other hand, finds itself in a virtuous circle. It can create and fully exploit new technology because it has high levels of accumulated knowledge. It has high levels of accumulated knowledge because it can create and also take full advantage of new technology.

Where there are vicious and virtuous circles, we are bound to have a threshold below which a polity is trapped in vicious circle, and above which a virtuous circle begins. One can transition through the threshold only by means of a coordinated push to overcome the vicious circle that holds a society in a low technology trap in a fashion similar to gravity, which ensures that we are stuck to this planet unless we use rockets to overcome it.

The use of knowledge by someone does not preclude the use of the same knowledge by anyone. Indeed, the widespread use of the same knowledge would, as a rule, enhance the use of such knowledge by everyone. In other words, knowledge is a non-rivalrous good, a public good. Public goods cannot be efficiently allocated by the market.

The technology market is thus plagued by deep and extensive market failure due to increasing return to scale and because technology has characteristics of a public good. That the technology market is riven by such market failures is admitted even by neo-liberals.

The theory of Information economics pioneered by Joseph Stiglitz provides an even deeper understanding of market failure in the technology market. We all know that a free competitive market can exist only if there are homogeneous goods to be sold in the market. If every grain of wheat is fundamentally different from every other grain of wheat one cannot have a free and competitive market for wheat grain because every grain would be a unique good in the market. Only where each grain of wheat is fundamentally the same as every other grain of a certain variety of wheat can we even begin to think of competitive markets.

In the technology market, every new technology is a unique product, for if it were not unique the product would not be new. A market where each product is unique, however, cannot be competitive as there is only one product of a certain type in the market. The technology market cannot therefore be competitive, not only in practice but also in theory.

Stiglitz's theory also highlights the information asymmetry in the technology market. The creator of the new technology has infinitely more information about the technology than everyone else. Indeed if he were to share it with all the buyers in the market, all the buyers would all get the knowledge, declare that they are not interested in it, go home and use the information they have gained without paying anything to the creator of the new technology.

Such a market cannot exist. A non-market mechanism has to be introduced to make it work. Such a mechanism is that of patents and copyrights. The new knowledge is made public but nobody can use it without paying the creator royalties. Such royalty payments are created and enforced not by the market but by the state. Without such state intervention there cannot be any functioning technology market.

The key to development is technological capability accumulation and the market for technology is totally unworkable without massive and extensive government intervention due to information asymmetry, increasing returns to scale, the public good nature of the product and many other market failures. Such intervention is required at every stage of the process. Every government, especially those of developed countries, provides public or subsidized education to create an adequate minimum level of knowledge. Every government, especially those in developed countries, invests billions in financing or in various ways subsidizing research and the creation of new knowledge. Every government, especially those in developed countries, creates and enforces patents and other intellectual property rights to enable the technology market by fundamentally restricting it.

Developing countries face even deeper problems in the technology market, not only because they are caught in a vicious circle of low technology trap, but also because of the different nature of their process of technological capability accumulation. Developing countries accumulate technological capability primarily through adoption and adaptation of technology already discovered by the developed countries. Such a process of adoption and adaptation is every bit as challenging as the creation new technology.

Whoever wants to embark on the process of adoption and adaptation will have to carry out an extensive search for the best available technology and the best supplier of that technology. Such a search costs time and money. Once such technology has been bought, the company and its personnel will have to learn to use it properly through learning by doing. This is an expensive process of making mistakes and learning from them. Assuming that the pioneer company has succeeded in its efforts and fully acquired the technology it will have no patent rights over it because it did not create it. Sooner or later others will acquire the same technology without going through the same process by simply poaching the employees of the pioneer.

From the point of view of the economy as a whole, such leakage is vital because diffusion of new technology throughout the economy is the name of the game. From the point of view of the pioneer company, it is forced to carry the cost of introducing the technology and compete with those who copy from it without carrying the cost in time and money. So long as this is left to the market there will not be enough pioneers to accumulate technology. Only massive and coordinated non-market intervention can help the country get out of the low technology trap. Developing countries have to intervene in the technology market even more than developed countries because of the unique nature of market failure that they face and the low technology trap associated with it.

While it is true that ultimately development is about technological capability accumulation rather than capital accumulation, it is also true that technological capability can only be accumulated through investments in new machinery, particularly in developing countries.

Banks play a critical role in mobilizing and allocating savings and are the vital source of external financing for firms, particularly in developing countries. Banks have the unique capacity to create money and allocate money that belongs to savers. Hence, every country worth its salt has a national bank that regulates money supply and guides and controls the resource allocation functions of banks. In the last analysis it is national banks who set the deposit rates and who set the prudential regulations on loan allocation and implement the regulations.

Neo-liberals themselves have for a long time now acknowledged that there are massive market and information failures in the financial market. Information economics, however, tells us that the problems are even deeper than what neo-liberals are willing to admit, even though what they are willing to admit is itself indicative of massive and pervasive market failure. Assuming that the financial market is a normal market, the supply of loanable funds on the one hand and the demand for such funds on the other have to be equilibrated by the price of loanable funds or interest rates. In a normal market, the price would be set at a level where there is market clearance or where supply and demand are equilibrated. Those who are prepared to pay the price would get the loanable fund they demand.

But as we all know that is not what happens. The borrower has much more information on what he or she will do with the money than the lender. The lender is unsure as to whether he or she will get their money back. They have to evaluate the borrower not so much on the price he or she is willing to pay, but on the overall likelihood of repayment. Interest rates, therefore, do not play the equilibrating role that prices are supposed to play in a normal market. The loans are rationed according to the perceptions of the lender rather than the interplay of supply and demand equilibrated by prices. The market for loanable funds is thus very far from being a free and competitive market.

Rationing of loans rather than competitive market allocation of loans is the norm whether banks are privately owned or not. There is no theoretical reason why private banks should be better at rationing loans, because both private and public banks face the same problem of information asymmetry and information failure.

Whether a private or public bank deals with the matter better is an empirical rather than theoretical issue. In certain instances where the government is able to intervene in the economy to generate sustained growth, public banks may be better at rationing loans because they will have a higher chance of repayment. They will have a higher chance of repayment because the government as a whole has created an environment where borrowers have the profit to repay loans and because government has the resources to enforce the law. In other instances where government or private rationing of loan is driven by rent-seeking activities loan allocation will be sub-optimal. The bottom line is that the capital market is driven by rationing rather than competitive market and price based allocation and hence is plagued by deep and extensive market failure.

What we have seen so far is that two markets central to the development process, the technology and the capital market, are plagued by deep and extensive market failures. While there is some quibbling about the scale and scope of these market failures, even neo- liberals cannot deny their prevalence in all economies, but particularly in developing economies. Perhaps more importantly, all economies, including those led by neo-liberals, massively intervene in both markets. A purely market based outcome in these two key markets would be so deeply flawed that no government, including a neo-liberal government, is willing to bet on it.

Let us now turn to the second pillar of the paradigm of development. There are two aspects to the claim made by neo-liberals in regard to the nature of state. First, the state as an institution consists of self interested individuals who seek to maximize rent from holding office. Second, the way to minimize the potential harm to the economy is to keep government small, not only in terms of its relative size, but also in terms of the scope of its role in the economy. The smaller the government the better the government is the neo-liberal motto.

It stands to reason that if states were comprised of such solely self-interested individuals, they would not survive for long. Not only would they be plundering the public, they themselves would come to blows in no time as each pursues his or her interest without regard to the interests of the others and that of the state as a whole. A state populated by such individuals would thus be closer to a failed state run by war lords than to a functioning modern polity.

A complex polity such as a capitalist society cannot function in an environment where all individuals are exclusively self-interested. As Stiglitz suggests, such a society requires a peculiar combination of self-interested behavior – enough to induce individuals to be on a continuous lookout for profitable opportunities and to seize such opportunities, and non-self-interested behaviour where ones' word is ones' honor, where social rather than economic sanctions suffice to enforce contracts. The bottom line in this regard is that there is no functioning complex society without a minimum level of social capital.

The theory of social capital accumulation and the practice of everyday social life thus show that the assumption that states are populated by solely self-interested individuals is simply wrong and unfounded. If that were to be the case, we would not get a well-behaved night watchman state but an incoherent band of marauding robbers. It is not the size of the state that determines how it behaves vis-a-vis the societal cookie jar. What keeps the hands of the state away from the cookie jar even as it maintains its monopoly over the means of violence is the social capital and political economy on which it is based.

This is confirmed by daily social practice. In the advanced capitalist countries of the West, we notice that adequate social capital has been accumulated. People within and outside the state display that peculiar combination of behavioral norms and values that Stiglitz describes as essential for the smooth functioning of a complex capitalist society.

But the mix varies from country to country. Most people would agree that in general there is a higher level of social capital in the Scandinavian countries than, say, in Southern Europe or even in the United Kingdom. Sweden has for nearly a century been massively intervening in the economy, so much so that its critics refer to it as the nanny state. The massive government intervention, however, has not meant that the Sweden state is more corrupt or predatory than those of other advanced countries. On the contrary Sweden is known to be much less corrupt, and globally more competitive, than countries such as the United States where neo-liberalism reigns supreme.

Thus, the second pillar of the neo-liberal paradigm does not survive scrutiny. It fails to do so because both in theory and in practice people are not solely economic animals but also social and political ones. It fails also because limiting the state to a night watchman is unavailing. If people were solely self-interested, then the night watchman state would instantly degenerate into the day and night robber state. Conversely, if people are not exclusively self-interested, then there is no reason why the state should be made small in order to contain rent-seeking behavior and its damage to society.

## 2. `The Case for Democratic Developmentalism

It is not enough to demonstrate that markets in developing countries are marred by deep and extensive market failures and that without government led corrective action these countries could be caught in a low technology poverty trap indefinitely. Nor does it suffice to show that the positive or negative role played by the state is determined, not by its size, but by its political economy and the accumulated social capital on which it is based. Showing that the theoretical bases of the neo-liberal paradigm are weak is one thing. Showing that there is better alternative is quite another.

Recent history of the last half-century provides an instructive lead for tackling the question. Where effective states, commonly referred to as, have emerged and taken root, poor countries have succeeded in transforming their economies and joining the industrialized nations. Here, the history of many East Asian countries is particularly instructive.

Development thinkers and practitioners have studied the nature of such states and have come to the conclusion they share three essential characteristics in common. One key characteristic is that they are fully committed to accelerated shared growth and development, if not obsessed by it. Such overwhelming commitment allows the state to focus its energies and take all the necessary steps to achieve its development objectives. While the reasons that prompt such a commitment vary to some extent from country to country, success in respect to fast development is typically felt to be a matter of survival for the state, if not for society as a whole. The Kuomintang in Taiwan was convinced that its very survival was at stake if it could not achieve fast and shared growth in Taiwan. The same feeling of threat to the survival of the South Korean state and society informed the fervor of the South Korean developmental state for accelerated and shared growth.

Deep commitment to accelerated and shared growth on the part of the state is necessary but not sufficient. Development is about social and economic transformation. For such transformation to succeed and for growth to be accelerated and shared, society as a whole must be an active and informed participant. The population at large must acquire the norms, values and skills that would motivate it to add value and to benefit accordingly. In other words, there needs to be a broad national consensus on the imperatives and strategies of development. Alternatively put, the development discourse should be hegemonic in the Gramscian sense.

The third and final shared characteristic is the relative autonomy of the state, its political and economic independence from the business community. The developmental state will have to use a heavy dose of both carrots and sticks to support the private sector and to direct it away from rent-seeking activities to productive ones. If the state is dependent politically and economically, it will be incapable of effectively applying either carrots or sticks with a view to generating shared accelerated growth.

The developmental states in East Asia were able to keep their independence from the private sector, while at the same time supporting capitalist development, because they could politically depend on the indifference, if not active support, of the large peasantry and because they controlled the so-called commanding heights of the economy. The unique political economy that enabled the states to emerge is that of a large peasantry that benefited from radical land reform and from effective rural development programmes, and hence of a peasantry that was supportive of the developmental state at best and indifferent at worst. Such an environment neutralized the potential challenge to the state from key urban constituencies, particularly business and labor, thereby enabling it to maintain it political independence.

The East Asian states were able to build on this foundation and mobilize huge state machineries, particularly armies, which served to insulate the state from pressures of urban constituencies. Both Taiwan and Korea for example had huge armies made up largely of sons of the peasantry. While initially the developmental discourse was far from hegemonic in either country, the success of fast and shared growth soon generated a broad national consensus on which the developmental states could capitalize. State control of key institutions such as banks and utilities, in addition to the normal fiscal resources of the state, also beefed up the developmental credentials of the state.

Each of the three shared characteristics of a developmental state presents an element of a political economy that is inimical to rent-seeking and supportive of developmentalism. Like everything else in life their achievement is the product of hard work. Developmental states are created out of predatory states through well-articulated programmes of reform and transformation.

Having gained some understanding what it takes to forge a developmental state, and under what circumstances such an endeavour has a reasonable chance of success, the key challenge is to adjust these general guidelines to the circumstances of each country. In this regard a pertinent question is whether a developmental state can be democratic. This is doubly pertinent because most developmental states, particularly those of East Asia, have not been democratic and some have come to the conclusion that the fundamental political economy of such states is not conducive to democratization. I beg to differ.

The social base of these states has normally been a broadly satisfied, if atomized, peasantry. Such a social base has sometimes been associated with non-democratic regimes, the atomization and indifference of such peasantry being seen as the main culprits. While it is true that an atomized and indifferent peasantry can be the social base of undemocratic regimes, it is also true that rural development and commercialization of agriculture can overcome the atomization and indifference, whereupon the peasantry can form a solid base for democratization. The history of the oldest democracy in the world, the United States, gives clear indication that this is indeed possible.

Democracy can be sustained only where there is broad national consensus on the way forward for a polity. There can be no developmental state unless such consensus on the future of a nation is established. There is thus coincidence between what it takes to have a stable democracy and the requirements for establishing a developmental state. Democracy and developmentalism, then, not only can go hand in hand, but also can reinforce each other.

One of the defining characteristics of a developmental state is that it creates a political economy where pervasive rent-seeking is overcome and replaced by a political economy that is conducive to development and value creation. Rent-seeking is a zero sum game whereas value creation is not. Politics, including democratic politics, based on a political economy of pervasive rent-seeking is naturally bound to be a zero sum game. Hence the developmental state creates the political economy on which a stable democracy can be established.

In sum, the fact that developmental states in East Asia have not been democratic has nothing to do with the political economy of those regimes. The explanation for their undemocratic character has to come from the political circumstances in which they emerged. Since these regimes had historically had an uneasy if not hostile relationship with their social base, the peasantry, and could not visualize democratic means of achieving their objectives. Not only can developmental regimes that face no such constraint be democratic, they can become better developmental states by embarking on democratization.

l believe it is clear from what has been said so far that the neo-liberal paradigm has no theoretical leg to stand on, and that a democratic developmental approach can be an alternative. Both practice and theory support that this is indeed the case.

The neo-liberal paradigm has been a failure in Africa. Its programme of transforming the African state into a night watchman state has been a failure. It is true that as a result of neo-liberal reforms, the African state is now a small one, too small to perform the normal public services without the NGOs that have mushroomed during the reform period. But it has not become the well-behaved night watchman state. It was plagued by pervasive rent-seeking when it was larger, and it remains plagued by the same problems now that it has become diminutive. This is so because one cannot change the nature of the state, its political economy, by cutting down its size. The efforts to change the African state into a well behaved night watchman by shrinking its size could not therefore but fail because the path of reform followed was a dead-end.

The attempt by neo-liberals to transform African economies by keeping the hands of the state out of the cookie jar and unleashing the market has also failed miserably. In an environment where African societies are kept in a low technology poverty trap, the expectation that these market failures would somehow resolve themselves and generate development and transformation was destined to fail. Shackling the state and unleashing the markets where the markets themselves are shackled by pervasive failures is a dead-end. In consequence, neo-liberal reforms could not but lead to an economic dead-end. It is true that in recent years there has been a commodity prices driven boom in African economies but there has not been development and transformation generated by neo-liberal reforms.

The attempt to promote democratization in Africa without a transformation of the political economy from one of pervasive rent-seeking to one of value-creation has simply provided a democratic veneer to the pre-reform zero sum politics of Africa. It has not so far succeeded in establishing stable democracies. So long as the approach remains mired in the neo-liberal paradigm, with a focus on reducing the size of the state rather than changing its nature, the path of neo-liberal democratization will remain a dead-end.

This, then, is the essence of my paper. The neo-liberal paradigm is structurally flawed, and the neo-liberal reforms in Africa have reached an impasse. A developmental and democratic alternative is available and possible. The choice is for each country to make. The EPRDF had made its choice long before my paper was written. The results so far are encouraging.

I thank you.

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