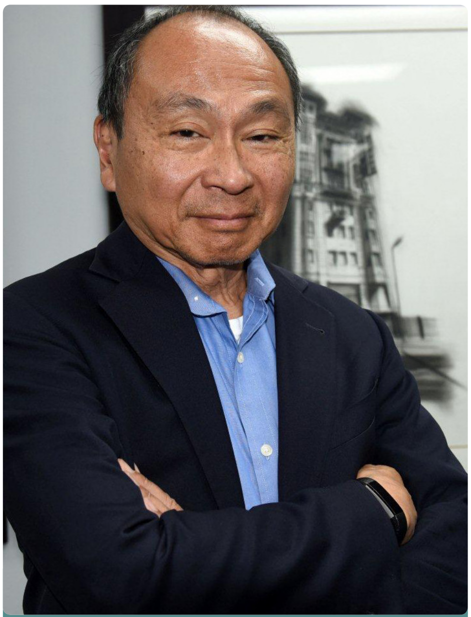
CDE INSIGHT

The state and economic development

Professor Francis Fukuyama



This is one of three publications arising from Prof Fukuyama's talks in South Africa. All are available at **www.cde.org.za**

Introduction

In March 2019, CDE brought internationally renowned scholar, Francis Fukuyama to South Africa for a series of public lectures and more intimate engagements with policy-makers and business leaders. Professor Fukuyama is a Senior Fellow at Stanford University. He is one of the world's most prominent public intellectuals and founder of The American Interest. *He has published a dozen influential books on subjects as diverse as biotechnology, trust and the development of the state in modern history. He is most famous for a 1989 article on* 'The end of history' *and a related 1992 book,* The End of History *and the Last Man that together helped many intellectuals in the West to frame the implications of the end of the Cold War.*

This paper is based on Professor Fukuyama's reflections on the role of the state in economic development which he offered at a series of public lectures, and workshops with government officials. In his view, the key question has been how governments can create the conditions for business-led economic growth. He detailed the changing views that have surrounded this issue since the end of the Second World War. He also set out the key considerations for a country like South Africa in a complex global policy environment.

August 2019

Changing ideas about the role of the state in development

Professor Fukuyama began his analysis by noting that the need for an effective state has been widely acknowledged, even by political and economic liberals, but that ideas about the proper role of the state have changed considerably over time, and has varied between the very minimal and the highly interventionist. Proponents of even the most minimal role for the state acknowledge that states must provide "public goods" that markets cannot deliver, including law and order and defence against foreign aggression. Crucially, even minimal states must maintain a framework of property rights and regulate natural monopolies. Many economic liberals also envisage a role for the state in maintaining the boom-bust economic cycle.

An "intermediate" conception of the scope of state activity includes the provision of basic health care, interventions to address negative externalities, for example in environmental pollution, and basic protections for the poor. Intermediate states also seek to maximise positive externalities, for example through the provision of public education systems. Such a state might also regulate systemic risks in the banking sector and in the financial system. It can facilitate the emergence and stability of social insurance systems that can remain market based.

Finally, Fukuyama identifies a more "activist" conception for the state, in which it engages in wide-ranging industrial policy and the redistribution of income and wealth.

Fukuyama set out a periodization highlighting how institutions and economists' views have changed over the decades. Between 1950 and the early-1970s, 'state-centred' approaches to development were fashionable. This was partly in response to a context in which the capitalist world had experienced the Great Depression and the Soviet Union's economy was growing quickly, with the result that many counties adopted five-year plans. At this stage, the limitations and internal tensions of state planning were not fully understood.

The impact of the apparent success of the Soviet economy on policy ideas was reinforced by the Harrod-Domar model of economic development. This implied that developing countries' greatest need was for higher levels of investment in capital equipment and infrastructure, and it seemed plausible that these would be better provided by the state than private firms in these economies, which were, in any event, often small and uncompetitive. In this context, governments tried to use infrastructural investments, import substitution policies, and targeted industrial policy (including infant industry protection) to encourage industrialisation. The hope was that these policies would allow local firms to grow big enough to compete in international markets.

Problems with these state-centred approaches began to become evident in the late 1960s and 1970s. From the early 1970s, Western economies were hit by oil price rises, 'stagflation' (a combination of inflation and unemployment) and debt crises. It also became clear that infant industry protection often became an unaffordable entitlement that established firms refused to relinquish even after they were no longer infants. Industrial policy often turned into an unsuccessful attempt to "pick winners", or worse still the provision of subsidies to particular politically connected or politically sensitive businesses.

The 1980s and the Washington Consensus

The 1980s and 1990s saw the emergence of more market-centred approaches to development that displaced the state-centric orthodoxy that preceded it. These changes were associated with a so-called "Washington Consensus", originally formulated in an article in 1989 by economist John Williamson at the Institute for International Economics in Washington, DC.

Williamson had distilled emerging themes from international financial institutions' recommendations to governments of developing countries that had experienced economic crises. He noted that the World Bank and the International Monetary Fund emphasised ten key issues:

- Fiscal discipline
- A reduction of subsidies and increase in provision of pro-growth services
- Tax reform
- Market driven interest rates
- Competitive exchange rates
- Trade liberalisation
- Prioritising foreign direct investment
- Privatising state owned enterprises
- Deregulation and increasing competition
- The strengthening of property rights

Professor Fukuyama believes this shift to market-oriented interventions had much to recommend it. However, especially in the aftermath of the collapse of the Soviet Union, pro-market policies often slipped over into a form of "market fundamentalism".

Fukuyama remains sympathetic to the proponents of cross-border investment, an open trading system, and other dimensions of international integration. But an extreme form of neoliberalism, in his view, became a "religion": it "went too far", undermining community life, national sovereignty, and the social underpinnings of democracy. This, together with the uneven and sometimes disappointing results of the implementation of the policies embodied in the Washington Consensus in emerging economies (e.g. the privatisation processes in Eastern Europe and Russia as the rise of inequality across many countries), has itself led to a rethink, with more and more attention now being paid to the critical importance of strong institutions.

More recently, the Washington Consensus has been shaken by the association of its recommendations relating to the financial sector with a series of international financial crises. Fukuyama notes that financial systems were relatively stable before the deregulation and liberalization of the financial sector in the 1980s. Financial markets, however, are less stable than other parts of the economy, subject to booms, panics, and manias. Financial institutions are politically powerful and seek to evade regulation. Banks also generate systemic risk that makes it impossible for governments to refuse to bail them out. All told, a liberalised financial sector imposed massive risks and costs on the rest of the economy.

Good governance

While disenchantment with so-called "neo-liberalism" was crystallizing in the late 1990s, interest began to grow in the notable success of East Asian "Tigers" or "developmental states", many of which did not appear to adopt the Washington Consensus's 10 recommendations uncritically. This has been reinforced by China's experience of rapid growth sustained for a long time.

At the same time, international financial institutions shifted their focus to issues of "good governance". Promoted especially strongly by the World Bank, the good governance agenda was intended to reduce the prevalence of corruption – now viewed as a major drag on development – and build growth and welfare-enhancing systems of accountability and transparency.

This had some successes, most notably in Eastern Europe, where European Union accession conditions forced aspiring members to deepen accountability and transparency, fight corruption, and entrench the rule of law.

Unfortunately, good governance initiatives have been less successful in developing countries. Professor Fukuyama notes that "anti-corruption programmes often don't work very well" and that "improving state capacity is very difficult indeed". The donor community, it turned out, had very little leverage over domestic politicians and could not drive behavior change in the face of incentives for bad governance.

The causal relationships between good governance and economic growth, moreover, turned out to be complex. Although good governance and growth often seemed to go together, it was not clear which, if either, should come first. Borrowing a term coined by development theorist Merilee Grindle, Fukuyama noted that "good enough governance" might be the right immediate goal for most developing countries to aim for.

The Beijing challenge

While the Western development community debated the relative merits of less or more restricted markets, the state, and good governance, the Chinese economy continued to motor ahead. The idea of a "China Model" or "Beijing Consensus", has, as a result, began to be counter-posed to the foundering "Washington Consensus".

The Beijing Consensus, according to the man who coined the term, Joshua Cooper Ramo, did not set out a competing model to the Washington Consensus and there was no suggestion that other countries should follow the development path of China. Rather the Beijing Consensus embodied the idea that each country would follow its own development path, using its own combination of state and market, and deploying different institutional configurations. Ramo rejected the alleged universality of the Washington model, but also of any alternative model.

Other proponents of the China Model, however, have sought to articulate clear differences of approach between it and the previous pro-market consensus. Trust in "the free market" was devalued; the role of the state in development was celebrated; any link between democracy, human rights and economic growth was disavowed; and experimentation and pragmatism were celebrated. This approach to development, however poorly specified it might have been, began to receive far greater attention after the 2008 global financial crisis that China weathered more successfully than most western nations.

Where are we today?

Fukuyama notes that there is no longer any international consensus about how to encourage economic development.

- 'Market fundamentalism' has generally been abandoned, but the critical role of markets in economic growth remains universally accepted.
- The plausibility of a state-led development model has made a partial return, encouraged by the apparent success of the Chinese development experience.
- There is a general acceptance that we need to abandon the 'good governance' project, and accept that 'good enough governance' represents a more plausible and pragmatic approach.

What, then, is the way forward for a country like South Africa?

Fukuyama argues that we should not despair that there is no longer any consensus about any particular overarching development model. This is a happy situation because we are no longer trapped by ideology or by the false temptation of universalist recipes for success.

Every country, South Africa included, needs to formulate its own development strategy. In his lectures and responses to presentations, Professor Fukuyama made a number of important points about how such a strategy should be advanced:

- **Steer clear of "bad ideas"** that have been resurrected by some intellectuals and policy-makers, some of whom disavow prudent fiscal policy and embrace a host of failed ideas. Developmental states, for example, have been successful in places like East Asia, but their success was due to specific historical and cultural traditions, like long experience with meritocratic bureaucracy. These conditions do not necessarily exist in other regions of the world.
- **Don't bet on China's being a savior.** China's emphasis on investment in infrastructure may bring advantages to developing countries because they "are good at building things for general public benefit". However, China may be "too relaxed about risk" and is likely to be overestimating the returns on investments whose long-run sustainability remains at best uncertain.
- **Encourage labour-intensive industries.** This cannot be done, however, by climbing the same ladder as South Korea. "Given the structure of the global economy, it is very unlikely that a developing country is going to replicate the stages of development that South Korea went through: the upper ranks of that development ladder are now occupied by China". Instead we need to "find a niche that is not already occupied." Intra-African trade expansion, encouraged by appropriate infrastructure and the removal of barriers to trade and investment, would help.
- **Attract Foreign Direct Investment.** South Africa's problem has been that much investment has historically been in extractive industries that are capital-intensive, frequently corrupting, and located in areas of low population density. Special energy needs to go into promoting transparency and ethical behaviour.
- **Address corruption.** South Africans need to recognise that corruption has been a universal problem but that many have found that it can be solved by promoting economic competition, weakening oligarchs, and changing bureaucrats' behaviour. Anti-corruption prosecutors "can work".
- **Plan for technological change.** "A lot of jobs are already being automated away, and that process is going to continue in the future. Every society – including South Africa's – is going to have to figure out how to retrain people."
- **Keep the developmental state simple.** "Before looking for out-of-the-box solutions, try fixing basic public good provision... If you want a developmental state, get the electricity on 24/7." Fukuyama believes that, "you should probably figure out how to do the basic kind of goods provision, and fix that first: no complicated strategy is going to work if your lights keep going off".

CENTRE FOR DEVELOPMENT AND ENTERPRISE

Published in August 2019 by the Centre for Development and Enterprise
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