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Response to Addo

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I. Alice, an Introduction

We have been taken on an extensive tour of neoradical political theory. We have had the good fortune of having Professor Herb Addo as our guide, so the tour has been lively and illuminating. However, in the end, one gets a sense that this neoradical political theory is a lot like Alice's Wonderland. It begins with a long and sorrowful tale, nearly drowns us in a sea of tears that accompanies the sad whining of an outmoded dependency theory, and ends with a trial in which it is axiomatic that something called "Global Capitalism" is guilty of the "ever-increasing efficient accumulation of global capital" and that "the only thing that remains the same is the changing continuity of the exploitation of the Third World by ever-refining imperialist ways and means." As in Alice's trial, the West is already judged guilty and no evidence need be presented. What case there is is made by the rhetorical devices of assertion and repetition.

But Alice eventually awakes from her dream Wonderland and, so, I feel obliged to try to drag our neoradicals from their intellectual demimonde. In doing this, I will take on some of the neoradicals' assertions directly. First, I would like to straighten out some of the supposed facts about economic growth and international capital flows. Second, I would like to indicate why I think much of radical or neoradical theory is not very useful. Finally, I would like to briefly describe what are probably more mundane but certainly more useful recommendations on economic policies that a Third World country can follow to increase its rate of economic growth.

II. What We Know about Development

A basic tenet of the radical and neoradical faith is that the "center" has been getting richer at the expense of an increasingly impoverished "periphery." In a recent paper, Parente and Prescott show that if one compares the real per capita income of the five richest and the five poorest countries in the world (as fractions of the U.S. per capita income), the ratio has remained virtually unchanged over the last thirty years. The average per capita income of the five poorest countries has remained at about one thirty-second of that of the five richest. If one looks at the country by country distribution of per capita income (again as fractions of U.S. per capita income), there has been an important change over the last thirty years: the global distribution of per capita income has become flatter. This change in distribution implies an increasing variance in income of about 16 percent during the thirty-year period. However, the increasing variance did not come by poor countries uniformly becoming poorer; some of the poorest countries in 1960 were among those that experienced the fastest growth. The increased variance occurred because some middle-income countries became richer, some poorer. Most of the ten countries that showed the greatest decline in per capita income were involved in either civil or international conflicts during the period. For someone outside the neoradical faith, the issue is complex and is not simply one of the "North" growing "inordinately rich" and the "South" growing "filthy poor."

While the radicals and neoradicals claim that the distribution of income inside Third World countries has worsened, there is little data to bring to this claim, most of that anecdotal. Most Third World countries have growing middle and upper classes that have at least reduced their ostentatious display of wealth. For example, in modern Argentina, there is no current display of wealth similar to that of the palaces built by the turn-of-the-century cattle barons. In Third World countries, the really wealthy of today are those politicians who ruled their countries during natural resource booms. Among the economics profession, the most famous of these is former Mexican president Portillo, who, upon retiring from the presidency, is reported to have gone to Switzerland to join the two-billion-dollar pension fund he managed to stow away there during his presidency. Similar anecdotes, but with smaller numbers, exist involving Indonesia, Nigeria, and Venezuela.

Many Third World countries currently subsidize the domestic price of basic food commodities such as rice, beans, and corn and, by doing so, raise the living standard of the urban poor. (I would be derelict not to point out that this potentially useful practice is frowned upon by World Bank officials.) Unfortunately, in many countries this subsidy is paid by the rural poor, who are forced to accept lower prices for the goods they produce. So the urban poor are made better off by a policy that makes the usually poorer rural poor even worse off. In the great majority of Third World countries, many people who are officially unemployed are really working in the informal sector. How many of them there are and what they are earning are unknowns. In any case, the data are contradictory. It is not a fact that income distributions in Third World countries are worse today than, say, fifty years ago. We simply do not know.

Except for a few unusual years, Latin American countries have been net receivers of world investment since their independence. Neoradicals frequently point to Argentina, Brazil, and Bolivia during their years of hyperinflation and to Chile during the years of gross economic mismanagement under Salvador Allende as periods when nationals with wealth sought international safe havens and generated net capital outflows. In almost every other period, Latin American countries have received an enormous amount of capital from international capital markets. Very shortly after gaining independence from Spain, Latin American countries were able to borrow on the London market, and private European banks opened branches in major Latin American cities. In another example, the phenomenal growth of Latin American railroad networks in the late nineteenth and early twentieth centuries and the economic booms that followed were almost entirely financed by British and U.S. capital. Consider Africa. Since independence, the countries of Africa have received massive inflows of capital, some as direct private investment, some as government to government gifts, some from international agencies, and some as loans. In fact, the *World Development Report 1991* shows that in each decade since 1950, every region of the Third World has received net resource inflows. In 1992, the resource inflow to the forty poorest countries of the world averaged five percent of their total consumption.[1] Neoradicals may argue that they would prefer the resource flows into the Third World to be larger than what they have been and, in fact, so would I. However, based on the data, the claim that the goal of the "Global Capitalism" is "the everincreasingly efficient leakage of capital from the periphery of the system to the center of it" is very strange because, if that is the goal, "Global Capitalism" is failing dismally at achieving it.

III. A Critique of Neoradical Thought

Why is it that most of what comes under the heading of radical or neoradical thought about development is not very useful? For some intellectual effort to be useful, it is not sufficient for it merely to name the actors in the global farce and to assign various amounts of blame to each one of them. To be useful, it must provide alternatives. In addition, it is particularly helpful if these alternatives are (1) technically feasible; (2) sufficiently well articulated to permit careful analysis, testing, and implementation; and (3) do not require a social revolution for implementation. The first two are characteristics one would ask of any good theory. The third is included because revolutions are known to be particularly difficult to control and far too frequently have unfortunate outcomes. May I offer the French Revolution, the Cultural Revolution in China, and Pol Pot in Cambodia as examples?

Real intellectual advances among radicals have been hamstrung by their slavish adherence to the canons of Marxian theology. Professor Addo's paper is proof enough of that and, in addition, it is proof that Professor Addo is a brave man. In what is a significant departure from standard radical fare, a large fraction of his paper is devoted to a serious attempt to get the faithful to abandon one of the major pillars of Marxism: that History (with capital H) inexorably advances to a particular goal and that this goal is the fall of capitalism and its replacement by a proletarian utopia. The Marxist Inquisition has historically been unkind to heretics.

Professor Addo's creative pessimism fails to be useful for the second of my three reasons. While he peddles creative pessimism as a magic elixir, as an intellectual paradigm it is insufficiently well articulated to be either implemented or analyzed. It is also not necessary. Professor Addo's unease about events in Russia shows that he has considerable sympathy for Edmund Burke, who followed similar lines of argument with respect to the French Revolution. My own unease about Russia has a quite different basis. I have watched the rulers of the countries of the new Eastern Europe squabbling over the ruins of the Soviet empire and dismantling the old Soviet allocation mechanisms while failing to put into place the legal and taxation systems required to get new mechanisms working. Private enterprise systems do not operate well without well-defined legal rights to private property and adjudication mechanisms for settling disputes. In addition, the method of setting prices under the old centrally planned economy generated substantial implicit subsidies and tax revenues. Russia's enormous inflation and the rise of extralegal enforcement agents (more commonly known as the Russian mafia) are the inevitable results of this delay in implementation.

Viewed from the perspective of usefulness, the radical and neoradical theory of dependency and its religious equivalent, liberation theology, fail utterly. This theory is almost totally outward looking. Based on the dual delusions of paranoia and aggrandizement, dependency theory views both the poverty and the failure to grow of Third World countries as a result of their dependence on the firms and governments of First World countries for most of the technology and goods they consume and for the markets for the natural resources and (generally primary) products they produce. Dependency theorists argue that the "North" should pay more for goods they import from the Third World and charge less for goods they export to the Third World. How this will be done in a decentralized global economy where pricing mechanisms are outside the control of any government is never explained. That these arguments have had any effect on resource allocations at all is more a testament to the humanity and sympathy of the citizens of First World countries than to the intellectual merit of the theories. Of course the Third World countries are dependent on the global economy — every country that trades is, rich or poor. Of course they cannot control it—except for a temporary event like the OPEC price rises of the 1970s, no one can. The poorest countries are not so much subservient to the world economy as they are irrelevant to it. In 1992, a mere 2 percent of world trade involved the 40 poorest countries and only 22 percent involved the poorest 108. Seventy-eight percent of the world's trade was between the richest twenty-four countries. One can easily understand the popularity among the intellectuals of Third World countries of a collective delusion that claims that their countries are very much "functional parts" of world capitalism, "in the process of the system's self-creation by self-propulsion." However, if this were true, their countries would be taken more seriously in world affairs.

Social or development theories that use religion as a predictive variable (as Professor Addo uses when he proposes that the prevalence of Confucianism among the Asian NICs is what causes their development) miss the point entirely. Religion is endogenous to a society; each society has the religion that fits that society's nature and requirements. History has shown us that when a religion fails to fit that nature, it is discarded for another one. Admittedly, the institutional hierarchy of a religion will resist the change, but over time the resistance is usually futile. Aggressive, expansionist societies require aggressive, expansionist religions. Passive, introspective societies require passive, introspective religions. The correlation that Professor Addo (following on similar theories of other eminent scholars such as Max Weber) has pointed out between Confucianism and the newly industrialized countries of Asia only reflects the fact that Confucian ideas appeal to the societies that prize order, obedience, and learning — three characteristics that apparently aid in growth. The Asian countries where these ideas are not valued so highly do not have such high growth rates and, concomitantly, do not have a strong Confucian ethic. Claiming that Confucianism gives rise to growth is imputing a causal direction that is not warranted. In fact, thirty years ago, social theorists used Confucianism to "explain" why Asian countries were not growing.

IV. What Just Might Work

Having spent this much time talking about what is wrong with the radical approach to development theory, I would like to point out some directions of research that I think are potentially very useful.

For twenty years, from 1965 to 1985, economic theory had not been able to say much about what a Third World country can do to help itself. Western economics' principal technical tool was Robert Solow's neoclassical growth model (1956). This model concentrated on the role of the labor force, technological progress, savings, and capital accumulation as the main engines of growth. This theory fell into disfavor because one of its main predictions was that massive amounts of capital should flow from rich (high capital-to-labor ratio) countries to poor (low capital-to-labor ratio) countries. Over time, all countries should end up with the same capital-to-labor ratios and the same growth rates. This result is flatly contradicted by the data. An embarrassed silence fell on development theory. It was unable to explain the failure of poor countries to attract capital.

That silence was broken in 1986 by Paul Romer. Romer added skills (which economists call human capital) to Solow's model and hypothesized that the more skills there are in an economy, the easier it is for others in that economy to acquire skills. Romer's version of the neoclassical growth model provided predictions dramatically different from the earlier version. Poor countries with low skill levels would not attract foreign capital because the return on the capital would be low; machines are not very productive when those using them are relatively unskilled. Countries with few skills could become trapped in a poverty equilibrium where the low skill level made it very difficult if not impossible for young members of the economy to get international-level skills. The continuing low levels of human capital discourage foreign investment in physical capital. In other words, when the slaves on Saint Domingue revolted and slaughtered almost everyone in their country who had an education, they may have been condemning their descendants to perpetual poverty. Romer's model also predicts that poor countries that make large investments in human capital may be able to break out of the poverty equilibrium and achieve high rates of growth. The Asian NICs are unusual in both their high levels of economic growth and their high rates of investment in skills.

Bob Lucas has produced a model that is an interesting variant on Romer's. In Lucas's model, skills are acquired on the job so that countries that are producing goods learn to produce those goods better. In the early stages of their modern growth experience, both Korea and Japan encouraged production for export (and discouraged imports) by intentionally undervaluing their currency. This policy encouraged expansion of higher skill industries and a learning-by-doing driven by comparative advantage in manufactured goods. Note that this policy is very different in both its incentive structure and its outcomes from the Import Substituting Industrialization policies of most Latin American countries in the 1960s.

While net resource flows to the poorest forty countries have been positive, net private capital flows to these countries have been slightly negative. These countries have so little physical capital that the return on investments there should be very high (even when their relatively low skill levels are taken into account). Most Third World countries do not have the legal structure, enforcement mechanisms, and financial institutions that would allow investment and the monitoring of that investment to be done relatively inexpensively. Most private firms in Third World countries are financed on familial, extended familial, or interlocking (reciprocal) ownership lines. The extrafamilial networks of trust and the legal institutions that protect and encourage trust that are the hallmark of developed countries' capital markets simply do not exist in Third World countries. The failure of Third World governments to develop appropriate financial and legal institutions condemns their countries to a scarcity of capital and a form of petty capitalism that makes them unable to compete in international markets.

In many countries, the legal and governmental atmosphere is even worse than unhelpful to the private allocation of capital—in many countries the atmosphere is positively hostile. Every country has governmental regulations that facilitate rent-seeking from governmental officials and needlessly hamper productive activity. By needless regulations I am not referring to those that are aimed at achieving some particular social benefit such as pollution reduction or safety in the workplace. Regulation for regulation's sake is pervasive in Latin America and elsewhere. In Lima, Hernando de Soto set up a simulated sole proprietor clothing factory and needed 289 days, faced expenses of $1,231 dollars (at the time equal to thirty-two times the minimum monthly salary), and could find no way to get around two of the ten bribes requested in order to get the necessary legal approvals. It is a small wonder that most Third World firms belong to the informal sector. Of course, belonging to the informal sector prevents a firm from legally exporting its products and from being able to acquire the capital required to grow beyond some quite small size. The incentives built into these systems are truly perverse. Most of the firms do not want to get very big, for then they will attract the government's attention and be forced to meet the many regulations or suffer high costs in side payments to avoid them.

I could continue for quite some time, but I think the policies I have mentioned above are the most crucial. For most countries of the Third World, improvements in education and training in productive skills are prerequisites for economic growth. Making the financial system simpler, more transparent, and easier to monitor will help in reducing the costs of investing. A legal system that protects the rights of both the owners of capital and the workers, that makes incorporation and entry into the formal sector simple, that can effectively deal with business and governmental corruption, and that provides for stable transitions of political power is necessary for growth. Too many of the politicians and intellectuals of the Third World look upon international markets, multinational firms, and their own business communities as something to fear and avoid. While they cannot control international markets, they can use them wisely. They can (and do) control the legal system under which production inside their own countries takes place. They must do this without imposing the weight of excess regulation on their own people. While governments have limited ability to make their countries grow, they can easily prevent whatever growth might be possible. This idea is far from new. I would like to end by quoting advice to government officials given in Stephen Mitchell's translation of the *Tao te Ching*, written some 2,500 years ago.

> When taxes are too high, people go hungry.
> When the government is too intrusive, people lose their spirit.
> Act for the people's benefit.
> Trust them, leave them alone.

Note

1. *World Development Report 1994* (New York: Oxford University Press, 1994), 178.

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