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Development and the capitalism-capable society: The role of the State, social policy and economic growth

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MAIN POINTS
Development is a social context or network which involves a particular set of institutions: the capitalism-capable society. The State, social policy and economic growth are the key ingredients. Developing countries are not capitalism-capable: that is their crucial problem.

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Executive Summary

This OCGG Economy Section *Analysis* sets out a theory of development. Following Amartya Sen, Development is defined as the appropriate context for individuals to exercise 'their reasoned agency'. But development is also about economic growth since, without it, that context is difficult to create. The relevant question is then: what produces economic growth?

Based on growth theory (from the works of R.Solow to those of D. North), it is argued that, behind growth, we find the establishment/consolidation of a particular context of interaction which involves citizens, government, legislation and territory: the State. The latter is crucial because it constitutes the primary social facility which allows for the existence of other facilities. Without a State there are no formal institutions to back economic relations nor a functioning pro-growth social policy; both are necessary to achieve economic expansion and, therefore, development.

A holistic social policy is key in the construction and preservation of economic growth and development. Its tasks are: a) the creation/consolidation of technological innovation/adaptation capabilities; b) to compensate those who lose when society changes owing to economic growth; c) to redistribute income through education and health services, as well as financial support for entrepreneurial projects, and d) civic education to strengthen the State. Development is then the product of a package; it is systemic. In such a package there is, *at least*, the State, social policy and economic growth: the *capitalism-capable society*. These terms are used for the following reasons: 1) in the literature, when dealing with "the economy", one is dealing with the *capitalist* economy and not any other type of economy, and 2) *society* means that development is the result of a collective effort.

Given that development is a social context, actor-network theory is introduced and development is then redefined as a network at the service of individuals: it is emphasised that the problem of developing countries is their recurrent failures to build such network.

The policy recommendations presented in the paper are as follows:
1) The relationship between government and citizens in developing countries has to be strengthened and governments must be stronger so that they can put in place the institutions and policies the *capitalism-capable society* demands. The promotion of the importance of the law, of good governance, of corruption-free societies and of the rights of others is essential.
2) The quality of the labour force is crucial. Governments should make sure individuals are skilled in production, capable of operating machinery, create new ideas and new methods in economic activity. Besides this, the right environment for innovation should also be set up: (i) protection for the benefits arising from ideas, and (ii) the use of public funds to finance technological research and development if possible.
3) Measures such as free education, housing and health may be necessary for certain individuals to be able to deliver, i.e., to be productive.
4) Although always full of ideas to generate wealth, many people in developing countries cannot materialize their projects because of a lack of capital and/or markets. Governments should try to link people to markets and set up financing schemes to provide poorer people with the funds they need.

Introduction

This is a theoretical paper about Development, so let us begin by defining it. Following Amartya Sen (1999), I shall define Development, to begin with, as a matter of people; it is about providing individuals with the appropriate context to exercise 'their reasoned agency'. Development is then individual freedom from, among others, poverty, tyranny and intolerance. But Development is also about economic growth. Why? Because without growth it seems very difficult to create the 'appropriate context' Sen refers to:

> [p]olitical freedoms (in the form of free speech and elections) help to promote economic security. Social opportunities (in the form of education and health facilities) facilitate economic participation. Economic facilities (in the form of opportunities for participation and trade and production) can help to generate personal abundance as well as public resources for social facilities (Sen, p. 11).

The relevant question then is: what produces economic growth? In simple terms, economic theory teaches us that growth depends on the combination of capital (physical and human) and labour given a particular production function. Basically, the more labour and/or capital there is the more growth there will be. But because a simple increase in either capital and/or labour may lead to decreasing returns, the ultimate explanatory factor of growth is the evolution of the production function, which is represented by technological innovation/adaptation: the ways in which capital and labour are combined are far more important than how much there is of each of them.

This explanation is harmonious but superficial. This, however, does not mean that it is useless or simple: theorizing economics is very complex and it does help us to understand how markets and exchange work and how economic growth takes place. But, as Douglas North expresses in his Nobel Prize lecture, it does not tell us anything about how to construct markets (North 1994) nor exchange, nor the basis of economic growth. Another Nobel Prize winner, R.H. Coase, has also emphasised the superficiality of standard economic theory. According to him, most economists live in a world in which 'exchange takes place without any specification of institutional setting. We have consumers without humanity, firms without organization, and even exchange without markets' (Coase 1990:3).

The key question is not then whether to grow an economy needs more capital/labour and/or better ways to combine them: that is obvious. The relevant questions are: what is behind technological innovation? What determines that some societies produce more innovations than others and/or adapt better to them? Why some societies accumulate more capital than others? Etcetera. Answers such as 'because some societies have better education systems or more entrepreneurs (willing to take risks to innovate) than others' are obviously superficial too since, in that case, the questions then become: why some societies have better education systems than others? Why are there more entrepreneurs in society X than in society Y?

For Amartya Sen the key to economic growth is not as simple as economic theory suggests: it lies, precisely, on the 'appropriate context' I referred to above: freedom is then both *the means to* and *the end of* Development, i.e., freedom/Development is expected to lead to economic growth but, at the same time, economic growth is necessary for freedom/Development to exist. This interaction, though, has to start somewhere. Where?

Through a long and ample analysis of the many varieties of economic growth theory I will argue the following: societies which generate innovations and growth are so because of its *constitution*, i.e., because of how they are arranged: mid to long-term economic growth, and stagnation, are collective/social outcomes; they are systemic. Behind economic growth, the crucial means to Development, we do not find the facilities Sen talks about but the establishment of capitalism-oriented institutions: societies which are *capitalism-capable* are the ones most likely to produce economic growth and, in that way, generate the wealth necessary for Development to take place. Sen is right: Development is a context, however, it is not freedom but a *capitalism-capable society*; freedom is part of it.

Because it is a context, Development can be understood as network at the service of individuals, which is why mine is an actor-network approach, as we will see ahead. But why the terms *capitalism, capable* and *society*?

a) Whether we like it or not, capitalism, i.e., the system of production in which economic decisions are made mostly by private agents who seek profit in free or, at least, relatively free markets, has proven to work: it produces wealth in amounts vast enough for humans to meet their needs, specially to meet the needs of mass societies. Given that at the end of the day some kind of economic organization is a natural feature of all societies, and given too that capitalism has shown to deliver, it should then be considered as, if not the best, the least bad way to organize a mass economy.

b) When taken all the branches of economic growth theory into account, that is to say, when bringing together the conclusions of each of them, growth, and along with it, Development, can be understood as the outcome of a package: growth is systemic. The system, which in the literature is usually referred to as *the economy*, as if there was no other type of economies or systems, is not any economy: *it is the capitalist economy*, whether explicitly or not. Allow me to elaborate: what we learn in economics books is usually explained to us as being about the *economy*, as if there was only one type of economy or, even worse, as if there was a “natural” economy. However, it does not take much to realise that this “natural” economy is the capitalist economy. It does not take much either to realise that this “natural” economy is not the only one possible since there are many ways to arrange an economy depending on the role and scope of markets, the regime property and the role of government, at least. So, a capitalist economy is not the only one that can exist. History and theory, nevertheless, show that the most successful way to arrange a mass economy is in a capitalist way, i.e., through private property, private decision-making, market-based resource allocation, etc.

c) As said above, economic growth, and stagnation, should be understood as a social outcome, i.e., it is collectivities which are responsible for it. This is why I talk of a system; of *societies*. Abramovitz (1986) argues that economies expand when societies develop certain ‘social capabilities’, such as the facility to diffuse knowledge, the creation of macro-economic conditions to encourage investment and the ability to speed structural change. I agree, but the problem with this argument is that it speaks of ‘social capabilities’ as if there was only one possible set of them, or as if those societies which have developed them are the only ones with capabilities: “primitive” societies, according to Abramovitz, would simply have no capabilities at all. And the same goes for the countries which were once socialist, like the USSR and the GDR. This is of course wrong since all societies have capabilities of one kind or another. The key of my argument is that those societies which have *capitalism-oriented capabilities* are the ones most likely to produce economic growth: just like it is not any random economy but the capitalist one we are talking about, it is not any random capability or 'social capability' I refer to, it is capitalism-oriented capability.

Making the explicit point that the *economy* is the capitalist economy is of relevance because it allows me to stress the following idea: economic growth is to be understood as capitalist economic growth, and not any other type of growth. So, for instance, when it is said that developing countries lack economic growth, what it should really be said is that they lack capitalist economic growth. This is done by De Soto (2001) when he tries to explain why capitalism works in the West but not everywhere else. However, he leaves the point half way and ends up doing the reverse of what most economists do, i.e., he does not talk of an economy which "turns out" to be capitalism but of the latter as "naturally" being *the economy*. Because he does it "naturally", he fails to explain why capitalism is to be considered as *the economy* and why such system of production, and not any other, is the most likely to produce economic growth. The same goes for J. Schumpeter (1984 [1942) who is one of the few major economists of all times whose ideas are explicitly about capitalism and not about *the economy* (Karl Marx is another one. He does provide an explanation as to why he talks of capitalism, however, such explanation results from his Historical Materialism and is beyond the scope of this work).

The above, evidently, takes us back to both Sen and De Soto: certain social structures, certain context or institutions, are necessary for economic growth, understood in my case explicitly as capitalist expansion, to take place. North (1994; 1981) has also pointed out the relevance of institutions in so far as they arrange social interaction and, therefore, outcomes. And the same goes for Coase (*Op. cit.*: 10) who argues that markets require rules (institutions) governing the rights and duties of those carrying out transactions.

Certainly, strong institutions (*capitalism-oriented* institutions) are required to enable individuals to generate wealth continuously and, therefore, to enable society to build political freedoms, social opportunities and economic facilities. But what is it that allows for the existence of such institutions?

The State is the answer. By it, I mean a framework of peaceful and predictable interaction composed of four elements: population (understood as citizens), government, territory and legislation. A bunch of people living in the same territory but without a government cannot be considered a State. At the same time, a territory with a government but without citizens, i.e., without people who identify with such government and with each other, cannot be considered a State either. Legislation, which should be in favour of individual liberties and rights if it is to be pro-economic growth and Development, is key because it explicitly regulates the interaction of the actors: without it, or without its enforcement (the responsibility of the government), the State is not such at all.

Coase (*Op. cit.*) does highlight the relevance of the State but takes the latter as a given and thinks of it as government. North (1981) also stresses the key role of the State and even submits that no theory of economic transformation can be complete without an accompanying theory of the State. He does offer such a theory but I believe it is wrong because it also treats the State as what I would define as government. Besides, North presents the State as predatory and only focused in achieving more and more wealth for the rulers. Here, I do not offer an alternative theory of the State (this I shall try to do later on as my work progresses) but I do offer a set of ideas which could be considered as the departing point of it (above). Allow me to emphasise its crucial aspects:

1) The State is not the same as the government: it is, I insist, a framework of interaction and the government is one of its components.

2) The government is not a predatory entity trying to get more and more wealth for the rulers. Its functions are to provide and enforce legislation. It does obtain economic resources but not for the benefit of those in power (or at least not only for that reason) but of society's: the resources are used to finance the social policy required in the *capitalism-capable society*.

3) The root of the State, ie, what allows it to be the framework I have described, is a sense of citizenship, of belongingness, as well as the legitimacy of its rules. It is this sense of citizenship what induces individuals (not all, obviously) to respect the law and each other (more on this below).

4) Because there are always individuals who will be willing to break the law, ie to break the framework and, in that way, infringe an attack on society and on every member of it, the government must act, coercively if necessary, to back the State, ie, to hold the framework together.

In the absence of the State, economic growth and Development will be difficult to achieve for the following reasons:

1) When talking about mass societies, no State means no formal way to support the institutions which back the economic relations individuals engage in (contracts, exchange, etc), a situation which may hinder economic growth and minimize the possibilities of establishing the 'appropriate context'.

2) Without a State there can be no truly functioning pro-growth social policy; indeed there can be no policy of any kind.

The State is crucial then in the *capitalism-capable society*: *it is* the institutions and policies capitalism demands. To put it in terms of Sen's work, the State acts as the primary social facility as it allows for the existence of any other facilities. And in terms of Abramovitz's perspective, the State is the primary social capability since, without it, societies cannot establish the facilities to diffuse knowledge nor create the macro-economic conditions to encourage investment and the ability to speed structural change.

But if the State is so crucial, then we must ask ourselves what is it that determines State strength. I do not know (which is very unfortunate given that we are talking about one of the most crucial questions ever). I do have a hypothesis, though: civic education, understood mainly as the creation of the sense of citizenship I keep on referring to, seems to be the answer or at least part of it. Without such sense and a government backing it up, individuals tend not to respect the law. When people refuse to respect the law, that is to say to respect the institutions which regulate social interaction and particularly economic activities, then there is no chance for capitalism, nor for any other system, to work properly.

When talking about the consolidation/strengthening of the State, what I mean then is the creation, precisely, of a consciousness of citizenship. The message is then that as long as developing nations remain incapable of building strong States, which is not the same as to say authoritarian States, then they really have no chance of achieving economic growth (nor maybe even anything at all); without States what we can expect is institutional weakness or no institutions at all, i.e., no State = no viable mass economy = no Development.

Obviously, good governance is essential in the equation too since, without it, the rules of the framework I call State will not be considered as legitimate. The building of institutions in developing nations depends then on governments: they have to deliver the education and the governance. But society is also crucial: people have to be ready to respect the law and to demand from their governments to do the same. It is, therefore, an interactive game: people and government must both contribute to build a State and, at the same time, they have to implement policy, design and respect the right institutions, work hard and, hopefully, rip the benefits. It is here where the greatest challenge for developing nations lies: the building of the State/citizenship.

A *capitalism-capable society* then is one in which the reproduction of capital is not only allowed but encouraged through favourable institutional arrangements, and policies, which work because they are embedded in the framework I have labelled as State. In this type of society, economic growth should happen but in order for it to be maximized, and for its benefits to be used in the creation of Sen's 'appropriate context', social policy is necessary. Without social policy, economic growth may fail but, even if it happens, it will most likely be uneven and/or slow, i.e., without social policy economic growth may occur but Development not necessarily. Therefore, there are, at least, 4 roles for social policy (a holistic social policy) in the *capitalism-capable society*:

a) The creation/consolidation of technological innovation/adaptation capabilities: contribute to the emergence of a skilled and healthy labour force, and dedicate resources to technological research and development. This is relevant because without technological progress and a labour force capable of dealing with it, economic growth may be difficult to achieve.

b) To compensate those who lose when society changes due to economic growth (or to allow economic growth by compensating those who oppose to it because it may be costly for them at least to begin with).

c) To redistribute income through education, health services and financial support (credit) for entrepreneurial projects, at the individual and/or collective level, in favour of those who need it most so that the 'appropriate context' can be accessible to all. Without a conscious effort for redistribution it is likely that economic growth will deliver inequality rather than Development; that is usually what untamed capitalism tends to produce. But the inequality issue is deeper than that: if too large, inequality can actually be harmful for economic performance, i.e., for capitalism, so, social policy aims at both constructing Development and to sustain it.

d) Civic education to strengthen the State, ie, to make sure citizens behave as such and respect the law, each other, etc: the creation of a sense of citizenship.

Notice that the roles I attribute to this holistic social policy are about “helping” economic growth, particularly because of the link to technological change. The point is that economic growth cannot take place, successfully, without social policy (this is a conclusion drawn from growth theory itself, as we will see). But as it helps in achieving growth, the proposed social policy also helps to build Sen’s ‘appropriate context’ precisely by interacting with, and using, growth. So, in the *capitalism-capable society*, the role of growth is to provide the means (resources) for social policy to function and the role of the latter is to ensure economic growth takes place, as well as creating the right framework for individuals ‘to exercise their reasoned agency’. Social policy is, therefore, about constructing Development, i.e., constructing the State, building capitalism (growth) and setting up Sen’s ‘appropriate context’, and then keeping all of these in place by using the product of economic growth. (The latter, in turn, makes it easier to achieve even more growth as it results in the expansion and deepening of markets).

The point then is that developing societies, as a whole, are not equipped to adapt to capitalism. Therefore, if these societies want to create wealth, it is advisable that they go for capitalism-oriented institutions. This is, of course, not a guaranteed strategy for growth but it is probably, again, the least bad one available. Given all of the above, State building/consolidation, strong capitalist institutions, and a holistic social policy are the tasks developing countries have to complete if they are to have any serious expectation of achieving economic growth, and Development. They are the elements of a *capitalism-capable society*, ie, they are the elements of, precisely, Development. It is the governments’ responsibility to take steps in this direction but also societies’: people have to be ready to act as responsible citizens, in all senses.

Now, because it is a context, Development/the *capitalism-capable society* can be described as a network at the service of individuals. Therefore, actor-network theory (Law 1992) can be of use here: the *capitalism-capable society* is a heterogeneous network which includes tangible elements such as persons, machines, tools, research centres, etc. and intangible ones such as ideas and institutions. The lack of the State (a node and a link) and/or social policy (also a node and a link) and/or economic growth (the source of many of the elements which constitute the network) can mean the entire failure of the whole of the context, i.e., of the network. And the same goes for the absence of responsible citizens, which to me is equivalent to the absence of the State as defined above.

Defining Development as a network has a further advantage as it makes it obvious that the difference between Developed and underdeveloped countries is that the social network in the former is richer than in the latter and that, therefore, developing countries should aim at progressively finishing (or simply building) the construction of their corresponding networks.

From Actor-network theory we also get these lessons: 1) social systems which survive, ie which manage to reproduce successfully, are not any different to those that fail: they are all composed of interaction between actors. The difference between successful and failing societies is how such interaction is organized (Law: *Op. cit.*), which is exactly why I argue that aiming at being *capitalism-capable* is the best way for a society to arrange itself in order to achieve economic growth and Development; 2) an actor is always a network, ie, an agent is always a result of the network in which it exists (*Ibid.*) So, because Development is about improving people’s life then the network in which they interact/are is crucial and, again, this is why developing countries should aim at building a network like the one here described.

A few clarificationsar e necessary (I appeal to the reader's patience since I acknowledge this Introduction is a bit long by now):

1) I do not argue that only those societies which "look" like what I have described above are developed. There could be societies in which individuals find a context to realize their reasoned agency even if, to the eyes of others, they seem poor or "backwards", for instance some of the aboriginal peoples of Australia and the Amazons. Because those societies, from the perspective of its natives, provide such a context for their members, then they could be considered as developed, at least in their own terms. My point then is that what is relevant is *the context* or network; its qualities, shape, etc. may differ from society to society, according to what each group of people believes to be the reasonable goals and expectations of the individual. I insist, however, that when talking about mass societies, which have evolved to a level of complexity in which it is impossible for anyone to acquire all the goods and services necessary for survival on her own or even relying on family and friends, the *capitalism-capable society* framework seems like a good yardstick to measure Development. Besides, the smaller societies like the aboriginal peoples of Australia, although up to a point independent, are part of larger societies and, therefore, they would also benefit if such larger societies were to become, or remain as, developed.

2) My argument should not be taken either as implying that those mass societies which are very much capitalism-capable are fully developed or that they have reached Development. Indeed, Development is an endless process since there is always some degree of poverty, discrimination, intolerance, exclusion, etc. everywhere: the network can always be improved and it can always weaken if not taken care of. Look for instance at Germany, where it is evident that the economy is not working properly and that, therefore, little by little more and more Germans end up unemployed and even in (relative) poverty: the German network is no longer working.

3) I know my argument may be interpreted as a *recipe* for Development, however, I acknowledge such recipes, unfortunately, do not exist. Evidently, societies cannot stop their everyday activities so that they can build/consolidate their States if they still do not have them. Also evidently, there is usually some degree of economic growth, or at least activity, taking place at all times everywhere. The point then is that, in order to construct Development, one does not move from, let us say, the State, to social policy to economic growth but that one should aim at, sooner or later and the sooner the better, build a society in which the three co-exist; a *capitalism-capable society*: Development.

4) My ideas should not be taken to mean that I believe all societies have to be the same nor that industrialization, obviously associated to capitalism, is the only alternative. (This I will show using some case studies, from the developing world, at the end of the paper). What I mean is that, at least in terms of the institutional framework which we know backs capitalism, societies wishing to produce wealth should resemble those which have achieved economic success, which are the ones in which capital accumulation, and the continuous reinvestment of such capital, find fertile ground. Beyond that, there is room for divergence. Look, for instance, at Japan, France, the United Kingdom and even China (even there capitalism-oriented institutions are emerging) just to name a few examples: in all of these countries long-term economic growth has been successful because capital meets with the necessary arrangements to reproduce, however, these 3 countries are very different in many ways.

As mentioned above, I look at growth theory in order to build my argument, so, in section one I describe the neoclassical growth model. In section 2, I move on to the new growth theories (from these 2 sections important lessons for social policy will be drawn and the need to concentrate on institutions will be made evident). In the third section, I deal with the productivist view (here, I will emphasise the importance of education and health in social policy). The 4th part of the paper is dedicated to the schumpeterian-evolutionist branch of the theory (which emphasises the role of institutions). There is a 5th section in which I explain in detail what institutions we are talking about and why. The 6th part complements the 5th since it focuses on the relevance of the State. Indeed, sections 4 through 6 make up the institutional part of the paper. In section 7, I turn to actor-network theory and explain why all of my argument can be framed in terms of such theory and why this is useful. Some case studies which illustrate why *capitalism-capable societies* are required in developing countries are presented in the 8th part. Finally, conclusions and (broad) policy recommendations will be drawn but, before moving on, a last clarification: I acknowledge that the literature of each of the branches of growth theory I touch upon is much more vast than what I present here, however, I believe that, in my review, I have managed to capture the main messages that emanate from each of them.

I. The neoclassical paradigm

The basic neoclassical understanding of economic growth (Solow 1956 and 1957) is that the latter is the outcome of the interaction of certain key elements: the rate of savings (which equals the rate of investment), the rate of growth of the labour force (which is assumed to be the same as the rate of population growth), the rate of depreciation of the stock of capital (which at least in Solow's original work is assumed to be incorporated into the production function) and the rate of technological progress. Given these rates and assuming full mobility of the production factors (capital and labour) as well as decreasing returns to capital, the system will tend towards a steady state. In such a state, the growth of the ratio of capital to labour is cero which means that the stock of capital is growing at the same rate as that of labour. If on top of that, the rate of technological progress is cero, then the economy grows only enough to guarantee everyone the income level corresponding to the given rates of savings and of population growth and to meet key investment needs such as more tools and machines to equip the new workers that the system must absorb.

Up to here, one point should be clear: the *rates* of savings and population growth determine the *level* of income per person in the steady state. If technological change is absent, the only way to achieve a higher steady state is either to reduce population growth or to increase the savings rate. However, once in the new steady state, the economy, again, will not grow more than enough to meet investment needs and to guarantee the new, higher, corresponding level of income per person.

What happens when the rate of technological change is above cero? In this scenario, economic growth can go beyond what the key parameters (savings and population) would dictate. Indeed, once in the steady state, the economy grows at the same rate as that of technological progress. In other words, the key to continuous economic growth beyond current income per person and investment needs, i.e., the key to the kind of growth which is considered to be desirable, specially in the developing world, is technological change. *A reasonable question to ask then is: what determines technological progress?* The neoclassical model does not provide us with an answer. As a matter of fact, Solow himself points out that what he terms technological change must be understood as 'all sorts of things' or anything that increases the productivity of the given production function. This includes, for instance, a better trained labour force but, if we think about it, it could also include "abstract" elements difficult to measure such as cultural factors and/or political institutions. That is why in the neoclassical world technological progress is considered to be exogenous; it just happens (the rates of savings and population growth are exogenous too).

The key issue then is that, ultimately, economic growth depends on technological change but we do not know what determines the latter, indeed we do not know what is meant by it. Does this mean that the neoclassical model is useless? Of course not, in fact, at least 2 policy recommendations can be drawn from it:

1) Measures to increase the savings rate, to facilitate investments (healthy and operational financial markets, political stability, etc.) and to reduce the rate of population growth to reasonable levels are all welcome.
2) Dedicating resources to the development of technology, including the creation and/or the enhancing of human capital, is a positive measure as well.

The problem with these 2 policy guidelines and their relation to the neoclassical model is that they do not actually arise from the latter; they are just recommendations by implication. Indeed, the basic neoclassical view, i.e., the neoclassical world *à la* Solow, does not leave any room for direct government action: in the long term what the government does is irrelevant for the economy will tend to its steady state. Besides, given that in the model it is assumed that the economy is fully competitive, government intervention is not desirable as it will necessarily create inefficiencies by distorting the incentives economic actors take into account to make economic decisions such as how much to save, how much to invest, how many workers to hire, etc. This is why, for instance, one of the main implications of Bort's model (Borts 1960) which is the neoclassical model taken to a regional context, is that capital, and labour too but mostly capital, will leave the regions where it collects low returns for regions of higher returns. Given that government intervention decreases returns to the factors of production, for instance by imposing income or corporate taxes in order, for instance, to finance education for all, then capital will flee to those countries or regions where there is no such intervention.

The last point above leads me to another important implication of the neoclassical model, also more visible in Bort's work: owing to the decreasing returns to capital and to the mobility of factors of production, all economies should converge to a similar level of income per person as those countries/regions which receive capital will grow faster than those which see capital leave until they all share the same capital to labour ratio and, therefore, the same returns to capital and to labour (which is understood as income per person). This, however, is conditioned to all economies having the same exogenous parameters, indeed, identical ones. That is why Mankiw points out (1995: 284) that the neoclassical model predicts convergence of each economy to its own and particular steady state but not *necessarily* between economies.

The issue of convergence, that is to say the issue of factor mobility, and that of the distorting "power" of government intervention are key in any discussion relating social policy and economic growth as, obviously, social policy is mainly about intervening the economy. That is why I dedicated a good deal of this section to them, and return to them below.

Two last points end this first part of our theoretical discussion. First, I want to emphasise that, by implication, it is possible to argue that the 2 policy guidelines outlined above are "valid" from the basic neoclassical point of view but, at the same time, it is difficult to justify them: they either imply distorting the economy, which creates a series of problems – mainly the risk of "losing" capital – or they require enormous solidarity among individuals as, for instance, it would be possible for them to sacrifice income in period t in order to save, invest and produce more in period $t + 1$ and then use the extra production to build, for instance, schools or hospitals for all. Of course, this "policy" implies that individuals would be ready to sacrifice income both in t, to save, and in $t+1$ (not using the extra income produced for personal satisfaction but for collective goods) but it would not distort the economy. Finally, from our discussion up to here we can conclude that if there is going to be any social policy that favours economic expansion it should look something like the recommendations outlined above.

II. The new growth theories

According to Mankiw (*Op. cit.*: 282-292), Solow's explanation to economic growth is not convincing. Indeed, it suffers from three shortcomings which arise from the common assumption in economics, based on US and other countries' national accounts, that the share of capital is about 1/3 of national income and that of labour is 2/3. Following this assumption, the neoclassical model predicts that rich countries will be twice as wealthy as poor ones, however, in the real world the difference between rich and poor is well above 10 times. That is the first loop in the model. Second, the latter predicts that each economy converges to its own steady state at a rate of 4% per year but in different empirical studies which tackle the issue it has been found that such convergence occurs at a rate of 2%. Third, the model implies that the return to capital should be 100 times larger in poorer countries than in wealthy ones which, of course, is not the case. In short, the basic neoclassical explanation to growth is not consistent with reality.[1]

But the problems pointed out by Mankiw are not the only ones associated to the neoclassical model. A critical assumption in it is that the production function exhibits decreasing returns to capital. And, therefore, there is room for arguing the *possibility* of convergence. However, as Romer points out (1986: 1008-1013) there is solid empirical evidence which demonstrates that poorer nations do not tend to grow faster than the rich ones. There is also statistical evidence which shows that, in the developed world, the productivity per hour of labour has constantly increased in the last several decades. All of this suggests that the returns to capital do not behave as claimed by Solow and that the possibility of *increasing*, or at least constant, returns to capital should not be ruled out.

The neoclassical model suffers then of at least three major shortcomings: 1) at the end of the day, it attributes long term economic growth to technological change but it does not have a good explanation as to what must by understood by the latter (see section 1, above); 2) it is incapable of explaining reality, and 3) the decreasing returns to capital assumption is questionable. The so-called new growth theories arose precisely in order to try to solve these problems. I say 'so-called' because, as I will show along the paper, what is considered to be "new" in these theories is really not as a lot of what they claim to have "found out" was already out there in the growth literature long ago, for instance in the works of Young (1928) and Myrdal (1957). Besides, what these theories do is either to extend or redesign the Solow model. This is not to say, however, that there is absolutely nothing new in the theories I am about to present: although I will not provide details on it, one must acknowledge the quality and scope of the mathematical modelling involved in their elaboration.

The new growth theories can be divided in 2 groups. The first of them is about redesigning Solow's model dropping the assumption of diminishing returns to capital. This first group is known as endogenous growth theory and can itself be broken into 2 categories: those pieces of literature which focus on the role of knowledge (Romer 1986) and those which emphasise the role of human capital (Lucas 1988; Romer 1990). The second group of the new growth theories is also about improving the

[1] See Mankiw's paper for details of all of his calculations.

neoclassical model, this time by broadening the concept of capital, but keeping the assumption of diminishing returns (Mankiw *et al* 1992; Mankiw *Op. cit.*).[2]

Endogenous growth theory

In my view, A. Young (*Op. cit.*) can be considered as the first theorist of endogenous growth in the sense that, long before the new growth theories saw the light, he claimed that the returns to production are not decreasing but increasing. Indeed, one of the main exponents of endogenous growth theory, P. Romer, quotes Young extensively in his 1986 work. Basically, Young claimed that increasing returns do occur and that they are the result of a systemic interaction: an innovation in one industry/sector of the economy, generates new applications and innovations in others, which increase the productivity of the different sectors, and of all the economy, through positive externalities. Of course, the increasing division of labour, and the discovery of new natural resources and new ways to use them, are also key in understanding increasing returns and economic progress. The interaction Young is talking about is no other than that of a capitalist nature: '...the principal economies which manifest themselves in increasing returns are the economies of capitalistic or roundabout methods of production...[these economies] even more than the economies of other forms of the division of labour, depend upon the extent of the market' (*Op. cit.*: 531). In other words, economic progress is the result of the interaction between division of labour, innovation, and the size of the market (buying power of the market), and the more growth there is the easier it is to produce even more of it in the future.

The role of knowledge in endogenous growth theory

The work of Romer (1986) is considered as one of the pioneers in endogenous growth theory. He introduces a model in which capital, understood as knowledge, displays increasing returns. Technological progress, which is behind economic progress, is not exogenous but the result of investments by maximizing agents (entrepreneurs) who, seeking profit, dedicate resources to technological research. So, the rate of growth of the economy is determined by the rate of growth of knowledge. The last assumption in the model, which reminds us of A. Young, is that the creation of knowledge by one agent generates positive externalities over the production possibilities of the rest of agents as knowledge cannot be kept fully in secret. What this means then is that a factor K, representing the general level of knowledge in the economy, is part of the production function of each agent.

Notice that because K is the same for everyone and it's at their disposal free of charge, and because it is more productive when anyone makes any contribution to

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[2] According to Ray (*Op. cit.*:100-111), both groups of the new growth theories can be labelled as endogenous growth theory since the models they introduce determine growth from within the models themselves. However, this is not valid for Mankiw *et al* (*Op. cit.*) since these authors explicitly say in their work that their ideas are not to be considered part of endogenous growth theory because they do not assume increasing returns to capital but decreasing. Besides, the key factor in Mankiw *et al*'s work, human capital, is considered as exogenous. So, we should not confuse works like Romer's (1990) which talk about human capital from an endogenous perspective and those from Mankiw *et al*, which deal with human capital from an exogenous one.

knowledge because the latter cannot be kept in total secrecy, then all the agents face incentives not to invest in innovating but to wait for somebody else to do it and, then, take advantage of the new ideas or knowledge that has been produced. In this case, the economy does not reach its optimal growth rate since there would be too little investment (or too much consumption since the model assumes that investment funds come from savings). There is room then for government intervention in the way of providing incentives for saving and for investments on knowledge.

We have then that technological progress is not an exogenous variable, that government intervention is desirable and that knowledge is a form of capital which has increasing returns. Romer's model also implies that convergence, given the increasing returns, does not have to happen necessarily.

The role of human capital in endogenous growth theory

Romer (1990) presents another model. Like in the 1986 one, economic progress is determined by technological change. The latter, in turn, is itself the result of deliberate actions by those who know will benefit from innovating. Production is carried out using technology, physical capital, labour and human capital (labour improved through education and/or experience). There are three sectors in the economy: a research one, which uses human capital and the stock of knowledge to produce more of the latter which, let us make it clear, is to be understood as designs to produce intermediate goods; an intermediate sector which uses knowledge and capital to produce, precisely, intermediate goods; and a final sector, which uses labour, human capital and intermediate goods to produce final goods. The key to the model is that the research sector has increasing returns, so the more human capital one dedicates to research the more knowledge it is produced; permanently and increasingly. At the same time, the more knowledge there is the higher the productivity of those who, in fact, produce it since knowledge is cumulative and it is available for all of those who do research.[3]

The main lessons emanating from the model are: 1) the rate of growth of knowledge is crucial in determining the rate of growth of the economy; 2) the creation of knowledge is dependant on human capital but also in the interaction of ideas; 3) there is no convergence between countries since those who already have a pool of knowledge and of human capital have an advantage over those who do not, and 4) in terms of policy, the model suggests that governments should make sure that enterprises have economic incentives to generate knowledge (or even subsidize research), and subsidize the creation and accumulation of human capital.

Another model in which the role of human capital is of high relevance is that of Lucas (*Op. cit.*). In this work, by human capital it is meant the general level of skills of

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[3] Just to avoid confusion a clarification is necessary: those actors who manage to produce a design to be used by the intermediate sector have absolute property over its *production use*, i.e., there is no perfect competition for the *use* of designs in the production of intermediate goods. That is why the relevant agents do research (there is an incentive for it). However, designs become part of the stock of knowledge and the latter is available for all of those engaged in trying to come up with new designs. Notice that, without a monopoly in the production use of designs, it would be difficult to justify why research takes place and carries on, which is the case in the 1986 Romer model (which is why government intervention becomes desirable in it).

individuals. Lucas' model is an extended Solow model, that is to say, it is like Solow's but incorporates the human capital variable and assumes constant returns to the latter. The key to understand economic progress is the time which individuals dedicate to acquire skills, i.e., to accumulate human capital: the more they do so the more productive all factors of production will be and, therefore, the economy itself. The rate of education or training, determined by the time dedicated to it, determines the rate of growth of the system. Again, the obvious policy recommendation is to provide continuous and good quality education and/or on the job training.

Human capital and non-endogenous growth

As mentioned in the beginning of this section, some of the problems associated to the neoclassical model arise from the fact that the share of national income credited to capital is usually assumed to be 1/3. Let us now retake this thread. Mankiw (*Op. cit.*) points out that, if such share were higher, the neoclassical model would capture reality much more appropriately. But why would it be higher? This indeed could be the case if we broaden the definition of capital to include *human* capital (schooling and on-the-job training), i.e., not only physical capital. This implies, of course, that part of what is usually thought of as labour's share of national income will be now part of the share of capital. How much?

The first step in determining so is to establish how much of labour income should be credited to human capital. According to Mankiw, to estimate this we can look at the minimum wage. In the US, the minimum wage is about 1/3 of the average wage, which suggests that the return to human capital is about 2/3 of labour income. Given that labour's share of national income is about 2/3, then to find out how much of such share is actually a return to human capital all we have to do is multiply 2/3 (which is the part of the income of labour credited to human capital) by 2/3 (which is the national income share of labour). The outcome is 4/9 or about 0.5. In other words, the return to human capital is close to one half of national income. If to this figure we add the normal 1/3 of national income attributed to capital, then we have that about 80% of income should be credited, in total, to capital (human and non-human) which raises its share from about 0.3 to 0.8. With such a high share of capital, all of the problems of the neoclassical model, remarked by Mankiw, vanish. The message then is that *human* capital is a key factor in explaining economic growth in and *between* nations.

Based on these ideas, Mankiw *et al* (*Op. cit.*) introduce an extended Solow model in which production is a function of labour, the level of technology, the stock of capital and the stock of human capital. The authors assume decreasing returns to the totality of capital, i.e. human and physical. Through mathematical manipulations and using regression analysis including several countries, Mankiw *et al* show that, when defining human capital as the fraction of the working-age population which is enrolled in secondary school, then their extended Solow model is capable of explaining, in about 80%, the differences in income per capita one finds in the world.

Another of the conclusions of their work is that human capital is related to the savings rate in the sense that human capital accumulation is a kind of saving. This enhances Solow's conclusion according to which those economies which save more reach a higher level of stationary income per capita: to put it simple, and according to Mankiw *et al*, a country with more human capital is a country that has saved more and, therefore, enjoys a higher income than a country with less human capital. This also helps us to understand why we do not see convergence between countries: not only are the rates of saving and population growth relevant in determining it; the rate of accumulation of human capital is crucial as well. So, no surprise that poorer countries do not catch up, automatically, with richer ones. The obvious policy recommendation is to enhance education and on the job training.

Some final words on the new growth theories

The works I have presented in this section question the neoclassical model, but they do not reject it; they try to improve it. The ones by Romer and Lucas are about opening the black box, i.e., trying to understand what the residual factor Solow talked about is made of. (Let us remember that the neoclassical model claims that growth is the result of technological change but it does not tell us what it is meant by it; it is understood then as a residual factor). So, in my view, more than being *growth* theories, the works by Romer and Lucas, and the alike, which are many, are *innovation* theories, i.e., they try to explain why and how innovation occurs. In this sense, these models answer the question Solow did not: what determines technological change? And they come up with very good answers but they leave one open question, very relevant I believe: is technological change, understood as innovation and all that it involves, really the determinant of growth? Just because technological change is now presented as endogenous, it does not follow that, indeed, innovation is behind economic progress. After all, in the neoclassical world by ‘technological change’ it is meant ‘all sorts of things’. So, one of these things could be innovation, and now thanks to endogenous growth theory we understand it better, but what about political institutions, social values and culture? Or to put it another way: how much of the ‘all sorts of things’ is innovation? How much is values? How much is institutions? Or could it not be the case that what is truly relevant is how all of these “things” interact?

Now, if, in any case, innovation is the result of enterprises investing in research and/or individuals spending hours training/educating themselves, and assuming that technological progress is the only variable behind economic growth, then what is it that pushes enterprises and/or individuals to do research or to train? It seems that the answer, according to the theory, is economic incentives, such as monopolizing the use of a design or achieving a higher wage. But, if we want to take matters to its roots, then one must ask: why are there societies in which individuals/enterprises find the right incentives to behave more or less like the theory expects them to and societies in which these incentives do not exist? This would be the relevant question. A tentative answer is that the institutions which shape economic interaction and behaviour are to blame or to praise. I will pick this up ahead, here I just want to make it clear that endogenous growth theory helps us understand innovation but, like its neoclassical predecessor, does not tell us what really lies behind economic growth. Again: what are the ‘all sorts of things’?

The works by Mankiw and Mankiw *et al* are also an extension and an improvement of the neoclassical paradigm: now we know that human capital is key in explaining why some countries remain richer than others or why some grow more than others. But human capital continues to be exogenous. In other words, we do not have an ultimate answer to economic growth, i.e., if human capital is what determines economic performance, then the relevant question is: why some countries have a greater stock of human capital than others? And, again, how much of economic growth is actually the result of human capital? How much of innovation? How much of institutions? Or how much of the interaction between the latter? Indeed, the very same Mankiw *et al* finish his work in the following way: 'future research should be directed at explaining why the variables taken to be exogenous in the Solow model vary so much from country to country. We expect differences in tax policies, education policies, tastes for children, and political stability will end up among the ultimate determinants of cross-country differences' (*Op. cit.*: 433).

All of the above takes me back to A. Young: growth is systemic. And because Development cannot happen without economic growth, then the former is also systemic. Certainly innovation is relevant and this is why it is important to understand how technological change occurs, but the theories so far described also take into account savings, investments, division of labour, education and, of course, economic incentives (which are linked to institutions). So, up to here, I believe I am in a good position to claim that growth seems to be the outcome of a package which includes, at least, the mentioned variables and, most crucially, their interaction. Unfortunately, I think it is not possible to say with all certainty what variable causes what on any other, or in what magnitude, however, we can appreciate that probably the best social policy is the one that aims at putting together all the parts of the package.

In particular, the works reviewed in this section signal that to achieve economic prosperity, and Development, societies should aim at improving and extending education; creating, accumulating and disseminating knowledge; investing in technological research and development and, above all, not to think, if one is a poor country, that, without doing anything, one day one's country will be a rich one: convergence between rich and poor is not the rule; not even the exception.

III. The productivist view

This branch of growth theory was elaborated by Gunnar Myrdal. He believed that convergence among economies will not happen because those regions or countries that are richer will always remain as such unless some interventionist force does something about it. Government action is therefore necessary as too much inequality can get the economy ill and condemn it to sluggishness (Myrdal 1957; 1970; 1974; 1982 [1960]).

Why is it that richer regions remain rich and poorer ones poor? According to Myrdal, the world operates under circular cumulative causation: if you are poor you will remain as such because you will not be able to work as you do not have access to proper food and health care (you are weak). Because you cannot work you get poorer and so on. In other words, poverty is a vicious circle. The opposite, a virtuous circle, emerges when you are rich. If nobody does anything about it, then inequality will increase. This is valid for people and for countries and is the outcome of free markets, i.e., the latter accentuate inequality. The mechanism is simple: those countries or regions which are already rich attract more capital, more workers and more trade, which enhance the creation of wealth.

At the same time, poor regions tend to be precisely the ones that send workers to richer areas. Usually, those workers are young and productive; they are the people that should actually be working in the poorer regions if the latter are to have any chance of success. So, as these workers leave, they enhance the poverty of their regions of origin (Myrdal 1957: Chapter 2). So, richer regions grow more and, on top of that, they do so with increasing returns and inequality is perpetuated (*Ibid.*: Chapter 3). Although Myrdal does not express things in these terms, it is possible to interpret his ideas in the following way: richer countries have all the required elements of the growth package and, therefore, this is why they keep on attracting more and more of them.

That is what happens under free markets. The implication is that government intervention is desirable for moral reasons but also because inequality can reduce the productivity of the poor (regions/individuals) and, therefore, can block economic growth (Myrdal 1970: Chapter 3). This is exactly what social policy (mainly in terms of health and education) has been about in the developed world, which proves that intervention in the markets can be beneficial to economic expansion (Myrdal 1982 [1960]: Chapter 5).

From Myrdal's thinking we get the following policy recommendations: 1) diminish inequality through direct government action if necessary; 2) provide health and education for all; 3) do not seat and wait for poor countries to become rich only through markets; one has to work with the market and not for it. Social policy is the useful because it is beneficial for economic growth. Because without the latter there can be no Development, then social policy is not only about constructing growth: it is about building Development.

IV. The Schumpeterian-evolutionist view

For Schumpeter (1984 [1942]: chapter 5), capitalism is essentially evolutionary; it is in a constant state of transformation and redefinition. The engine of such evolution is innovation, which is desirable as it reduces costs, allows mass production, drives prices down and, therefore, makes it possible for people to have access to more goods, i.e., innovation rises our standard of living. The evolving nature of the capitalist system was captured by Schumpeter in his theory of *creative destruction*: capitalism can never be steady. Behind its constant movement one finds the capitalist enterprise, which creates new goods, new ways to organize industry, new means of transportation and new markets. We have then that, for Schumpeter, as for every theorist we have dealt with so far, the key behind progress is technical innovation. Based on Schumpeter's ideas, there has emerged a branch of growth theory known as evolutionary economics; let us have a glance at it. We will see that we move more and more in the direction of confirming that growth is a systemic phenomenon.

Nelson and Winter (1982) argue that enterprises engage in three kinds of routines: 1) operational, which are those based on production capabilities and cannot be modified in the short term; 2) investment, which aim at altering the stock of capital, and 3) search, whose purpose is to improve operational routines (this is where technological research and development come into the picture). Enterprises do not have a given production function but an array of production possibilities determined by their accumulation of knowledge and information. If they had a production function it would imply that they know *all* the technical possibilities to produce, even those that nobody has never tried before.

Enterprises interact with the economic environment and those routines which are successful, that is to say which generate profits, expand and those which are not contract (survival of the fittest). The successful routines are passed on to the next generation of enterprises. In this way, routines which pay off are kind of like genes which survive the environment. But the latter can also be altered by the former, for instance, the prices of the production factors can change according to the expansion/contraction of the enterprises.

The authors hold that the total product of the economy results from the decisions made by the enterprises. Therefore, the key to economic growth is their routines and, among them, the search ones as it is from them that innovation decisions arise. Notice that, according to this perspective, technological progress is not exogenous: it is determined by the accumulation and the use of knowledge (Foster and Metcalfe 2001: 13).

Gilpin (1996) argues that Nelson and Winter focus too much on enterprises. The stress should be placed, he believes, on national systems of political economy: economic success is a function of the strategies and structures adopted by the entire system. This is why some national economies are better than others at producing technological innovations and taking advantage of markets. But, why are some economies better? Because they are capable of successfully adapting to the environment by transforming both their institutions and technologies as required. This does not necessarily mean that countries which are successful today will be so tomorrow as there is a chance that entire systems get blocked by power groups and institutional and economic practices which were key in achieving success yesterday but are not suited for today's needs.

Every system of national political economy is made up of three components: 1) the objective it pursues (social welfare, military might, etc.); 2) the role of the State *vis à vis* the economy, and 3) a certain type of industrial and entrepreneurial organization, which can be influenced by the role of the State.4 The interaction of these 3 elements is what will determine the adaptability capabilities of the system and, therefore, its success or failure. Gilpin drives us then into thinking of economic progress as the result of a package.[4]

Nelson (2001) introduces a theoretical argument which constitutes an extension of Nelson and Winter's ideas (*Op. cit.*) and is very similar to Gilpin's. The point is simple: technological evolution determines economic progress but the former is in turn determined –its scope, pace and direction– by the institutional framework in which the relevant actors wish to innovate. By institutional framework, Nelson means those factors which shape and define human interaction at the organizational level and among organizations. Because such factors are in fact a co-ordination mechanism and allow individuals to reach goals which require collective co-operation, Nelson claims they must be considered as a social technology. In other words, institutions are to be understood as social technology.

The evolution of the system, Nelson argues, proceeds in a functional way: a new physical technology demands a transformation of the existing social technologies either in the form of new laws and regulations and/or new co-ordination methods. This implies that social technologies have a great impact on the production of physical technology as they determine the organizational limits that actors face when trying to produce physical innovations. The transformations in the system can arise from either direction, that is, a change in physical technology demands changes in social technologies but a redefinition of the latter can open the door for a change in the former. Nelson claims then that both types of technology co-evolve. Economic progress, whose engine is innovation, depends on this co-evolution, which is clearly systemic.

The message from the Schumpeterian-evolutionist perspective is then the following:

a) There will be no convergence between economies as it is natural that some systems adapt to the environment better and even dominate it. The implication is *innovate or die*, or at least be ready to adapt to innovations. Therefore, governments should support innovation efforts, including the creation of human capital. Above all, governments should implement an institutional framework capable of encouraging agents to innovate. Why? Because Schumpeter, and every other growth theoretician so far, have made it clear that technological progress is behind economic success, but what is behind the former? What determines innovations? Dosi (1988: 1120) argues that

> [p]rivate profit-seeking agents will plausibly allocate resources to the exploration and development of new products and new techniques of production if they know, or believe in, the existence of some sort of yet unexploited scientific and technical opportunities; *if they expect that there will be a market for their new products and processes; and, finally, if they expect some economic benefit, net of the incurred costs, deriving from the innovations.* In turn, the success of some agents in introducing or

[4] Notice that for Gilpin, as for many others but not me, the State is the same as government.

> imitating new products and production processes changes their production costs, their market competitiveness and, ultimately, is part of the industries affected by the innovations (emphasis added).

That is why having the appropriate framework, the appropriate institutions, to encourage innovations is so important.

b) We encounter again that economic progress requires something resembling a package; it is systemic. Of course, a problem arises: what to do if, as Gilpin points out, a system is stuck in practices that were good in the past but that are not so anymore? How to get rid of interest groups which block transformations?

The answer is, precisely, social policy as, through it, those groups which may lose when the system evolves can be compensated. So, social policy can play the role of a compensator, as it has traditionally, and, as stated before, it can also promote technological development. But that is not all: as Myrdal has stressed the government should aim at diminishing inequality by direct action if necessary, and provide health and education for all.

V. What institutions?

This is what I have established so far: whether we like it or not, societies have to be capable of being capitalist, they have to be *capitalism-capable societies* if what they wish is to create wealth. This is not to say that all societies have to be the same nor that industrialization is the only alternative. What I mean is that, at least in terms of the institutional framework which we know backs capitalism, societies wishing to grow should resemble those which have achieved economic success, which are the ones in which capital finds fertile ground. Beyond that, there is room for divergence. For example, Japan, France, the United Kingdom and China (even there capitalism-oriented institutions are emerging) just to name a few examples: they are very different in terms of culture, but in the four countries capital meets with the right framework to reproduce successfully.

We know that one of the key institutions in the capitalist system is private property. Without it, individuals cannot develop assets, that is, they cannot accumulate *and* turn what they have accumulated into capital (De Soto *Op. cit.*). Another key element in capitalism is markets. Therefore, the institutions which shape how they work are also highly relevant. Hence, any rules which prevent people from doing so should be removed and rules which encourage/allow/facilitate people to participate in markets should be put in place. For instance, in many countries it is considered inappropriate for women to work; this is an institution which should disappear or at least be revised. The same goes for racial, ethnic or any kind of discrimination.

I am not advocating for totally free markets (remember that a lot of my argument relies on social policy), what I am arguing is that, for people to leave poverty behind, access to properly working markets is crucial and, therefore, governments should make efforts to build markets and make sure they work.

Institutions also shape all kind of investment decisions, such as those aimed at technological innovation. Given of all the above, institutions or rules are as important as economic and social policy for any country to achieve economic growth, and Development. I will not elaborate further on this as the works of Gilpin and Nelson, above, are explicit about it. Also, and of course, Douglas North and Ronald Coase have extensively written about this issue and make it clear that institutions are crucial in understanding social functioning and economic outcomes (North 1981; 1994, Coase *Op.cit*) as I explained in the Introduction of this text.

So, for capitalism to be a success certain institutional arrangements are necessary, but then a key question is the following: what is it that backs such institutions?

VI.- The relevance of the State

The State is what backs the institutions I have been talking about. By it, I mean a framework of peaceful and predictable interaction composed of four elements: population (understood as citizens), government, territory and legislation. A bunch of people living in the same territory but without a government cannot be considered a State. At the same time, a territory with a government but without citizens, i.e., without people who identify with such government and with each other, cannot be considered a State either. Legislation, which should be in favour of individual liberties and rights if it is to be pro-economic growth and Development, is key because it explicitly regulates the interaction of the actors: without it, or without its enforcement (the responsibility of the government), the State is not such at all.

The relevance of the State is self evident: it (not the government, see above) embodies the rules which shape social interaction. In the case of capitalism, such rules are aimed at encouraging competition to get the best out each individual. But this does not mean that capitalism is only an individualistic system since the point of it is to facilitate individual initiative not for the sake of the individual *per se* but of society as well: capitalism is a way to construct social cooperation and obtain social outcomes which are superior (at least in terms of economic growth and prosperity) to those produced by any other economic system.

Coase (*Op. cit.*) does highlight the relevance of the State but takes the latter as a given and thinks of it as government. North (1981) also stresses the key role of the State and even submits that no theory of economic transformation can be complete without an accompanying theory of the State. He does offer such a theory but I believe it is wrong because it treats the State as what I would define as government as well. Besides, North presents the State as predatory and only focused in achieving more and more wealth for the rulers. Here, I do not offer an alternative theory of the State (this I shall try to do later on as my work progresses) but I do offer a set of ideas which could be considered as the departing point of it (above). Allow me to emphasise its crucial aspects:

1) The State is not the same as the government: it is, I insist, a framework of interaction and the government is one of its components.

2) The government is not a predatory entity trying to get more and more wealth for the rulers. Its functions are to provide and enforce legislation. It does obtain economic resources but not for the benefit of those in power (or at least not only for that reason) but of society's: the resources are used to finance the social policy required in the *capitalism-capable society*.

3) The root of the State, ie, what allows it to be the framework I have described, is a sense of citizenship, of belongingness, as well as the legitimacy of its rules. It is this sense of citizenship what induces individuals (not all, obviously) to respect the law and each other (more on this below).

4) Because there are always individuals who will be willing to break the law, ie to break the framework and, in that way, infringe an attack on society and on every member of it, the government must act, coercively if necessary, to back the State, ie, to hold the framework together.

In the absence of the State, economic growth and Development will be difficult to achieve for the following reasons:

1) When talking about mass societies, no State means no formal way to support the institutions which back the economic relations individuals engage in (contracts, exchange, etc), a situation which may hinder economic growth and minimize the possibilities of establishing the 'appropriate context'.

2) Without a State there can be no truly functioning pro-growth social policy; indeed there can be no policy of any kind.

The State is crucial then in the *capitalism-capable society*: *it is* the institutions and policies capitalism demands. To put it in terms of Sen's work (*Op.cit.*), the State acts as the primary social facility as it allows for the existence of any other facilities. And in terms of Abramovitz's perspective (*Op. cit.*), the State is the primary social capability since, without it, societies cannot establish any other.

In short, the State is the beginning of the road to economic growth and to Development. Therefore, in order for *capitalism-capable societies* to be such, they need to have strong governments (this is not the same as non-democratic governments) which establish and enforce the relevant institutions and policies. They also require citizens who identify with such governments and with each other (a sense of citizenship). In other words, *capitalism-capable societies* need Strong states, ie, strong peaceful and predictable frameworks of interaction in which citizens who respect each other's rights can be.

In developing countries, the absence of the institutions which back capitalism is more than that: it is, in many cases, the absence of *true and solid* States (of any orientation, let alone pro-Development ones). So, these countries have to consolidate their States, and do so without being victims of any authoritarian temptations. It is complicated but it is a must. If they do not do this, they may never achieve continuous and important economic expansion: the absence of the State is the absence of institutions, policies, economic growth, and Sen's 'appropriate context'.

But if the State is so crucial, then we must ask ourselves what is it that determines State strength. I do not know (which is very unfortunate given that we are talking about one of the most crucial questions ever). I do have a hypothesis, though: civic education, understood mainly as the creation of the sense of citizenship I keep on referring to, seems to be the answer or at least part of it. Without such sense and a government backing it up, individuals tend not to respect the law. When people refuse to respect the law, that is to say to respect the institutions which regulate social interaction and particularly economic activities, then there is no chance for capitalism, nor for any other system, to work properly. Therefore, I suggest that as part of the social policy agenda, poorer countries include civic education as a top priority for if social policy's goal is to improve the social environment, then "abstract" elements like education and the promotion of the rule of law should be as important as the typical social programmes are.

When talking about the consolidation/strengthening of the State, what I mean then is the creation, precisely, of a consciousness of citizenship. The message is then that as long as developing nations remain incapable of building strong States, which is not the same as to say authoritarian States, then they really have no chance of achieving economic growth (nor maybe even anything at all); without States what we can expect is institutional weakness or no institutions at all, i.e., no State = no viable mass economy = no Development.

Obviously, good governance is essential in the equation too since, without it, the rules of the framework I call State will not be considered as legitimate. The building of institutions in developing nations depends then on governments: they have to deliver the education and the governance. But society is also crucial: people have to be ready to respect the law and to demand from their governments to do the same. It is, therefore, an interactive game: people and government must both contribute to build a State and, at the same time, they have to implement policy, design and respect the right institutions, work hard and, hopefully, rip the benefits. It is here where the greatest challenge for developing nations lies: the building of the State/citizenship.

VII. Development and Actor-network theory

I turn to Actor-network theory (Law 1992) simply as a frame for my argument. I do so because I believe it makes very explicit what I mean: Development is a context at the service of individuals (like A. Sen has stressed). I have labelled such context the *capitalism-capable society*. Because it is a social context, I think it can be better explained as a network, and because it is at the service of individuals then such network is supposed to allow individuals *to be*.

Actor-network theory defines society as a heterogeneous network, ie, it is composed of individuals and of “things” which can be tangible or not. In those terms, then, the *capitalism-capable society* can be conceived as heterogeneous network which includes tangible elements such as persons, machines, tools, research centres, etc. and intangible ones such as ideas and institutions. The lack of the State (a node and a link) and/or social policy (also a node and a link) and/or economic growth (the source of many of the elements which constitute the network) can mean the entire failure of the whole of the context, i.e., of the network. And the same goes for the absence of responsible citizens, which to me is equivalent to the absence of the State as defined above.

Individuals are important not only because the network is for them, they are the agents, but because persons themselves can also work as nods and links: if they do not respect anything, the network collapses, for example. And if they invest, have ideas, access to credit, etc. then they can become sources of economic expansion, employment, etcetera.

Defining Development as a network has a further advantage as it makes it obvious that the difference between Developed and underdeveloped countries is that the social network in the former is richer than in the latter and that, therefore, developing countries should aim at progressively finishing (or simply building) the construction of their corresponding networks.

The above leads me to this point: just because a country is considered to be Developed it does not follow that it will always be so or that everyone in that country *is*: at all times and in all places there are always individuals who are not really linked to the network or that are banned from benefiting from it for a variety of reasons. So, Development is never over and if not taken care of it can suffer, ie, the network can be weakened. Look at for instance at Germany, where it is evident that the economy is not working properly and that, therefore, little by little more and more Germans end up unemployed and even in (relative) poverty: the German network is no longer working.

From Actor-network theory we also get these lessons: 1) social systems which survive, ie which manage to reproduce successfully, are not any different to those that fail: they are all composed of interaction between actors. The difference between successful and failing societies is how such interaction is organized (Law: *Op. cit.*), which is exactly why I argue that aiming at being *capitalism-capable* is the best way for a society to arrange itself in order to achieve economic growth and Development; 2) an actor is always a network, ie, an agent is always a result of the network in which it exists (*Ibid.*) So, because Development is about improving people’s life then the network in which they interact/are is crucial and, again, this is why developing countries should aim at building a network like the one here described.

VIII. Some examples which illustrate the need for *capitalism-capable societies*

I believe the following 3 examples help us understand why capitalist-style institutions are required everywhere and I do not exaggerate when I claim that they are the first best solution for economic growth (and Development).

The case of some of Ghana's farmers

Lyon (2000) concentrates on Ghana's agricultural economies. He argues that for many Ghanaians there is really no legal framework to stick to. Therefore, for instance, transactions between farmers and traders are carried out on the basis of trust. Indeed, after studying these transactions, Lyon concludes that 'there is a wide range of circumstances where resource poor farmers and traders develop cooperation or draw on existing networks, allowing them to *enter into new markets and increase incomes*' (676, emphasis added). Notice the following: farmers and traders, like almost any other human being, seek higher incomes and, to achieve them, they participate in markets. In Ghana, such markets work on the basis of cooperation but this is only a second best solution, i.e., what is really required is formal institutions to back them. This is why, Lyon suggests as a policy guideline the creation of a 'formal legal system that is more appropriate for micro-enterprises [which would] allow more time and resources to be put into building up other relationships and establishing new opportunities. It is also necessary to identify those who are excluded from networks that have the potential to lift them out of poverty, and those that are tied into networks or dependency relations that can be highly exploitative' (678).

We can see then that even for poor "traditional" farmers, and not only for the capitalists entrepreneurs of the West, the absence of formal institutions backing the markets they want to participate in is costly: 1) transactions are under risk since they are only based on trust. Of course this does not mean that transactions cannot take place, they do, but there is always a risk; 2) because there is no legality then relationships can become exploitative, and 3) the informality of the markets implies the impossibility of extending networks and/or resources beyond the already established relationships. This is an important shortcoming since networks are of key importance as they do lead to farmers getting higher incomes. So, it is not unreasonable to think that impediments to network expansion should be eliminated. If the absence of an appropriate legal framework is one of them, then we know what to do. This is why institutions are so relevant. This is also why poor countries have to be *capitalism-capable*, which, I repeat, does not mean they have to be industrialized, as this case study shows.

The case of the silkworms cocoon producers in West Bengal, India

As argued here, an important factor for Development to take place is the creation/consolidation of markets to be accessed by all. This is well exemplified by a group of women in West Bengal, India, who managed to come up with co-operatives to produce and commercialise silkworms cocoons (Webster 2002). They were successful because they found a product that is demanded in the market and they got linked to that market because their government, regional government, helped them to do so. The point is clear: poor people are always ready to seize chances, the problem is that they have no links to markets and that they suffer the lack of reliable, strong, committed States whose governments are capable of providing them with help.

The case of some of Mexico's indigenous people

In Román-Zozaya (2002), I discuss the case of the city of San Cristóbal de las Casas, Chiapas, Mexico, where a group of indigenous people, who did not live in the city previous to the 1970s, has managed to take control of two of the most important sectors of its economy: food distribution and public transportation. This indigenous people arrived to the city with nothing on them because, for reasons beyond this work, they were expelled from their home communities outside of San Cristóbal. Owing to their tenacity, creativity and hard work, now they are crucial actors in the city's economy (and politics). The city government did nothing for them; indeed it tried to force them out of the city in several occasions. So, they have managed to be successful starting from zero in an environment hostile to them and in a city which, like them, is poor.

However, they face limits to what they can do: their level of schooling is low (some of them are simply illiterate) and a bunch of them do not even speak Spanish; this blocks their employment opportunities. San Cristóbal is a small and relatively poor city, so the size of its market is also a limit to what indigenous people can achieve in terms of economic progress. In a case like this, I believe it is clear that if these people were given proper education and training, health care, credits to back their projects, security to develop their business (there is conflict, which has led to violence, between them and the original inhabitants of the city and even among indigenous people themselves) and if they were linked to a bigger market, they would be capable of creating more wealth for them and on behalf of society.

There are many examples like these, for instance the case of the Grameen Bank (Yunus 1999) which shows how far people can go when given the possibility of accessing credit. There is also the 'fair trade' campaign and activities by Oxfam, which illustrate, again, the potential of linking poorer producers to markets. And Kyle's Andean transnational peasants (Kyle 2000), a case that, like many others, shows how far people are willing to go in order to find a source of income (I use 'far' in terms of efforts although these peasants go all the way to New York to find jobs). Why do they do this? Because there are no options for them in their countries, so they go to where the options are.

What all of these examples unravel is that all humans, obviously, need a way to make a living, that in developing countries most people are in true hardship and that, therefore, they come up with whatever they can to meet their needs. Why not provide these peoples with the right framework to do so? It does not matter whether we are talking about poor peasants or city dwellers in Mexico, India, Ghana or anywhere: you give people an opportunity and they will generally take advantage of it. Indeed, like the case studies show, poorer people tend to invent their own opportunities even when the environment they live in is not in their favour: imagine then what would happen if you put these very same creative, hard-working peoples in *capitalism-capable societies*.

IX: Policy implications and conclusions

Development is the product of a package; it is systemic and can be considered as a network at the service of individuals. In such package, we find many variables but it seems that there are, at least, three crucial ones: the State, social policy and economic growth, all of them interacting with each other and aiming at the creation and preservation of collective capabilities to develop, and/or to adapt to, technological transformations, the reproduction of capital, the creation of wealth, and the distribution of such wealth in order to guarantee everyone a minimum standard of living and equal opportunity to benefit from the network. I have labelled this package as the *capitalism-capable society*.

Inside the capitalist machine there are a number of variables that determine its success or failure. We may be unable to establish how these variable relate to each other exactly but we can provide a reasonable account of what variables seem to be a *sine qua non* of the system. This is why I argue that economic growth (and along with it Development) is the product of a package: 'All happy families are the same; each unhappy family is such in its own way'. We can reformulate Tolstoy's opening line in *Anna Karenin*: 'All rich countries are the same; each poor country is such in its own way'. The theoretical review I have presented in this work strongly suggests that, to be rich (happy), countries which are poor (unhappy) need solid states, capitalism-friendly institutions, capability to innovate and capability to adapt: they have to be *capitalism-capable societies*. The absence of one of these elements can impede the proper functioning of the system, i.e., can make countries unhappy.

A holistic social policy can contribute to create a happy family. All the theories agree in one thing: growth is not associated to only one variable. However, they also coincide in pointing out that education and technological change are among the *sine qua non* elements of what I define as the capitalist package. This implies that our conception of social policy has to be enlarged to include scientific and technological actions. Or, to put it another way, given the socio-economic importance of science, knowledge, education and technology, all policies related to these areas should be considered as social policy.

That does not mean that social policy should abandon its traditional role: that of compensating groups that may lose when society evolves. The justification for this compensation is twofold. On the one hand, by compensating, social policy can help minimize opposition to change and, on the other hand, it can help prevent the emergence of, or reduce, inequality, which is not desirable as it can make the economy unproductive. In short, then, social policy should have at least 3 goals: 1) enhancing innovation; 2) preventing the emergence of opposition to change by compensating those who suffer when the latter arises, and 3) minimizing inequality. However, that is not all.

From our theoretical discussion it seems reasonable to conclude that convergence between economies is not the rule. Therefore, poor countries need to actively try to improve their economic performance, otherwise, it is likely they will become even poorer. In so doing, besides aiming to create a social policy like the one I have described, these countries need to work towards building the institutional framework which will allow capitalism to reproduce itself successfully, i.e., which will allow their economies to work properly. Indeed, social policy should be extended to include a fourth dimension: civic education.

Obviously, I am not the only one who believes that economic growth is not enough for Development to take place. Indeed, I would label my ideas as ‘developmentalist’ in the sense that I aim at linking social policy to economic outcomes and I am people-centred (Hall and Midgley 2004). Mkandawire (2001) also believes in a holistic social policy. Indeed, he defines social policy as collective interventions which affect social welfare, social institutions and social relations. And, by social welfare, he means access to adequate and secure livelihoods and income.

I subscribe myself to this way of thinking and I should not be taken as someone who blindly believes in markets. The fact that I call for such an active and wide social policy and for institutions, for States, makes it obvious that I realize markets cannot be without a State. Besides, let us remember that if we lived in a world of fully competitive markets, a world of what in economic theory is known as perfect competition, then it is very likely that we would not enjoy the fruits of innovations, i.e., we would be deprived of one of the key ingredients for economic progress for, as Schumpeter has pointed out (*Op. cit.*), in a world of perfect competition information cannot be kept secret and, therefore, those who innovate cannot enjoy the benefits of their innovation and, hence, nobody would want to invest resources on innovating.

Markets are then important and the institutions to back them must be strong but they are not everything: behind all of these elements, the consolidation of the State is crucial for developing countries to have realistic expectations of achieving any progress whatsoever. This is why State consolidation, social policy and economic growth, the elements of a capitalism-capable society, are required for Development to take place.

To end, four broad policy recommendations which can be summarised like this: aim at creating the Development network. Let us see:

1) Consolidate the State (and the sense of citizenship). The relationship between government and citizens in developing countries has to be strengthened and, at the same time, governments themselves must be stronger, though not authoritarian, so that they can put in place the institutions required for the rule of law and economic growth to take place. To achieve these two goals, governments have to be legal and legitimate. Legitimacy comes from the respect of the law and the promotion of socially desirable goals by the authorities themselves. It is a long-term objective but it is a must: without States, developing countries are not going anywhere. It is here that civic education is important: the promotion of the importance of the law, of good governance, of corruption-free societies and of the rights of others is crucial in the consolidation of States and in the road to Development.

2) Develop a capable labour force. ‘[L]abor that is skilled in production, labor that can operate sophisticated machinery, labor that can create new ideas and new methods in economic activity’ (Ray 1998: 100). That is what developing countries require because this is what nurtures technological progress or, at least, allows countries to adapt to it. To complement this, the right environment for innovation should also be set up (mainly, protection for the benefits arising from ideas and even financing for technological research and development if possible). This does not mean that everyone should be an engineer or that society should be obsessed with innovating. What it means is that 100% literacy should be an objective in every developing nation and that at least 12 years of schooling are needed for individuals to be ready to incorporate to the labour market. The knowledge of foreign languages should also be a must but, most importantly, the consolidation of one national language is also a

priority as it usually happens in developing countries that many individuals do not speak the language required for them to have jobs. Of course, these people should not be banned from speaking their own language but they have to be taught the one which will allow them to incorporate themselves to the national (and even international) economies.

3) Aim at diminish inequality. If people are too poor they may not be able to work. In cases like these, it is necessary to distribute income in favour of the poorest. Measures such as free education, housing and health may be necessary for certain individuals to be able to deliver, i.e., to be productive. The point is not to have a society in which everyone has exactly the same income; it is impossible and not desirable. The point is to give people at least the essential elements for them to participate in the economy.

4) Trust people's intuition and help them achieve their goals. Poor people in developing countries are usually always full of ideas to generate wealth. However, most of the times these peoples cannot carry their projects out because of a lack of capital or of markets, among other things. Therefore, governments should try to link people to markets and they should set up financing schemes to provide poorer people with the funds they need. The examples I have included in this work support the view that when producers in developing countries actually find a way to get to potential consumers and/or to put their ideas to work, they are very successful and can generate income for themselves and for society. Listen then to what people believe can be productive activities and help them to carry them out; they are right most of the times. Again: think of what these creative, hard-working people could do in the right environment.

Measures like the ones suggested here, tailored by each government to the particular needs of the people they govern, should allow for the participation of all in the economy, for the creation of wealth, which in turn should bring more wealth by expanding markets and deepening the division of labour, and for the setting up of Sen's 'appropriate context'; what Development is all about.

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This OCGG Economy Analysis is part of a series of publications stemming from the OCGG Economy Section's Development and Fiscal Policy project, by early career-stage researchers currently studying and working at leading universities around the world. The central theme is the reassessment of fiscal policy priorities in development.

The project seeks to assess the prospects for poorer countries moving towards stable and sustainable long-term paths on which governments are able to pursue poverty reduction and broader human development goals through the exercise of fiscal policy. Advice for bilateral and multilateral donors will focus on the nature of development assistance provided and on the policy priorities pursued.

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- offers new theoretical perspectives (e.g. on political inequality and inflation as a tax, and the decomposition of poverty changes into their growth and inequality components); and
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