

Role of the State in Developing Countries: Public Choice versus Schumpeterian Approach

Dilek Demirbas^a

Safa Demirbas^b

Abstract: It is obvious that even though modern public choice theories, which were first developed for Western pluralistic societies (society-centred), might have highlighted many hidden subjects in developing countries such as rent-seeking, corruption, strong state tradition, undemocratic decision mechanisms, etc, however, they still cannot hold and explain all the dynamics of these countries since they need to adopt a state-centre approach. In that sense, we propose that the Schumpeterian approach can help us in understanding the dynamics of developing countries even better. Therefore, our main objective in this paper is to provide a synthesis of public choice approach and the Schumpeterian approach to understand the role of the state in developing countries. We know the fact that this study still remains incomplete and not enough to cover all the needs of the subject, but at least it highlights some hidden issues for developing countries and starts a new discussion on this path.

Keywords: Public Choice, Schumpeterian approach, Developing countries, The role of the state

JEL Classification: N01, O50, P00

1. Introduction

The question of what the role of the state should be in the 21st century is the question we wish to examine in this study. In particular, looking at the role of the state in developing countries from a Schumpeterian perspective, which stands on the left-wing side of thought, and from the modern public choice school perspective, which stands on the right-wing side, require a good understanding and critical knowledge on the specification of developing countries' agenda of the state.

In this paper, our intention is to offer a new perspective, in other words, a new approach to understand the role of the state in the 21st century by integrating a Schumpeterian economics into modern public choice approach.

It is obvious that understanding the relationship between the state and society has been one of the main concerns of political and economic scientists. In particular the fundamental question 'what should be the role of the state?' has occupied the attention of many scholars for many years. For some scholars, the basic functions of the state were/are to supply law, order and to protect property rights. In that sense, from the classical view, the state provides a framework of order on which the rest of the economy is built. Therefore, it has been seen that the state potentially can play a major role in facilitating economic development due to incomplete markets, imperfect

^a PhD., Reader in Economics and International Business, Newcastle Business School Northumbria University, UK, Dilek.Demirbas@unn.ac.uk

^b PhD., Freelance Economist and Deputy General Manager at TESIS, Ankara, Turkey, safademirbas@yahoo.com

information, transaction costs and imperfect competition. Although there is an important role for the state in facilitating development and promoting institutional changes, there is no inevitably that the state will take the initiative nor that its policies will succeed. The state can fail, like the market economy, not only if it does the wrong things but also if it does too little or too much about the right things. As Max Weber claimed, the state has monopoly power over the legitimate use of coercion in a given region, so naturally it can impale a desirable institutional innovation (Weber, 1947).

In classical economic theory, the most desirable state is the one that is limited to the basic functions of protection against force, theft, fraud, enforcement of contracts, etc. This is the night-watchman state. However, in practice, the state has extended its spheres of influence well beyond those of a minimal state. Beside the monopoly power of the state, the state has also emphasised its role in relation to the currency and the business cycle. For example, by the 1950s, there was an acceptance of government intervention in the economy, based on the Pigovian approach, which viewed government's role to correct market failures and to overcome negative externalities in order to achieve efficiency. In particular, after World War II, the Keynesian revolution in economic theory convinced the public that various forms of market failure were responsible for the Great Depression of the 1930s. Neo-Keynesian fiscal policies, the extension of public ownership and an increase in a wide variety of forms of state intervention were the main issues of the postwar period of the 1970s. Therefore, the Keynesian postwar welfare state became the culmination of a long period of increased state intervention.

This historical example is an appropriate one since it explores the Keynesian approach to the questions: How should the state interact with the market? What are limits of state intervention? Of course, one major difficulty in attempting to isolate the economic role of the state from its political, social and military roles is that these roles are closely interdependent. Naturally, this point led Hayek (1944) and many other liberal economists to argue that an extension of state ownership or the forms of the state involvement in the economy necessarily give rise to a totalitarian repressive political system. We claim that although Hayek's contention is not completely true for pluralist developed countries, unfortunately it is often manifest in the less-developed countries with increasing state involvement resulting in a repressive political setting.

It is also interesting to observe that public opinion has changed again to now favour a reduction in the economic role of the state. The inflationary pressure of the 1970s, the slowdown in the growth of the world economy, the apparent inefficiency and loss-making of some state enterprises are all seen as a result of government failure. The 1980s witnessed a swing towards economic liberalism, suggesting a rolling back of the frontiers of state ownership and involvement in the economy.

Our intention here is not to discuss the details of the perceived performance of different types of state interventions. Rather, it is to discuss the main issues of the new public choice idea to be able to offer new policies for developing countries by attempting to answer the question: 'What should be the role of the state in developing countries in the 21st century?'

Before doing that, we would like to set out the fundamentals of the public choice paradigm (for Western pluralistic societies) in order to clarify the role of the state in non-pluralistic societies, such as authoritarian states and semi-democratic countries.

2. The Public Choice School in Western Pluralistic Societies

We start with the well-known definition set forth by Mueller:

“Public Choice can be defined as the economic study of nonmarket decision making, or simply the application of economics to political science. The subject matter of public choice is the same as that of political science: the theory of the state, voting rules, voter behaviour, party politics, the bureaucracy, and so on. The methodology of the public choice is that of economics, however. The basic postulate of public choice, as for economics, is that man is an egoistic, rational, utility maximizer” (Mueller, 1979, p. 1).

On the same line, Buchanan, who has been recognised as the founder of the modern public choice school, defined it as:

The theory of the public choice is the application and extension of economic theory and economic tools to politics, or governmental choice (Buchanan, 1978; 1979; 1986; Brennan and Buchanan, 1984).

A basic assumption of public choice thought is that individuals act as *rational egoists*, who pursue their private interests in both economic and political life (Self, 1993, p.4). Public Choice theories, which mean the application of the principles of economic methodology to political behaviour and institutions, contributed powerfully to our understanding of the state and society. In particular, the state, for them, is an evil which restricts people's freedom. According to public choice studies, not only should public responsibilities of the state be reduced and public policies be adjusted to the pressure of economic markets, but government itself should also be remodelled and transformed according to market concepts of competition and efficiency. This is because, at the most basic level, public choice has been founded on the idea that human behaviour in governmental settings is motivated by the same self-interested forces that guide human behaviour in private settings.

Following public choice theories, in practice, governments in western democracies adopted a series of policies shaped by public choice's individualist and rationalist assumptions. From the theoretical point of view, the theory of the state, voting rules, party politics, bureaucracy, interest group politics, rent-seeking, an economic theory of legislation etc. were accounted as a subject matter of public choice. Slimming the size and the functions of the state, pursuing privatisation and restructuring government were the key targets of this new doctrine in the 1980s.

In particular, analysing interest groups and rent-seeking within the public choice framework results in the construction of highly abstract models based on strategic choices, policy outcomes and their economic consequences in developed countries. Using this framework, interest group politics in public choice based on a society-centred approach, assumed interest mobilisation and government response to lobbying activities¹. As it is known, in Western political history, the state and interest group interactions were/are defined in the framework of pluralist and neocooperatist approaches that also stem from the society-centred idea.

When we look at the classical literature of public choice, we will see that a couple of works had a very important impact on the development of the idea. Two particular works have a special place in the early development of public choice, even though one of them, Schumpeter's *Capitalism, Socialism and Democracy* (1942) has been criticised by many modern public choice scholars, since he defended and

recommended socialism. However, some scholars such as Mitchell (1984a, 1984b) and Udehn (1996) have put Schumpeter's work within a special place in the early developments of public choice and mentioned his main contributions to this area. Following their recommendations our intention is also to classify Schumpeter's work in the early public choice literature since it is almost impossible to ignore his effects on the very famous works of public choice theorists. The second work was Arrow's *Social Choice and Individual Values* (1951/1963). Since our main theme is to discuss the role of the state in developing countries, it is essential to present briefly a short view on Schumpeter's and Arrow's arguments to exhibit the Western pluralist societies' structure and the role of the state in their case.

In his work, Schumpeter (1942) attacked the 'classical doctrine of democracy for being naive and unrealistic' (1942/1976, p.21). For his understanding:

[t]he democratic method is that institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote.

Arrow (1951/1963) has reached an even more rigid conclusion for the theory of popular sovereignty, meaning that 'there are logical barriers to aggregating individuals' preference orderings into a social preference ordering'. For him there is no such thing as a 'general will', or a general social choice function. The implications for the possibility of a social welfare function are continuing matters at issue. With the 'Possibility Theorem', Arrow has tried to set down a number of reasonable assumptions about individual preference orderings and social preference ordering.

Apart from these two very well known works, another major contribution is that of Downs' *An Economic Theory of Democracy* (1957). He has also suggested the '*self-interest*' assumption to be the most realistic assumption about political behaviour' (Downs, 1957, pp.27-28). In addition to this, for him, political institutions are populated with *Homo economicus*, who acts rationally. Assuming a self interested, egoist and rational human in every sphere, he intended to explain the behaviour of bureaucrats, politicians and voters in the context of democracy.

A fourth public choice classic appeared with the publication of Buchanan and Tullock's *The Calculus of Consent* (1962), which was accepted as one of the most important works in the new political history. The first aim of this work was the development of an economic theory of constitutions and the second was the analysis of decision-making rules. Although the constitutional economy has been subsequently developed and evaluated by Buchanan's, it can be said that the first seeds were planted with this study. They have also supported the idea that peoples are *Homo Economicus* and they act according to their self-interests.

We can also acknowledge Olson's *The Logic of Collective Action* (1965) as being amongst the most important public choice classics since it also emphasised the behaviour of the rational egoist and his strategies, who will not engage in collective action, unless the collective is small, or some private privileges are added to the benefit from the collective good.

In their analysis, public choice scholars have more or less shared the same point that the locus of possessive individualism is the *market*. Because the market has the unique quality of being efficient, all other ways appear inefficient. Hence, they have developed a slogan that the market is all good and government is all bad.

Consequently, their main policy suggestion is that there should be no state intervention so as not to disturb market rules. These recommendations were later criticised by many schools of thought, especially for developing countries.

In this section, we have examined very briefly some public choice classics. In the next section we will examine developing countries and analyse why we cannot apply directly, without any modification, the existing public choice approach to them.

3. Public Choice and Developing Countries

In the mid-1970s, although the new political economy began to be applied to politics in developing countries, specifically, in the area of trade restrictions², a general consensus on the differences of the developed and developing countries' political structure emphasised the modification of the public choice theories for developing countries. A group of political economists claimed that the state and the role of the state in developing countries are very much different from the democratic western societies. Among those economists, we can count Grindle, Meier, Findlay and Tullock. These scholars claimed that unless a state-centred approach is accepted, it will be too difficult to understand the whole structure and to apply the public choice approach to developing countries.

In particular, among these scholars, Grindle (1991) researched the applicability of public choice to conditions in developing countries. He suggested that public choice is not applicable to the dynamics of policy making in developing countries when it takes a society-centred approach³. However, it might be much more applicable when this society-centred approach is replaced with a more state-centred perspective⁴. On the basis of this idea, Grindle analysed lobbying by interest groups, the actions of policy makers and the activities of bureaucrats. He considered that, although the interaction of individualistic rent-seeking bureaucrats and individualistic rent-seeking citizens does not explain the most critical aspects of the politics of policy implementation in developing countries, it still gives crucial information on this topic. On the same parallel Meier (1991) also claimed that the economic role of the state has to be specified very carefully to know whether the state is *autonomous* (has its own objectives), or merely *passive* (responding to the demands of various interests or classes in society).

For Findlay (1991), most of developing countries today are ruled by military juntas or are one-party dictatorships, and that the state dominates civil society. In the light of this specification, Findlay grouped the types of states in the developing countries as *traditional monarchies* (Saudi Arabia, Morocco, Jordan etc.), *traditional dictatorship* (Cuba, Paraguay, Haiti etc.), *authoritarian states* (right-wing authoritarian states: Turkey, Egypt, Brazil, Argentina etc.; left-ring authoritarian states: China, Vietnam, North Korea etc.), *democratic states* (Sri Lanka, Venezuela, Costa Rica, Jamaica etc.). He claimed that, since in each of these developing countries state structure is very different from the developed countries, techniques of analysis must also be different. Tullock also pointed out that the majority of people are ruled by autocracies as the dominant form of government in the world today. He observed that 'since 1914 on the whole democracy has become a less significant form of government and dictatorships more important' (Tullock, 1987, p.1). He explained that since the most autocracies are in developing countries, the modified relationship between the new political economy and developing countries is a necessity.

In short, we can say that if the new political economy and public choice theories are to be modified to developing countries, this applicability might be able to highlight some of the most important problems of developing countries such as rent-seeking, corruption, trade restrictions, import substitution policy, resource allocation, and dependence on foreign capital. But this modification requires some clarifications on the state decision-making process and the principal agent problem in those countries.

4. The State's Decision Making Process and the Principal-agent Problem in Developing Countries

There are four general approaches to explain the state's decision-making process in both developed and developing countries.

The *first* approach, advocated by a wide range of social scientists including the Marxists, views *the state as the agency of a particular group or classes*. The state institutes property rights that maximise the revenue (benefit) of the ruling class regardless of its impact on the wealth of the nation as a whole.

According to the *second* approach, *the state consists of a multitude of agents, politicians, technocrats and bureaucrats* (Buchanan and Tullock, 1967). As accepted by Public Choice, each agent has his/her own interests and the state is viewed as an instrument for achieving collective action. Thus, the policies of the state are endogenously determined by the competing powers of the various interest groups. We will examine this approach in more detail in the next section.

The *third* approach views *the state as a personalised organic entity with its own values, motivations and objectives that are independent of the individuals of whom the state is composed*. As an integrated cell of the state, an individual loses his/her own identity since the state acts to maximise its own welfare or utility.

The *fourth* approach, suggested by Downs (1957), is where decision making by *the state is seen from the point of view of a single political party* (or set of political elite). The party is a multi-person team seeking to control the governing apparatus by legal means. Since its members are assumed to agree on all their goals, it can be viewed as a single person with a consistent preference ordering.

On the basis of the third approach that sees the state as a personalised entity, it will be obvious to see that the state in developing countries displays greater variation in their institutional arrangement. According to a classification by Findlay (1990) the states in developing countries range from traditional monarchies, through traditional dictatorships, to right-wing and left-wing authoritarian states, and finally to democratic states.

In almost all developing countries, states tend to dominate civil society and have a substantial degree of autonomy in policy making. Therefore, a more appropriate framework for studying the behaviour of the state in developing countries is the multi-level, principal-agent framework. At the *first level*, the head of the state (the ruler) can be treated as the agent of the people, or the ruling class. The ruler-king, dictator, president or prime minister is the ruling person, who has a substantial degree of autonomy in pursuing his/her own legitimacy and the legal tradition of the society.

At *the second level* of the principal-agent problem, the ruler has to employ bureaucrats as agents to assist him in implementing law and rules. Nevertheless, bureaucrats are rational in the sense that their interests will not coincide with the ruler. Hence, they will use the authority delegated to them by the ruler and bureaucrats will maximise their own benefits. It is true that the discretionary behaviour of bureaucrats cannot be completely eliminated, even in totalitarian states, and in many cases there is collusion between bureaucrats and others who divide up the revenue of the state by bribe-taking and rent-seeking. The constraints on the ruler's decision making and the bureaucrats' discretion vary with the nature of the state, often becoming more restrictive as the nature of the state shifts from traditional monarchy, to traditional dictatorship, to authoritarian state to democratic state.

5. The Role of the State in Schumpeterian and Public Choice Approaches

5.1. Schumpeterian Approach and the Role of the State

In his earliest work, *The Crises of the Tax State* (1918), Schumpeter observed that states came into existence only after public and private sectors had distinct roles in the societies. For him, Feudalism did not produce a state since all the property rights were wasted in the pension of a lord. With the evolution of feudalism, property was divided into private and public titles. Then, as property and the market system developed, state activities and especially war had to be financed by states. Thus, 'taxation of private activities and property became the chief form of revenue' (Mitchell, 1984a, p.85). Schumpeter claimed that the tax state, capitalism and war were elements in the same basic social changes. In his later work, Schumpeter (1954, pp.6-7) observed that the extraction of tax revenue by the state has an enormous influence on economic organization, social structure, human spirit and culture, and the fate of nations. For this reason he argued that the study of the social processes behind taxation and public finances, that is, fiscal sociology, is one of the best starting points for an investigation of society, and particularly its political life.

It is also very interesting to enquire whether what Schumpeter meant by 'The Tax State', as Jackson claimed, was 'the mixed economy' (Jackson, 1989, p.2). The question of the appropriate mixture between the public and private sector found its answer again in Schumpeter's statement that 'propositions about the working of democracy are meaningless without reference to given times, places and situations and so, of course, are anti-democratic arguments' (Schumpeter, 1942/1976, p.243). What he means in that statement is actually very clear and satisfactory. According to Schumpeter, 'different societies will provide different mixes of liberty, freedom, efficiency and welfare distributions' (Jackson, 1987, p.2). Consequently, the mixture of public and private sectors will differ from society to society. What about if the states are in capitalist states? Would states in this capitalist system be able to survive?

In *Capitalism, Socialism and Democracy* Schumpeter (1942) raised the question whether capitalism as an economic system would be able to survive, and he concluded that socialism would eventually replace capitalism in Western democracies. Even if he thereby reached the same conclusion as Marx, his arguments were quite different. It was not the shortcomings or the instability of capitalism that produced the victory of socialism. Instead it was the superior performance of capitalism that paved the way for socialism. He saw the declining economic importance of the entrepreneur as one of the major forces in the transformation from capitalism to socialism.

Schumpeter claimed that by means of modern techniques and modern modes of organization the innovation process would become more and more automated. Innovations would no longer be connected with the efforts and the brilliance of a single person, who is called as entrepreneur and these innovation were increasingly to become the outcomes of the large organized teams. This would be done most effectively within the framework of large corporations. In fact, the entrepreneurs were, according to Schumpeter (1942), the backbone of the bourgeoisie, thus providing capitalism with its institutional and political basis. By destroying the entrepreneurs through its effectiveness, capitalism would also destroy its own political basis. In an economy that is increasingly dominated by giant corporations and devoid of entrepreneurs, the defence of capitalism has no constituency. Instead, capitalism will have to confront increasing hostility.

So that, capitalism would kill itself by undermining its political base by its own efficiency; the forces of creative destruction would eventually kill capitalism itself. By using the proceeds from its monopoly power to finance new innovations, the large corporation could improve its monopoly position and in practice crowd out entrepreneurs and smaller firms. Like his view on the mixture of public and private sectors, which differ from society to society, Schumpeter also underlined the fact that different countries are more likely to follow the different route to socialism.

In that sense, it is not possible for anybody to offer any single mix or a precise dividing line between what is and what should be. If we go back to our main question, 'What should be the role of the state?' it will find its answer again in a Schumpeterian perspective. Moreover, according to Schumpeter, the 'public sector can intervene in the economy in order to correct inefficiencies, imperfections that are thrown up by capitalism in the tax state' (Jackson, 1987, p.7). For the same reason, Schumpeter was also not against providing private industry with subsidies, as long as they help adaptation. On the other hand, he was against them if these subsidies are distributed inefficiently in order to protect jobs. In sum, it can be claimed that he was not against government intervention with a limit.

Schumpeter also supported the idea that the public sector should finance defence, police, internal justice and some investments (such as education) from the budget. Interestingly, Schumpeter assessed that 'the budget is the skeleton of the state stripped of all misleading ideologies...' (Schumpeter, 1918, p.6) and 'public finances are one of the best starting points for an investigation of society, especially though not exclusively of its political life. With these suggestions, we should admit that Schumpeter contributes a lot to public choice by evaluating the state and democracy, and preparing a basic structure in some areas for the modern public choice theories such as Downs' democracy and Brennan and Buchanan's tax limits. It is obvious that, as well as similarities, there are also many important differences between the Schumpeterian approach and modern public choice school.

5.2. Modern Public Choice and the Role of the State

Hayek (1944) asserted that the distribution of resources produced by the market is socially optimal. Hence, the state should limit itself to the minimal state because the market is capable of working efficiently if there is no state intervention. Brennan and Buchanan (1980), in *The Power to Tax*, stated that the modern tax Leviathan depends upon an on efficient private economy if its own spending activities are to be sustained.

The key value judgement of this statement is that governments are seen as passive and benevolent despots, so that they should be constitutionally constrained as a tax-levying power of the Leviathan. On the other extreme, Hayek even claimed that individuals should be protected from interference by governments. Brennan and Buchanan accepted that the Hobbesian state of nature is an intolerable and unsustainable situation in which everybody's self preservation is endangered as a result of a lack of constraints on individual actions. They suggested that Hobbes's Leviathan should be constrained with *constitutions*. Otherwise, government will attempt to levy taxes at a constitutionally inadmissible rate. In other words, government should be limited so as not to be a danger for our liberty. Not only Hayek and Brennan and Buchanan, but also other modern public choice scholars agreed on the same objective since they thought that government is too big and public expenditure, in Western Democracies, a gigantic waste of resources. How do governments waste resources? By increasing the size of government above its optimal level, the resources which are supposed to be used by the market efficiently and productively, are not used in productive enhancing activities. How do they increase the size of the government? Bureaucrats, for example, influence the level of public spending twice; first in their capacity of budget-maximising civil servants; second in their capacity of utility maximising voters. Interest groups, as a second example, engage in rent-seeking to maximise their benefit such as politicians and bureaucrats (Udehn, 1996). For public choice theorists, the minimum state is the best state. Therefore, to be able to achieve this optimum level, slimming the state, privatising welfare and restricting government should be the policies pursued. In the next section we will indicate the common points and the differences of these two ideologies to offer our new public choice approach for the LDCs: *Modified Public Choice*.

6. A New Approach for Developing Countries

6.1. Common Points and Main Differences of Schumpeterian and Modern Public Choice Approaches

Common Points

i) In both approaches, the economic process is described through the *actions of individuals*. This is a very important point because it shows that their methodological postulates stem from the same source. In Schumpeter's mind, individuals and their choices are always embedded in historical time and the culture of a particular place. He views political man as a rational but uninformed agent who tries to maximise his own welfare (Schumpeter, 1942/1976, pp.XX-XXIII). Although he recognised self-interested rational man, in his work, he gives the biggest emphasise to the methodological difference between political choice and market choice. Schumpeter viewed that 'market choice is necessarily superior to political choice'. Modern public choice theorists are also engaged with the same kind of postulate.

ii) Like public choice scholars, Schumpeter was also aware of 'the possible inefficiency and wastage which results from the competitive process'. He also identified this waste in the political process as the leaders' short-run view that, in the long run produces inefficient policies that are inconsistent with the best long-run interests of the people.

iii) Like many modern public choice theorists, Schumpeter asserted a limited role for the voters since they do not know how to be rational to realise costs and benefits in politics. This point was explained in modern public choice with 'myopic voters', who are unable to consider their benefits as a result of fiscal illusion.

Differences

i) Schumpeter's analysis of the behaviour of politicians is very different from modern public choice analysis. In Schumpeter's work, the individual is selfish in both the market and politics, but he is less egoistic in the polity than the market. Buchanan called this difference 'bifurcated minds' and altogether rejects the idea of less rational (egoistic) man in the polity. For Buchanan, the individual is self-interested, egoist and rational in every market and in every setting.

ii) Having a very clear *vision* of not only the capitalist economy and its development but also of socialism, Schumpeter introduced a graphic vision, not a theory of politics. We cannot see that kind of vision in the public choice approach.

iii) Although Schumpeter viewed democratic competition among politicians as institutionalised, he did not consider *constitutions* and *party systems*. Nor did he seem to be interested in viewing constitutions and other normative arrangements by which to limit the power of Leviathan. On the other hand, modern public choice theorists spend quite a lot of time on this subject proposing solutions to limit government.

iv) In Schumpeter's vision, as mentioned above, the dynamic nature of capitalism is based upon the creative destruction wrought by an entrepreneur in his search for profits. According to him, the politicians play a similar role to that of the entrepreneur engaged in competition. Both competitions solve different problems of, may be, the same individuals. While creative entrepreneurs deal with the problem of the market by developing new products, new techniques to produce, etc., that process will lead to increase welfare for the ordinary consumer in the long run. Similarly, the politicians compete for the welfare of the voters but they are unable to achieve the same degree of rationality or moral choice displayed by the businessman. Furthermore, for them, the creative leader is essential to the operations of a democracy as a businessman powers the economy.

From the modern public choice theorists' point of view, *homo economicus* exists in both political and economic markets. While market competition is good for the economy (entrepreneurs increase welfare of the consumer in the long run by solving problems), political competition wastes resources since they will not create any value for the whole society.

v) Schumpeter considered a place, role and responsibility for bureaucratic management in a socialist society rather than capitalist one. This difference is one of the most important, since the modern public choice theorists do not stand on the leftist side. In some cases, Schumpeter went further and claimed that bureaucracy must be strong enough to guide and if need be, to instruct the politicians. His general view that bureaucracy is capable of effective, efficient allocation of resources was totally rejected by Mises and Hayek, and of course by their followers.

6.2. Can We Integrate the Schumpeterian Approach into the Modern Public Choice to Offer an Alternative View: Modified Public Choice Approach for Developing Countries?

In this section, our intention is to combine these two approaches, considering developing countries' special conditions by taking into account only powerful assumptions of both Schumpeterian and modern public choice approaches in order to establish a state-centred perspective (compared to the society-centre perspective of pluralistic public choice approach). In other words integrating a Schumpeterian approach into modern public choice to give us a new perspective.

Schumpeter believed that socialism and democracy were compatible with each other. Similarly, why can we not consider democracy as a competent and consistent way of controlling bureaucracy since we already know that in developing countries the state and its bureaucracy are very powerful institutions and can be described as an organic entity? In that structure, it is obvious that interest groups can not represent their preferences. Consequently, policy making tends to be more closed and more centred in the political executive. As a result, lobbying activities in developing countries become very different to those in developed countries. From this perspective, the use of society-centred political economy models is a misleading method to follow for developing countries (Grindle, 1991).

It is true that few public choice studies have already provided sensible insights about how political decisions on economic policy can be both rational and socially non-optimal in some of developing countries⁵. Rent-seeking, corruption, strong state etc. have been examined in that sense by many of them. However, because not only the state structure is different in these countries, but because their societies and their interest groups also differ subsequently from each other, we need new a perspective to analyse these kinds of distortions.

As can be remembered, the public choice scholars' main solution to limit the Leviathan in all developed and developing countries, was to limit government by *constitution* in order to control central expenditure, revenue and debt. In that solution a *smaller politic* has been offered for better economics. Grindle (1991) suggested that this solution is a very weak one to understand policy making in developing countries and to solve the problem. Schumpeter's argument in that context will be more helpful, since he claimed that politics should not be viewed as a negative factor. Instead it can be seen as the product of politicians, who sell policies like their counterparts (entrepreneurs) in the economy. Political innovations, which involve laws and public policies, are not obtained very easily. If we take into account all of these issues we will see that a Schumpeterian approach makes more sense for developing countries than does public choice. This is especially so, if we concur that 'Schumpeter also discerned the beginnings of rent-seeking society' (Mitchell, 1984b: 165) when he observed that 'a considerable part of the labour of lawyers and of the state apparatus, itself, is engaged in the unproductive task of 'protective activities' (Schumpeter, 1942/1976, p.198). According to Jessop (1993), the Schumpeterian workfare state has distinctive economic and social objectives, which can be summarized in abstract terms as: the promotion of product, process, organizational, and market innovation; the enhancement of the structural competitiveness of open economies mainly through supply-side intervention; and the subordination of social policy to the demands of labour market flexibility and structural competitiveness. The most distinctive features of the Schumpeterian workfare state among them are: a concern to promote innovation and structural competitiveness in the field of economic policy; and a concern to promote flexibility and competitiveness in the field of social policy.

Actually, developing countries depend on mixed economies for the optimum combination of the public and private sectors. However, it is also true that in these countries authoritarian states tend to dominate and pressurise society with the military powers that they hold. How is it possible to break this vicious circle? To ensure an appropriate set of incentives for private sector decision making, the powers of the state need to be controlled so that corruption, rent-seeking, etc.- even if they cannot be stopped altogether - can be controlled. Comparative efficiency in both the public and private sectors can be obtained by moving along the same lines that developed countries already passed. In order to follow a Schumpeterian approach, perhaps Hayek's liberalist societies and Brennan and Buchanan's minimum state by constitutions, can be targeted.

7. What should be the Policy Implications for the Role of the State in Developing Countries in the 21st Century?

As we mentioned earlier a modern public choice approach is helpful but is not sufficient to explain the dynamics of developing countries. In a system where no new technologies or information are being incorporated into economic activity, the economy will tend towards equilibrium with current technological changes in production and market. With current technological changes (which is the main need of developing countries to apply to their industries) in production and distribution, disequilibria are introduced into the economy (there will be new opportunities for growth in investment, output and productivity) (Meier, 1991). Modern public choice theorists have nothing to say about this problem unless they consider a more dynamic solution.

At this stage, we consider Schumpeter's ideas, as an early public choice theorist, about capitalism - especially about how capitalism tends to destroy itself because it generates insoluble economic problems. Schumpeter (1942) described capitalism as an 'evolutionary process' and the dynamics of this process come from the competition between entrepreneurs (small firms) and the large firms. Schumpeter argued that stationary capitalism is impossible and contradiction in terms. Schumpeter also claimed that 'for the central figure on the capitalist stage, the entrepreneur, is concerned not with the administration of existing industrial plant and equipment but with the incessant creation of new plant and equipment, embodying new technologies that revolutionize existing industrial structures' (1946: 193). For Stokvis (2001), in terms of how knowledge creation is possible in the capitalist system, Schumpeter stressed the importance of the R&D activities for new commercially exploitable knowledge embodied, as corporations themselves grew in size and economic significance.

In his *Capitalism, Socialism and Democracy*, Schumpeter (1942) claims that the development of the capitalist economy itself undermines the entrepreneurial or innovative function, which Schumpeter regards as the essential feature of capitalism, because technological progress and the bureaucratic administration of large enterprises tend to make innovation itself a routine matter. In addition, capitalism, according to Schumpeter, erodes its own institutional framework by destroying the protective strata-small businessman, farmers etc. This process is referred to as *vanishing investment opportunity*. Finally, capitalism encourages a *rational* and *critical* attitude, which is essentially turned against its own social system and this process is greatly assisted by the creation of a large group of intellectuals (Schumpeter, 1942/1976).

In the context of innovation, Schumpeter (1939) identified a pattern behaviour of cyclical ups and downs coinciding with the entrepreneurial introduction of innovations and their gradual assimilation by way of which entrepreneurial profits were undermined and the benefits of new technology passed over to the consumers in the form of reduced prices. Hence, the economy alternated between phases in which there were first positive profits due to monopolistic advantages and then zero profits with competition among many equals. Schumpeter (1942) argued that capitalism would not survive into the future because of its inevitable extra-economic consequences that were bound to undermine in turn its success. In other words, capitalism was fast becoming the very victim of its own economic success by destroying its institutional framework. This process, in Schumpeterian terminology, is called as creative destruction. Although capitalism still survives in contrary to his prediction in today's world, modern biotechnology is a clear example of a set of new combinations with new technologies that create a technological discontinuity in existing pharmaceutical industry. By and large, the Schumpeterian perspective on the creation of profits is shared by innovative companies based in the most dynamic centres, and by the more internationally integrated multinational companies particularly in sectors at the leading edge of innovation.

In the Schumpeterian view, an entrepreneur is primarily an agent of change, who is searching for new opportunities and not necessarily a strictly rational, economically maximizing, a risk taking capitalist, as it is described in the 'classical' theories of entrepreneurship (Santarelli and Pesciarelli, 1990; Hagedoorn, 1996). In his early work, Schumpeter (1911) described small and independent entrepreneurial companies as major agents of change within new industries. For Schumpeter (1911) the small entrepreneurial companies are important because society needs them as a major generator of new innovations. These companies are innovators that successfully introduce new products and are largely financed by external sources, not by internal cash flows. In modern strategic management terminology, Schumpeterian small and innovative entrepreneurships are based on proactive strategies that capitalize on firm specific advantages and innovative capabilities, financed through back loans and venture capital. In Schumpeterian argument, there is also an important role for large companies. In his 1942 work, Schumpeter pictured large science based companies as dominant agents in the innovative environment, which innovations were developed in large research labourites and R&D activities.

Concentrating on Schumpeterian points and following his suggestions, we can analyse each of the developing countries separately, understanding each of these countries' state structure and development processes. Generating one solution for every developing country, as Schumpeter suggested, is very misleading. Instead, we may consider technological developments and continuing innovations (both in politic and economic markets) in order to solve each developing countries dynamic problem separately. Supporting entrepreneurs in small countries and their contributions to the system should be the main target as entrepreneurs are the back bones of the innovativeness. If these developing countries are trying to be capitalist countries by following developed ones, the survival of the capitalist economic system will depend upon innovations and expansions (considering Schumpeter's points and combining it with some of the public choice assumptions).

8. Conclusion

We set a question to examine “What should the role of the state in developing countries?”. To answer this question we selected two approaches: the Schumpeterian and the public choice. We knew that one approach would not be enough to fulfil our requirements. That's why we intended to select the best sides of these two approaches in an attempt to create a new perspective. We believe that it still remains incomplete and not enough to cover all the needs of the subject, but at least it highlights some hidden issues for developing countries.

Public choice scholars claimed that the distribution of resources produced by the market is socially optimal. Hence, the state should limit itself to the minimal state because the market is capable of working efficiently if there is no state intervention. For public choice theorists, the minimum state is the best state. Therefore, to be able to achieve this optimum level, slimming the state, privatising welfare and restricting government should be the policies pursued. The public choice scholars' main solution to limit the Leviathan in all developed and developing countries, was to limit government by *constitution* in order to control central expenditure, revenue and debt. In that solution a *smaller politic* has been offered for better economics. By doing that, rent-seeking activities and corruptions will be controlled and efficiency will be maintained. But in developing countries, as Findlay (1999) stated, the state structure is very different from the developed countries, and techniques of analysis also should be different. Therefore, a more appropriate framework for studying the behaviour of the state in developing countries is the multi-level, principal-agent framework. Grindle (1991) suggested that limiting the Leviathan solution is a very weak one to improve policy-making process in developing countries.

Schumpeter's argument in that context will be more helpful, since he claimed that politics should not be viewed as a negative factor. Instead it can be seen as the product of politicians, who sell policies like their counterparts (entrepreneurs) in the economy. For Schumpeter, the development of the capitalist economy itself undermines the entrepreneurial or innovative function, which Schumpeter regards as the essential feature of capitalism, because technological progress and the bureaucratic administration of large enterprises tend to make innovation itself a routine matter.

¹ Actually, there is a certain irony in the use of public choice thought in a policy context in which self-seeking political behaviour supports the idea of the slimming of the state would be unsuccessful because of the necessary mobilisation of new interests and the costs of buying out existing interests (Self, 1993).

² It has been claimed that in these developing countries which has applied special trade protection policy, interest groups have created rent-seeking interventions and, thus, free trade has been sacrificed in order to protect domestic industry from international competition by government.

³ It is based on assumptions about interest mobilisation and government response to lobbying activities.

⁴ It is based on political elites who are actively engaged in maximising their political power or on rent-seeking bureaucrats

⁵ Krueger's (1974) study for Turkey and India can be mentioned here. Bhagwati and Srinivisan's works should also be mentioned.

References

- Arrow, K. J. (1951/1963). *Social Choice and Individual Values*. New Haven: Yale University Press.
- Brennan, G. & J. M. Buchanan (1980). *The Power to Tax. Analytical Foundations of a Fiscal Constitution*. Cambridge: Cambridge University Press.
- Buchanan, J. M. & G. Tullock (1962). *The Calculus of Consent. Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.
- Buchanan, J.M. & R. Wagner (1977). *Democracy in Deficit. The Political Legacy of Lord Keynes*. New York: Academic Press.
- Buchanan, J. M. & R. D. Tollison (1984). *The Theory of Public Choice. Political Applications of Economics*. Ann Arbor: University of Michigan Press.
- Buchanan, J. M. (1978). From Private Preferences to Public Philosophy: The Development of Public Choice. (Ed) A. Selden. *The Economics of Politics*, (pp.1-18). London:1978.
- Buchanan, J. M. (1979). Politics without Romance: A Sketch of a Positive Public Choice Theory and its Normative Implications. (Ed) J. M. Buchanan and R. D. Tollison (1984). *The Theory of Public Choice. Political Applications of Economics*. Ann Arbor: University of Michigan Press.
- Buchanan, J. M. (1986). *Liberty, Market and State*. Brighton: Wheatsheaf Books.
- Downs, A. (1957). *An Economic Theory of Democracy*. New York: Harper and Brothers.
- Findlay, R. D. (1991). The New Political Economy Power for the LDCs. (Ed) G.M. Meier *Politics and Policy Making in Developing Countries: Perspective on the New Political Economy* (pp.13-41). USA: ICS Press,
- Grindle, M. S. (1991). The New Political Economy: Positive Economics and Negative Politics. G. M. Meier. *Politics and Policy Making in Developing Countries: Perspective on the New Political Economy*, (pp.41-69) .USA: ICS Press,
- Hagedoorn, J. (1996). Innovation and entrepreneurship: Schumpeter revisited, *Industrial and Corporate Change*, 5, pp. 883-896.
- Hayek, F. A. von (1944/1962). *To Road to Serfdom*. London: Routledge and Kegan Paul.
- Jackson, P. M. (1987). The Role of Government in Changing Industrial Societies: A Schumpeter Perspective. *University of Leicester Discussion Paper No. 60*, March 1987.
- Jessop, B. (1993). Towards a Schumpeterian Workfare State? Preliminary Remarks on Post- Fordist Political Economy', *Studies in Political Economy* 40: 7-39.
- Meier, G. M. (1991). *Politics and Policy Making in Developing Countries: Perspective on the New Political Economy*. USA: ICS Press.
- Middleton, R. (1996). *Government vs the Market*. Edward Elgar.
- Mitchell, W. C. (1984a). Schumpeter and public Choice, Part I. *Public Choice*, (42), 73-88.
- Mitchell, W. C. (1984b). Schumpeter and Public Choice, Part II. *Public Choice*, (42), 161-174.

- Mueller, D. C. (1976). Public Choice: A Survey, in Buchanan, J. M. and R. D. Tollison (1984). *The Theory of Public Choice. Political Applications of Economics*. Ann Arbor: University of Michigan Press.
- Mueller, D. C. (1979). *Public Choice*. Cambridge: Cambridge University Press.
- Mueller, D. C. (1989). *Public Choice II*. Cambridge: Cambridge University Press.
- Niskanen, W. A. (1971). *Bureaucracy and Representative Government*, Chicago: Aldine-Atherton.
- Olson. M. (1965). *The Logic of Collective Action*, USA: Harward University Press.
- Santarelli, E. & E. Perciarelli (1990). 'The emergence of a vision: the development of Schumpeter's theory of entrepreneurship', *History of Political Economy*, 22, pp. 677-696.
- Self, P. (1993). *Government by the Market? The Politics of Public Choice*, China: Macmillan.
- Schumpeter, J. A. (1954). History of Economic Analysis. Edited from manuscripts by E. B. Schumpeter, London: Allen & Unwin., New York: Oxford University
- Schumpeter, J. A. (1946). 'Capitalism,' reprinted in R . W. Clemence (ed) Essays of a J. A. Schumpeter Cambridge, Massacheesetts: Adison-Wesley, 184-205.
- Schumpeter, J. A. (1942). *Capitalism, Socialism and Democracy*. New York: Harper and Brothers
- Schumpeter, J. A. (1939). 'Business Cycles: A Theoretical Historical and Statistical Analysis of the Capitalist Process', abridged by R. Fels (New York: McGraw-Hill
- Schumpeter, J.A. (1918/1954). The Crises of the Tax State. (Ed) W. F. Stolper and R. A. Musgrave, *International Economic Papers*, 1954, London: Macmillan.
- Schumpeter, J. A. (1911). *The Theory of Economic Development*, London, Oxford University Press
- Stiglitz, J.E. et al (1989). *The Economic Role of the State*, edited by Arnold Heertje, Great Britan: Basil Blackwell.
- Stokvis, R. (2001). 'Knowledge and the Nature of capitalism: Some Schumpeterian Observations', Discussion paper, University of Amsterdam, The Netherlands
- Thain, C. and M. Wright (1995). *The Treasury and Whitehall*. Clarendon Press Oxford.
- Tullock, G. (1987). *Autocracy*. Boston: Kluwer Academic Publisher.
- Udehn, L. (1996). *The Limits of Public Choice. A Sociological Critique of the Economic Theory of Politics*. New York: Routledge.
- Weber, M. (1947). *The Theory of Social and Economic Organisations*. The Free Press: New York.