

Democracy, Inclusion, and Prosperity¹

Thank you for inviting me to this Festival of Ideas. Since this festival is about ideas, I am not going to tax you with the Reserve Bank's views on monetary policy, which are, by now, well known. Instead, I want to talk about something I have been studying for many years, the development of a liberal market democracy. In doing this, I will wear my hat as a professor in the field known as political economy, and discard my RBI hat for the time being. If you came here expecting more insights on the path of interest rates, as I expect many of you did, let me apologize for disappointing you.

My starting point is the truism that people want to live in a safe prosperous country where they enjoy freedom of thought and action, and where they can exercise their democratic rights to choose their government. But how do countries ensure political freedom and economic prosperity? Why do the two seem to go together? And what more, if anything, does India have to do to ensure it has these necessary underpinnings for prosperity and continued political freedom? These are enormously important questions, but given their nature, they will not be settled in one speech. Think of my talk today, therefore, as a contribution to the debate.

Fukuyama's three pillars of a liberal democratic state

In his magisterial two-volume analysis of the emergence of political systems around the world, political scientist Francis Fukuyama builds on the work of his mentor, Samuel Huntington, to argue that liberal democracies, which seem to be best at fostering political freedoms and economic success, tend to have three important pillars: a strong government, rule of law, and democratic accountability.² I propose in this talk to start by summarizing my (necessarily imprecise) reading of Fukuyama's ideas to you. I would urge you to read the books to get their full richness. I will then go on to argue that he leaves out a fourth pillar, free markets, which are essential to make the liberal democracy prosperous. I will warn that these pillars are weakening in industrial countries because of rising inequality of opportunity, and end with lessons for India.

¹ Speech by Dr. Raghuram Rajan, Governor, Reserve Bank of India, at the D.D. Kosambi Ideas Festival held on February 20, 2015 in Goa.

² *The Origins of Political Order: From Pre-Human Times to the French Revolution* by Francis Fukuyama, 2011, Farrar Straus and Giroux, New York, *Political Order and Political Decay: From the Industrial Revolution to the Globalization of Democracy* by Francis Fukuyama, 2014, Farrar Straus and Giroux, and *Political Order in Changing Societies* by Samuel Huntington, 1968, Yale University Press, New Haven.

Consider Fukuyama's three pillars in greater detail. Strong government does not mean one that is only militarily powerful or uses its intelligence apparatus to sniff out enemies of the state. Instead, a strong government is also one that provides an effective and fair administration through clean, motivated, and competent administrators who can deliver good governance.

Rule of law means that government's actions are constrained by what we Indians would term *dharma* – by a historical and widely understood code of moral and righteous behaviour, enforced by religious, cultural, or judicial authority.

And democratic accountability means that government has to be popularly accepted, with the people having the right to throw unpopular, corrupt, or incompetent rulers out.

Fukuyama makes a more insightful point than simply that all three traditional aspects of the state – executive, judiciary, and legislature – are needed to balance one another. In sharp contrast to the radical libertarian view that the best government is the minimal “night watchman”, which primarily protects life and property rights while enforcing contracts, or the radical Marxist view that the need for the government disappears as class conflict ends, Fukuyama, as did Huntington, emphasizes the importance of a strong government in even a developed country.

No matter how thuggish or arbitrary the government in a tin-pot dictatorship, these are weak governments, not strong ones. Their military or police can terrorize the unarmed citizenry but cannot provide decent law and order or stand up to a determined armed opposition. Their administration cannot provide sensible economic policy, good schools or clean drinking water. Strong governments need to be peopled by those who can provide needed public goods – it requires expertise, motivation, and integrity. Realizing the importance of strong government, developing countries constantly request multilateral institutions for help in enhancing their governance capacity.

Strong governments may not, however, move in the right direction. Hitler provided Germany with extremely effective administration – the trains ran on time, as did the trains during our own Emergency in 1975-77. His was a strong government, but Hitler took Germany efficiently and determinedly on a path to ruin, overriding the rule of law and dispensing with elections. It is not sufficient that the trains run on time, they have to go in the right direction at the desired time. The physical rail network guiding the trains could be thought of as analogous to rule of law, while the process by which consensus is built around the train schedule could be thought of as democratic accountability.

But why do we need both rule of law and democratic accountability to keep strong government on the right path? Would democratic accountability not be enough to constrain a dictatorial government? Perhaps not! Hitler was elected to power, and until Germany started suffering shortages and reversals in World War II, enjoyed the support of the majority of the people. The rule of law is needed to prevent the tyranny of the majority that can arise in a democracy, as well as to ensure that basic “rules of the game” are preserved over time so that the environment is predictable, no matter which government comes to power. By ensuring that all citizens have inalienable rights and protections, the rule of law constrains the majority’s behaviour towards the minorities. And by maintaining a predictable economic environment against populist democratic instincts, the rule of law ensures that businesses can invest securely today for the future.

What about asking the question the other way? Would rule of law not be enough? Probably not, especially in a vibrant developing society! Rule of law provides a basic slow-changing code of conduct that cannot be violated by either government or the citizenry. But that, by itself, may not be sufficient to accommodate the aspirations of new emerging groups or the consequences of new technologies or ideas. Democratic accountability ensures the government responds to the wishes of the mass of the citizenry, allowing emerging groups to gain influence through political negotiation and competition with others. Even if groups cannot see their programs translated into policy, democracy allows them to blow off steam non-violently. So both rule of law and democratic accountability check and balance strong government in complementary ways.

Where do these three pillars come from?

Much of Fukuyama’s work is focused on tracing the development of each pillar in different societies. He suggests that what the nature of states we see today is largely explained by history. For instance, China had long periods of chaos, most recently before the Communists came to power; groups engaged in total war against one another. Such unbridled military competition meant groups had to organize themselves as hierarchical military units, with rulers having unlimited powers. When eventually a group was victorious over the others, it was natural for it to impose centralized autocratic rule to ensure that chaos did not remerge. To rule over the large geographic area of the country, China needed a well-developed elite bureaucracy – hence the mandarins, chosen by exam based on their learning. So China had strong unconstrained effective government whenever it was united, and Fukuyama argues,

unlike Western Europe or India, did not have strong alternative sources of power founded in religion or culture to impose rule of law.

In Western Europe, by contrast, the Christian church imposed constraints on what the ruler could do. So military competition, coupled with constraints on the ruler imposed by canon law, led to the emergence of both strong government and rule of law.

In India, he argues, the caste system led to division of labour, which ensured that entire populations could never be devoted totally to the war effort. So through much of history, war was never as harsh, or military competition between states as fierce, as in China. As a result, the historical pressure for Indian states to develop strong governments that intruded into every facet of society was muted. At the same time, however, the codes of just behaviour for rulers emanating from ancient Indian scriptures served to constrain any arbitrary exercise of power by Indian rulers. India, therefore, had weaker government, constrained further by rule of law. And, according to Fukuyama, these differing histories explain why government in China today is seen as effective but unrestrained, while government capacity in India is seen as weak, but Indian governments are rarely autocratic.

Any of these grand generalizations can, and should, be debated. Fukuyama does not claim history is destiny, but does suggest a very strong influence. Of course, the long influence of history and culture is less perceptible when it comes to democracy where some countries like India have taken to it like a duck to water. A vibrant accountable democracy does not only imply that people cast their vote freely every five years. It requires the full mix of a raucous investigative press, public debate uninhibited by political correctness, many political parties representing varied constituencies, and a variety of non-governmental organizations organizing and representing interests. It will continue to be a source of academic debate why a country like India has taken to democracy, while some of its neighbours with similar historical and cultural pasts have not.

I will not dwell on this. Instead, I turn to a different question that Fukuyama does not address. Clearly, strong governments are needed for countries to have the governance to prosper. Equally, free markets underpin prosperity. But why is it that every rich country is also a liberal democracy subject to rule of law?

I will make two points in what follows: First, free enterprise and the political freedom emanating from democratic accountability and rule of law can be mutually reinforcing so a free enterprise system should be thought of as the fourth pillar underpinning liberal market democracies. Second, the bedrock on which all four pillars stand is a broadly equitable

distribution of economic capabilities among the citizenry. That bedrock is fissuring in industrial countries, while it has to be strengthened in emerging markets like India.

Free Enterprise and Political Freedom

Why are political freedoms in a country, of which representative democracy is a central component, and free enterprise mutually supportive?

There is, of course, one key similarity: Both a vibrant democracy and a vibrant free enterprise system seek to create a level playing field which enhances competition. In the democratic arena, the political entrepreneur competes with other politicians for the citizen's vote, based on his past record and future policy agenda. In the economic sphere, the promoter competes with other entrepreneurs for the consumer's rupee, based on the quality of the product he sells.

But there is also at least one key difference. Democracy treats individuals equally, with every adult getting one vote. The free enterprise system, by contrast, empowers consumers based on how much income they get and property they own. What then prevents the median voter in a democracy from voting to dispossess the rich and successful? And why do the latter not erode the political rights of the ordinary voter. This fundamental tension between democracy and free enterprise appeared to be accentuated in the recent U.S. Presidential elections as President Barack Obama appealed to middle-class anger about its stagnant economic prospects, while former Massachusetts governor Mitt Romney appealed to business people, disgruntled about higher taxes and expanding healthcare subsidies.

One reason that the median voter rationally agrees to protect the property of the rich and to tax them moderately may be that she sees the rich as more efficient managers of that property, and therefore as creators of jobs and prosperity that everyone will benefit from. So, to the extent that the rich are self-made, and have come out winners in a competitive, fair, and transparent market, society may be better off allowing them to own and manage their wealth, settling in return for a reasonable share of their produce as taxes. The more, however, that the rich are seen as idle or crooked – as having simply inherited or, worse, gained their wealth nefariously – the more the median voter should be willing to vote for tough regulations and punitive taxes on them.

In some emerging markets today, for example, property rights of the rich do not enjoy widespread popular support because so many of a country's fabulously wealthy oligarchs are seen as having acquired their wealth through dubious means. They grew rich because they managed the system, not because they managed their businesses well. When the government

goes after rich tycoons, few voices are raised in protest. And, as the rich kowtow to the authorities to protect their wealth, a strong check on official arbitrariness disappears. Government is free to become more autocratic.

Consider, in contrast, a competitive free-enterprise system with a level playing field for all. Such a system generally tends to permit the most efficient to acquire wealth. The fairness of the competition improves perceptions of legitimacy. Moreover, under conditions of fair competition, the process of creative destruction tends to pull down badly managed inherited wealth, replacing it with new and dynamic wealth. Great inequality, built up over generations, does not become a source of great popular resentment.

On the contrary, everyone can dream that they, too, will become a Bill Gates or a Nandan Nilekani. When such universal aspirations seem plausible, the system gains added democratic support. The rich, confidant of popular legitimacy, can then use the independence that accompanies wealth to limit arbitrary government, support rule of law, and protect democratic rights. Free enterprise and democracy sustain each other.

There are, therefore, deeper reasons for why democratic systems support property rights and free enterprise than the cynical argument that votes and legislators can be bought, and the capitalists have the money. The cynics can only be right for a while. Without popular support, wealth is protected only by increasingly coercive measures. Ultimately, such a system loses any vestige of either democracy or free enterprise.

The Bedrock: Equitable Distribution of Economic Capabilities

There is, however, a growing concern across the industrial world. The free enterprise system works well when participants enter the competitive arena with fundamentally equal chances of success. Given the subsequent level playing field, the winner's road to riches depends on greater effort, innovation, and occasionally luck. But success is not pre-determined because no class of participants has had a fundamentally different and superior preparation for the competition. If, however, some group's economic capabilities are sufficiently differentiated by preparation, the level playing field is no longer sufficient to equalize a priori chances of success. Instead, the free enterprise system will be seen as disproportionately favouring the better prepared. Democracy is unlikely to support it, nor are the rich and successful as likely to support democracy.

Such a scenario is no longer unthinkable in a number of Western democracies. Prosperity seems increasingly unreachable for many, because a good education, which seems to be today's passport to riches, is unaffordable for many in the middle class. Quality higher

educational institutions are dominated by the children of the rich, not because they have unfairly bought their way in, but because they simply have been taught and supported better by expensive schools and private tutors. Because middle class parents do not have the ability to give their children similar capabilities, they do not see the system as fair. Support for the free enterprise system is eroding, as witnessed by the popularity of books like Thomas Piketty's *Capital in the 21st Century* while the influence of illiberal parties on both the Left and Right who promise to suppress competition, finance, and trade is increasing. The mutual support between free enterprise and democracy is giving way to antagonism.

Moreover, as class differences create differentiated capabilities among the public, governments can either continue choosing the most capable applicants for positions but risk becoming unrepresentative of the classes, or they can choose representativeness over ability, and risk eroding effectiveness. Neither biased nor ineffective government can administer well. So government capacity may also be threatened.

Thus, as the bedrock of equitable distribution of capabilities has started developing cracks in industrial countries, all four pillars supporting the liberal free market democracy have also started swaying. This is, to my mind, an enormously important concern that will occupy states across the world in the years to come.

Lessons for India

Let me conclude with lessons for India. India inherited a kind of democracy during British rule and has made it thoroughly and vibrantly her own. Of the three pillars that Fukuyama emphasizes, the strongest in India is therefore democratic accountability. India also adheres broadly to the rule of law. Where arguably we may have a long way to go, as Fukuyama has emphasized, is in the capacity of the government (and by this I mean regulators like the RBI also) to deliver governance and public services.

This is not to say that we do not have areas of excellence strewn throughout central and state governments – whether it is the building of the New Delhi Metro, the reach of the public distribution system in Tamil Nadu, or the speed of the roll-out of the Pradhan Mantri Jan Dhan Yojana – but that such capabilities have to permeate every tehsil in every state. Moreover, in many areas of government and regulation, as the economy develops, we need more specialists, with the domain knowledge and experience. For instance, well-trained economists are at a premium throughout the government, and there are far too few Indian Economic Service officers to go around.

An important difference from the historical experience of other countries is that elsewhere typically strong government has emerged there first, and it is then restrained by rule of law and democratic accountability. In India, we have the opposite situation today, with strong institutions like the judiciary, opposition parties, the free press, and NGOs, whose aim is to check government excess. However, necessary government function is sometimes hard to distinguish from excess. We will have to strengthen government (and regulatory) capability resisting the temptation to implant layers and layers of checks and balances even before capacity has taken root. We must choose a happy medium between giving the administration unchecked power and creating complete paralysis, recognizing that our task is different from the one that confronted the West when it developed, or even the task faced by other Asian economies.

For instance, a business approval process that mandates numerous government surveys in remote areas should also consider our administrative capacity to do those surveys well and on time. If it does not provide for that capacity, it ensures there will be no movement forward. Similarly, if we create a multiple appellate process against government or regulatory action that is slow and indiscriminating, we contain government excess but also risk halting necessary government actions. If the government or regulator is less effective in preparing its case than private parties, we ensure that the appellate process largely biases justice towards those who have the resources to use it, rather than rectifying a miscarriage of justice. So in thinking through reforms, we may want to move from the theoretical ideal of how a system might work in a country with enormous administrative capacity, to how it would work in the actual Indian situation. Let me emphasize, we need “checks and balance”, but we should ensure a balance of checks. We cannot have escaped from the License Permit Raj only to end up in the Appellate Raj!

Finally, a heartening recent development is that more people across the country are becoming well-educated and equipped to compete. One of the most enjoyable experiences at the RBI is meeting the children of our Class IV employees, many of whom hold jobs as business executives in private sector firms. As, across the country, education makes our youth economically mobile, public support for free enterprise has expanded. Increasingly, therefore, the political dialogue has also moved, from giving hand outs to creating jobs. So long as we modulate the pace of liberalization to the pace at which we broaden economic capabilities, it is likely that the public will be supportive of reform. This also means that if we are to embed the four pillars supporting prosperity and political freedom firmly in our society, we have to continue to nurture the broadly equitable distribution of economic capabilities among our

people. Economic inclusion, by which I mean easing access to quality education, nutrition, healthcare, finance, and markets to all our citizens, is therefore a necessity for sustainable growth. It is also, obviously, a moral imperative.
