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The Paradox of Catching Up

Rethinking State-Led Economic Development

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To my family

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Preface

This book considers state-led economic development in the second half of the twentieth century, and offers a new perspective for interpreting the choice of the state-led approach by relatively late-developed economies.

State-led development is worthy of continual study, because it remains a significant phenomenon that could hardly be ignored by economic theories. One of the most noticeable happenings in the contemporary world is the rapid rise of China as an economic force. How could China, which has not abandoned core state-control institutions, outperform other former central planning economies that fully embraced market liberalization and privatization? The other occurrence drawing global attention is the persistent international trade and payment imbalance with the United States running a large trade deficit against the East Asian state-led economies as a whole. Why do state-led developers even at a high-income stage stay high-propensity savers and net exporters? Are these attributes favourable in their competition for the world's economic leadership? If so, why didn't Japan, the most successful developmental state, overtake the United States as observers widely predicted in the late 1980s and early 1990s?

These questions require a consistent explanation for the causes, the rationale and the consequences of state-led development in both history and today. Although the demise of the Soviet system as an extreme case of state-led development has vindicated the superiority of the markets, and free-market economics has taken hold in mainstream thinking, the alternative method of the state as a coordinating agent has still not lost its appeal to latecomers. Neither has its 'miraculous power' waned. After all, the phenomenon of state-led development did not start with the Soviet Union and will not end with it. Moreover, the trends of increasing globalization appear to have rendered more advantages to state-led development.

This book takes a 'generalized' approach to the subject matter. It is not meant to be a country or regional study. Unlike publications that focus on the specific experiences of individual state-led economies, the book treats state-led developers as a whole, with an intention to find their common characteristics as well as the general logic that governs their developmental processes. Strictly speaking, each country's economic system is unique, having evolved from its own history, culture and social heritage. Undoubtedly, research on the particularity of individual economies carries great value. However, the methods of generalization and abstraction remain indispensable in economic studies.

The investigation here is conducted with some degree of abstraction. The method of abstracting the essential elements of given phenomena has been long used in social, economic and historical researches. In this tradition, this investigation focuses on the common institutional attributes of various state-led economies. These attributes do not necessarily cover all the characteristics of any particular case but capture the essentiality of the state-led development as an economic phenomenon. In other words, the book does look into individual cases of state-led developers – the country experiences examined here are used as examples to derive the general propositions, not the other way round.

In theoretical terms, the book 'harmonizes' schools of economics thinking relevant to the subject, instead of treating them as rival theories exclusive of each other in analytical capability. The synthesis in this study draws its strength mainly from two new areas of economics research: the transaction cost theory (Douglass North, Ronald Coase) and the evolutionary theory of economic development (or Neo-Schumpeterian theory of economic development). In the author's view, both schools are consistent with neoclassical economics in principle, but at same time have greatly expanded the explanatory capacity of economics as a social science. Altogether, they provide powerful tools for the study of state-led development.

This book is an attempt to integrate institutions into the study of state-led development. Among the authors who haven taken a similar approach on the subject, Alexander Gerschenkron, in his research works in the 1960s, linked a country's choice of institutional instrument for industrialization to its relative position in the world's development at the beginning of its industrialization process. He made the proposition that 'late' latecomers in economic development tended to use the state as a developmental instrument and introduced the concept of 'advantage of backwardness'. In a way, this book is an expansion of his line of thinking.

The world has changed a lot since Gerschenkron's days. The passage of time has allowed us to observe more instances of state-led development, to gain more understanding of this economic phenomenon, and to be better equipped to add new dimensions to the study on the subject. This book benefits greatly from the progression in both the real world and economic theories.

Finally, I'd like to express sincere gratitude to my publisher, Palgrave Macmillan, for the privilege of sharing my views with the readers.

LI TAN

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Introduction

An intriguing subject in the field of economics and related social sciences is how to interpret 'state-led' economic development, a phenomenon that has been persistent throughout modern history and remains significant today. By standard economics or mainstream economics, the markets stand for the most efficient method for human societies to coordinate economic activities, thus should work best as well for economically backward countries in their modernization efforts. Yet, in practice, relatively less developed backward economies or latecomers in the world's development, from Russia in the late nineteenth century to contemporary China, have persistently resorted to the state as a developmental instrument in their economic catching up.

How should this disparity between theory and practice be reconciled? Furthermore, why did those latecomers that used the state as a developmental instrument and had the bureaucratic capacity to do so achieve higher growth and thus modernize faster than many of those that relied more on domestic traditional markets? Finally, do the successful state-led developers, with all the spectacular growth in their economic catch-up, have the potential to take the leading position in the world's developments? Or under what conditions could they do so? These are the questions this book intends to answer.

The key characteristic of the state-led developers or 'developmental states' in contemporary terms is their governments' coordinating function in the economy's production activities, which distinguishes them from the early market developers, namely, the Western industrial economies in general.

It is true that there is no 'pure' free-market economy, and that all the world's economic systems can be viewed as 'hybrids' of the market and state. But, the extent to which, and the way in which, the state is employed in economic activities differs tremendously among various types of economies. In contrast to the developed market economies where the government mainly serves as the regulator or the referee of the game, the income re-distributor, the provider of social and public goods and the guard of macroeconomic stability, governments in state-led economies take on the additional function of coordinating the nation's industrial transformation, including acting as a direct producer. Moreover, in pursuit of this coordinator's role, governments in the state-led economies reduced their own opportunities to develop the functions of an impartial referee and thus remain underdeveloped in such functions. This is because fulfilment of the coordinator's role requires close alliance between the government and domestic industrialists, which is by nature at conflict with the impartiality of third-party enforcement.

In economics, the most important argument for state intervention in production activities is 'market failure' or 'market imperfection'. That is, the government should step in, where and when the markets do not function. For instance, governments are often called upon to deal with monopoly and externality (spill-over). The argument serves well in justifying state intervention in the developed market economies, as the state plays merely a complementary role to the markets in this case. The underlying implication that the markets fail only marginally is consistent with the principle of market supremacy. However, the argument becomes somewhat problematic when is extended to the state-led economies, because in this case the government becomes the main actor in industrial development, instead of a mere assistant. Consequently, the 'market failure' argument, in justifying state intervention on such a scale, has to admit massive market failure and incapability, which is rather inconsistent with the principle of market supremacy.

This book goes beyond the traditional argument of 'market failure', and examines state-led development from the institutional perspectives. Its purpose is to find an explanation that could rationalize the latecomers' choice of the 'state-led' approach but without compromising the wisdom of the free markets.

The twentieth century was undoubtedly a triumphant century for the free-market system. The United States, the most developed market economy, assumed and maintained its leading position in the world's unprecedented technological and economic progress in the twentieth century. The group of advanced Western industrial economies or the early developers of capitalism continued to prosper in the century and followed the leader closely in productivity and income growth. On the other hand, the state as a coordinating method alternative to the markets had also produced miraculous results in the other parts of the world and posted serious challenges to the principles of the free markets throughout the century.

The most severe challenge came from the emergence of the Soviet Union at the dawn of the century and then the camp of Socialist countries after World War II. For quite some time, the Socialist central planning system captured the hopes of developing countries, and amazed the world with its remarkable economic growth. The collapse of the Soviet system towards the end of the century has no doubt vindicated the supremacy of the good old free markets, but its survival as a complete non-market system over the span of nearly three-quarters of a century as well as its ability of generating high growth, at least for some periods, remains to be fully explained in theory.

Seemingly unrelated yet no less significant in the world's development in the twentieth century is the rise of Japan as an economic power. With its formidable industrial policy, the Japanese developmental state rapidly narrowed the technological, productivity and income gaps with the leader, the United States, and rose to the rank of the world's second largest economy and the most powerful exporter in the post-World-War-II period. As many studies have suggested, the Japanese economic system bears a distinct feature of state management that is largely absent in the Western market economies, and the close government–business collaboration has rendered the Japanese economy great advantages in global competition. However, although it closely challenged US economic leadership, Japan did not succeed in overtaking the US as many observers predicted in the late 1980s and early 1990s. Instead, the Japanese economy slipped into a long stagnation in the last decade of the century. Statistics showed that the productivity and income gap between Japan and the US widened again in the latest wave of technological revolution that ushered in the 'information age' towards the end of the century.

If the Soviet system is viewed as an extreme case of state-led development, the Japanese system represents the 'general' type of state-led development, that is, state-led development based on private property ownership. Different from the Soviet complete non-market approach, the state only partially replaces the coordinating function of the domestic markets in the Japanese model. In comparison to the Soviet system, the Japanese state-led approach certainly has much greater and more lasting impacts on the latecomers in their economic catch-up.

The greatest story of economic catch-up in the second half of the past century, however, belongs to the smaller poorer East Asian economies. These traditional agricultural societies achieved rapid industrialization by following the Japanese state-led development model, succeeded in economic 'take-off', and created, with Japan, the 'East Asian Miracle' as described by the World Bank.[1] Note that both the Soviet Union (rather, Russia for the matter) and Japan had already achieved industrialization at the beginning of the twentieth century. Their economic advances in the century and convergence in income to the leader were in effect only 'catching up' within the group of developed industrial economies. By contrast, the East Asian poor economies had made a much bigger leap – a leap from the developing to the industrial world in a matter of decades.

As studies show, the twentieth century saw a continuous uneven pattern of economic development in the world, with further divergence in income and living standards between the poor and rich countries, although productivity and income converged within the group of high-income industrial economies for periods of time. Nevertheless, as an exception to the trend of the poor countries falling further behind, the East Asian developing economies beat the fate of divergence, and moved out of poverty. Some of them even reached the income levels of the OECD countries at the turn of the century. With China and other Asian economies joining the camp in the 1990s, the Asian region has become the fastest growing part of the global economy.

In comparison with other developing countries, especially those still stuck in the 'vicious circle of poverty', the East Asian societies have indeed achieved a great deal in raising income, productivity and living standards in general. Again, what is the theoretical underpinning for the state-led development approach that led to this East Asian success?

In economic studies, a popular way of dealing with the East Asian success was to mould it into the standard free-market model by ignoring the state-led aspect of these economies. Especially after the downfall of the Soviet Union, many analysts chose to identify the East Asian approach completely with the free-market model and view the East Asian experience as a success that has nothing in common with the Soviet system. The optimistic prediction of the coming Asian Century prevalent in the early 1990s was largely based on the conventional view that the East Asian development approach conforms to the standard free-market model. On the other hand, the strong feature of state management exhibited in the East Asian development process had been brushed aside as a non-essential aspect. It was the Asian crisis in the late 1990s that brought East Asia's state-led approach into open scrutiny and criticism.

Serious doubts were cast on the previous optimism for East Asia at the end of the 1990s, with the eruption of the Asian Crisis in 1998 and when the Japanese stagnation had fully manifested its obstinacy. The East Asian system as a whole was criticized for its 'crony capitalism' (referring to the collaborative relationship between government and business), 'systematic corruption' and 'connected banking', although these types of practices had long existed in the East Asian economies, in their glorious years of rapid growth. Thus, the issue arises: how should one reconcile East Asia's high-growth performance with the unappealing aspects of 'crony capitalism' in these economies?

Since the 1998 Asian crisis, the enthusiasm over East Asia has somewhat shifted onto China, as China emerged relatively unscathed from the Asian crisis and has risen as a dynamic economic force through rapid output growth. However, China, as a former centrally planned economy, has relied much more on the state in its economic development than did the East Asian high performers. Also, as many scholars have pointed out, China escaped from the Asian Crisis because the country had a relatively closed financial system that insulated it from the currency contagion, not because the Chinese system is void of 'crony capitalism' that got the more open East Asia economies into financial crises in 1998. Then, is the current optimism about China's future growth well founded?

The investigation in this book will focus on three cases of state-led development in the postwar period of the twentieth century: the Soviet Union as an extremity of non-market coordination; Japan and the East Asian newly industrialized economies as successful state-led developers; and China as a case of transition from a complete non-market system to the state-led development based on private ownership. We will use the experiences of these economies as the factual basis to abstract the common institutional attributes of state-led economies and to derive the general propositions of state-led development.

The theme of 'state-led' industrialization or economic growth is not new in studies of economic development. Among many authors, Alexander Gerschenkron, an economic historian, linked a country's choice of institutional instrument for industrialization to its relative position in the world's development at the beginning of its industrialization process. He suggested that 'very backward' countries or 'late' latecomers in economic development tend to rely on the state as an institutional instrument in their industrialization process, for example, Russia and the Hungarian part of the Austro-Hungarian Empire in the late nineteenth century (Gerschenkron, 1962). But, Gerschenkron did not offer much explanation for why backward countries tend to rely on state-sponsored industrialization process, other than that these countries were facing 'greater pressures for high-speed industrialization'.

Mainstream, or neoclassical, economics has provided solid theoretical underpinning for the free market system as the most efficient form of human coordination, yet cannot sufficiently explain why less-developed societies tend to opt for a different approach in their economic catch-up. Neoclassical economics demonstrates that in free markets, voluntary exchanges of self-interested economic players (consumers, producers and so on) guided by price signals lead to mutual gains, optimal allocation of resources, and ultimately, maximization of the society's total economic wellbeing. However, a severe limitation of neoclassical theory is that it assumes that the exchange process is free of costs, namely, there are no transaction costs in the markets. The zero-transaction-cost assumption allows neoclassical economics to avoid the potentially messy treatment of transaction costs so that the mathematical theorization could stay focused, succinct and elegantly cogent. Yet, on the other hand, the neglect of transaction costs restricts the theory's capability of dealing with non-market forms of economic coordination such as state-led economic development, as the huge costs of using the markets might serve as an important clue for understanding the latecomers' inclination to use the state as a developmental instrument.

The other limitation of neoclassical economics, for the purpose of the investigation conducted here, is the static or comparative static nature of its core analysis and the 'institution neutrality' of its growth model. The core neoclassical theorization, from partial to general equilibrium analysis, has proven the optimality of resource allocation and maximization of society's total economic benefits in perfectly competitive markets only at given time or at different stationary states. The neoclassical growth model sprung from the main body of the neoclassical framework does describe the dynamic process of economic growth over time, but it mainly investigates the growth relations between production factors (labour, capital) and total output in an economy. As a result, the growth model becomes somewhat detached from the strong free-market institutional bearings of the neoclassical core theory built upon the behaviour rules of self-interest maximization (utility, profit and so on) and the coordinating role of market prices for economic players (consumers, firms, resource owners and so on). But, the benefit of this 'institution neutrality' is that it has made the model applicable to all types of economies, including the Soviet non-market economy.

With Robert Solow's important contribution in the 1950s that incorporated technological change as a key determinant for economic growth, the neoclassical growth model has been widely applied to various type of economies and helped identify empirically the sources for the output growth for the economies under review. As we all know, Robert Solow found that technological progress was the major source for the economic growth in the US for the first half of the twentieth century, which explained the sustained economic expansion in the US. On the other hand, as Paul Krugman pointed out in his well-known article in 1994, empirical works such as Alwyn Young's 1994 paper suggested that East Asian growth, like the Soviet high growth, appeared to be driven by extraordinary expansion in labour and capital rather than productivity growth or technological progress, which called the sustainability of the East Asian growth into question.

However, the neoclassical growth model basically treats technological change as an exogenous variable, and the residual term or the term for technological progress in the model remains something of a black box. Even with various modifications, the model does not look into the dynamics of technological innovation and the diffusing process nor does it recognize the interaction between institutional and technological changes in an economy, both of which are essential for the study of state-led economic development. Although neoclassical growth accounting could help identify the factor contributions of the output growth in an economy, the factor composition in output growth for a given period could only serve as a reference not a criterion for evaluating the growth sustainability of the economies in concern. As empirical studies show, the Western industrial economies that had achieved sustainable growth in the past, including the US, also experienced periods of input-driven growth. The more important question, at least for the study in this book, should be why a certain type of economy is inclined to deliver input-driven growth or what factors make an economy more likely to generate technological progress from time to time. Due to its 'institution neutrality', the neoclassical growth model does not provide much assistance for the investigation of state-led development.

Among the new schools of economic thinking, the transaction cost theory pioneered by the works of Ronald Coase and the evolutionary or neo-Schumpeterian theory of economic development are the most useful for the purpose of the investigation conducted in this book. Both theories, while being consistent with classical economics in principle, have remedied, to a great extent, the limitations of neoclassical economics and thus provided sturdy analytical tools for this book's investigation of state-led development.

Generally speaking, transaction cost theory emphasizes that there exist costs for making transactions or voluntary exchanges in the markets and thus there is a cost for using markets, as against the neoclassical assumption of zero transaction costs. With the focus on the importance of transaction costs, this school of thinking is able to analyse various non-market forms of organization as well as other related economic and political issues, and has greatly extended the scope of economic studies.

While transaction costs analysis is mostly conducted at the microeconomic level for the study of various types of industrial organizations, the theory does recognize the existence of transaction costs as a whole at the aggregate level in an economy. In their 1986 study, John Wallis and Douglass North (Wallis and North, 1986) estimated that transaction costs accounted for nearly one-half of national income in the US economy. In other words, nearly half of the productive resources in the world's most developed market economy are devoted