The State and Institutions in East Asian Economic Development:
The Past and the Future

Chung H. Lee

The Journal of the Korean Economy, Vol. 3, No. 1
Spring 2002
The Association of Korean Economic Studies
The Journal of the Korean Economy, Vol. 3, No. 1 (Spring 2002), 1-17

The State and Institutions in East Asian Economic Development: The Past and the Future*

Chung H. Lee**

The paper presents a review of the role of the state in economic development in East Asia and argues that state intervention, whether effective or not in promoting rapid economic growth, was based on social exchange relations rooted in socio-cultural values of East Asian societies. What liberalization and deregulation have done in those economies was to reduce state intervention in markets without changing the social exchange relations underlying the intervention. To sustain economic growth in the age of globalization the East Asian economies will need to carry out reforms that are far more reaching than simply removing government intervention from markets.

JEL Classification: N4, P5, O1
Keywords: state, institutions, economic development, East Asia

1. INTRODUCTION

What role the state has played in East Asian economic development of the past several decades remains a controversial issue. On one side of the debate is the view that what the state has done was to create an environment conducive to efficient market operation, while on the other side is the view that the state has taken a more activist approach to promoting economic development. Typical of the first is the view proffered by the World Bank in its 1993 publication, The East Asian Miracle: Economic Growth and Public

* Much of the work for this paper was carried out while the author was at the European Institute of Japanese Studies, Stockholm School of Economics. The author wishes to thank two anonymous referees for their useful comments.
** Professor of Economics, Department of Economics, 2424 Main Way, University of Hawaii at Manoa, Honolulu, Hawaii 96822, U.S.A., Tel.: +1-808-956-8427, E-mail: ichung@hawaii.edu
Policy (henceforth referred to as the World Bank). It represents the mainstream neoclassical economics position that, on balance, government intervention in markets is detrimental to efficient allocation of resources and is in stark contrast with the second view espoused by authors such as Amsden (1989), Chang (1994), Johnson (1982), and Wade (1990). These authors find in the East Asian experiences a case of successful government intervention in promoting rapid economic growth.

In spite of this controversy over what happened in the past there is now a general consensus that the models of economic growth used in East Asia to hasten economic growth are no longer effective and new models or institutions will have to be introduced if the East Asian countries are to sustain economic growth. In fact, these countries have undertaken various degrees of economic reform although what the new model of economy the reforms will lead to still remains uncertain.

We begin our review of the debate with a critical examination of the aforementioned World Bank publication as it represents a position widely held by professional economists and policy makers. In doing so we will draw upon some of the new insights derived from recent developments in the New Institutional Economics (NIE), which allow us to take the debate beyond the simple state-market dichotomy. By recognizing the pervasive presence of the transaction cost in the market economy, NIE has weakened the laisseez-faire case for relying on markets for the provision of goods and services. It has at the same time undermined the view that the state is a benevolent and omni-competent manager of the economy. The relevant debate on the role of the state is not, therefore, whether government or markets can do better in allocating scarce resources but how and to what extent the imperfect government should be brought into play to improve the workings of imperfect markets (Toye, 1995).

Our discussion then moves on to the role of informal institutions in government-business relations in East Asia, as discussed especially in the literature on those relations in Japan. This literature should be of special interest to those advocating institutional reform as necessary for sustained economic growth in East Asia, as it sheds light on the limits of formal institutional reform in changing a country's political economy. The paper ends with some concluding remarks.

2. THE ROLE OF STATE: RIGHT "FUNDAMENTALS" OR INDUSTRIAL POLICY?

According to the World Bank, the governments of Asia's "miracle" economies (Japan, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia, and Thailand) all have had one set of policies in common even though they have experimented with a wide range of policies. These policies—the policies in common—are what the World Bank calls the right "fundamentals" or "market-friendly" policies: low inflation and competitive exchange rates, broadly based human capital development, effective and secure financial systems, limited price distortions, the absorption of foreign technology, and a limited bias against agriculture. And these are the "bedrock" policies that have driven the "miracle" economies to grow at rapid rates with an equitable distribution of income.

The World Bank recognizes that for a government to be successful in achieving rapid economic growth it must not only adopt the right fundamentals but also be able to effectively implement them. Effective implementation in turn requires that the country have the right institutional mechanisms, which include an institutional environment that encourages private investment, a competent bureaucracy that can implement policies, and institutions that facilitate communication between the state and the private sector. (Even within Asia the quality and type of bureaucracy vary from country to country—from the highly meritocratic and insulated bureaucracies of Japan, Korea, Singapore, and Taiwan to the less effective and less insulated public administrations of Indonesia and Thailand)

The World Bank acknowledges that in most of the Asian economies, especially those in East Asia (Japan, South Korea and Taiwan), the state did
more than get the fundamentals right by directly intervening in markets in
order to hasten economic growth. The intervention was carried out basically
with three policy instruments—promotion of specific industries, directed-
credit programs, and promotion of exports. The policy of promoting specific
industries was not generally effective, according to the World Bank, while
directed-credit programs worked in certain situations only at a high risk.
The export-push strategy was, admittedly, highly effective, bringing about
rapid export expansion and a high rate of economic growth in the economies
where it was adopted.

Various programs of directed credit were used in Asia with credit mostly
allocated according to export performance. The track record of the programs
is, however, mixed. In the economies where there were competent and
insulated bureaucracies and banks to select and monitor projects, a directed-
credit program was successful. In such economies credit could be allocated
on the basis of economic rationality and not by political patronage or
influence. In contrast, in the economies where those conditions were lacking
and where favouritism and political influence determined the allocation of
credit the program failed, not surprisingly, to achieve its objective of
promoting selected industries.

The export-push strategy—intervention to promote rapid export growth—
was, according to the World Bank, East Asia's most successful case of
selective intervention. Shifting out of an import-substitution phase the East
Asian economies all adopted pro-export policies such as establishing a free
trade regime for exporters and offering a range of export incentives. The
World Bank, however, makes the point that the various subsidies adopted in
Japan, Korea and Taiwan to promote exports did not actually create an
incentive structure biased in favor of exports but rather created a structure that
was neutral on average between export and import-substitute sectors: what
the export subsidies in fact did was to offset the negative effects on exports of
the various measures that had been adopted to protect import-substitute
industries in those countries. In other words, what the export-push strategy
did, as interpreted by the World Bank, was to create an incentive structure
similar to the one that would have prevailed if those countries had adopted a
free-trade regime.

It should be pointed out, however, that the argument that the incentive
structure for the entire economy was on average neutral has little bearing on
the question of whether the policy of selective industry promotion was
effective or not. What matters for that debate is whether or not the specific
industries selected for promotion received larger subsidies than the average—
the average for the entire manufacturing sector—even if the incentive
structure was neutral on average between export and import substitute sectors.
The fact is that the industries selected for promotion received larger incentives
than the average for the entire manufacturing sector and, furthermore,
subsidies were not given to every firm even in a selected industry as the
provision of subsidized credit was strongly contested by competing firms.
(In the case of Japan and Korea, the success of the policy was in no small
measure due to the fact that their bureaucracies were competent and relatively
honest, and firms and bureaucrats were subject to a single yardstick of export
performance in the allocation of credit.)

The World Bank (p. 354) defines industrial policy, admittedly rather
narrowly, as an attempt to achieve more rapid productivity growth by altering
industrial structure and concludes that the policy failed to achieve its
objective in Japan, Korea, and Taiwan. As evidence for that conclusion, it
points out that their pattern of industrial growth tended to be "market-
conforming," being consistent with market forces and factor-intensity based
comparative advantage, and productivity changes in the promoted sectors
were not significantly higher than that in other sectors.

In spite of its overall conclusion that industrial policy was ineffective in
changing industrial structure, the World Bank nevertheless concludes that
government intervention in East Asia—Japan, Korea, and Taiwan—was
effective in bringing about rapid export expansion and economic growth. It
does not, however, see this success as due to governments' ability to pick the
winners but rather to their practice of setting export targets for the promoted
industries and using them as a basis for credit allocation. The World Bank
nevertheless admits the possibility of industrial policy lessening the problem of investment co-ordination through information exchange between government and business and thus bringing about earlier and better investments in what ultimately became market-conforming sectors.

Although the World Bank recognizes those positive effects of industrial policy, its basic stance is that industrial policy, defined as a policy of selective promotion of industries, was not effective in changing industrial structure. But we must argue that this definition of industrial policy is too narrow, as it refers to only one of the three inter-related policies of intervention—selective promotion of industries, direct-credit programs, and promotion of exports—that were used to promote rapid industrial development through export expansion. Directed-credit programs were used, albeit not successful in every case, to promote specific industries to help them become globally competitive and thus become export industries. If industrial policy is defined as a package of industry-specific policies for promoting rapid export expansion and industrial growth, we are led to the conclusion that industrial policy, especially as practiced in East Asia, was a success even by the criterion set by the World Bank. This does not mean that the right fundamentals were not important but rather that industrial policy, when combined with the right fundamentals, has contributed to bringing about rapid economic growth in the East Asian economies.

A number of studies on the role of the state in economic development in Japan, Korea, and Taiwan argue, in contrast to the World Bank view, that the state successfully used industrial policy to hasten economic growth in East Asia (Amsden, 1989; Chang, 1994; Johnson, 1982; and Wade, 1990). These studies, which we may say take the statist view, argue that the developing countries all suffer a pervasive presence of market failure and offer a state-led development strategy as an alternative to the "market friendly" approach of the World Bank. Somewhat close to this statist view is the position taken by Aoki et al. (1997) that government and markets are not mutually exclusive substitutes because the government can improve the workings of markets by becoming directly involved in coordinating the decisions of independent agents. These authors—advocates of the so-called market enhancing view—argue that in the developing countries "coordination failures" are a common cause of under-investment in areas where investments are complementary to each other and need to be coordinated. An example is the case of building a steel plant and building a power plant to supply power for the steel plant. The steel mill will not be built unless there is an adequate supply of power, and the power plant will not be built unless there is a demand for power. Because of this strategic interdependence of investment the market system will fail to bring about their establishment even though, if built simultaneously, both will be profitable. In such cases, Aoki et al. argue, the government can coordinate the decisions of independent private agents (e.g., through a deliberation council) and improve the outcome of their decisions by helping them overcome the coordination failure inherent in the market system.

According to them, this role of government is ignored in the neoclassical economics that has evolved primarily in Anglo-American academia (Aoki et al., 1997, p. 35).2

The presence of market failure is not, however, a sufficient condition for employing industrial policy since in principle the market failure can be corrected with the Pigovian tax-cum-subsidy scheme. In other words, the presence of market failure does not warrant direct government intervention because there is the alternative of an arm's-length intervention with taxes and subsidies. The presence of coordination failure does not warrant government intervention either, as they can be corrected in principle through vertical

---

1) According to Okimoto (1985, p. 4), Japanese industrial policy consisted of a "nuisible assortment of policy measures, pragmatically devised to address the diverse, ever-changing, and sometimes conflicting needs of a broad range of industries at different points in time."

2) In a recent publication Gomory and Baumol (2000) argue that free trade is not necessarily beneficial to all trading partners and thus provides a theoretical rationale for industrial policy. One reason for that outcome is the presence in industrialized countries of "retainable" industries, the entry into which is difficult because of high start-up costs or scale economies. Retainable industries have a substantial degree of protection from competitive entry, allowing them to pay higher wages than otherwise. This protection also means that a developing country may have to resort to state intervention such as industrial policy if it is to establish the same industries.
integration. In the example cited above, the steel mill and the power plant can be integrated, their investment decisions taking place as a matter internal to the vertically integrated firm. The coordination failure can be also addressed in "hybrid forms" such as corporate alliances in the form of Japanese keiretsu, which allow the firms to do away with the bureaucracy inherent in large vertically integrated firms (Noble, 1998). Given these alternative ways of handling the market failure, it is not obvious why the choice made in East Asia was industrial policy—the particular government-business relationships of East Asia.

Lee (1992) and Haggard and Lee (1993) offer a rationale why industrial policy was a more efficient policy instrument than the tax-cum-subsidy scheme by arguing that the government and large private corporations (or peak organizations such as trade associations) in fact constituted a quasi-internal organization. Its structure is similar to the multi-divisional structure of a modern corporation in that the government functions as corporate headquarters and large private corporations as its subunits. And, for the reasons that a multi-divisional corporation can be more efficient than markets for carrying out economic transactions can the quasi-internal organization be more efficient in carrying out government policies than the arm's-length intervention through taxes and subsidies.

As Williamson (1975) argued, markets are superseded by organizations when the latter are more efficient in carrying out economic transactions. For example, because financial transactions are especially subject to moral hazard and costly contract enforcement, firms may develop their own internal capital market for the purpose of allocating financial resources. Such an internal capital market is a crucial feature of the multi-divisional structure of the large modern corporation. With its capacity for strategic planning, monitoring, and control the multi-divisional structure can effectively reallocate cash flows among its subunits to high-yield uses. But, just because a hierarchical system of credit allocation can be efficient does not mean that it necessarily is so. One reason why hierarchical systems of credit allocation within a firm can be efficient is because it is subject to competitive pressure from the markets in which it operates.

A directed credit program is in effect a hierarchical system of credit allocation—an internal capital market in which the government allocates credit among large private enterprises and through which it could coordinate investment projects of private corporations, which are in effect its subunits. In East Asia, government intervention with credit allocation was efficient because the East Asian economies adopted outward-oriented development strategies and export performance provided their governments with a transparent, objective criterion for credit allocation.

This brief review of the role of the state in economic development in East Asia shows that both sides of the debate can marshal theoretical support for their respective positions. Depending on one's own inclination and prejudice, one might find the theoretical support and empirical evidence for one side more persuasive than that for the other. The debate will remain far from settled as it is about competing interpretations of history for which there is no definite test.

3. END OF INDUSTRIAL POLICY AND REFORM IN INSTITUTIONS

Industrial policy in East Asia, whether we accept it as having been effective in promoting rapid economic development or not, was an institutional innovation designed to implement the political decision to hasten economic growth and catch up with the advanced industrial countries. But, a number of reforms, especially those introduced since the middle of the 1980s, have led to the establishment of a more market-oriented political economy and the end of industrial policy, at least its overt use. Those reforms, however, relate to changing some of the formal institutions of those countries

---

3) In fact, the presence of coordination failures in developing countries is a symptom of underdeveloped capital markets and an inadequate endowment of human resources. As a result, they are unable either to mobilize sufficient funds for large-scale projects or to undertake the combined operation of steel and power complexes.
and have little bearing to the informal institutions that underlay industrial policy—more broadly government-business relations—in East Asia. It is doubtful whether such reforms would succeed in changing the political economy in East Asia in a fundamental way. Industrial policy may be no longer practiced in East Asia, but the informal institutions such as social norms that underlay industrial policy do not disappear simply with the formal ending of industrial policy.

In his study of Japan's industrial policy, Okimoto (1989) argued that the main contribution of industrial policy to Japan's economic success was the promotion of communication and consensual policy making between government and business and the strengthening of public-private policy networks. According to him, these networks, which are based on long-term, obligatory and affective ties, have given Japan's policy economy extraordinary flexibility.

Japan's policy networks are based on ascriptive relations such as marital and kinship relations (keibatsu), the common place of origin, contact through mutual friends, school ties (gakushatsu), and on functional ties that emerge from friendships developed in the course of government-industry contact, participation in informal study groups, and amakudari networks. According to Okimoto (1989), these public-private policy networks are an exemplary case of the "fusion" of what tend to be regarded as mutually exclusive opposites in the West—market and organization, public and private, and formal and informal. As he sees it, this fusion is a notable characteristic of government-business relations in Japan and a by-product of Japan's deep-rooted socio-cultural values, which give "distinctive shape and life to the institutions of Japanese capitalism" (Okimoto, 1989, p. 237).

Murakami and Rohlen (1992) likewise emphasize the importance of policy networks in Japan's industrial policy and argue that the networks are based on social exchange between government and business—a mode of exchange that entails long-term unspecified obligations on the part of participants. This social exchange is what has made Japanese businesses to comply with the government's administrative guidance even when there are no statutes compelling them to do so. There is, as Murakami and Rohlen (1992) put it, the "implicit give-and-take operating in a long-term framework in which both government and private firms get what they want—that is, a social exchange framework." Such a framework is necessarily exclusive in nature with benefits and obligations of social exchange (and security thus provided) limited to the participants. Similar policy networks—school, family, and regional ties—also exist in Korea where the government and large business enterprises constituted a quasi-internal organization, as discussed above.

The East Asian countries may no longer use industrial policy to hasten economic development, but that does not mean that the social exchange relationship between government and business has disappeared. If, as in Japan, government-business relations are a by-product of a country's deep-rooted socio-cultural values, then those relations are not going to disappear simply because governments have stopped using industrial policy.

Until the Asian economic crisis of 1997-98, the debate on the role of the state in East Asia focused primarily on whether or not industrial policy was effective in bringing about rapid economic growth. The crisis has, however, radically changed the tone of the debate, some now pointing at government-business relations as a culprit for the crisis. It is now widely recognized that a high proportion of bad loans and bad investments, and thus the crisis in Asia, were caused inter alia by government intervention in business and the practice of relying on political or personal relationships to advance and protect business ventures (e.g., Lim, 1999).

It is, however, important to note that many of the so-called weaknesses of

---

4) Another term for such networks is social capital. Putnam (1993) identifies social capital as involving networks, norms, and social beliefs that evolve out of processes that are not overtly investment activities. Investments made in building trust and reciprocity is investments in building social capital.

5) Hayami (1998) describes the Japanese system as a nexus of pseudo-community organizations, which has evolved through serious conflicts, compromises and syntheses between the traditional value system and the imitated Western institutions and organizations.

6) In social exchange, unlike in economic exchange, the obligations incurred in exchange are not clearly specified in advance. Social exchange requires trusting others (and in turn credence trust), and benefits from social exchange are less detachable from the source that supplies them than are economic commodities (Blume, 1988).
the East Asian economies ("inadequate regulation, lack of transparency and, worse, crony capitalism") are intrinsic part of what Okimoto calls the fusion of opposites in the West. The fusion might have given Japan's political economy (and Korea's) its extraordinary flexibility, but by blurring the distinction between public and private it has also made it easy to use the public-private networks based on social exchange for the private interest of network participants. For example, a company official may offer a government bureaucrat a membership in an exclusive golf club in the name of solidifying their social exchange relationship. The acceptance of the gift will obligate the bureaucrat to take an action in return that will benefit the company even though it may be against the public good. His sense of obligation may overwhelm his sense of what is the right thing to do for the public good. Inadequate regulation, now cited often as a reason for the weakness of financial systems in East Asia, might be due to such behavior and not due to lack of rules and regulations on the books (Lee, forthcoming).

The point being made here is not that such exchanges do not take place in the West but that they can take place more easily in a society where the public-private distinction is not clearly delineated and where social exchange underlying government-business relations has been long in practice. In other words, the fusion of the opposites that supposedly has given the East Asian political economy much flexibility makes it easy for participants in the social exchange relationship involving government and business to cross the line between what is legitimate and what is not.

In the late 1980s, Murakami (1987) wrote that Japan's catch-up model was no longer appropriate for the new society and Japan should "...prepare sufficient room for creative adventures, technological as well as social, without being afraid of the possible risks involved. This is liberal in a wide sense and is contrary in many ways to the Japanese approach in the catch-up phase." Japan, he predicted, is likely to fail to maintain its level of prosperity unless it overrides the institutional inertia from the past. But, cognizant of the importance of cultural differences in accounting for the differences between the Japanese political economy of the post-war era and those of other industrial societies, Murakami does not foresee Japan adopting the Western-type individualism. As he sees it, the Japanese mode of decision-making ("long-term, multi-issued, often implicit agreements"), which is based on Japan's deep-rooted socio-cultural values, will remain more or less unchanged.

About a decade later, Hayami (1998) likewise argued that Japan's catch-up model, which he says is based on its own unique culture and tradition, has become ineffective in sustaining economic growth. The model he envisions for Japan to sustain economic growth is a country that is creative in innovative ideas and concepts. In that society, free competitive markets will have replaced the community or social exchange relationship both within and between corporations and entrepreneurs are encouraged to innovate with proper rewards. According to Hayami (1998), South Korea and Taiwan, which also have succeeded with their versions of the catch-up model, have reached or will soon reach this stage of transition.

The move in Japan toward a system of free, competitive markets does not mean, according to Hayami (1998), the abandonment of its cultural identity. As he sees it, most of the present government controls and regulations were created as a device for catching up and are not necessarily rooted in the unique culture of Japan. It is not Japanese culture but the vested interest groups opposed to deregulation and liberalization and the slow recognition by the public that the formerly successful catch-up system is now an obstacle that has slowed the move toward the new system.

More recently, Gyohten (2000) argued that for Japan to pull itself out of the current economic malaise it has to adopt new principles such as "competition, transparency, accountability and self-responsibility." But, as he recognizes, adopting those principles would mean an almost complete turnaround, or almost complete denial of the traditional Japanese principles that had served the country well in the past. In other words, it would mean doing away with traditional practices such as "corporate social responsibility, stable employment and human orientation, the maintenance of social order." These are social exchange relations between big businesses and their employees and
between them and society at large that have been in practice in Japan for many years, and terminating those relations, a Nash equilibrium, will not be an easy matter for anyone on either side of the relationship. The government will, for example, have to let the insolvent firms that have been its partners in social exchange go bankrupt, but doing so will not be easy because it violates the relationship of trust and cooperation between members of that social exchange.

It will be difficult, as observed by Gyohten (2000), for members of a society that values the deep-rooted tradition of community or social exchange relations to adopt the principles of "competition, transparency, accountability and self-responsibility." More difficult, however, will be extending these principles to a global scale, which globalization and a liberal trading order will require. Globalization and a liberal trading order mean that exchange transactions are carried out in a globally impersonal manner that does not discriminate on the basis of nationality. Such impersonal transactions are, however, incompatible with social exchange relations, which by definition involve a limited number of participants. It will be, however, the societies that succeed in carrying out transactions in that manner that will be able to take advantage of a greater division and specialization of labor in the age of globalization.

4. CONCLUDING REMARKS

According to North (1998), "...most societies throughout history got 'stuck' in an institutional matrix that did not evolve into the impersonal exchange essential to capturing the productivity gains that came from the specialization and division of labor that have produced the Wealth of Nation." It may very well be that Japan and the other East Asian countries are now in such an institutional matrix and they need to get unstuck from it. Their challenge is, however, greater than that, as they will need to replace the old systems with new ones if they are to continue with the good economic performance that they have enjoyed in the past several decades. As remarked by North (1995), however, creating a flexible institutional matrix that adjusts in the context of evolving technological and demographic changes as well as shocks to the system would be a difficult task for any society. It would be especially so if it is to be done in a short period of time and requires changing age-old informal institutions.

The new institutional matrix that will emerge in Japan may not be the Anglo-American system but a system based on Japan's own unique culture and tradition. The same may be said for other East Asian countries. Nobody can predict what these new systems will be. But one thing is certain: the East Asian countries cannot continue with the systems that helped them achieve an economic "miracle" in the second half of the 20th century.

REFERENCES


