The Encompassing State—A Contribution of the East Asian Model

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The East Asian model was once hailed by the world as a miracle that other developing countries should aspire to (World Bank, 1993). However, the slowdown of the Japanese economy and the Asian Financial Crisis seemed to have rendered the East Asian model obsolete. In particular, the pro-active role of the government that was once regarded as central to the East Asian model has been subject to rethinking and even rebuffing (Stiglitz and Yusef, 2001). In this paper, I will first argue that the seemingly declining of the East Asian economies is a phenomenon of the transition from a catch-up economy to a mature economy, and it will be only temporary if the transition is successfully managed. Then I will argue that the core of the East Asian model is the existence of the encompassing state, i.e., a state that is keen to represent the long-term interests of the country. I will show that the underdevelopment of other developing countries is exactly due to the lack of such a state. I emphasize the role of East Asia’s unique historical and cultural heritages in bringing about such a state in that region. I also point out that the encompassing state should opt for a major change after the catch-up period finishes. At the end of the paper, I will discuss the future of the encompassing state in a democratic society.

The Change of the Development Model

It has been long debated whether a catch-up development model is viable in the long run. In my view, this debate itself is ill placed, for two reasons. First, development by definition is a catch-up process because its aim is to finish in several decades the development process that the present industrial economies took 100-200 years to accomplish. Developing economies can never be satisfied with an annual growth rate of 2 per cent, though it might be a respectable record for industrial economies. Nor will they be satisfied either by the record—high growth rates, i.e., 5 to 6 per cent, experienced by the industrial economies in their history. For catch-up to happen in a short period of time, a growth rate higher than 7 per cent has been regarded as the norm. Second, catch-up automatically has a limit, that is, it stops when the catching-up economy reaches a pre-set objective (for China, for example, this objective is to reach the middle-income level). Therefore, it is a void question that whether the catch-up strategy is viable in the long run. If we admit that development is catch-up, the relevant question then changes to how to catch up instead of whether to catch up. This naturally leads us to study the factors that promote catch-up.

Developing countries all start at very low levels of physical and human capital stocks, technology, and managerial skills. With limited resources, it is thus critical to find a wise usage of them. Two factors thus have become very important in the searching of such a use. The first is scale economies. Modern technologies are characterized by significant scale economies. Market size, for instance, is critical for a modern technology to survive. This was emphasized by the classical development economists such as P. Rosensten-Rodan and A. Hirschman, but had been forgotten for decades before the new growth model began to treat scale economies seriously. The second is coordination failures arising from the lack of information. Let me use an example for illustration. Suppose that an economy is only comprised of two firms. Firm A produces cars, and firm B produces steel. Both have scale economies. If both expand their production, then both can make profits because B finds A a major buyer of steel, and A can sell more cars because the income of the workers in both firms increases. However, if B is unsure about
A’s production capacity, it will not expand its production of steel because it fears that it cannot sell its steel. In addition, if it is unsure about the market demand, A will not expand its production of cars. In both cases, the society loses the opportunity to increase its GDP.

To overcome the hurdle set by the scale economies, East Asian economies have developed several effective strategies. Exporting is certainly high on the list and has been hailed by some people as the single most important key to the East Asian miracle. While the role of exports can be understated, one needs to realize that exporting is a way to overcome the limitation of the domestic markets. In this sense, exporting is a passive strategy. What I want to elaborate in this paper are two other strategies that have international significance but have not been fully appreciated by the world.

The first is the build-up of a set of solid manufacturing capacities. At the very be say, ginning of their development, East Asian economies relied heavily on agriculture to generate income. The manufacturing sector barely existed. One alternative for those economies to join the rank of the industrial economies would have been to follow the example of the old capitalist economies, say, Great Britain, but that would have forced them to wait for two hundred years in order to finish the catch-up. A fast build-up of the manufacturing basis is needed if a developing economy wants to shorten the catching-up process. Toward that end, some protection is needed when an economy is building up its domestic manufacturing capacities. However, as it so often happens, the liberal camp deliberately ignores the fact that all the East Asian economies experienced a period of import substitution and, until very recently, it had imposed restrictive custom policies toward imports. If it is transformed into efforts to realize full-fledge self-reliance, like what happened in the planning period of China, India before its recent reform, and Latin America before the 1990s, the import substitution policy is doomed to fail because it cuts off a country’s ties with the rest of the world and prevents it from benefiting from trading with other countries. The key to the success of the East Asian economies is that they have been conscious of the adverse effects of import substitution and have intended to use the policy to build their own industrial capacities. Take the example of China. To a large extent, the planning period of China was a failure. But it failed more in the political rather than in the economic sense. The industrial capacities—heavy industries and a well-trained workforce—built up in the 1950s and to a lesser extent in the 1960s have played an important role in gaining China’s unprecedented growth record in the reform period. Without such industrial capacities, China’s economic growth rate would be unimaginable. In particular, without a well-trained workforce, it would also have been unimaginable that China could attract so much foreign direct investment. The cost of the capacity build-up, however, was the distortion of the economy that put too much emphasis on heavy industries. But the good thing was that Chinese scholars and policy makers were aware of this cost. Mao Zedong discussed the problem in his famous work On Ten Major Relations published in 1957. As soon as the political atmosphere was allowed toward the end of the 1970s, a renewed discussion on the policy started and the result was the open-door policy and the flourishing of the light industries and agriculture.

The second strategy adopted by the East Asian economies in overcoming the hurdle of the scale economies is to identify sectors that have the highest potentials to illicit demand or to bring backward and forward linkages. Both help to enlarge the market and for that matter increase national income. The most serious constraint faced by any developing economy is the lack of capital. In the early stage of development, it is wise to concentrate the limited resources on a few promising sectors. To use the management jargon, such strategy is equivalent in finding the sectors that the economy has the highest potential to be competitive in the world market. Competitiveness is not only defined by efficiency, but also defined by raising the national income (Reinert, 1995). The most successful case of building up national competitiveness is the semi-conductor industry in Korea. Korea started R&D in the semi-conductor industry in as early as the late 1970s. This long lasting effort has paid off: Korea now is the second largest chip producer in the world, only behind Japan.

This is related to the East Asian governments’ strategy to overcome the coordination problem. They have been deeply engaged in activities that are regarded as private businesses in the industrial economies. Before the Asian Financial Crisis, bank lending in Korea was largely directed by the government to support certain industries. In Japan, government intervention has been more subtle. Persuasion replaces order to direct investments, and government officials exert their influences more through the chamber of commerce and other civil organizations (Aoki et al., 1996).

These strategies have largely paid off. However, they only fit into the early stage of development when the economy maintains a manageable size. At that time, information was not a serious problem for centralized investment decisions and the failure rate was relatively low. As long as the industrial basis was built up, the
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The role of the government in East Asian economic development has been intensively discussed. For the liberal camp, the role of the government was irrelevant, if not negative, in the East Asian miracle. All what was needed was the functioning of the free market, especially those related to exports. For others, the government in East Asia played an active and positive role in fostering their economic development. From this view came the phrase the developmental state (World Bank, 1993). Some people even went further to suggest that the East Asian governments also engaged in interventional activities that defied the orthodox doctrines of the standard economics by deliberately “getting the price wrong” (Amsden, 1989). A third view tries to mediate between the above two views by proposing the market-enhancing thesis. As Aoki et al. (1996) tried to argue, governments in the East Asian economies played an active role in their economic development, but their intention was not to replace the market in resource allocation, but rather to enhance the market’s functions. The debate will not likely to be settled. What I want to discuss here is not the merits or shortcomings of the above three views, rather, I would like to approach the issue from another angle. The above three views all revolve around the relationship between the government and the market, discussing whether the two are substitutes or complements to each other. My approach is to move the discussion beyond this market-state delineation, and to enter the discussion of the political economy of the state.

For many developing countries, the failure to catch up is not caused by the lack of the market, but rather the lack of good governance. Myrdal’s classical study of Southeast Asia can attest it (Myrdal, 1972). Good governance may have many forms, each of which is suitable only for a specific context. Democracy can be a good form of governance in a country with homogenous residents and stable economic and social environments, but may not be as effective in a developing country. Democracy is a passive aggregating device. Under normal conditions, it can prevent disastrous events, but it cannot provide the impetus that is necessary for catch-up. As the classical works of Mancur Olson have convincingly shown, democracy tends to foster interest groups that care more about distribution rather than economic growth, and for that matter, democracy tends to react slowly toward the changes of the economic environment (Olson, 1982). For catch-up to happen, a more active state is needed.

Yet we do not want to have a Leviathan. We want to have an active state with a considerable amount of limits placed on it. Such a state can be authoritative, but lies far away from a dictatorship. I call such a state the “encompassing state.” An encompassing state maintains a clear goal to maximize the long-run aggregate welfare of the country. This requires that the encompassing state be a utilitarian that stands still against interest group pressures. In many cases it implies sacrificing the interests of some groups to exchange for the advancement of the whole country. As such, persuasion and coercion may happen. To avoid social unrest, though, the encompassing state also possesses another feature of maintaining a fairly equal income distribution by deliberately designed industrial and employment policies. These features distinguish the encompassing state from other types of authoritative states. It differs from the dictatorship in that the dictator only cares about his own and his cronies’ interests but ignores the interests of the country; it differs from the populist state in that it does not bend to the populist pressure to redistribute; and it differs from the Soviet-style socialism in that it is open to all kinds of ownership and admits the market as the fundamental tool for resource allocation.
Catch-up needs the concentration of resources, a task that cannot be fulfilled by the market alone in the presence of scale economies and the coordination problem. In East Asia this task has been taken by the government. However, this government has to be effective and have a clearly defined goal. The encompassing state in East Asia provides exactly such a government. To reach the goal of catching-up, East Asian governments have adopted various measures, ranging from engaging in market-enhancing coordination to establish a socialist planning system, to accelerate capital accumulation and technological progress. For the encompassing state, the goal is more important than the means, so the three views about the government, the liberal view, the “getting-prices-wrong” view, and the market enhancing view, are meaningless. The encompassing state is pragmatic.

As I reasoned in the first section, there will come a time when the catch-up strategy should be dropped. For East Asian governments, the challenge is to resist the pressures of vested interest groups not to change. The concentration of resources means that some sectors and even some firms are favored and some are not. Those with the favor would strongly oppose the change because they would lose their privileges once the change happened. The encompassing state stands still in front of the pressures. One example is the Korean government under the leadership of president Kim Dae-chung that pushed forward the economic transition after the Asian Financial Crisis hit Korea with severe consequences. Another example is the Chinese government under the leadership of premier Zhu Rongji that initiated a major structural adjustment and privatization program for the Chinese industry in the mid-1990s. A large number of SOEs closed and millions of workers lost their jobs. Although the adverse impacts can still be felt today, the structural adjustment has greatly strengthened China’s competitiveness and the privatization program has increased firm efficiency.

Curiously enough, populist pressures could win their way in some authoritative regimes. The most telling example is Argentina under the rule of Piron. While he has been regarded as a dictator, Piron adopted strong populist policies in his two terms of presidency. The working class was systematically favored and redistribution was on a large scale. The result was that Argentina slipped from the group of high income countries in the early 20th century to barely a middle-income country. It would have been anticipated that the later Argentine leaders should have learned the lesson, but the populist legacy has lingered on. The culmination of this legacy was the 2002 financial crisis. The dollarization of the Argentine economy was designed to bind the monetary authority’s hand not to engage in inflationary expansion. The initial outcome was very encouraging, hyper-inflation was curbed. However, the government did not tie its own hand in handing out social welfare. Under the populist pressure, the government had to keep up its welfare spending. This, coupled with Argentina’s bad trade records, had shaken the confidence of the ordinary Argentine people. Thus there was a run on the bank, which eventually caused the collapse of the Argentine peso. The East Asian governments have done a much better job than Piron and the recent Argentine government. Instead of engaging in large scale redistribution, the East Asian governments have encouraged the dissemination of benefits created by the leading sectors. In Korea, industries were concentrated in Soul and Pusan in the initial stage of development, but a large scale migration was encouraged and it enabled the residents in the rural areas to gain the benefits. In China, labor-intensive industries moved quickly to the countryside under localized rural industrialization. In the early stage of Japan’s economic development, labor-intensive industries were also encouraged. All these measures enhanced productivity and improved income distribution at the same time. As a result, the growing pie is accompanied by a fair distribution among the population.

The encompassing state is endowed with power that is beyond the scope of a democratic government. While it is necessary for economic catch-up, the concentration of power has detrimental effects and even disastrous consequences in the political arena. It is so easy for the ruling group to use the power to pursue its own interests, so corruption and political suppression are common. East Asia had lived with the dilemma through its earlier development stage; with catching-up as its paramount goal, it had opted for favoring economic development rather than political freedom. However, the change of the economic model calls for the change in the political arena. With catch-up approaching its end, the concentration of power has lost its causes, and decentralized economic decisions call for economic democracy. The most significant consequence that this trend brings about for the political arena is the diversification of the political basis and the creation of a large middle class, which make political democracy inevitable. Korea has gone through this process, but Singapore has lagged behind.

Historical and Cultural Roots of the Encompassing State
Why has the encompassing state emerged in East Asia, but not in other regions? I believe that this has a lot to do with the history and culture of East Asia. In the recent history, East Asia were subject to imperialist invasions and colonization. Japan’s door was forced open by the American fleet, and China’s door was forced open by the joint forces of the western powers. Korea’s case is unique. It was the battlefield of imperial China and Japan and after China’s defeat in the Yellow Sea in 1894, Korea fell into a colony of Japan. Although the causes and extent of the imperial suppression varied among the three countries, the humiliation had been the same. Against it is the strong historical and cultural pride shared by all the three countries, and the tension has become one of the strongest impetuses for them to catch up with the world powers in all spheres.

Singapore is a city state that has gained independence for only 40 years. For her the only way to gain international recognition is to succeed economically. Thanks to the great leadership of Lee Kwan-yew and his personal charisma, Singapore has become the most competitive economy in the world.

History matters, but let us not forget the role of culture. There are many other countries that had a long history of imperial invasion and colonization, noticeably, those in sub-Sahara Africa, but the encompassing state has never taken roots there. I believe that Confucianism has been a vital factor for the survival of the encompassing state in East Asia. Confucianism believes in goodness and requires that the ruler be a good person and rule the country with good governance. This gives the ruler a serious moral constraint. Even in the Ming Dynasty, when the emperor began to gain absolute power, daring government officials still frequently appealed to morality to challenge the emperor’s rules (Huang, 1981). Today morality is still important in China’s political life. On the other hand, respect to collective interests and obedience to authority are core values of Confucianism. This makes the ruling easier. As a friend put it when he commented on Singapore: “Singapore has a government that is good at governing and a people that is willing to be governed.” I believe that this comment can readily apply to the other countries in East Asia.

The Future of the Encompassing State

After catch-up concludes, it seems that the encompassing state has lost its reason for existence. Indeed, its economic functions are no longer useful, and its political monopoly will be replaced by democracy. The encompassing state as a form of state governance should stop. I would like to argue, however, that the ideas of the encompassing state should be preserved in a democracy. Popular participation will flourish in a democracy, but so will interest group activities. Indeed, redistributive interest groups were believed by Olson as the most serious challenge to democracy (Olson, 1982). He believed that the relative decline of Great Britain after the Second World War was the consequence of too many redistributive interest groups in that country. Democracy can be very passive if it yields to the demand of the redistributive interest groups. In the newly democratization countries in the former Soviet Union, democracy is even hijacked by powerful oligarchies. Therefore, the very idea of the encompassing state to resist interest group pressures is still valuable in a democracy. Besides, democracy can also increase the populist pressure on the government. The recent defeat of the Vajpayee government in the Indian election highlights this point. The Vajpayee government had made great achievements in economic reforms and growth, and the world has begun to talk about India as the next Asian giant that has the potential to take over China. However, the reforms and economic growth have not benefited the vast majority in the countryside to the same extent as they have benefited the elite sectors, which gave the Congress party a chance to win the election. It has a deep historical root for the failure of the Vajpayee government to raise the rural living standard as fast as the urban living standard, including Congress party’s own socialist planning policies. It needs time to revert the historical trend. But people cannot wait. It is widely expected that the Congress coalition government will engage in more redistributions. Like interest group activities, populism has the same effects to retard a country’s economic growth. Therefore, the idea of the encompassing state still have a value in a democracy.

Yet the implementation of the idea should be very different. In the catch-up period, the idea is attached to and implemented by the centralized state governance. Now that the state governance is democratized, such a way is no longer feasible. We need to find new ways. I do not have subscriptions at this stage, and would like to subscribe to professor Amartya Sen’s call to submit the matter to open public discussions. Open and democratic discussions allow people of all walks to express their ideas, so interest groups do not dominate. In addition, such discussions can serve as an important vehicle for consensus building. If the efforts succeed, East Asia will make another contribution to the world.
References


\footnote{Let us not forget that Hitler was appointed as the German chancellor through democratic process.}