Nueva Sociedad Nro. 221 Mayo-Junio 2009

State versus Market in Latin America: A Perspective from East Asian Experiences

Won-Ho Kim

As in Latin America, the East Asian state played an important role in economy. Nevertheless, a consistency and prudent macroeconomic management in long-term strategies and different behaviors on the parts of the East Asian state and businesses determined the region's different path from Latin America. The East Asian bureaucrats were not actually isolated from the businesses, but they closely interacted with them for the cause of national development coordination. The market failure should not be the immediate justification for an automatic return to new state intervention. The state should focus on its own institutional capability building. A serious leader would promote the responsibility of the state for providing high-quality human resources and other infrastructure for the better functioning of the market.

Won-Ho Kim: Professor, Graduate School of International and Area Studies, Hankuk University of Foreign Studies; Executive Director of the Korean Council on Latin America and the Caribbean; President of the Latin American Studies Association of Korea; Formerly, Research Director of the Korea Institute for International Economic Policy.
Key Words: State, Market, ISI, Institution, Development Model, East Asia, Latin America.
Note: This work was supported by Hankuk University of Foreign Studies Research Fund of 2008.

Introduction

Throughout the post-independence history of Latin America, the debate over state versus market has persisted in economic and social policymaking as well as in political events such as presidential elections. This actually characterized the region's political and economic changes and transformations in the 20th century and seems to continue in this century. Although the debate is not unique in the region, but universal to include not only developing countries but also industrialized ones, the dynamic interactions of economic and political repercussions in the region make it typical of the region's political economy.

The debate over the supremacy of state or market has evolved and deepened with conflicts over market failure and state failure. Interpretations of experiences from one statist or market-oriented model tended to simplify the problems entailed to argue for the supremacy over the other. This fundamentally erases out any compromising attempts to find complementarities in the two. Misinterpretations of others' success stories from the application of an alternative model tend to fortify the possibly-biased prescriptions, and *vice versa*.

The purpose of this paper is to explore East Asian experiences in comparison with Latin American ones over the issue of state versus market. In late 1980s and throughout the 1990s, many literatures explored East Asian successes. Some of them focused on the nature of free market in East Asian economies, the private sector's participation and leading role in economic growth.[1] Ironically, others emphasized the role of the state in East Asian economic development model.[2] Under the contradictory circumstances, policy practitioners who wish to learn from those experiences would rather choose those interpretations to be compatible with their own policy orientation.

In the following sections, this paper will critically review the interpretations of the East Asian success by casting a question over the role of the market and that of the state, and attempt to find real differences in the models of the two regions. Then it will look into the Asian financial crisis of 1997-1998 from the perspective of state failure vs. market failure. What has it done to the earlier interpretations? Was it a market failure or state failure? Cross-regional lessons must be learnt only from the critical understanding of others' experiences. Finally, it will draw implications of East Asian experiences for Latin America development today. The author' view over East

---

[1] Howard Pak and Larry Westphal: «Industrial Strategy and Technological Change: Theory versus Reality,» *Journal of Development Economics* 22 (1986), pp. 87-128; Gary Gereffi and Donald L. Wyman (eds.): *Manufacturing Miracles: Paths of Industrialization in Latin America and East Asia*, Princeton University Press, Princeton, NJ, 1990; Alice Amsden: *Asia's Next Giant: South Korea and Late Industrialization*, Oxford University Press, New York, 1989.

[2] World Bank: *The East Asian Miracle: Economic Growth and Public Policy*, Oxford University Press, New York, 1993; Robert Wade: *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*, Princeton University Press, Princeton, NJ, 1990.

Asian experiences may be limited to South Korea (henceforth, Korea) plus some other cases by the constraints of his first hand observation. In fact, the Korean and Taiwanese models followed the Japanese, and the Chinese follows the state part selectively from the others. Yet a generalization throughout the region should be cautious. Comparison of regional developments may sound carrying some normative judgments, but this author's intention is to simply attempt to explain the outcomes.

Was the Market Principle Sustained in East Asia?

When Latin American economies faced an unprecedented debt crisis in the 1980s, the diagnosis centered on the bloated state in the region. Since the 1930s, Latin American governments undertook industrialization to produce goods to substitute imports and meet the balance of international payments. With the utmost necessity to industrialize, they relied on the state as the key investor, employer, producer and service provider. The international political and economic environments also were favorable for this policy orientation. The world was in depression and each industrial country had to cope with the challenges to create jobs. Keynesianism prevailed and the 'invisible hand' of the market faded away. Many European leaders turned fascist authoritarians, particularly in Italy, Spain, and Germany, who influenced on the political climate in Latin American polity. Confiscation and nationalization of foreign-owned industries to strengthen the state account, prestige and leverage of the economy were justified in the name of sovereignty and national development. The import-substitution industrialization (ISI) model looked successful at least by the time immediately after the World War II. When ISI model preceded toward the deepening stage to extend to heavy industries, however, Latin American economies began to suffer from what would become chronic afterwards: low productivity, fiscal and commercial deficits, and foreign debts. In the meantime, the state monopoly appeared conspicuous in the region.

Most of the post-debt crisis analyses wanted to blame the strong state presence in the Latin American economy. They turned to East Asian economic successes to draw implications of the apparently excellent performance of the markets there to make the engine of exports and growth. There indeed were numerous, internationally competitive names of Asian private enterprises to represent the Asian success. Their contribution to national economic growth was huge, not to be compared with that of meager Latin American counterparts. The role of the state in East Asia looked minimal to the extent that the private sector dominated the economy and business. In this perception, both the classical free market economists and Marxists coincided here to attempt to focus on the critical role of the private sector in East Asian political economy.

The observer of the policymaking process in East Asia, however, would not agree to this simplified explanation of the model.

Firstly, it was not the free-market economic model but the similar ISI model that East Asian economies relied on to grow. Most of East Asian economies did not disregard neither abandon it in early times. Dani Rodrik was correct in arguing that while inspired partly by the East Asian experience, Latin American economic reforms went «considerably beyond those undertaken in East Asia.» Korea and Taiwan were not enthusiastic with deregulation, trade liberalization, privatization, and financial liberalization well into the 1980s.[3] Such measures were limited if any. In Korea's case, such strategic sectors as electronics and culture industries had not opened doors until the international lenders of the International Monetary Fund (IMF) and Japan asked in late 1997 as conditionality for the rescue packages.

The ISI models of the two regions were not identical, either. The real differences between the two models resided in whether they had a long-term strategy, whether it was carried out consistently, and whether a prudent macroeconomic management accompanied. Once protected, the businesses, private or public, would be complacent with the *status quo*, and long for the permanent continuation of such paternalist government-business relationship. Restructuring would not be an easy process, but the East Asian governments let the businesses exposed in due time to the international competition with incremental liberalization measures. It was rather coincidence for them to decide to switch strategy from ISI to export substitution industrialization (ESI), which would focus on exports rather than import substitution, by the time ISI was to distort the economy as experienced in Latin America in 1970s.[4] Rodrik argues that unlike most of Latin American countries, Korea and Taiwan followed the orthodox path in maintaining conservative fiscal policies and competitive exchange rates.[5] The pro-stabilization policy preferences by the

[3] Dani Rodrik: «Understanding Economic Policy Reform,» *Journal of Economic Literature* 34: 1, March 1996, pp. 9-41.
[4] James L. Dietz: «Overcoming Underdevelopment: What Has Been Learned from the East Asian and Latin American Experience?», *Journal of Economic Issues* 26, June 1992.
[5] D. Rodrik: *op. cit.*

policymakers let them find an exit from otherwise «protracted periods of macroeconomic instability.» By selectively liberalizing, they attempted to absorb the shock and maintained microeconomic divergences from the orthodox path in general. Their prudent macroeconomic management and the timely strategic switch from ISI to ESI paved the way for longer life for their microeconomic strategy. Under such national scheme, more firms had achieved technological catch-up and grown up competitive.

Secondly, the market principle was not the rule of the game in East Asian political economy. The market principle should be based on free competition and pricing. Throughout the postwar economic development history, East Asia was more state-led than market-led. The state intervened not only in the production of goods and services through ownership, protection and subsidy, but also regulated market participants at the stage of entry, exit, and financing for them. The Korean government exercised a selective industrial policy to support infant industries and ultimately to create strategic sectors such as steel, shipbuilding, automobile, chemical, electronics, and so on. Free competition between the conglomerates or *chaebols* was regulated and largely avoided for the benefit of monopolistic or oligopolistic market participants. Conglomerate Samsung's entry in the Korean car industry was not permitted until 1990s, when deregulation began to prevail. Business associations were the channels of communication between the government and the leading private sector rather than those of interest representation. The members of the Federation of Korean Industries were composed of major *chaebols*, the beneficiaries of the Korean government's selective industrial policy.

The difference of government-business relationship between the two regions was in the state and business behaviors. The East Asian state was clear and consistent in their protectionist industrial policy, which continued until the private sector grew up quite competitive internationally, or by the time designated in the national development plans. Even changes of governments did not affect the original government schedule toward businesses. In contrast, however, the liberalist versus conservatist power struggle in Latin America was extended to the government-business relations and often triggered the pendulum effect between protectionism and neoliberalism in the second half of the 20th century. As for business behavior, East Asian businesses invested for the sake of their own competitiveness to survive when the government no longer protects them. This was contrasted to the complacent and politicized business sector in Latin America, who would hold on under protection by every means.

Meanwhile, what determines the way in which governments and businesses share a vision, hold on with each other, and behave relevantly or not is another important but relevant question. In different cultural settings with various systems of value and beliefs, actors in the policy arena seek for their own interests with specific norms, codes of conduct, and philosophy. It will still carry certain relevancy in cross-regional comparison of developing economies. However, this will be beyond coverage of this paper, and reserved as a future research agenda.

In short, the postwar East Asian development model also had the ISI component, and hardly can be classified as a market-driven one. As in Latin America, the East Asian state played an important role in economy. Nevertheless, a consistency and prudent macroeconomic management in long-term strategies and different behaviors on the parts of the state and businesses determined the different paths of the two regions.

Were the Public Officials in East Asia «Insulated»?

Comparative development studies suggest that the East Asian public officials were insulated from society in formulating policy alternatives and implementing decisions and that such autonomous state character contributed to enhancing efficiency in public administration. The same point was made when intraregional comparison was explored to contrast Chile to other countries in Latin America. Chile's 'Chicago Boys' in the 1970s were characterized by their «insulated» nature of policymaking from any pressures by social interests to the effect that the state autonomy was sustained.

In East Asia it was a historically long tradition to recruit public officials by national examination. They came from all sectors of the society, in many cases with very humble family background. For those from low-income family, national examinations were the only and unique channel to promote their social status. Once recruited, their politically-neutral legal status and career development was guaranteed by law with the rule of meritocracy. This enhanced social mobility immensely, and reinforced state capability. In fact, the supremacy of meritocracy over clientelism in East Asia was not only the case for government jobs. But state-owned companies and large conglomerates also recruited most of their new employees by national examinations.

Professionalism of public officials and meritocracy may have enhanced their insulation.

However, «insulation» may not be the accurate term in East Asia when it comes to the state-business relationship. A close look into the East Asian model, particularly in the cases of Japan and Korea, would find more frequent contact and coordination activities by public officials for businessmen. During the ISI and ESI periods, Korean government officials, not only from the Economic Planning Board (EPB) but also Ministry of Trade and Industry and other agencies, frequently met with representatives of conglomerates to discuss and coordinate their investment decisions, financing with preferential international loans, sectoral tax incentives, subsidies, labor dispute settlements, international trade performance, etc. In early times, Korean conglomerates even had relied heavily on the government's allocation to them of properties confiscated from the Japanese after the end of the colonial rule, and then on their takeover of some government enterprises and insolvent businesses under the surveillance of the government.[6] Both groups of the state and of the businesses, in many cases networked and bound together with the same regional, high school or university backgrounds, shared the merits of the development strategy and the vision for a nation.

Marxist and dependency theories that explain the dominance of capitalists and internationally conspired interests over the state hardly can explain the East Asian model. The state was not «captured» by those interests at least in early times. On the other hand, the state autonomy theory may run the risk of exaggerating the insulated nature of the public officials. They were not isolated from the businesses, but they closely interacted with them for the cause of national development coordination. In short, «interacting» rested in the precarious borderline between being «captured» and being «insulated.» A misstep on the fence would fall into one of the two. The Asian financial crisis of 1997-1998 may have come from a misstep.

Lessons from the Asian Financial Crisis

The Great Depression triggered by the 1929 Wall Street fall and the current global recession represent the market failure. The 1980s debt crisis in Latin America and the fall of the formerly communist countries were called as the state failure. Then, was the

[6] Jaeho Yom: «Economic Reform and Government-Business Relations in Korea: Towards an Institutional Approach,» in Akio Hosono and Neantro Saavedra-Rivano (eds.): *Development Strategies in East Asia and Latin America,* St. Martin's Press, New York, 1998, pp. 139-156.

Asian financial crisis of 1997-1998 the market failure or the state failure? Few literatures attempt to answer this question. It will not be easy because the Asian model was not a purely market-led one but the crisis was triggered by the excessive investments, non-performing loans and debts in the private sector.

It is hard to deny that the East Asian model had been close to exhaustion by the time of the crisis. It was the model itself that failed, if any. The state's coordination in facilitating businesses under the ISI and strategic ESI models may have been simpler in the 1960s through 1980s, but the increasingly liberalized and ultimately globalized business context in the 1990s was beyond public officials' coordination capacity to handle with. By the time, the state attempted to withdraw from interventions and deregulate economic activities. The private sector succeeded almost free hand on financing with sovereign credit earlierly guaranteed by the state. They began to enter the formerly restricted industrial sectors where other firms had enjoyed a preferential entry in the past.

At this point some public officials could have realized the risk of a financial difficulty sooner or later. The conglomerates or the former beneficiaries from the state intervention now had grown up to even threaten the state autonomy. Due to the conglomerates' overwhelming weight in the national economy, the government no longer would decide on their entries or exits except in rare instances. Rather, the public officials preferred the traditional mode of interactive relationship with the private sector without the same leverage as before. As far as the traditional state practice remained and the technocrats tended to resist any threat by the businesses to capture the state, the most convenient solution was collusion or corruption. The conventional belief that «the individuals in the public sector are motivated by a Benthamite vision of social justice»[7] unlike those in the private sector acting in their self-interest lost much of its ground. Governments or public officials were not selfless and social guardians in the end. The public officials began to lose their power to formulate policies with pressure groups lobbying, not being captured but still continuing to interact yet this time on the initiatives of their private counterparts.

In the case of Korea, the financial crisis came as a disguised blessing. The government that succeeded the financial crisis was in a better position to correct the situation. Kim Dae-jung, once critical of chaebols, was elected president in December 1997, one

[7] Anne O. Krueger: «Government Failures in Development,» *Journal of Economic Perspectives* 4: 3, Summer 1990, pp. 9-23.

month after the financial crisis broke out. Under the crisis situation and with the IMF pressure, his government was able to practice a severe operation on the corporate governance of the conglomerates. Several conglomerates were disintegrated into smaller businesses, inefficient banking sector or former policy financing arms restructured and non-performing businesses sold off. What had remained hard to do by the time the old model approached exhaustion, or the house-clearing job before globalization finally was done during the Asian financial crisis. Ten years from the crisis, East Asia looked fairly stable and dynamic back. Although the global financial crisis came in then, it does not mean any serious setback of the Asian economic dynamism yet.

The Asian financial crisis left a precious lesson. The state cannot be omniscient nor omnipotent and it pays to learn how the market can work when the state leaves. The outgoing state should have established institutions of surveillance because the once-guided businesses sometimes are not fully ready to go without the state intervention and may make improper decision-makings.

Conditions for the State Intervention in Latin America

It looks clear that the state is back in Latin America. During the 1990s, most of Latin American countries accepted the Washington Consensus and implemented its policy prescriptions of market-oriented reforms either by international pressure or by their own choice. Even though they had similar experiments in the Southern Cone in the 1970s (Chile from then onwards) and at some scattered points of history, it came as a shock therapy with differences of degree. «Prudent macroeconomic policies, outward orientation, and free market capitalism»[8] that urged privatization of formerly state-owned companies, trade liberalization and deregulation characterized the remarkable return of the market to the region. In ten years or so, however, the constituencies would no longer stand the social cost, unemployment and inequality particularly, triggered by the economic reforms and globalization,[9] and began to support the statists back. By the time of this writing, more than two thirds of Latin American countries turned left. The current global financial crisis may accelerate such trend by strengthening opponents to neoliberalists.

---

[8] John Williamson: «What Washington Means by Policy Reform,» in John Williamson (ed.): *Latin American Adjustment: How Much Has Happened?*, Institute of International Economics, Washington, DC, 1990, pp. 7-20.

[9] Dani Rodrik suggests a correlation between openness of states through increased global trade and government expenditures. D. Rodrik, «Why Do More Open Economies Have Bigger Government?» *Journal of Political Economy* 16: 5, 1998.

Although leftist politicians will not agree, today's statism in Latin America cannot stay forever, either, which one already learnt by historical experiences in the region, East Asia and any other parts of the world. One needs to be wise enough to learn lessons from the history that state failures often outweighed market failures, and to deal with any possible negative ramifications when the state leaves. In dealing with this task, one needs to rethink the most desirable conditions for the state intervention that can improve the functioning of the market. Lessons can be learnt from the basic of the state involvement and the experiences of East Asian development model, its exhaustion, and search for a new model in the globalization context.[10]

Above all, the market failure should not be the immediate justification for an automatic return to new state intervention. One should first find answers why the market failed. It will be ideal if the state involvement aims to cure and correct the shortcomings of the market, and facilitate the functioning of the market. It may be more realistic to assume that neither the state nor the market does stay permanently as an exclusive alternative, but institutions can do. In most cases, market failure is the result of undeveloped institutions. The state should have made the rule of the game, watched whether it works properly, and left without any negative legacy. Those institutions include economic and political ones. The state should specify «a set of criteria, or rules, by which interventions will be administered.»[11] Development depends on the effectiveness of economic institutions.[12] In their turn, the effective political institutions enhance the capabilities of the economic institutions.[13]

When state intervention is indispensable, however, its activities should be restricted to those of the state's comparative advantage vis-à-vis the market because of the opportunity costs for other governmental activities.[14] Now, based on East Asian experiences, two conclusions for state intervention can be drawn.

[10] Some may wish to reconsider globalization as a constant variable at the contemporary juncture, but the author would not agree with such uncertain assumption.

[11] While exploring state failure in pursuing ISI, Krueger asks a question of institutional design: «what sets of institutions and incentives are likely to be most conductive to achieving a least-cost outcome?». A. Krueger: *op. cit.*

[12] Irma Adelman and Cynthia Taft Morris: «Development History and Its Implications for Development Theory,» *World Development* 25: 6, 1997, pp. 831-840.

[13] Sanjay Pradhan emphasizes three sets of institutional mechanisms that improve the state capabilities: Restraints and rules such as juridical independence and the separation of powers; voice and partnerships to give business and civil society a voice in the state activities; and competitive pressures through competition in civil service recruitment and promotion to build a motivated, professional bureaucracy. S. Pradhan: «Improving the State's Institutional Capability,» *Finance and Development* 34: 3, September 1997, pp. 24-27.

One is that the state should focus on its own institutional capability building. The state capability does not signify how far the government ownership extends nor how much assets the state owns, but how strong the institutional foundations are, and how far skilled human resources the state is armed with. The success of state intervention will depend on the strength of the state institutional capabilities. The state autonomy can be secured only when the state is filled with technocrats on the meritocratic promotional track. Otherwise economic policies and programs will be more easily swayed and shaped by political and powerful private interests throughout the whole process of policy formulation, decision and implementation. Specialization and meritocracy may not be sufficient conditions against corruption and favoritism, but necessary ones at least.

The perfect market functions when information is shared among interested participants. Professional coordination by the state may complement imperfect market functioning just as networks of social relations among economic actors may be «aberrations arising from imperfections in the hypothesized perfect market.»[15] The Korean state in the developing decades maintained its supremacy in expertise through high-quality technocrats and economists as in EPB and the Korea Development Institute who had formulated together a series of Five-Year Economic Development Plans since the 1960s. A regulatory framework and industrial policies should be prudently pursued only when specialized technocrats can manage because such intervention «can result in large costs for firms and society» if badly designed for any reasons, political and technical.[16]

The second is that the state should be consistent in its policies toward business and long-term strategies. By the strategy, the state should cultivate the private sector and promote its competitiveness. The state should encourage the business to invest for their future competitiveness. Market development only can be attained when governments clearly define property rights to protect from «arbitrary government actions that disrupt business activity.»[17] Long-term investment by private firms is

---

[14] Anne Krueger suggests that the government should focus on those large scale activities that private agents may face a disadvantage in attempting to do: maintenance of law and order, provision of information, and provision of basic public services or infrastructure. A. Krueger: *op. cit.*

[15] Nichole Woolsey Biggart: «Explaining Asian Economic Organization: Toward a Weberian Institutional Perspective,» *Theory and Society* 20: 2, 1991, pp. 199-232.

[16] Brian Levy: «How Can State Foster Markets?», *Finance and Development* 34: 3, September 1997, pp. 21-23.

[17] Ibid.

most necessary for them to be competitive. Expenditures by the private sector on research and development (R&D) may indicate business perception. As of 2006, Japan and Korea ranked in the 3rd and 4th places of the world in business R&D with 2.54 and 2.49 percent out of GDP respectively while Brazil, Mexico and Chile as top of the region ranked in the 31st, 38th, and 46th places with 0.51, 0.25, and 0.14 percent respectively.[18] This indicates that businesses in Latin America are not fully encouraged to invest long term.

The two conditions above only can be met when sufficient capable manpower is provided. The market may ignore the importance of general education. The classical economic theory never conceives that massive investments in education facilitate economic growth, and does not contemplate free public education or education for the whole society. But human capital theories prove that investments in education achieve sustained growth and social progress.[19] Investments on the people and on knowledge secure the welfare of the societies. Furthermore, endogenous growth theory pays attention to science and technology R&D or acquisition of technological capability with the knowledge stock and accumulation of human capital as the basis of economic growth.[20] Public investments on education will deserve the most for the future of the nation. East Asian countries have not experienced the severe inequality that Latin American counterparts suffer. This relatively egalitarian situation was achieved not by direct redistribution of wealth but by universal education and the subsequent higher social mobility. Such outcome of better distribution contributed to stronger social cohesion, which enhanced capability to respond to crisis as in 1997-1998. This has left the East Asian state freer from its otherwise-heavy social responsibilities that Latin American state chronically was obsessed to handle with.

By way of conclusion, these considerations warn against any hasty full-fledged comeback of the state into today's Latin American political economy. Just as the revolutionary market-oriented transformation of the development model in the 1990s brought about huge social cost, the same range of the pendulum movement leftward will bring no less huge economic cost. The state should not be the substitute for the market, but the state should play the role of enhancing the capacities of economic agents. Particularly the institutional capabilities in most countries of the region are

[18] IMD World Competitiveness online, Updated: May 2008.

[19] Theodore W. Schultz: *Investing in People: The Economics of Population Quality*, University of California Press, Berkeley, CA, 1981; Gary S. Becker: *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education,* University of Chicago Press, Chicago, IL, 1994.

[20] Paul Romer: «Increasing Returns and Long-Run Growth,» *Journal of Political Economy* 94: 5, October 1986, pp. 1002-1037.

not developed yet enough to handle with intensive government involvement such as the nationalization of key industries. A long history of authoritarianism, clientelism, populism and prompt shift of development models has left little space and time for institutional development in the region. Under these conditions, ambitious government actions tend to rely upon the performance of a single leader or interest groups not through institutions. They may apparently promote public purposes, but ultimately result in further predatory actions by the state. A serious leader would take the chance to promote the responsibility of the state for providing high-quality human resources and other infrastructure as social capital and for professionalizing and strengthening institutional capabilities for the better functioning of the market itself. A selfless «benevolent social guardian» leader would not be boasted with his or her own performance in directly promoting public purposes, but lament the undeveloped institutional machinery to efficiently translate his or her policy preferences into effective actions and would be interested in fostering it.

Este artículo es la versión original en inglés de «Estado versus mercado en América Latina: Una perspectiva a partir de las experiencias de Asia del Este», incluido en Nueva Sociedad N° 221, mayo-junio de 2009, ISSN 0251-3552, **<www.nuso.org>**.